Aquila Deep Thoughts
Models & More

Monetary policy today – A threat to growth, the financial markets and our fundamental freedoms (and its connection with all those zombies on life support)

We use plain language to outline the medium and long term effects of today's monetary policies on financial markets, the economy, the behavior of market participants and individual freedoms. We show that central banks will have limited policy options when it comes to combatting the next recession. Indeed, there is a good chance the next crash will see a further erosion of market principles, the abolition of cash and a weakening of citizens' rights.

Central banks have been big buyers of bonds and equities in seeking to combat the Global Financial Crisis
Responding to the financial crisis, central banks - such as the Fed, the European Central Bank (ECB), the Bank of England (BoE), the Swiss National Bank (SNB) and the Bank of Japan (BoJ) - have expanded their balance sheets enormously over the last decade, buying bonds, and in the case of the SNB and BoJ, equities as well. As an example, the Fed's balance sheet was around $900bn. at the end of 2008 but reached a peak in September 2015 at $4500bn.

Central bank buying drives bond and stock prices sky-high
The purchase of bonds and shares by central banks has had a direct positive effect on their prices but the effect on real economic growth has been rather disappointing. Monetary policy affects growth chiefly via the behaviour of monetary aggregates such as M3 (a broadly defined measure which includes large time deposits and institutional money market funds as well as cash and sight deposits). In recent years the growth of the more broadly defined monetary aggregates has been disappointingly slow despite all the official securities purchase programs. While the central banks bought bonds and shares from banks, those banks, still fearful of bankruptcy and faced with higher reserve requirements on their lending, tended to book the cash received back into their deposits with the central banks rather than lending it on to their customers. As a result, M3 measures of money supply have grown less rapidly than central banks had expected and less rapidly than needed for decent economic growth. Low demand for credit due to the meagre economic growth is, of course, part of the explanation. But here we have the familiar chicken and egg problem. (Which came first: weak economic growth causing a low demand for credit or weak demand for credit which resulted in weak economic growth?).

Shareholders and property owners have benefitted more than employees and the broader economy
Conclusion: QE programs favored in particular shareholders, property owners and bond investors through higher asset prices (the primary effect). The desired positive effect on the real economy was disappointing. With shares now more highly-priced, investment should be stimulated (the secondary effect). This is because an entrepreneur focused on expansion has basically two options: he can buy a company (e.g. on the stock exchange) or invest directly (in factories,

distribution systems, brands etc.). At current share prices, buying a company has become more expensive so, via the Tobin Q reasoning, direct investment ought to be stimulated. Unfortunately, investment has been anemic since the global financial crisis. Also, the impact of higher security prices on consumption, via the wealth effect, has been limited.

Central bank policies favor the already wealthy and impoverish the savers of the future
Quantitative Expansion programs involving securities purchases are a powerful force for wealth redistribution. Those who already own assets benefit but wage earners and those who still need to save are negatively impacted. Because stocks, bonds and property are now so highly priced their long-term return potential is low. Thus, to the "haves", more has been given. But to the "have nots" and the "yet to haves", life has been made more difficult – their investment prospects have been impaired, as assets can only be purchased in the latter stages of a massive bull market. The price for today's monetary policies will be paid by tomorrow's savers and pensioners.

The ongoing subsidy for effectively insolvent firms and countries will show up in poor productivity trends
Less obvious is the damage being done to "good" enterprises. Reasonably high costs of capital are in fact vital if a (beneficial) Darwinian selection process is to take effect in an economy. With limited decent investment opportunities available, investors may feel forced to advance funds to zombie companies, and even zombie countries, on the assumption that central banks will bail them out. (After all, in their efforts to soothe financial markets, the world's central banks have already bought many zombie bonds, and even zombie equities). What are zombies? They are enterprises and states than can only secure their existence by issuing more and more capital. In other words, operational cash flows (in the case of companies) or tax and other income (in the case of countries) are insufficient to service existing debts. Thus zombies can only finance maturing debts, interest payments and business operations (or in the case of governments, public spending) if they take on more debt.

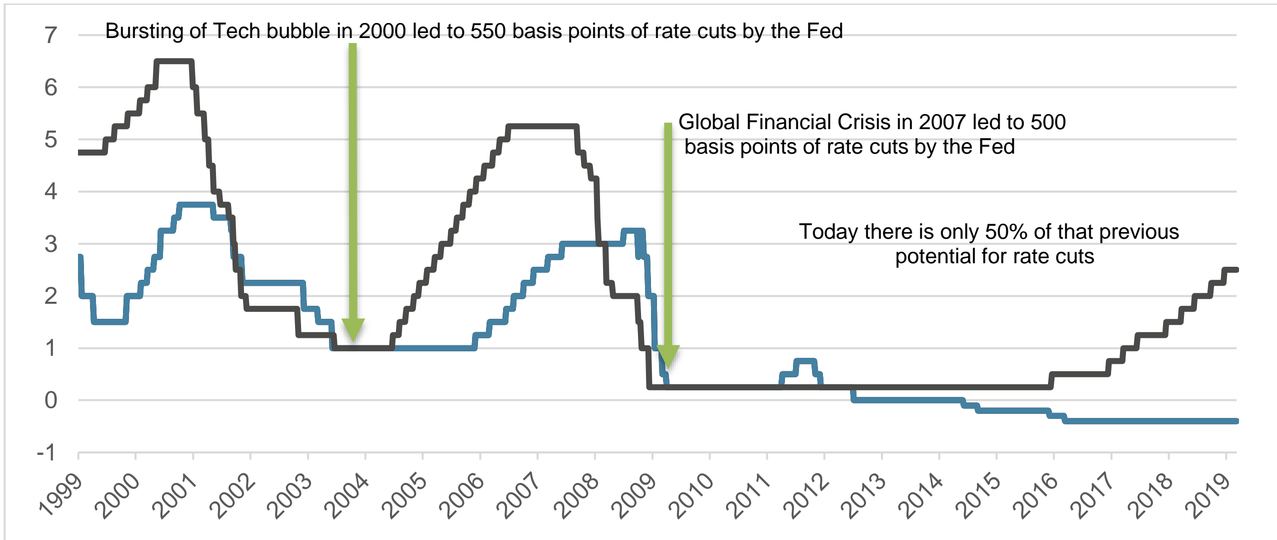
Zombies impact negatively the productivity of "healthy" organizations
When capital is allocated inefficiently, structural change is impeded (as outlined by Schumpeter in his analysis of competition). Zombie companies and countries continue to feed in the capital markets at the expense of the healthy. Indeed, the zombies may infect the healthy as the latter will be less motivated to undertake sensible commercial risks once they notice that fundamentally uncompetitive companies are still able to continue.

Moral hazard: Reckless debtors are rewarded and the prudent punished
Further, current central bank policies undermine the rules of good citizenry. It is a prudent business tradition to set something aside in good times in order to provide for bad times. But in a world where debtors and shareholders are subsidized such behavior is no longer rational. The result is what we see today - zombie organizations being kept indefinitely on life support.

In recent years the Fed has tentatively restocked its monetary policy arsenal
The Fed has been shrinking its balance sheet since October 2017, and more recently has increased the pace of reduction from $10bn. per month to $50bn. per month. As a result, the Fed's balance sheet has been cut by a cumulative $500bn. At the same, US interest rates have been increased from effectively zero to the 2.25%-2.5% range.

The traditional instruments of monetary policy will not be able to combat the next recession
Unlike the Fed other central banks have not restocked their policy arsenals and will have little or no scope to counter the next recession using traditional monetary policy tools. Even the Fed's scope is limited. (See Chart 1 below.) The Fed responded to the negative economic impact of the bursting of the Tech bubble in 2000 with 550 points of rate cuts and reacted to the Global Financial Crisis in 2007 with 500 basis points of rate cuts. But with US Fed funds now just above 2%, there is less than half the previous potential for rate cuts, if needed to offset a future recession. The ECB would be simply unable to cut Eurozone rates further unless cash was abolished. So long as cash is accepted, bank depositors would naturally respond to negative interest rates by withdrawing deposits. Europe's banking system would then be faced with bankruptcy unless all private claims on banks were replaced by central bank funding.

Chart 1: Policy interest rates of the Fed and ECB since 1999

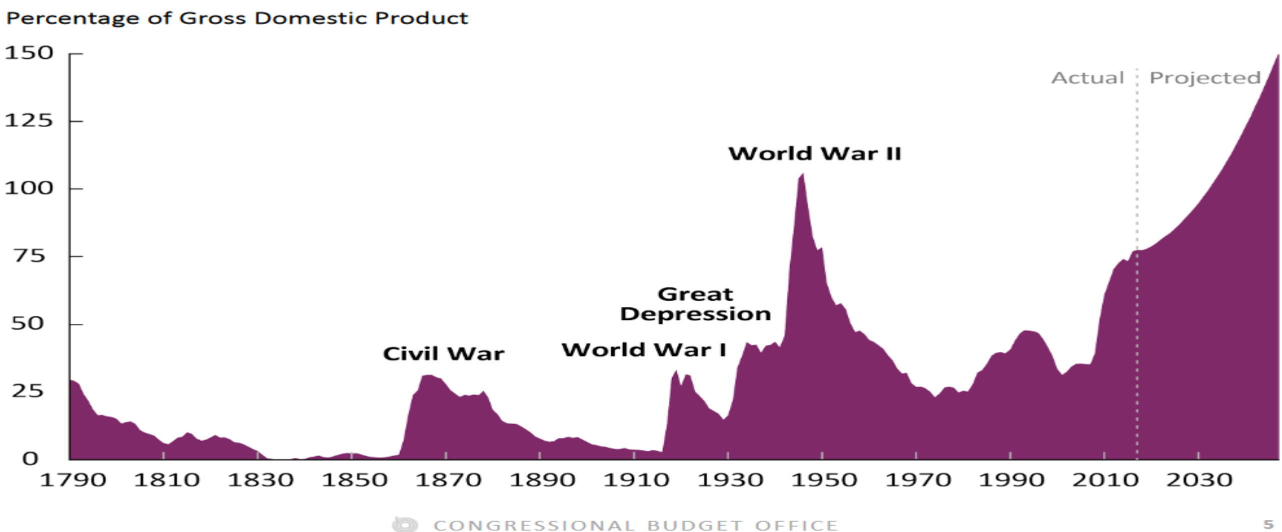


Source: Thomson Reuters / Datastream & Bloomberg

Limited scope for fiscal policy to work

The problem posed by the inadequate leverage of traditional monetary policy is aggravated by the huge debts of many governments. (See Chart 2 with respect to the US). Many countries are now no longer able to combat the next recession with fiscal stimulus and the limited scope for fiscal policy will put more pressure on central banks to keep zombies alive. Life support for zombie companies and zombie states can be analyzed as a quasi-Ponzi scheme. All Ponzi schemes have a bad ending. As in Ponzi schemes, early investors in zombie companies and zombie sovereigns can for a time make a lot of money, but those coming late to the party may get wiped out. When it comes to bull markets, central banks cannot prevent the eventual crash. They can influence the playing time but not the outcome.

Chart 2: Development and outlook for US government debt as a % of US GDP



Source: Congressional Budget Office

Chart 2 shows the development of US government debt as a percentage of US GDP since 1790 as well as the projections of the Congressional Budget Office (CBO) for this metric. We note that previous peaks in US government indebtedness have often been associated with wartime. But the record levels projected by the CBO out to 2027 assume that the US remains at peace.

The Fed has reacted to a slowdown in the world economy

There was widespread surprise when Fed Chairman Jerome Powell said that current data suggest no further US rate rises are warranted. He also said that the appropriate size of the Fed's balance sheet may be larger than previously thought. Specifically, the Fed has said that its balance sheet reduction will be slowed from May and terminated from September. Meanwhile, Fed guidance now indicates no further interest rate rises this year. The American central bank has reacted to a widespread slowdown in the global economy. But, unlike parts of Europe, for example Italy, which are close to or in recession, the US continues to post high levels of economic activity. Even assuming a slowdown, a US recession is still relatively far away. Hence the surprise at the Fed's policy shift. Whereas the Fed has at times seemed rather independent of the political pressures in Washington, today it is hard to avoid the thought that it is now in the business of helping to secure Mr. Trump's re-election in 2020.

The Fed's change of course has prolonged the bull market

The Fed's change of course has allowed the stock market rally which began at the end of December to continue. The standard arguments for continuing to invest in equities are (i) don't fight the Fed and (ii) one must avoid bonds with negative or only slightly positive (real) interest rates. With bonds thus off the table, equities are the default option.

Danger beyond the short term: Our forecasts

The world's central banks have responded to massive political pressures – both from the right and the left – and the formal independence of central banks is now seriously at risk. But in reality central banks have not been behaving independently for some time. They have been enslaved to the financial markets. This accusation will likely be made with increasing force by the left, but it is one also made by right-wing populists. It is possible that the political pressure on central banks, and the demands for a new global financial system, will only be sufficient to force a major change once those central banks have exhausted their remaining policy "trump cards".

Central bank trump card No. 1: The introduction of substantially negative interest rates and the simultaneous abolition of cash. Substantially negative interest rates have little effect without the simultaneous abolition of cash, as otherwise those with bank deposits would simply withdraw them as cash. But in the eyes of many cash is a basic guarantor of citizens' rights. Without cash the shadow economy would substantially disappear. "Transparent" citizens would emerge, all of whose transactions could be monitored by the state. In such a world, extensive expropriations are technically feasible, with officials just having to press a button. A huge redistribution program could be implemented with appropriate political majorities. If trump card No. 1 is played, citizens stand to lose their "humanity" and "freedom".

Central bank trump card No. 2: Massive purchases of equities, bonds, property – in short, "almost everything". The playing of Trump card No. 2 would imply that socialism, or a communist economic system, had won the battle against a market-driven economy. The central banks (in effect, the state) would become the principal owners of the means of production and exchange. Thus, central banks (who already with their QE programs feel sufficiently knowledgeable to set interest rates across the yield curve and the credit spectrum) would play a role indistinguishable from that played by Gosplan, the Central Economic Planning Committee of the Soviet Union, for much of the twentieth century. Obviously, Trump card No. 2 also implies a loss of "humanity" and "freedom".

If a true economic crisis unfolds, the "free market" system would unjustly be accused as the perpetrator. It could be condemned and (at least partially) abolished.

In such an environment, the allegations from the left – that a market economy and a capitalist system do not work – would be widely accepted, possibly by the majority. And calls for state intervention would become more pressing.

But such allegations are unjustified. This is because a true, properly functioning capitalist, market system would not have allocated to the central banks a monopoly role in the creation of legal tender (such as "notes and cash"). Instead, legal tender would be created through a continuous competitive process, whereby currencies compete against one another with good and widely-accepted currencies continually driving out weaker ones.

If our economic and financial system were to collapse it would be precisely because market forces have been abolished in the field of monetary creation (and replaced by central planners who control ever more sectors of the economy centrally). Accused and sentenced, abolished or locked away but completely innocent: the (social) market economy. Let's give the word to Friedrich August von Hayek, winner of the Nobel prize for economics in 1974 (together with Gunnar Myrdal). He writes that the history of state money creation, except for a few short, happy periods, has been a story of incessant lying and deception. The danger that the (social) market economy suffers permanent damage, and is eroded far more than hitherto, is high. Economic efficiency, and all of us, would be the losers. Even "decent independent central banks" would find their continued existence jeopardized.

Central banks should not regard their independence as "God-given"

Central banks need to consider their future steps regarding the issues raised here and also with respect to developing political pressures. It would be a mistake if they assume they are invulnerable to political pressures. Anger against central banks is increasing – not only from the ranks of "savers" but also among radical political groupings, both on the left and the right. Central banks should not regard their independence as God-given.

What now? Will there be happy ending?

The author is most concerned that this story of central banks bravely combatting economic depression should have a happy end, that when the curtain falls all zombies will be completely healed and that their return to health can be generally celebrated. The mere survival of good, healthy companies would not constitute a proper happy end. For that we need zombies to be brought back to life, investors not to lose money and central banks to feel they can stop trying to lure investors with Ponzi schemes.

But can anyone think of a Zombie film with a really happy ending?

Contact

Thomas Härter, Aquila AG | Bahnhofstrasse 43 | CH-8001 Zürich

www.aquila.ch | Telephone +41 58 680 60 44 | Fax +41 58 680 60 01

Disclaimer: The information and opinions in this document come from sources that are considered to be reliable. Nevertheless, we cannot guarantee the reliability, completeness or accuracy of these sources. The information and opinions in this document do not constitute and shall not be construed as a solicitation, offer or recommendation to purchase or sell any investment or to engage in any other transaction. We urgently recommend that interested investors consult their personal investment advisor before making any decisions based on the document so that personal investment objectives, financial situation, individu-al needs, risk profile and other relevant information can be duly taken into account in conjunction with comprehensive advisory services.