Les Folies Lagarde (25/09/18)

‘Let us not, in the pride of our superior knowledge, turn with contempt on the follies of our predecessors. The study of the errors into which great minds have fallen in the pursuit of truth can never be un instructive....He is but a superficial thinker who would despise and refuse to hear of them merely because they are absurd.’

Extraordinary Popular Delusions and the Madness of Crowds
(Charles Mackay 1852)

Another apology for another delay in the Fortnightly, this time as your analyst has been working on the new quarterly report - Can China Reflate The World? It seems that the markets have become somewhat excited by the prospect of a Chinese reflation, given the sudden rise in the price of Chinese equities, the decline in the price of treasuries and the rise in the price of copper et al as the Trump tariffs escalate. However, the key question investors need to ask is, “What are the consequences for the RMB exchange rate from such a reflation?”

The change coming for China’s exchange rate management system is not just cyclical in nature but structural. Without running through the conclusions in detail from such a huge shift, the summary of the impacts of such a momentous change comes best from little Miss Dorothy Gale, heroine of that allegory on sound money, The Wizard of Oz: ‘Toto, I’ve a feeling we’re not in Kansas anymore.’

Other reasons for the delay in the production of this Fortnightly include relaunching the Library of Mistakes’ twitter account (https://twitter.com/EdinburghLoM) and re-reading Extraordinary Popular Delusions and the Madness of Crowds (Charles Mackay 1852) in preparing a foreword for a new edition of this great work. While these tasks are not directly connected to the travails of near-term forecasting of financial markets, they do serve as crucial reminders that both supply and demand, the ultimate arbiters of price, are grossly impacted by the psychology of the crowd.

To hear many investors opine on the current market, one might well believe that folly was extinct. As Mackay makes clear in the quote above and throughout his book, it is arrogant in the extreme to believe that follies are a thing purely of the past. There have been many financial follies since Mackay first published his book in 1841; indeed the 1852 edition came out to capitalise on demand following a great railway mania. Such a reminder from the past of future follies should be seen as a very prescient present. For it is on the subject of folly that The Solid Ground would like, once again, to warn investors of the forthcoming rebirth of capital controls.

While long forecasting that capital controls would spring soonest and most damagingly from the pen of the President of Turkey, it now seems an opportune time, with distress spreading to Argentina, to focus on the role that the IMF will likely play in the rebirth of capital controls. Since bringing up this subject in Bringing up the Bodies (August 31st), further research suggests that the IMF is closer to the implementation of capital controls than one at first thought. Conditions are now ripe for the IMF to impose such controls in Argentina and for investors to recognize at last that the world will never be the same again, at least for this generation of investors.

Today, as quickly as the IMF can pump capital into Argentina it is flowing back out again. Since Argentina and the IMF agreed the US$50Bn the bail-out deal on June 7th this year, the largest in IMF history, the ARS has fallen almost 50% against the USD. To the extent that the capitalists still hold ARS balances, it seems they are desperate to transform them into other currencies they consider to be better stores of value. The initial record large IMF plan for Argentina did not provide the ‘shock and awe’ necessary to stabilize the
capital account and the ARS exchange rate. The IMF funds have simply not flowed quickly enough to offset the net private capital outflow.

The Government of Argentina has now negotiated for accelerated payment of the IMF loan, and the IMF-agreed austerity programme has begun to impact the populace, provoking demonstrations on the streets. President Macri is aiming to create a primary fiscal account that balances, while accepting the major economic contraction that will most likely flow from a rise in three-month interest rates from 25% in May to 45% today! Whatever pain the people may have borne already, there is much more to come. The IMF presumably expects President Macri to be able to pass further austerity measures against this economic background, and ultimately be returned to power in the general election in October 2019. On such political stability has US$50Bn been provided.

At this stage the IMF’s involvement seems to be increasing uncertainty and capital outflow, given the likely political reaction to its involvement in Argentina. Given that economic and political uncertainty, it may take a large proportion of the US$50Bn the IMF has promised to Argentina to stabilise the exchange rate. The temptation to use capital controls, perhaps saving the IMF’s largest ever support programme from failure, will grow with every lurch lower in the exchange rate. If no such move to exchange controls comes, then the IMF is simply providing a wonderful exit opportunity for those private owners of wealth who can see the likely political chaos that must follow the current economic meltdown.

It may be that the IMF is content to keep pumping capital in until they have facilitated the capital outflow to the full extent desired by the capitalists of Argentina. Of course, it may be that they will not. If they are not content to pursue this course of action, then investors will be in for a huge shock as the IMF will have swung from being the key enforcer of property rights to a body demanding the negation of such rights.

The rest of this Fortnightly focuses on why such an apparent Damascene conversion is now likely and what it means for investors. What many portfolio investors have missed is that the IMF has been moving towards the utilisation of capital controls at least since 2012. That change was first formalized in The Liberalization and Management of Capital Flows: An Institutional View (IMF Policy Survey Paper November 2012). That policy shift has been followed by practical changes in capital control use since 2012.

Capital controls are no longer called capital controls, but have been rebranded as ‘capital flow management measures’ by the IMF. In an article in the Review of Development Finance (Regulating Capital Flows in Emerging Markets: The IMF and the global financial crisis - December 2017) Kevin Gallagher and Yuan Tian review the use of ‘capital flow management measures’ by the IMF after the change in official policy in 2012. They track numerous variations of ‘capital flow management measures’ available, many of them now relabelled as part of the ‘macro prudential regulation’ tool-kit.

There are numerous kinds of CFMs or capital controls, such as taxes on the inflow or outflow of capital, quantitative measures on the repatriation of portfolio investments, exit levies; prohibition of foreign purchase or holding of domestic assets; requirements to obtain administrative permission for a foreign bond issue; minimum maturity period for foreign bond issues; taxes on purchases of domestic assets by foreigners or on investment income earned by foreigners; reserve requirements on deposits held by foreigners and others.

This analysis of IMF actions shows how, post-GFC, there has been a significant shift in the IMF’s support for such measures:

Before the crisis, 12.2% of the countries observed gain partial support for capital controls from the IMF, 11.6% of the countries observed gain total support, while after the crisis the proportions are 22.3% and 7% respectively........
Much of the practical shift in the IMF’s role regarding capital flows has not been on the radar screen for portfolio investors as it has impacted the smaller commodity producing countries forced into default since the GFC, many of which are in Africa. Indeed, a new database by the Bank of Canada indicates that 62 countries have seen a rise in the total of their sovereign debt in default at some stage in the post-GFC period. Most portfolio managers would struggle to name more than just a few of the countries that have seen increased defaults during this period. Use of such controls in Argentina would make the change in policy by the IMF very clear to just about all portfolio investors. Even if the next set of controls do not come to a high-profile country like Argentina they could come in Angola, with implications for financial institutions in Portugal.

Your analyst is concerned about the use of capital controls not because of the direct losses they would inflict upon investors. The key cause for concern is that the modern financial system assumes that there are high levels of liquidity in financial assets. The 2018 Investment Company Fact Book, published by the Investment Company Institute, makes clear just how dependent the global financial system is upon this liquidity:

_As of 2017, worldwide capital markets, as measured by the value of equity and debt securities outstanding, totalled $186.3 trillion. Total net assets of regulated long-term funds constituted 23 percent ($43.4 trillion) of the $186.3 trillion in worldwide capital markets._

Almost a quarter of all financial assets are now held within open-ended structures that provide the end investor with the ability to redeem, usually daily. A guide to how this has changed over the years is also provided by this report as it shows that the percentage of US household wealth held in open-ended funds has risen from just 3% in 1980 to 24% in 2017. The movement of wealth from long-term investment funds with limited redemption possibilities, such as life insurance products, to funds that offer daily redemption assumes a world where capital both trades freely and moves freely.

Should the IMF continue to endorse and support the use of ‘capital flow management measures’, a significant portion of the assets held in some of these funds would cease to be liquid. Well beyond emerging markets, the consequences for such government-mandated restrictions on liquidity would reverberate through the world of open-ended funds that hold almost a quarter of the world’s portfolio assets.

Charles Mackay devotes a significant portion of his book to the study of alchemists. These men, for they all seem to have been men, with the exception of Mary the Jewess, promised to turn base metals into gold. For a generation the financial community has liquefied assets that had never before seemed capable of being formed into financial assets. Those assets, primarily credit assets, have been profitably shuffled by the various dealers and have come to rest within the open-ended structure. There have been significant fees associated with every part of that operation and, of course, they provide the end investor with the new advantage in the ability to quickly change their minds and, through a redemption, liquidate their positions.

Has anybody told the IMF of this structural change in the way the financial system works? Whatever the merits of ‘capital flow management measures’, for economic development economists it produces a liquidity and likely solvency crisis for key parts of the global financial system. For those tasked with the management of portfolio assets, the folly of capital flow management (formerly known as capital controls) will be all too evident soon enough. Thus, perhaps, in this regard at least Mackay will be wrong; for in a world without liquidity investors may not even have the luxury of recovering their senses slowly:

*_Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one._
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