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CAPITAL

Central Banks are Fighting Economic Fundamentals

After the latest wave of central bank rate reductions my clients and contacts have been consistently asking whether central banks know what they are doing. Given rate cuts over the last eleven years have delivered debt and asset price bubbles, but haven't delivered meaningful economic growth, could anyone think that further rate cuts are the solution?

The simplistic answer is that central banks are living out the adage that when the only tool you have is a hammer every problem looks like a nail. However, it's a lot more complicated than that as central banks are sometimes willingly and sometimes under a level of duress trying to fix problems that aren't necessarily of their own making. There's also a bunch of widely repeated misunderstandings that confuse the issue of who is responsible for what. I'll start with some of the misunderstandings then move on to the wider implications and some solutions.

Why are long term interest rates so low?

The most common answers given are that (a) there's a glut of excess savings and (b) because future economic growth expectations are low. These are typically put forward by central banks/academic economists and market pundits respectively. It's bizarre logic for central banks to argue that there is a glut of excess savings when they are manipulating the amount of assets available for savers to buy through quantitative easing.

The correct answer is neither of those. Long term interest rates reflect the market view of what future central bank rates will be, with some adjustment for the term premium. (Arguably there is a term discount in some cases at this point.) Long term rates have fallen this year as markets have heard central banks saying they will be keeping overnight rates lower for longer and have adjusted their long term rate expectations accordingly.

Long term economic expectations do play a part, in that central banks cite this as a reason for cutting rates. However, given rates are well below historically normal levels it is the central bank predisposition to lower rates that matters more. If standard Keynesian policies were being implemented at this point of the cycle, governments would be running small surpluses and central banks would be setting overnight interest rates at around average levels for the low inflation era (roughly 1990 onwards).

Why are central banks ignoring standard economic prescriptions?

Donald Trump's bullying of the US Federal Reserve is simply a more public form of communication of what typically happens behind closed doors. Central banks, with the tacit support of their governments, are engaged in a trade war. By lowering overnight interest rates central banks are hoping to gain a currency advantage over other countries and stimulate their economies. However, this only works temporarily as other countries typically respond in kind. This is a classic beggar thy neighbour policy, but comes with the added sting of negative unintended consequences such as debt/asset price bubbles and a reduction in long term productivity growth as zombie companies clog up the economy.

Whilst publicly pointing this out a few years ago might have been called a conspiracy theory today it is accepted fact. Central bank heads are publicly pointing to a lower exchange rate as a reason for their rate cuts, saying themselves what others have long suspected. I can understand why they do this, as it is the only argument they have for cutting rates that withstands scrutiny, their other arguments have been thoroughly debunked.

However, their best argument for lower rates (a lower currency) is weak after taking into account responses from other countries, negative unintended consequences and countereffects such as increasing the cost of imported goods which are used to create exported goods. One example of this import cost issue is a lower Australian dollar increases

the (local currency) receipts from commodity sales, but also increases the cost of importing diesel needed to dig up those commodities. The higher cost of imported goods also partly reduces the cost advantage for international students studying in Australia versus other developed countries.

What about central bank independence?

The commonly held notion of central bank independence largely died during the financial crisis. Since then, governments and central banks have worked together to adopt short term stimulatory measures (lower interest rates and deficit budgets) whilst ignoring the long term consequences. The ability of governments to run sustained deficits relies upon central banks keeping rates lower for longer. Normal interest rates would see large countries like Japan, much of Europe and the US having very large annual interest bills to pay for the large government debts that have been accumulated. Had central banks normalised overnight rates in line with standard Keynesian prescriptions from around 2011, governments would have been forced to wind back deficits or risk an emerging market style debt crisis.

It's largely impossible to separate central bank policy from government policy in the current environment. Even where central banks have very clear guidelines allowing for their independence, they are still reliant upon governments in the appointments to key roles. Would a substantially indebted government ever appoint a known monetary hawk to be the head of a central bank? Instead, more pliant people are appointed to key roles, who are skilled at detecting a change in the political breeze. Just as the US needed Paul Volcker to take politically unpopular action to break the high inflation cycle, today central banks need forthright and strong-willed leaders to address excessive debt levels.

The recent meeting and joint press conference between Australia's Treasurer and the Reserve Bank Governor is an example of these issues. After the meeting, the Governor addressed the media saying that the fundamentals of the Australian economy are strong, and that current government policy is helping to stimulate the economy. These comments seem inconsistent with his previous calls for the government to do more on fiscal stimulus and infrastructure development. They are also inconsistent with the per-capita recession Australia is currently in.

Another form of central bank independence that is almost never addressed is the career path taken by those that run central banks. The appointment of Jerome Powell to lead the Federal Reserve, originally a lawyer by trade, was a rare departure from the standard pathway. This typically involves an economics PhD, followed by long stints at central banks or treasury departments. These areas are typically closed shops for those who don't share the prevailing central bank/academic economic worldview.

Economists and bankers with practical experience of working with the day to day outcomes of economic policy, or who subscribe to the more evidence focussed Austrian worldview are typically shutout of working for these institutions or participating in their policy development and decision making. This is a textbook example of groupthink and shows the need for change to a culture that values true independence and diversity.

Do central banks understand the damage caused by low rates?

Hanlon's razor is a particularly blunt but helpful way to view human decision making. It states, "never attribute to malice that which is adequately explained by stupidity". When it comes to central banks, I would prefer to believe it is a combination of groupthink, an unwillingness to take career risk by speaking the truth and a willingness to either ignore or disregard counter evidence that has resulted in the detrimental decisions since the financial crisis. However, the increasing amount of evidence, often produced by central banks themselves, points to central banks being more culpable than gullible.

For several years the Bank for International Settlements (BIS) has been calling out the risks of excessive fiscal and monetary stimulus. Unlike central banks, the BIS can be considered independent in that it stands aside from domestic political concerns. This position allows it to reflect on the evidence and to put forward views that are focussed on long term economic stability. The BIS also serves as a place of learning and networking for emerging central bankers, with Australia's current Reserve Bank Governor spending a stint there from 2000 to 2002.

During his time at the BIS, Philip Lowe authored several papers relating to inflated assets prices and financial stability. In one paper co-written with Claudio Borio, the authors found that asset price bubbles and credit bubbles go hand in hand. It also pointed out that it is possible to have high levels of asset price inflation whilst goods and services inflation remain low as was seen in Japan in the 1980s. They recommended a combination of monetary policy responses and macro-prudential measures for these situations.

That paper expanded on a previous paper co-authored by Christopher Kent and Philip Lowe, which found that property price cycles and credit cycles go hand in hand. This paper recommended the use of monetary policy to burst property price bubbles, even when consumer price inflation remains low. The conclusion notes that "by bringing forward the collapse of the bubble, monetary policy can reduce the scale of the inevitable slowdown in economic activity". This paper also noted that lower real interest rates are likely to lead to a lower equity risk premium and higher share prices.

A recent paper by Trent Saunders and Peter Tulip from the Reserve Bank of Australia reviewed the reasons for the strong run-up in Australian residential property prices. The paper found the dominant factor was lower interest rates, with population growth and supply constraints lesser factors. This paper directly contradicts Philip Lowe's consistent assertions that lower interest rates were not a factor in higher Australian house prices.

Taking into account all of the above, it is increasingly difficult to accept that central banks are unaware of the damage they are doing to long term economic growth and financial stability through current monetary policy settings.

Are low interest rates that bad?

One thing almost all participants in institutional asset markets can agree on is that long term interest rates are the cornerstone of assessing the relative value of assets. Market participants typically use long term interest rates, most commonly the ten year government bond yield, as the starting point for considering asset prices. The logic is remarkably simple, if a (theoretically) risk free asset yields a particular rate of return, what should a riskier asset yield above that? This applies right across the spectrum, from investment grade bonds, high yield bonds, property and infrastructure yields (which have a double impact through a high use of leverage), to dividend yields on shares.

Setting interest rates at a low level discourages low risk investing. Retirees, pension funds, insurance companies and banks who all rely on normal interest rates for steady, low risk income are pushed to take greater risk when interest rates are set artificially low. As a fund manager participating in credit markets I have seen this happen directly; both in the way others are investing and in the way my business is growing.

As a result of the two recent overnight rate reductions by the Reserve Bank of Australia, the demand for medium and high yielding credit has jumped. Margins have fallen and the level of aggression shown in seeking to grab assets available for sale has noticeably increased from both retail and institutional investors.

On the business development side, I've had more inbound enquiries from potential clients in the last three months than in the previous seven years. Whilst I might like to think that referrals from clients satisfied with higher returns

and lower fees are the key reason, conversations that often start with the inability to accept lower term deposit rates and investment grade bond yields indicate that lower rates are doing the heavy lifting.

What I've seen in recent months is merely a continuation of what has happened all over the world over the last eleven years. Central banks have hoped that extraordinary monetary policy would kick start economic growth, but they have instead only created asset price growth. In applying their monetary policy hammer to problems that need a screwdriver they have created the preconditions for the next and possibly greater financial crisis. The outworkings of many years of malinvestment are now starting to show with increasing regularity.

Argentina's heavily oversubscribed issuance of 100 year bonds in 2017 was considered insane by many debt market participants at the time. The crash to below 50% of face value this month and request for maturity extensions is no surprise for a country that has a long rap sheet of sovereign defaults. Greece's ten year bond yield below 2% is another example of sovereign debt insanity.

Venture capital investors are flush with cash to put to work, with insane valuations being ascribed to businesses like Tesla, Uber and Lyft. There's been a pullback in recent months as investors realise these companies are unable to demonstrate a pathway to generating meaningful profits. The upcoming IPO of WeWork could be the piece de resistance for this sector.

Banks are hit particularly hard by lower interest rates, which eliminates the arbitrage banks used to get from accepting savings that receive no interest and lending those funds out at a much higher rate. There have been three regional bank failures in China in the last three months, likely an early warning of the bad debt crisis brewing in China's banks and debt markets. Europe's banks aren't in much better shape, there's still a cohort of weak banks in Germany, Greece, Italy and Spain that haven't fixed their problems that first surfaced a decade ago. Deutsche Bank is both fundamentally weak and the world's most systemically important bank, a highly dangerous combination.

These are just a small sample of the many situations that have been able to be covered over for years whilst interest rates were low and investors were bullied into taking greater risk. It is likely that had central banks normalised interest rates in line with the increases by the Federal Reserve during 2016-2018, we would now be in the midst of a cleansing recession that economies and financial markets are overdue for. The most recent round of rate cuts and guidance towards future monetary policy easing is likely to kick the can a little further down the road, but the inevitable correction of excesses cannot be postponed forever.

What actions should central banks be taking?

Just as the first step for an alcoholic is to admit their addiction and the damage it has done, central banks need to start by admitting they have gone too far with monetary policy and have caused substantial economic damage. An apology is owed to savers that have been punished for their prudence and to a generation of young people that have been substantially disadvantaged in their quest to purchase property without incurring excessive levels of debt. Central banks also need to admit that they have tried to use monetary policy to solve problems it simply wasn't suitable for.

Central banks need to start demonstrating their independence by publicly and regularly criticising governments for failing to enact tax, structural and productivity reforms, which are the only policy pathways to encourage sustainable economic growth. Philip Lowe's recent comments on this topic are a very good start. Citizens need to be given greater freedom and incentives to keep the money they earn and to find new ways to more efficiently serve each other in

commerce and charitable activities. Central banks are well placed to criticise governments for wasteful, special interest focused spending as well as a failure to generate surpluses and repay debts during reasonable economic times.

Coming off the addiction to monetary policy is going to be painful, but it is the only sustainable course. It is likely that normalising monetary policy will result in a global recession, but this must be accepted as an unavoidable outcome given the disastrous policies of the past. Excessive monetary and fiscal stimulus has pulled consumption forward, the process of unwinding that obviously requires a level of consumption to be pushed backwards.

Clarion calls to abandon change and cast-off austerity when difficult economic times arrive must be rejected. Those promoting such policies should be told to reconsider their arguments after reading economic history and reflecting on the decline of countries (recently Argentina, Venezuela and Zimbabwe) and empires that accumulated excessive debts and debased their currencies. They should also reflect on the decades of extreme monetary and fiscal stimulus in Japan, which has failed to deliver meaningful economic growth.

Central banks need to take two main actions regarding their own affairs. First, there needs to be a broader base of employees and board members with an explicit requirement to include different economic views (i.e. Austrian and debt aware economists, market practitioners) and different constituent views (i.e. savers). Second, financial repression needs to be forbidden. This can be expressed through a mandated formula as:

$$Minimum\ Reserve\ Bank\ Rate = \frac{Inflation\ Rate}{(1 - Top\ Marginal\ Tax\ Rate)}$$

Conclusion

With central banks now considering another round of rate reductions and further quantitative easing measures the time is right to reconsider the foundations of central bank policy settings. The last decade of Frankenstein monetary policy has largely failed to deliver meaningful economic growth and the desired reduction in unemployment because central banks have been using the wrong tools for the job. Ultra-low interest rates have boosted excessive debt levels, zombie companies and malinvestment, all of which are negative for long term economic growth.

Central banks need to admit their errors and acknowledge they are powerless to solve problems that require tax, structural and productivity reforms. Central banks need to demonstrate true independence by rejecting short term monetary and fiscal stimulus measures and taking action to reduce the inevitable recessions that accompany debt fuelled bubbles. An injection of a more diverse range of economic and societal views into central bank key positions and the elimination of financial repression are other necessary changes.

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