Lessons for Australia are stark

By Henry Ergas, The Australian, 8 June 2015

In the cartoons, before machines explode they start shaking violently, their shudders presaging the approaching conflagration.

Last week's convulsions on world bond markets, in which yields on Germany's benchmark 10-year bund rocketed from 0.68 per cent to 0.99 per cent before falling to below 0.85, may not be a similar harbinger of doom, but they highlight just how brittle world financial markets are.

After all, the market for German bunds, like that for US government debt, is extraordinarily liquid, so that large price fluctuations are highly unusual. With yields on bunds whirling, investors seemed on a knife's edge.

New, more concentrated, risks

Nor is that surprising. Thanks to interest rates at historic lows, and massive programs of "Quantitative Easing" in the Eurozone and Japan, investors face new, more concentrated, risks. It is no longer millions of consumers, voting with their dollars, who take the decisions that really matter; rather, it is a handful of central bankers.

No doubt, individual consumers are fickle; but their myriad choices, some going one way and others another, have a degree of statistical predictability. Not so those of the "masters of universe" who will determine just how long the world's great monetary policy experiment lasts.

As David Hume famously put it, "what depends on a great number, can be accounted for by determinate causes"; but the decisions "of a few persons [must] be ascribed to causes secret and unknown."

The result, as investors try to read the secrets in central bankers' minds, is that even offhand comments trigger wild gyrations. In suggesting that quantitative easing was boosting output in the single-currency zone, Mario Draghi, the president of the European Central Bank, may merely have wanted to reassure markets that there is light at the end of the tunnel; but they interpreted that light as a train rushing the other way, since the good news of recovery implied the bad news of rising rates and falling bond prices.

"Get used to periods of higher volatility"

And when Draghi, faced with the rout his comments had provoked, retorted that investors should "get used to periods of higher volatility", the response was to send world markets on a roller coaster ride that seemed designed to prove his point.

Naturally, it wasn't meant to be that way. On the contrary, a primary goal of empowering independent central banks was to allow monetary policy to be set on a predictable basis. In the language of policy wonks, expectations of the monetary environment were to be firmly "anchored", allowing businesses to concentrate on fundamental factors, such as investment and innovation, that underpin prosperity.

The anchor has been lost in the storm

Well, if there ever was that anchor, it has been lost in the storm. And abnormal monetary policy is doing nothing to restore it.

What it has restored is a toxic mix in asset markets. Even after recent sell-offs, a number of sovereign bonds trade at negative yields, while several countries (including debt-laden France and Spain) have managed to issue medium-term bonds at negative interest rates.

At the same time, in many advanced economies, low interest rates have driven equity prices to new highs; but particularly in the US, those valuations, instead of reflecting investors' view of the outlook, have been substantially affected by companies borrowing cheaply and repurchasing their own stock, with the companies that make up the S&P 500 committing to share buybacks an amount equivalent to three-quarters of their total capital expenditure.

And last but not least, the pathologies observable in the run up to the GFC have returned, with junk-grade companies securing funding at rates close to ultra-low government bond yields while the repackaging of high risk loans into collateralised loan obligations is back at its pre-crisis levels. Far from encouraging productive activity, all this introduces uncertainties that frighten it off. And nowhere are the signs clearer than in the shortfall in real investment.

The paradox is simple: the user cost of capital, which reflects the terms on which companies can finance investment, has fallen by some 30 per cent in the advanced economies since the 1990s; but investment remains well below the levels needed to keep the capital stock growing at its long run trend. The result is to entrench the problems that provoked desperate monetary policy experiments in the first place.

Investment remains well below the levels needed

In the US, for example, sagging investment levels have helped reduce labour productivity growth by nearly two-thirds, as new labour-saving technologies are implemented more slowly. In turn, weak productivity growth has put a lid on wages, deterring increases in consumption and making the recovery more fragile than its predecessors. And the fact that low interest rates have decimated the savings of older Americans, pushing large numbers back into the labour force, has only aggravated those effects.

None of that is to say the policies should never have been implemented. But what can no longer be denied is that they have high costs, and that those costs are rising. Unfortunately, having jumped into this bed, central banks are finding it hard to sneak out of, not least because of the danger of trashing the asset prices their own policies have done so much to inflate.

End with a bang or with a whimper?

Whether this will end with a bang or with a whimper no one knows, least of all the central bankers. Its lessons for Australia, however, are stark.

With virtually no progress on fiscal consolidation, and recent projections of public debt rising past 50 per cent of GDP by 2030, a serious downturn would find us with only monetary policy in the armoury; and as interest rates are already low, we would be in QE territory quick smart.

On the consequences of that, Draghi was right: once you're in QE-land, cupcake, you had better toughen up.

If that’s not the future our bleeding hearts want, it’s time they confronted the hard decisions.