



Too low for too long

The danger of a too easy monetary policy

Over the summer and early autumn the Bank of Canada (BoC) behaved in a by current standards highly unusual way. As pointed out repeatedly by Dennis Gartman, editor of the Gartman Letter, speeches by BoC spokesmen have regularly included hints of higher interest rates, eg as expressed by Senior Deputy Governor Tiff Macklin in Winnipeg on 4th October, when he said “To the extent that the economic expansion continues and the excess supply in the economy is gradually absorbed, some modest withdrawal of the present considerable monetary policy stimulus may become appropriate”. In mid-October, however, Governor Mark Carey omitted this text in a speech, implying that the BoC is no longer considering higher interest rates. Of course, on 23rd October, the Bank of Canada left its policy rate unchanged – but the language hinting at tighter monetary policy was reinstated! Nevertheless, in today’s world, where central banks are still mainly looking either at easing monetary policy further, or (eg, the Federal Reserve) promising to keep monetary policy loose even once the recovery has gained further traction, the Canadian behaviour was thought-provoking.

The current monetary policy debate seems dominated by two propositions. First, we can and must return to the growth rates of the mid-2000s. Secondly, the (only) means to achieve this is to keep monetary policy loose, since fiscal policy has to be tight. (This is of course a generalisation; there is no dearth of people arguing for looser fiscal policies; but very few are, as far as I am aware, arguing in favour of tighter monetary policy anywhere.) Leaving aside the issue of whether the growth rates of the mid-2000s are attainable, few seem to consider the effect of keeping interest rates low – possibly too low – for too long. Yet it is clear that there are effects and that these can be quite serious.

Standard economic theory on this goes back at least to Knut Wicksell and is pretty straightforward. If (to use Wicksell’s terminology) the “market” rate of interest (ie, the rate at which banks lend to non-banks) is lower than the “natural” rate of interest (ie, the rate at which savings and investment equalize), there is a misallocation of resources. The artificially low threshold for investments means that there will ultimately be a money and credit boom which will lead to inflation.

However, this stand may need to be modified in view of current circumstances. We are currently still in the midst or – at best – the aftermath of a money- and credit-induced boom and bust. While politicians are eager for banks to lend, banks are generally unwilling to comply; and while companies may be happy to take advantage of current low interest rates, households are still trying to deleverage in most advanced economies. Hence, an inflationary credit boom is, for the time being, highly unlikely.

In looking at the effects of ultra-low interest rates, it is initially helpful to distinguish between three sectors, government, corporate and household.

In terms of government, while low interest rates make it easier to finance current deficits – and therefore also make the future debt burden easier to carry – the risk is that governments feel that they can relax

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their structural reforms. Low interest rates are supposed to buy governments time; but there is an inherent temptation to use the time to postpone unpopular spending cuts and/or tax hikes (all spending cuts and tax hikes can safely be assumed to be unpopular with someone; and certainly with most politicians). A further attraction is for governments to issue debt at the shorter end of the yield curve, where interest rates are likely to be the lowest. The lure of this option increased in the euro area when the ECB announced that its Outright Monetary Operations would be concentrated on short-term bonds. But shortening the duration of the debt of course brings with it its own problems if and when interest rates eventually rise.

For the corporate sector, the situation is somewhat more complex. Low interest rates lower the threshold for necessary returns on investment, and so in theory boost corporate cap-ex. However, if the interest rate is artificially low, the danger of malinvestment – misallocation of resources – rises. In the longer term, this can reduce the economy's long-term trend growth rate. A report from the Federal Reserve Bank of Dallas¹ also notes that low rates further impede the reallocation from less to more productive use of capital as banks – unwilling to acknowledge losses on loans – extend further credit to 'zombie' companies. Low interest rates therefore have the effect of encouraging not only imprudent borrowing – but also imprudent lending. This trend was particularly noticeable in Japan in the 1990s and early 2000s.

The current world situation, with a combination of low market interest rates and banks unwilling to lend, introduces a further issue. This is that companies make greater use of markets and less of banks when it comes to raising money. That is not necessarily bad. But, it means that corporate borrowing will have no effect on money supply at a time when weak money supply growth is – or at least should be – of substantial concern. This concern is heightened by the pressure on banks to increase their capital/asset ratios, which has a direct contractionary effect on the stock of broad money.

But it is for the household sector that the effect of ultra-low interest rates is perhaps the most paradoxical and harmful. Yes, of course low interest rates help households to deleverage, at least to the extent that their borrowing is at variable interest rates. But, once again this encourages excessive borrowing, the more so if it is felt that current interest rates will remain for the foreseeable future. This is particularly acute in countries such as Sweden that still allow no-amortisation loans. But this is only part of the risk. Another is that low interest rates, rather than stimulating greater household consumption, may have the opposite effect, namely leading to higher savings. This could happen for one of three reasons: First, if households take advantage of low interest rates to accelerate their deleveraging process, not least if they do *not* believe that interest rates will remain low for ever. Second, if repeated government and central bank action to ensure continued ultra-low interest rates give the impression of panic and that the economy is in fact in a worse state than is generally perceived (ie, 'what do they know that we do not?'), causing households to increase their savings as a precautionary measure. Third and possibly most likely, if households, rather than aiming to save a certain percentage of their income, aim at achieving either a certain amount of savings, or an amount of savings that – presumably in retirement – will provide a

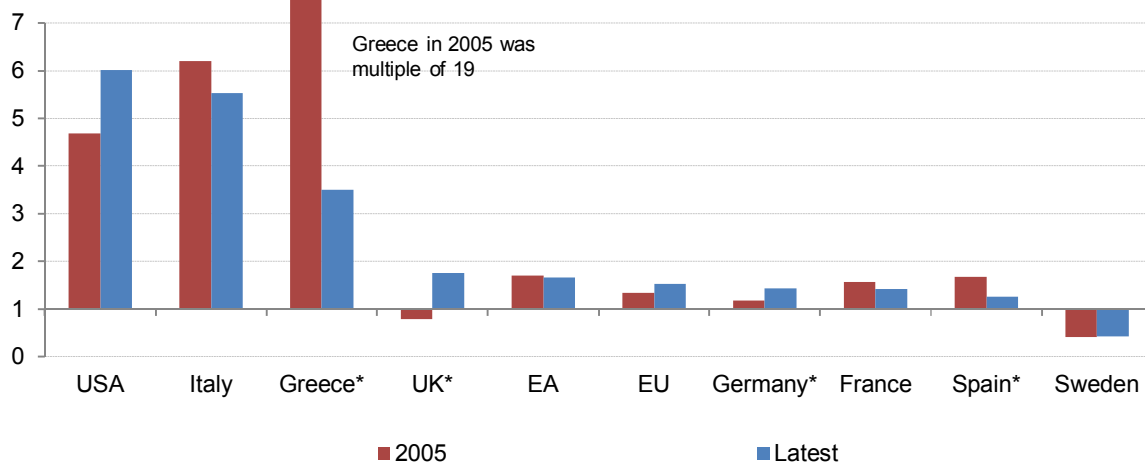
¹ William R White, Ultra-Easy Monetary Policy and the Law of Unintended Consequences, Federal Reserve Bank of Dallas Working Paper No 126, August 2012, <http://www.dallasfed.org/assets/documents/institute/wpapers/2012/0126.pdf>

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certain annual revenue. In spite of the rise in household debt in the run-up to the crisis and the low interest rate environment, households in most countries still have higher interest revenues than expenditures, Sweden being a significant exception. But in spite of interest rates having fallen sharply since the Great Recession began, interest income has remained stable relative to interest expenditure or even risen in some European countries (eg, the UK), hinting at an increase in savings.

**Household interest income relative to household interest expenditure
(‘Latest’ is 2011, unless marked * in which case it is 2010)**



This risk – that lower interest rates spur increased household saving rather than spending – is compounded by another factor. This is that it will be more difficult for any entity with long-term fixed liabilities – eg, insurance companies, pension funds or companies with commitments to paying defined benefit pensions – to achieve the returns necessary to fulfil their commitments. Low interest rates reduce their revenues and increase the net present value of future liabilities. If households become aware of this threat to their pensions, they are likely to respond by ramping up their own savings even more. Incidentally, this has other possible repercussions too: One risk is that insurance companies pension funds et al will be driven to riskier investments to compensate for the low returns on safer investments, a danger highlighted by the UK Financial Services Authority in late October – coincidentally the same day that the *Financial Times* reported a resurgence in the issuance of CLOs (collateralised lending obligations) in the US market with the same background.

It is finally also open to question whether low interest rates really do boost asset values. The evidence from the repeated QE announcements in the US, the UK or from the ECB’s various measures in the euro area certainly imply that the euphoria period gets shorter and shorter, and US mortgage rates have begun to rise again. Even if asset prices stay higher, do higher asset prices really have the intended effect on spurring household spending? Economic theory assumes they do; but once again, the experience of the

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last few years means that the wealth effect may be lower than in the past. Unfortunately, this is only conjecture; we will not be able to truly measure this for some years.

Moving away from these sectoral issues, there are also some considerations for the economy as a whole. Crucially, the current policy, however justified as a temporary measure, clearly favours debtors over creditors. Again, bearing in mind that the crisis was caused by excess debt – although this in turn was induced by excess savings elsewhere – it is doubtful if this is the ideal message to send. Connected with this is a further issue, namely that the longer the current situation lasts, the stronger the constituency in favour of maintaining interest rates at ultra-low levels is likely to become, making an exit more difficult.

Of course, all this assumes that current interest rate levels are indeed abnormally low. If so, interest rates will at some stage return to normal – and we will see the mother of all bond bear markets. However, this is what many people believed for years would happen in Japan, in the process losing a lot of money shorting JGBs. If current interest rate levels are instead the ‘new normal’ – in other words, if Europe and the US are the new Japan, with trend growth around 1% and deflation threatening – then we could be stuck with these rates for many years to come. I do not believe this to be the case however; but this comment is already 3½ pages long so that will have to wait for another time.

In short, ultra-low interest rates were a necessary part of policy to combat the financial crisis. But the longer they remain in force, the less effect they have and the greater the risks they carry with them.

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