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Insanity

Dr Robert Gay | Fenwick Advisers | 01 June 2016

> "Insanity is repeating the same mistakes and expecting different results."
> – from The Basic Text of Narcotics Anonymous (1981)

This quote often is misattributed to Albert Einstein but nonetheless has been used for many decades to drive home a simple point – mistakes lead to bad results. Nowadays, central bankers seem intent on sinking into a pattern of repeating each others', and their own, mistakes, especially when it comes to thinking that negative interest rates somehow will rejuvenate global demand.

Unfortunately, most companies are not interested in borrowing for investment purposes other than buyouts and acquisitions, and households seem more intent on refinancing old loans and mortgages at lower rates than on borrowing for new purchases. Meanwhile, the unintended consequences of negative policy rates and asset purchases are hastening the conditions that are so often associated with credit crises. The global economy would be better off if central banks would cease and desist from any further attempt at unconventional monetary policies – thereby avoiding further policy mistakes – and instead focus on the greater concerns of how to wean the world from its addiction to too much leverage and too much capacity, without throwing financial markets into a tailspin.

The efficacy of monetary policy

Monetary policy works best as a countercyclical tool when there is some semblance of balance in the economy – that is, when changes in the cost and availability of credit can make a meaningful difference. As Keynes pointed out, that condition fails to hold when nominal interest rates reach a lower bound of zero. That limitation becomes increasingly troublesome if inflation turns negative, thereby transforming a zero policy rate into a restrictive positive real interest rate.

Nowadays, with inflation hovering around zero and sometimes negative in Europe and Japan, the ECB and BOJ believe they can overcome that limitation with negative bank deposit rates.

Unfortunately, this strategy suffers from a serious misconception of the nature of the global economy's current disequilibrium. Two imbalances, in particular, are not susceptible to monetary stimulus – huge excess capacity in many mining and manufacturing industries, and a savings glut mostly in Asia that has been exacerbated by widening income inequality and has not been recycled to productive use. Neither of these impediments to growth can be remedied with the allure of low or even negative interest rates. Indeed, a good case can be

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made that negative interest rates will make them worse, as banks keep failing companies on life support and savers spend less to compensate for lost interest income.

The tradeoffs of negative interest rates

In Economics 101, we learned that a change in the price of a good or service brings forth two competing forces – a substitution effect and an income effect. As a price falls, we tend to buy more of that good and less of a higher priced substitute, if one exists. If the price falls enough to be a meaningful portion of our household budget, we are able to buy more of all goods with the extra money. In most cases, we are quick to buy substitutes when possible, and few goods are so expensive that a cheaper version leaves us with much more than a little pocket change.

That is not so with the price of money. Mortgages often eat up a third of disposable income and interest income constitutes a large portion of retirees' incomes especially when you include the viability of their pension and insurance plans. Small changes in interest rates can make a big difference. Americans, in particular, were well known for refinancing mortgages repeatedly as interest rates decline and spending those windfalls.

Times have changed. With the aging of populations throughout most of the world, the balance of this tradeoff has tipped in the opposite direction so that dwindling interest income now weighs heavily on households' spending. Low interest rates have not elicited more household borrowing, in part because debt burdens are already high and because globalisation has dimmed the prospects for future earned income and job security.

Meanwhile, the loss of interest income on cash deposits, and shrinking returns on savings in general, is motivating older generations to spend less as the value of their retirement nest egg stagnates. In short, aging populations have changed how monetary stimulus works on household spending patterns. Negative interest rates actually tip the behavioral balance even further as households worry that financial institutions will fail to deliver on pensions. German insurance companies are only the latest voice to raise the alarm on the possibility of having to cut payouts. With US$7 trillion of sovereign debt now trading on negative yields (see Figure 1), the adverse effect on incomes and pensions has become substantial.

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Figure 1: Lost income from negative yields now outweighs the allure of low rates
$7 trillion of negative-yielding bonds

Source: Bloomberg

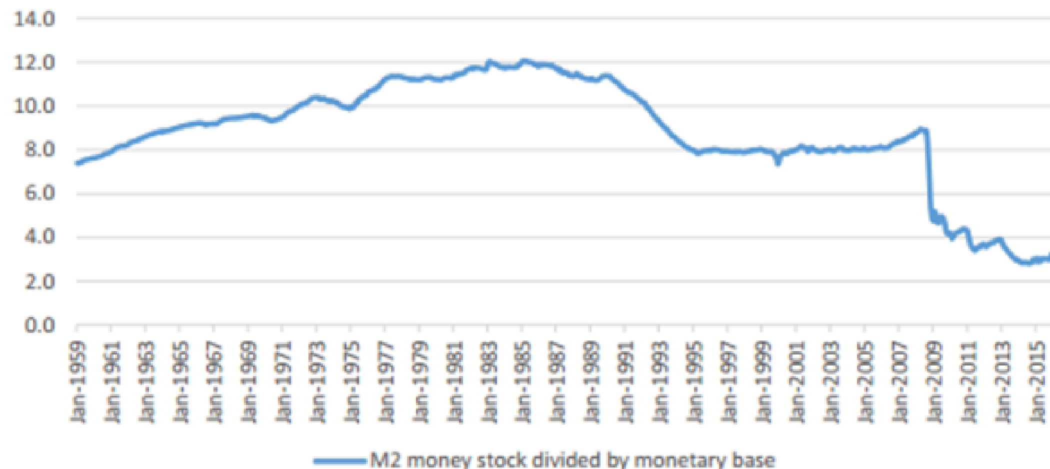
The story is similar for the hoard of corporate savings. Studies invariably show that, in making their investment decisions, businesses put much greater weight on expected future sales than on the cost of capital. Cheap financing alone without good prospects for sales rarely tips the balance. Global demand is now languishing with growth of only 3%, barely enough to maintain current capacity. Moreover, excess capacity and the threat of disruptive digital technologies have heightened uncertainties around most corporate forecasts. Those headwinds to new investment cannot be overcome by inexpensive debt. The best hope is that companies will save money on debt service but that is hardly a sufficient rationale for negative nominal yields because banks never will pay a client to borrow money.

Even in conjunction with asset purchases, NIRP and ZIRP have not delivered on promises to stimulate demand. One measure of the success of these policies is the so-called money multiplier, the ratio of M2 to the monetary base. When central banks buy assets such as government debt, they augment the monetary base against which banks can loan money.[1] When commercial banks subsequently underwrite loans, mortgages and credit cards, M2 expands. Thus, one would expect the money multiplier to fall sharply when the central bank buys assets but then begin to rise again as credit is extended and spent.

Figure 2 shows the money multiplier for the US where these policies have worked better than anywhere else. Note that with each round of asset purchase, the money multiplier fell as expected and then was followed by a gradual rise in the ratio over the subsequent year as banks expanded lending.

Figure 2: Unconventional Monetary Policies Have Failed to Create Money

US money multiplier



Sources: Federal Reserve and Pi Economics

Despite that partial success, the US money multiplier still is lower than at any time during the past five decades. By contrast, the money multipliers for Japan and Europe decline steadily with each round of asset purchases with little or no effect on M2.[2] In short, there are serious questions as to whether negative policy rates have any of the redeeming benefits that central bankers and the IMF seem to think they do.

The dark side of negative rates

Worse yet, negative interest rates are a disturbing sign that the current investment cycle is headed toward an ugly and destabilizing endgame. The bad side effects of ZIRP and asset purchases have accumulated over time, especially for the ECB and BOJ who were late to the game. Now they are doubling down with a policy that piles new risks on top of old ones.

Consider three consequences in particular.

First, negative interest rates on bank reserves squeeze profit margins because banks in general cannot pass on the cost to their clients. Most critics probably think that cost is justified given past financial messes but central bankers should be more wary. European banks in particular have dragged their feet on cleaning up their balance sheets and need profits to balance write-offs. NIRP merely kicks the can further down the road. Systemic risk lingers on.

Second, NIRP encourages riskier loans. Figure 3 shows the ECB's survey results on bank lending standards. European banks have been relaxing their standards for loans since 2014 as indicated by the negative reading. In a typical cycle, extended periods of relaxing standards leads to more nonperforming loans and a backlash from lenders. Bankers try too

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hard to approve ever riskier loans until the strategy comes unglued. When banks belatedly tighten up their standards, credit and liquidity suddenly dry up. Note that this credit contraction can occur spontaneously without an impetus from higher interest rates.

Figure 3: Lending standards are easing at European banks

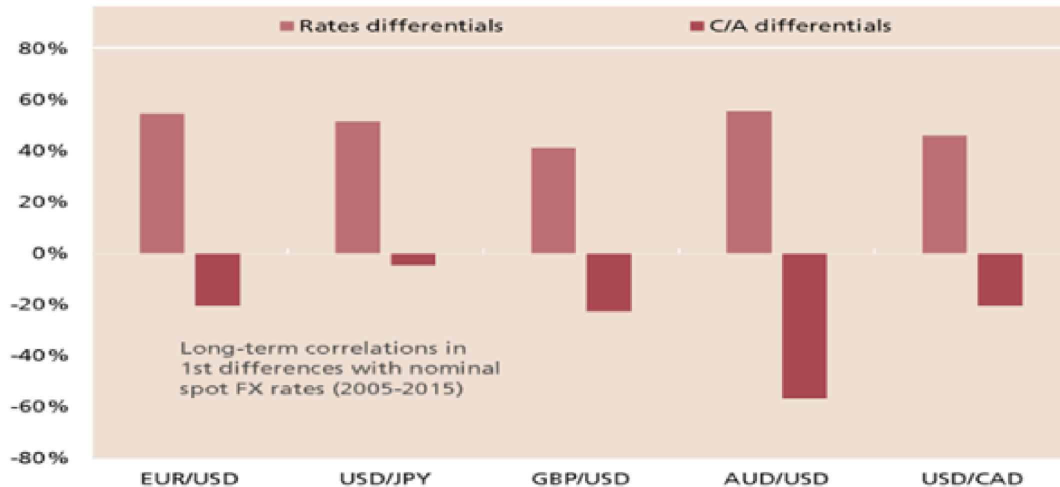
Source: Bloomberg

End of the carry regime

A third consequence is much less obvious and hence is much more dangerous. Low and especially zero policy rates are a breeding ground for carry trades – that is, the purchase of risk assets with short-term funding in currencies that have low interest rates. ZIRP is nirvana for such arbitrage.

Figure 4 gives a sense of the dominance of carry (as characterised by interest rate differentials) with fundamentals (as represented by current account balances) playing second fiddle in correlations with currency movements. This carry regime extended far beyond fixed income to equities, real estate and commodities and has been the principle source of liquidity that fueled bubbles in those asset prices over the past five years. When that source of liquidity dries up, asset prices will burst.

Figure 4: Carry regime has flourished in an environment of central bank intervention



Source: Lombard Street Research

If central banks indeed are at the end of their tether, then negative interest rates may be an early sign that the carry regime is winding down. If so, another banking crisis will not be a prerequisite for the next recession and a deflationary shock. The withdrawal of liquidity from carry trades alone might do the job. As pundits often say, it is the unseen risks that surprise us and, in the current cycle, the hidden risk lies in the carry regime that central banks have promulgated. Contrary to conventional wisdom, the failures associated with negative interest rates in Japan and Europe will prove to be the true harbingers of danger ahead, not the normalisation of rates in the US.

The tipping point – waste

Many observers sense that escalating debt burdens somehow will be the cause of the next financial crisis. They are half right. Despite low interest rates, debt service relative to incomes has risen for most countries and many companies. The presumption seems to be that when interest rates finally rise again, the game will be up, especially for the heaviest debtors. However, that is not the only possible scenario and may not be the most likely one.

The other requisite ingredient for most financial crises is waste. That word can encompass a wide range of behavior from foolish investments to greed and corruption. The essential ingredient of economic waste is that money is spent and debt is incurred on an activity or project that doesn't generate sufficient income to repay the debt. Negative real interest rates may help to repair balance sheets, especially those in the financial sector, but if that opportunity is wasted on unproductive or unprofitable ventures then another round of financial losses becomes inevitable. Granted, we are barraged with news of corruption and

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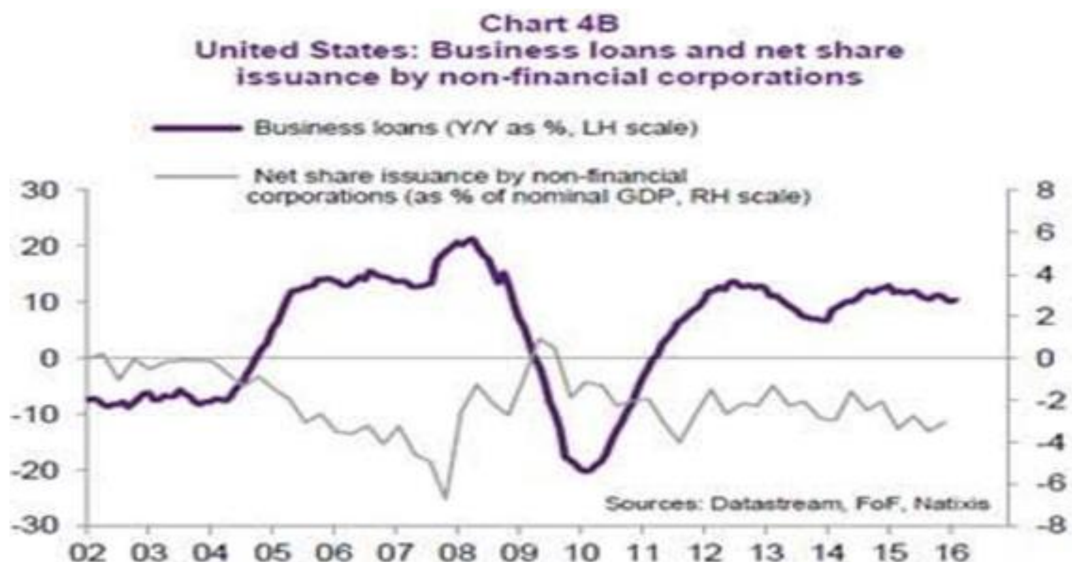
economic waste on a regular basis, so what is different this time? The answer, I believe, is that the protracted period of negative real interest rates and central bank intervention since the Great Financial Crisis has engendered several disturbing trends that are not sustainable, all of which involve the wasteful usage of funds.

First, governments have not taken advantage of low interest rates to reorder priorities and to eliminate waste but instead have become increasingly dysfunctional and prone to borrowing to finance largesse. Similarly, many commercial banks have engaged in the delusionary tactic of "extend and pretend" on loans to "zombie" companies and developers with little prospect of repayment. This practice has been particularly prevalent in China this year, even as the Communist Party has put a high priority on the rationalisation of excess capacity. In lieu of balance sheet repair, banks are issuing so-called coco bonds that convert to equity in times of stress and CLOs to offload liabilities on unsuspecting investors.

Meanwhile, companies have used a large portion of their new debt issuance to buy back shares rather than to invest in new ventures and technology. Figure 5 suggests this practice has been a central feature of firm behavior in the US since 2005, consistently amounting to almost 3% of nominal GDP since 2010. That strategy might add value when equity prices are depressed but makes much less sense at current valuations – unless, of course, companies simply do not have any productive use purpose. If that were the case, then why are they not paying down debt? The reason, of course, is that the self-interest of management aligned conveniently with those of shareholders – at least on a short-term view of the productive use of cheap financing in a world with a paucity of better options.

Figure 5: Are share buybacks a productive use of funds?



Sources: Datasteam, FoF, Natixis

The common theme is that a regime of negative real interest rates promotes both mispricing of risk and misallocation of financial resources to unproductive uses. It is the nature of the beast. In that context, negative nominal interest rates represent a final desperate act by central banks that fear deflation more than defaults. Pick your poison - we are likely to see some of both.

While it is true that the former exacerbates the latter, the strategy of incentivising banks to extend and pretend only buys a little time while the root causes of deflation are not addressed. The only "solutions" to deflationary pressures are to shut down excess capacity, to recycle the world's savings imbalance with creditors providing stimulus while debtors tighten their belts, and to reverse income inequality.

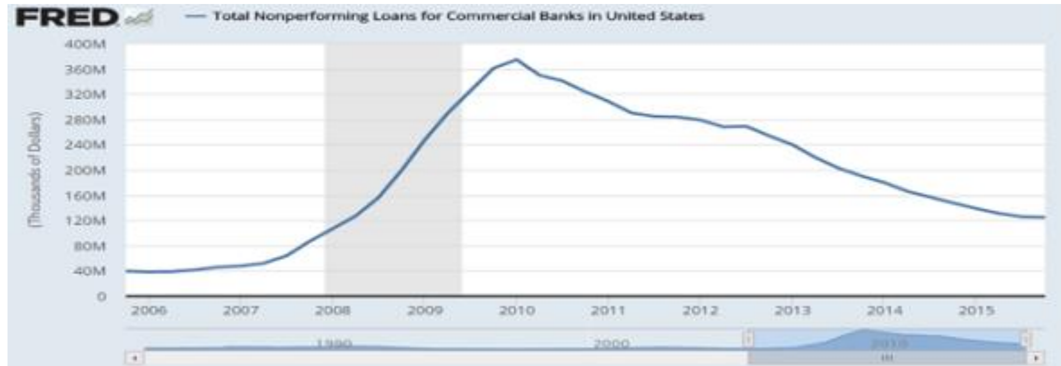
None of those structural prescriptions will come to pass within the viable time horizons of negative interest rates and central bank asset purchases whose inevitable endgame is the socialisation of public debt and, in the case of the ECB, private debt as well, perhaps, with the attendant loss of credibility of the central bank. That did not work for Latin American countries during the 1980s and 1990s and it will not work for industrialised countries either.

Plan for the worst

Long before anything so apocalyptic happens, the most likely outcome is the usual end cycle correction in asset prices. The only question is the timing. We already are seeing signs that financial markets sense the limitations of monetary policy. Both the yen and the euro are staging rallies, as the presumptions underpinning US dollar carry trades evaporate. That should be a red flag.

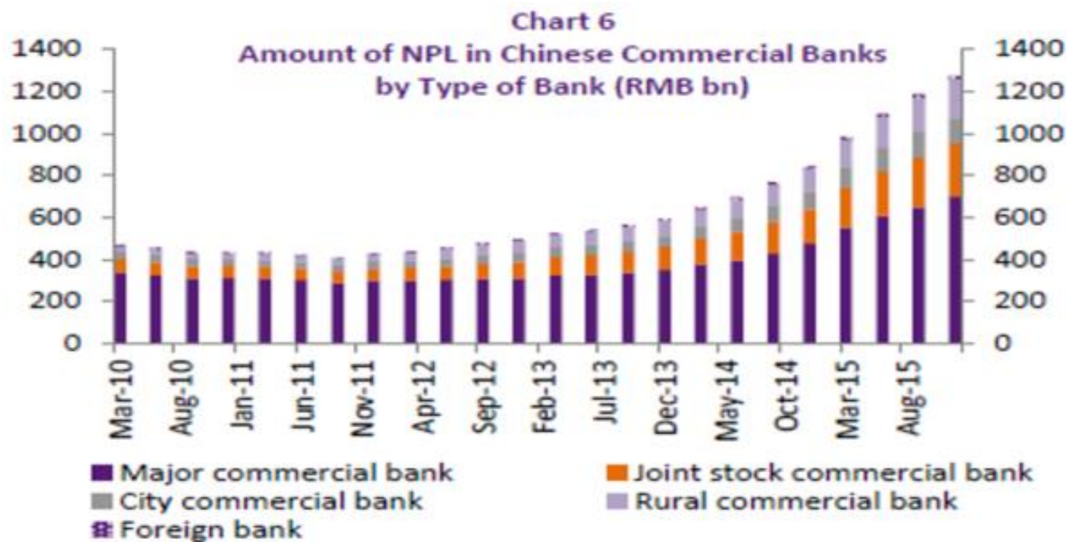
Because this cycle is debt-centric, the next signs should be a rising incidence of non-performing loans (NPLs) followed by a tightening of bank lending standards and a widening in credit spreads. In the US, NPLs are substantial but have not yet worsened in aggregate despite the woes of the energy patch. China's bad loans, by contrast, are just beginning to pile up albeit from a much lower level (Figures 6a and 6b).

Figure 6a: A long legacy of non performing loans in the US...



Source: Federal Financial Institutions Examination Council (U2)

Figure 6b: ... while China's bad loan problems have just begun

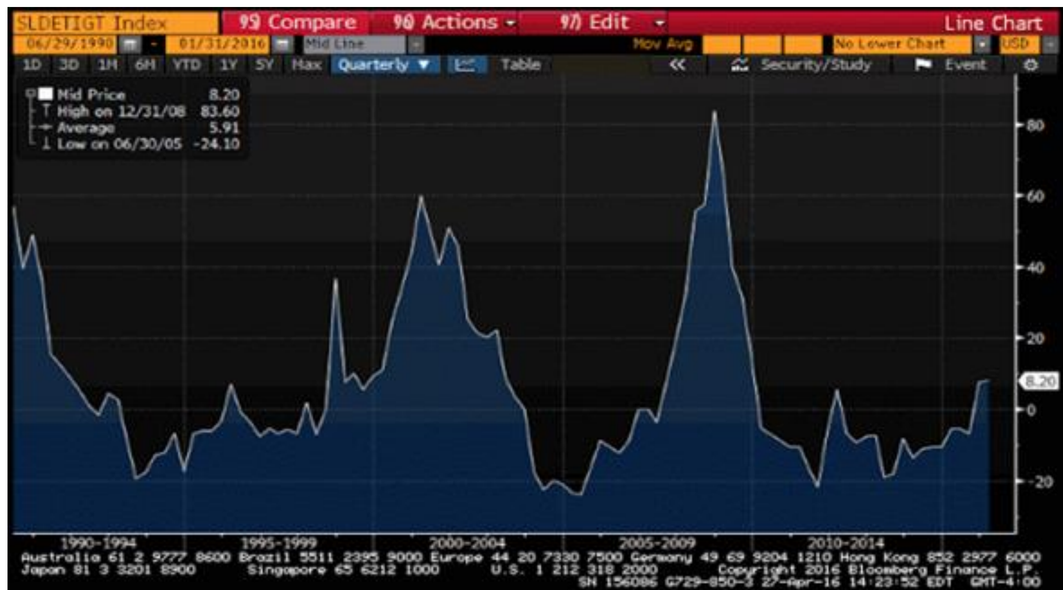


Sources: Bloomberg, Natixis

Western banks typically respond to bad loans by tightening lending standards so as to staunch the bleeding. To date, only US and Australian banks have tightened standards significantly and even then not by nearly enough to cause a credit crunch. As seen in Figure 3 above, European banks are still relaxing standards, although not to any worthy purpose.

Only when banks finally decline to roll over loans do markets begin to recognise the full consequences of tighter credit conditions amidst limited market liquidity.

Figure 7: Bank lending standards are a harbinger of a contraction in credit availability



Sources: Bloomberg

Normally, it would take a recession or even a financial crisis to cause credit spreads to widen so dramatically that a dearth of liquidity causes defaults on bonds. This time, though, the fleeting liquidity of the carry regime will disappear in a heartbeat and brokers will not step up to fill the void. Credit spreads, in my opinion, could widen almost as much as they did in 2009, even without an extra impetus from bank failures with the attendant extreme counterparty risks. Note in Figure 8 that speads for BBB-rated corporate debt as well as those for corporates in emerging markets have returned almost to the levels of early 2008 - which was the quiet before the storm.

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Figure 8: Yields are lower but credit spreads are back to 2008 levels

Source: research.stlouisfed.org

Central banks seem no more prepared for dysfunction in capital markets than they were in 2008. The saving grace is that US commercial banks are not likely to be the source of contagion next time. For that, we should be looking elsewhere with a keen eye, for trouble is clearly brewing. The catalyst could be a sudden end of the carry regime as all central banks are headed toward real policy rates of zero. My guess is that the unraveling will take a little longer. Markets seem fragile and the scope for policy blunders is very high. As Albert Einstein acutally did say:

> Only two things are infinite, the universe and human stupidity and
> I'm not sure about the former.
> - Albert Einstein

ENDNOTES

1. Technically, asset purchases increase both sides of the central bank's balance sheet – namely, the assets held and the excess reserves of commercial banks which are the basis for loans.

2. European and especially Japanese banks hold large portfolios of government debt and are happy to sell it to their central banks when it trades on negative yield. These direct sales leave commercial banks with more cash and fewer bonds but little change in their incentives to lend.

Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.