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EXECUTIVE BRIEFINGS
POLITICS & ECONOMY: CHEAP MONEY

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A double-edged sword

Following the global financial crisis, central banks in America, Europe and Japan ratified an unusual response through a colossal quantitative easing programme. What ensued was a bloating of their balance sheets with an estimated USD 7 trillion in government bonds that bear negative returns. Some would argue that they were left with little choice but to tinker with untested strategies, in the hope of prodding the economic system out of recession. Whilst this has worked in a tentative sort of way, with feeble growth in advanced economies, cheap money comes with a flip side. As this paper will explain, longer-term risks can play out, undermining both future growth and wealth creation.

Every asset class including bonds and equities will offer paltry returns for the coming 5 to 7 years. Whilst this will depress investor earnings the real anxiety is in pension liabilities that previously assumed yields of 7-8% per annum. Public pension plans in most advanced economies are likely to go awry. Despite pump priming, the whole world is increasingly looking Japanese where weak demand and a bias towards deflation are persistent problems. Even the most optimistic investors have now accepted that tenacious weakness in the financial system is the new normal and short-term interest rates will remain low for a very long time.

This leads to the second worry. The recession of 2007 was not a one-time event. Economies move in cycles of booms and busts and historical data suggests that America wanders into recession within two or three years of a hardening in the interest rates cycle. Frequently this creates a contagion across Europe, Japan and emerging markets. On previous occasions the Federal Reserve benefited from a sizable degree of latitude in its monetary policy with interest rates around 4%. But now with a demand slump, low capital expenditure and ultra low interest rates, that is no longer the case. While estimates vary, the inflation neutral rate for the US economy is currently estimated to be around 0.4%. This would suggest that even when the inflation target of 2% has been reached, the Fed is likely to keep interest rates at about 2.4% with a view to eliminating the risk of a rise in prices or for that matter a drop. But as things stand, inflation is stubbornly close to zero and, despite the considerable bond purchasing programme over the years, has refused to budge. Some forecasts by the Fed suggest that this is unlikely to reach its 2% target until 2017 or perhaps later.

The worry is if the global economy, nudged by an unexpected trigger such as a European banking crisis, a China stumble or perhaps Brexit, falters then central banks across the world have no ammunition in store to do anything about it. Demand and therefore investment will collapse, bond and equity markets will drift into a downward spiral with nobody having a clue as to what to do about it. Finally, negative interest rates affect the robustness of the banking system. Banks work on a pricing arbitrage. They borrow money at a certain cost and subsequently lend it to their customers with a positive margin that accounts for the risk towards such exposures. But now banks effectively need to pay borrowers to lend them money turning the model of the traditional banking system on its head. In July 2016, the German Government sold Euro 4 billion worth of bonds on negative interest rates. By accepting negative yields, investors effectively dumped any hope of a return on their investment, in what seemed a sensible price to pay to escape the uncertainties of falling stock markets or volatile commodities and currencies. This oddity does not end here. Investors are now paying for the privilege of lending their money to companies as well, a fresh sign of how aggressive central-bank policy is toppling conventional patterns in finance. German consumer-products company Henkel and French

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drug maker Sanofi each sold no-interest bonds at a premium to their face value. That suggests investors are paying more for the bonds than they will get back on maturity. They say financial markets can predict the future. The reason is – they cause it! On this basis the evolving economic scenario is prone to be disturbingly subdued.

Another impact of cheap money is in the housing markets. US property has recovered to pre crisis levels and new home sales are now at a high. This is good news. However, it does have a flip side. First time buyers are priced out especially in metropolitan locations, which is really where new jobs are created. Artificially propping up house prices locks future generations out of the housing market, distorts rental costs and delays banks and home lenders from recognising their losses. Apart from the various inadvertent consequences, ultra-low rates seem to have been inept in addressing real economic concerns. Financial markets have generally reacted positively pushing up stock prices, but there remains a worrying lack of growth and a sustained risk of deflation. Meanwhile, pensioners' incomes have been wedged leaving them poorer. Fearing for their financial future as their current or prospective incomes plummet, many have cut spending setting off a vicious cycle of falling demand and consequently investment.

It is tricky to predict how things will unfold. Be that as it may, risks weigh on the downside. Volatile markets, unpredictable money flows, shifty bond and stock prices are likely to remain the new normal. Therefore, cheap money is really a double-edged sword that can cut both ways.

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