Narrow Road Capital

## Central Banks Spawned This Crisis

The rapid and widespread sell-off over the last four weeks is a textbook systemic deleveraging. Whilst the culprits are many; hedge funds, risk parity strategies and investors using margin loans have all been caught out, the underlying cause is excessive leverage across the economy and particularly the financial system. The timing of the unwind and the economic damage from the Coronavirus wasn't predictable, but such a highly leveraged system was like a truck loaded with nitroglycerin driving down a road dotted with landmines.

Frustratingly, this inevitable deleveraging was clearly predicted. Rather than act to reduce systemic risks central banks encouraged governments, businesses and investors to increase their risk tolerances and debt levels. The Bank for International Settlements has routinely warned of excessive global debt levels in government, corporate and personal debt sectors, publishing many articles highlighting that the key ratios that warned of previous debt crises were flashing again. I've also regularly written on the growing risks and mismanagement by central banks including in December 2019, October 2019, August 2019, June 2019, March 2019, January 2019, March 2017 and October 2016. The 2016 article included the following;

*By focussing on trying to boost economic growth central bankers have created instability in financial markets and economies. Truly independent central bankers would have stopped lowering interest rates long ago. They would have told politicians to implement structural and productivity reforms that will help lift economic growth rather than running Frankenstein experiments with interest rates and money printing.*

*Central bankers that ignore the obvious evidence of asset price bubbles and yield chasing, created by their ultra-low interest rates and money printing, should be sacked just like any other underperforming employee.*

Central banks urged all and sundry to gorge on debt and we are now dealing with the indigestion as leveraged players in financial markets vomit out assets. This rapid phase of forced sales will end once leveraged players and those reliant upon short term debt have completed their selling. A subsequent round of forced selling is expected from unlisted funds that are or will soon see significant redemption requests. However, those hoping for a quick turnaround in financial markets are likely to be disappointed as a third wave of problems will come from the wider economic consequences of Coronavirus shutdowns and the unwinding phase of a Minsky debt cycle.

The Coronavirus linked shutdown of large (mostly discretionary) parts of modern economies has exposed the lack of savings and reserves by both businesses and consumers. Central banks have repeatedly told both groups to borrow for investing and spending. What businesses mostly did with their debt was buy other companies and buy back their own shares, resulting in very little economic growth but substantial growth in credit risk. Similarly, consumers borrowed and purchased houses, pushing up house prices which ultimately has a negative impact on long term economic growth.

Central banks used interest rate cuts as a battering ram to force low risk investors out of their comfort zones, creating a far more unstable economy with limited reserves to fall back upon. We now see the outworking of this in the chorus of voices crying out for bailouts as they do not have reserves to survive a month or two of reduced income. Those with savings have seen the return on their cash holdings slashed further, so they too are seeing their income reduced and are likely to respond by reducing their spending.

The problems we are now facing, both in financial markets and the wider economy, are a holdover of what should have been dealt with from 2009 onwards. In the financial crisis, central banks followed the Keynesian playbook of

cutting interest rates and providing liquidity. However, they then ditched the playbook and failed to normalise rates and reverse quantitative easing in 2012-2019.

To forestall the necessary deleveraging and structural/economic reforms, central banks chose instead to increase stimulus. They may have increased inflation and employment levels by a fraction of one percent for a time, but we now have a far larger financial and economic mess to clean up. Central banks have been wilfully negligent and should be carried out with the investors who followed their awful advice to increase leverage. For those who think this is an excessive criticism consider the following questions:

- If central banks had normalised interest rates and eliminated quantitative easing in 2012-2019 how much lower would asset prices have been before Coronavirus appeared?
- If investors were able to earn a reasonable return on their low risk assets, how much would they have reduced their risk taking and debt levels?
- If companies and governments faced higher borrowing rates, how much less would they have borrowed? How much more likely would they have been to look for productivity improvements that would have generated long term economic growth?
- If we faced the Coronavirus impacts with lower government, business and consumer debt levels as well as higher savings/reserves, how much more manageable would the health and economic implications be?
- If ultra-low interest rates and quantitative easing are the solution to financial crises, why hasn't Japan returned to normal growth levels more than 20 years after their implementation?

**The Pathway Forward**

Having diagnosed that previous central bank actions have created the current crisis, it is important to layout how they should be responding now and in the coming years. There are both immediate actions to lessen the economic consequences and medium term actions to ensure that inevitable future downturns are far less severe.

Immediate actions include:

- Provide liquidity to the financial system through short and medium term repurchase agreements that are secured by very low risk securities such as AAA rated government debt and AAA rated securitisation
- Provide support to programs that deliver liquidity to viable businesses to trade through the shutdown (central banks do not have the skill set to judge viable businesses, this is best left to commercial lenders)
- Refuse to be involved in programs that provide liquidity or bailouts to questionable and unviable businesses, which need to be resolved through bankruptcy
- Provide a medium term plan to normalise interest rates and end quantitative easing
- Publicly and repeatedly call for governments to embark on tax and productivity reforms
- Apologise for the mistakes made in the last decade and the needless suffering that has resulted from them

Medium term actions include:

- Replace all senior staff and board members that failed to publicly voice concern with the actions and policies that led to the current crisis
- Normalise interest rates and keep them at or above a level that ensures all participants in the economy can earn a positive return after factoring in taxes and inflation
- Wind-down quantitative easing and refuse to restart it in future downturns/crises
- Develop and publicly announce policies that cut-off moral hazard risks, particularly in the financial system

Written by Jonathan Rochford for Narrow Road Capital on 21 March 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

**Disclosure**

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.