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"Bitcoin is a Successful Economic Narrative"

Tech stocks can only go up. Buying a house is a safe investment with guaranteed profits. Big banks never go under. Whether true or false: ideas, stories and rumours can spread like epidemics, influence the economy and move the financial markets around the globe. Nevertheless, most economists hardly pay attention to them. Nobel Laureate Prof. Dr. ***Robert SHILLER*** *wants to change that. The Sterling Professor of Economics at Yale University examines how the stories we tell ourselves in everyday life can fuel speculative bubbles, he explains what narratives currently dominate the stock markets and why he sees parallels between Bitcoin and the currency turmoil of the late 19th century.*

Professor Shiller, your recent work puts focus on narratives and how they impact the economy. Why are narratives important when it comes to understanding the economic decision-making process of individuals and institutions?
First of all, most economists don't think that narratives are important. So I'm doing something controversial here. But to me, it's a matter of reality. Narratives have a known effect on human thinking, especially human-interest narratives with strong emotional effects: Narratives that have something to do with a sense of personal identity like who I am and why I'm a good person. So why wouldn't you think that they matter for the economy?

What exactly is a narrative?
The word narrative is often synonymous with story. But it's not a simple chronology. It's a story with a lesson, a moral or an emotional arousal of some sort, typically with some human interest, at least indirectly. For instance, when ECB chief Mario Draghi said he would do «whatever it takes» to maintain the unity of the Eurozone he was conscious of the narrative effect of his words. But economists don't study such narratives systematically. They don't like to bring them up in their forecast because it's not an accepted doctrine or it doesn't sound scientific. But the idea that economists don't have to

do any study of how people are thinking just doesn't sound right to me. That's denying reality.

What can we learn from narrative economics then?
I'm trying to bring the study of narratives into economics because they matter, even if they are not necessarily true. For instance, narratives from the second half of the twentieth century describe free markets as «efficient» and therefore impervious to improvement by government action. These narratives in turn led to a public reaction against regulation. There are of course legitimate criticisms of regulation as practiced then, but those criticisms were not powerful. Powerful narratives need some personality and story. One such narrative involved movie star Ronald Reagan who was elected president of the United States in 1980 and used his celebrity to launch a free-market revolution whose effects, some good and some ill, are still with us today.

What are the key elements of a powerful narrative?
Successful narratives are contagious. They go viral and morph into epidemics just like an influenza epidemic which spreads around the world. A virus knows no political boundaries. It goes from one country to the other and it can go fast. The same thing happens with narratives. They also fade unless we have manipulators of narratives who keep trying to remind you of themselves so that their narrative doesn't decline. Donald Trump, for example, is very skilled when it comes to narratives. The narrative that he is a tough, brilliant dealmaker and self-made billionaire is at the core of an economic narrative that led to his unlikely election in 2016. Also, he knows how to keep attention on him. He is talked about every single day for years because he is a genius at telling stories and judging his audience.

What does it take for a narrative to go viral?
It's difficult to state accurately or quantify the reason a few economic narratives go viral while most fail to do so. But some narratives are perennial, just like diseases. For example, this year is said to be a bad year for influenza. That's because the influenza season in Australia was worse than normal and we know it's going to make its way up here to North America as the weather changes. That means we can forecast diseases a little bit. On the other hand, the narrative accompanying the forecast is that you better get your flu shot right away. So maybe the narrative works the opposite way than the actual influence because more people are going to get flu shots.

What can investors learn from that?
Economics is not a precise science. We're not very good at forecasting. Only a few people forecasted the subprime crises. I issued warnings about the bloated housing market at that time, but I was a little shy about it because I was basing my forecast on my impression that there was a boom in real estate in many countries and that it was a bubble. Some other people were saying that, too. But it's hard to go out there and say: «I'm listening to stories and it makes me think that this is a bubble». That doesn't sound like science. But good scientists respect the evidence, even if it's not entirely systematic. If one experiment contradicts the theory, you can't forget about it.

What are the most important narratives for financial markets today?
There are a lot of narratives. They don't have clear boundaries and they're changing all the time. So I can't do a thorough accounting. But popular narratives are the rise of populism, polarization, inequality and trade wars. There's also a narrative about debt: That people got too much in debt before the financial crisis and they regretted it. That's a

narrative that's fading but it's still somewhat important. These are all the different narratives and there are still more. That's why I emphasize what I call perennial narratives: Narratives that just keep coming back with variations. For instance, the narrative epidemic of technological unemployment began in the late 1920s and became a persistent worry ever since. Then, it was automation, now it's artificial intelligence and robots coming for our jobs. These narratives matter because it scares people. You're not going to take a big, expensive vacation if you're worried you're going to lose your job.

It looks like the tensions between the US and China are not going away. What's the impact of the trade wars on the global economy?
There is the direct impact which economists always talk about. That's important and I'm not minimizing that. But there is also the narrative impact. It's leading to the latest polls about the president who imposed the trade war unilaterally and is getting less support. We will see how enduring that is. We have a president who is fraudulent and this is diminishing trust. I think that hurts businesses. But on the other hand, he's so pro-business. There are some Trump supporters who will never change their mind. But counter-epidemics of new narratives can suddenly appear. Maybe it's too early to tell, but right now in the United States it appears that there is rapid opinion change about Trump with this impeachment inquiry. It's a focal point of attention and maybe he will be impeached and thrown out. But this is beyond my expertise as an economist.

At the same time, talk of a coming recession is growing. What's your view through the lens of narrative economics?
There are signs of a recession, especially in Europe and in Germany notably. So maybe this will be a prominent narrative this time. But here's an interesting thing: Some of the most talked about narratives today are about the negative yields on bonds worth trillions of dollars and the inverted yield curve as a leading indicator of a recession. This narrative of the inverted yield curve has led people to think that it's some scientific study they're shown and that a recession is coming.

Every recent recession was forestalled by an inverted yield curve. Is it going to be different this time?
I have been studying the narrative of the inverted yield curve. I went back roughly a hundred years and I found references to the inverted yield curve in old newspapers. But at that time, they didn't say that it was a leading indicator of a business slowdown. The narrative that an inverted yield curve is a leading indicator of a recession has been growing with each recession starting around the 1970s, and over time there has been more and more attention to it – and this time it's talked about more than ever before. So it could bring on a recession. I think it has become a self-fulfilling prophecy.

As worries of a global slowdown rise, interest rates in Europe are at record lows. What's your take on 10-year Swiss government bonds yielding less than -0,7% from the perspective of behavioural economics?
It's not rational. If you were following the models it wouldn't happen. Why would you invest for ten years at a negative yield? You could just hold cash. Of course, there are multiple reasons that yields are low. Partly, it's because we have a demographic problem: A lot of people are nearing retirement. Another reason is that inequality scares people into safer investments. Also, because we're getting rising inequality, richer people tend to save more which brings the equilibrium interest rate down. But an important reason for these negative yields is a secular stagnation narrative that began in the Great Depression. I tie the term to the 1938 presidential address that Alvin Hansen gave to the American

Economic Association. He based it on demographics: That there weren't many births during the Great Depression. It's been a narrative ever since.

So how do narratives of the Great Depression affect how we think about economic downturns today?
The Great Depression is very much on people's minds today, more so than any other financial panic. It's been given this almost apocalyptic story. But as a matter of fact, they didn't call it the "Great Depression" during that time. Someone might have said, "this is a great depression", or something like that. But really it started with the 1934 book by Lionel Robbins called "The Great Depression". Yet, it wasn't that common until World War II. Then, the Great Depression became a legend and was also associated with the rise of Adolf Hitler. It became a powerful story that unemployment in Germany rose to very high levels and caused people to get angry and make a protest vote for the Nazi party. That's part of the narrative: The Great Depression is the scariest thing. So we actually named the recent recession the "Great Recession" after it.

Both downturns were related to a speculative frenzy in real estate. Do you spot signs of irrational exuberance today?
Yes, but I don't think it's that extreme. For example, I search for things like flipping houses on Google Trends. You can see it's coming up, but it's not at the peak levels we saw before the Great Recession.

Recently, animal spirits have been on full display with respect to the massive price swings in Bitcoin. What you do think about the emergence of Bitcoin and other cryptocurrencies?
The story of Bitcoin is an example of a successful economic narrative. It's a questionable invention but the Bitcoin narrative has been highly contagious. It involves stories about inspired cosmopolitan young people, contrasting with uninspired bureaucrats; a story of riches, inequality, advanced information technology, involving mysterious impenetrable jargon. I compare it to bimetallism because both represent radical ideas for the transformation of the monetary standard, with alleged miraculous benefits to the economy.

What was bimetallism about?
Bimetallism was a term that first became popular in the 1870s and it seemed to grow at an epidemic pace. It basically meant going off the gold standard to a bimetallic standard which has both, gold and silver. But the bimetallism experts tended to favor an exchange rate between gold and silver that was not the market rate. This would have caused the money supply to go way up and spark inflation. So there were winners and losers. It was an international phenomenon and it became a political thing. Especially in the United States, it became much talked about among the general public and it was an important contributor to the severity of the depression of the 1890s because it left people feel uncertain and quarrelsome.

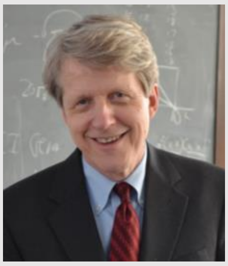
And what's the link to the contemporary Bitcoin narrative?
I think it's like bimetallism. Interestingly, both words begin with BI. So they sound similar and they're both new kinds of money. They both appeal to young people and are similar in the sense of the enthusiasm they generate and the polarization. As with Bitcoin today, when the bimetal narrative went viral the two sides called each other stupid and it became an internal identity thing: You can't admit that you were wrong on bitcoin or bimetallism.

In the investment world, the CAPE Ratio, also known as the Shiller P/E ratio, is a commonly used valuation measure for stocks. Right now, the CAPE Ratio is at around 30 for the S&P 500. What does this mean in terms of expected returns?
Based on statistics, it hasn't been this high very often in the past which means US stocks are overvalued. But the CAPE Ratio is not as high as it was in 2000 when it went up to 46. Also, it has been higher than usual for some time. Historically, a reading at 30 suggests a positive but reduced return, something like a 3% real return going forward. That's a low return relative to history since the mean is over 7% if you go back one hundred years for the US. But the offsetting thing is that interest rates are very low. So the idea of switching from stocks to fixed income is not particularly attractive. Neither is switching from stocks to real estate because real estate prices tend to be high. In other words: It will be ok to invest in the US stock market, especially if you invest in value stocks.

What else should investors keep in mind regarding valuations?
You want to be diversified: You don't want to hold too much in the United States because it has about the highest CAPE ratio in the world. In contrast, Europe on the whole looks attractive, and UK within Europe. Japan is hard to call because its CAPE Ratio has been so high in all of its history. Right now, it looks high, but it's not high relative to its recent values. So you might want to put some money in Japanese stocks, too.

How can investors apply narrative economics when it comes to investment decisions?
First of all, you have to realize that your home country has the most salient narrative. There is a home country bias which means people tend to invest predominantly in their own country and that means they become undiversified. So you have to be diversified, and then you can try to not put as much into high CAPE Ratio countries or sectors.

The CAPE Ratio is also incorporated in financial products like the Barclays Shiller CAPE US Sector Index to identify undervalued sectors in the stock market. Which sectors look attractive from a valuation standpoint today?
As we calculate it, communication services, materials, technology and health care are the cheap sectors in the US. Of course, technology looks rich, but we also make a correction for the fact that is has been high for a long time. In general, you have to realize the underpinnings of value investing are that people are affected by narratives: They are overinvesting in talked about stocks and underinvesting in those that are less talked about. It reminds me of Professor Goodenough who just won the Nobel Prize in Chemistry for the development of lithium-ion batteries. In my view, that's one of the most remarkable inventions of our time, but nobody could tell you who invented it.



*Prof. Dr. **Robert SHILLER** is a pioneer in the field of behavioral finance. For his studies on the effects of psychological, social, and emotional factors on economic decisions and market prices he was awarded the Nobel Prize in Economic Sciences in 2013. Professor Shiller received his B.A. from the University of Michigan in 1967 and his Ph.D. in economics from the Massachusetts Institute of Technology in 1972. In 1982 he joined Yale University where he is Sterling Professor of Economics. His newest book "Narrative Economics: How Stories Go Viral and Drive Major Economic Events" is published by Princeton University Press.*

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