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The ECB and the Bank of Japan have driven themselves into a corner

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The ECB and the Bank of Japan (BoJ) seem intent on outbidding one another in the direction of monetary expansion. The ECB is now purchasing Euro 80bn. worth of securities on a monthly basis while punishing the commercial banks with a negative 0.4% rate of interest on deposits held with it. Meanwhile, monthly purchases of securities by the BoJ amount to some USD 60bn. and commercial bank deposits are also penalized with a negative rate of interest. Relative to the size of the economy, Japan's central bank is the most aggressive of all the major central banks in terms of its balance sheet expansion.

In terms of effectiveness, these very expansionary policies have long passed their peak.

Although there are many explanations for the weak growth trends of recent years, central banks seem convinced that the world is suffering from "secular stagnation". It is widely believed that this condition can only be counteracted with zero or negative interest rates. So it is not surprising that the ECB and the BoJ believe that success in policy-making terms requires that monetary policy be shifted in a steadily more expansionary direction. In this, they forget Albert Einstein's definition of insanity – "doing the same thing over and over again and expecting different results". In fact, the ECB and the BoJ seem unwilling or unable to recognize that, in terms of effectiveness, their monetary policies have long passed their peak and are now counterproductive.

Negative interest rates hinder, rather than encourage, the supply of credit.

While negative interest rates and the flatter yield curve that derives from securities purchases are viewed by the central banks as likely to stimulate the supply of credit, these policies are in fact doing the opposite. This is because negative rates and a flatter yield curve hurt bank profitability and hence undermine the willingness to lend. Also, savers are punished as their assets no longer generate an income. This depresses consumer spending rather than boosting it. Further, very low interest rates allow essentially unviable enterprises to continue, whereas in a normal interest rate environment they would long ago have downsized or ceased to produce. This is one reason for the oversupply of goods and services which has deflationary consequences, thus undermining a key policy objective which is to boost inflation. These examples of unwanted policy effects illustrate the inconsistency of the policies being pursued by the ECB and the BoJ.

The misallocation of capital leads to asset price bubbles which sooner or later are bound to burst.

While the drawbacks listed above are viewed, and even accepted, by some as unavoidable by-products of measures which aim to boost growth, there is no dispute that current policies of the ECB and BoJ rob interest rates of their signalling and guiding function. A misallocation of capital is the inevitable consequence, in turn leading to asset bubbles which, sooner or later, have to burst. The effects are a destruction of capital, excessive debt, deflation or even depression.

The industrial country central banks have created the potential for substantial inflation.
Should the liquidity being pumped into financial markets by the central banks move out of the financial system and into the real economy, consumer prices would move sharply higher. The economy most at risk of high inflation in this respect is Japan, where the liquidity created by the BoJ's security purchase programs is now equivalent to nearly 50% of GDP. Equivalent percentages for the US and the Eurozone are, respectively around 20% and 10%. Central banks' statements that they will withdraw excess liquidity at the appropriate time show a confidence which may well be misplaced.

Confidence in paper, or central bank, money is being put at risk.
In spite of the unprecedented policies of monetary expansion in the Eurozone and Japan, growth remains very weak and inflation is dormant or non-existent. So it is not surprising that some economists argue for yet more aggressive policies of fiscal and monetary stimulus. Legendary bond fund manager Bill Gross says that, with aggressive monetary policies having been tried, it is now time to ratchet up fiscal expansion. His proposal is for states to cut taxes and, at the same time, increase public spending. Central banks would be co-opted into his plan as buyers of the government bonds required to finance the resulting public deficit. In this way the balance sheets of the central banks would be continuously increased without limit. Not far removed from this idea is the notion of "helicopter money", whereby money is spread across an economy, rather like "manna from heaven". This prescription originates from the monetarist economist Milton Friedman and is aimed at boosting both consumption and inflation. Were the central banks to embark on these sorts of policies they would in our view create a very dangerous situation. Free money is money without the quality of being in restricted supply. It would not take much for economic agents to lose confidence in such money and demand barter arrangements. Governments would quickly be forced into currency reforms.

The ECB and the BoJ are unlikely to be dissuaded from their current policies.
For us the most desirable, but least likely, scenario is one whereby the ECB and BoJ withdraw from their tasks as state financers and macro managers and return to their traditional duties. We also put a low probability on the scenario whereby the liquidity created by central banks breaks out of the financial system and into the market for goods and services, causing prices to rise sharply. It is far more likely that the ECB and BoJ continue on their present policy paths, applying ever stiffer doses of the same medicine to the financial markets. While we think an open resort to "helicopter money" is unlikely, a disguised version of this approach – for example, central bank financing of tax cuts and infrastructure programs via unlimited quantitative easing – is significantly more probable.

"Real assets" should be over-weighted in portfolios.
We expect a first phase in which all financial risk assets benefit from an extended monetary expansion. Thereafter, in a second phase, all financial assets are likely to suffer as asset bubbles burst with knock-on economic consequences. As the central banks respond, supplying free money, albeit in a disguised form, we expect a third phase in which confidence in paper money is eroded. In this situation the investor should focus on real assets and avoid nominal assets. As no one can predict the exact sequence of these phases and when they will occur, we advise that investors have their focus already on real assets. In this context, we prefer equities to property and gold.

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