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A Clockwork Orange and Fed Policy

As an 18-year old college freshman taking ‘Pysch 101’, I watched the highly-disturbing Stanley Kubrick film version of A Clockwork Orange. The story takes place in a dystopian futuristic London and exposes the extreme battle of good versus evil. After the sociopathic and violent gang leader Alex was captured, the government decided to deploy a modern behavioral modification method to reform him. This experimental treatment was highly-controversial. The government’s idea was to use the cruelest members of society to control everyone else. While well intentioned, the unintended consequences were poorly understood.

Extracting out the violence, I can’t help but notice the symbolic similarities of the motif-ridden story with the 2008 financial market fallout and subsequent attempts at economic rehabilitation. Leading up to 2008, unsavory behavior of both borrowers and lenders conspired with lax rules to provide the conditions for the crisis to manifest. Today, there are daily articles about how restrictive regulations are stifling banks and market-makers and causing a deleterious impact on market liquidity. The intention of regulators is to deter risk taking in the banking system with the goal of preventing a similar banking-style crisis from ever re-occurring.

The film forces the viewer to weight the values and danger of both individual liberty and state control. It forces us to consider how much liberty we are willing to give up for order, and how much order we are willing to give up for liberty. The central idea of the film has to do with the freedom of the individual to make free choices, but free choice becomes problematic when it undermines the safety and stability of society. It reminds me of the markets price discovery mechanisms (or lack thereof).

Bond rates and stocks are in the midst of the greatest detachment of prices from economic reality in history. Even during the Great Depression of the 1930’s, when unemployment was 25% and there was confirmed deflation, the US 10-year rate never traded below 2.00% yield. How then is it possible that the US 10-year note traded below 2.0% with the US economy near full-employment and inflation relatively stable near 1.5%?

The answer to the question is that price levels have become influenced by regulatory rules and central bank hoarding. They are also a function of shifts in investor behavior to the ‘respondent conditioning’ of central bank policies that foster moral hazard and risk seeking activity.

By promising to ‘do whatever it takes’, central banks have conditioned investors to buy the dip and over-weigh the riskiest assets. Despite the Fed being possibly out of fire power, the ‘classical conditioning’ response remains strong. However, it can wear off. In the movie, Alex was actually ‘cured of the cure’; he had so much of the ‘medicine’ that it eventually became ineffective. In the end, the experiment failed: the state replaced Alex’s violence with its own; he was freed; and eventually the original problem resurfaced in a different form.

This seems analogous to the Fed trying to eradicate systemic risk in the banking system. Yet, in the process, the Fed has fomented large asset price inflation; compromised market liquidity; and as Richard Fisher said, “the Fed is now the largest hedge fund in the world”.

Prior to being ‘cured of the cure’, side-effects materialized or became counter-productive to the process (as they were in experiments by B.F. Skinner or Ivan Pavlov). For global central banks, the long term problems of financial repression are clear. Any policy that punishes savers and frugality, and rewards borrowers and profligacy is not prudent in the long-run. Moral hazard and reduced investor discipline results from debt monetization. It also reduces incentives for politicians to control public finances.

Any process that is unsustainable will eventually end. Ever-growing reliability on debt-driven consumption and increases in levels of entitlements in order to drive economic growth, boost living standards, or manage inequality concerns, is untenable and a ruinous direction. Even Keynes said that a government should borrow money to close the GDP gap and get the economy back on track, but once it is back on track, the borrowed money should be paid back. Ten years into this crisis, the level of debt in every major economy has increased by a large margin.

There is no “free lunch”. At some point the underlying issues will have to be addressed with the correct policy tools. The end to political polarization in Washington may require a financial crisis. A move to QE4 could compromise the Fed’s independence or USD reserve currency status, so the next financial burden will hopefully fall to congress.

Regardless, at this point, Fed policies and its $4.5 trillion balance sheet may have reached its practical limit and may have even become a source of systemic risk and market uncertainty.

“What is it going to be then, eh? – Anthony Burgess, A Clockwork Orange