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Monetary policy Getting to grips with the unintended consequences of QE

Why easy money buys lousy assets

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Fusty pension funds, humdrum annuity providers and boring insurance companies are among those most at risk from the grand experiment in monetary policy that spawned its own set of exciting acronyms.

While quantitative easing (QE), unconventional monetary policy (UMP) and zero interest rate policy (ZIRP) have entered the lexicon along with the GFC that paved the way for them, it is a much less dynamic group that may bear the brunt of the fallout.

Since the global financial crisis escaped like dark vapour from the subway vents around Wall Street in September 2008, the central banks of the developed world have kept interest rates at near zero levels in an effort to push economies back up to speed.

More than five years later, growth levels are bloodless and investment markets are as volatile as teenagers.

Worst of all is that everyone appears to have gotten used to what has been termed "the new normal".

"The idea that ... we would still have zero Fed funds rates is inconceivable, and also very dangerous," Horace "Woody" Brock, founder and president of US-based economic think tank Strategic Economic Decisions, told the Portfolio Construction Forum Markets Summit in Sydney on Tuesday.

Titled The Great Escape, the conference was dedicated to exploring the unexpected and potentially dangerous consequences of the easy monetary policy that has dominated the globe since the advent of the GFC.

Dr Brock is not the only one who is concerned. In his 2012 paper, *Ultra Easy Monetary Policy and the Law of Unintended Consequences*, OECD chairman William White argued: "The capacity of such policies to stimulate 'strong, sustainable and balanced' growth in the global economy is limited". Ultra easy monetary policy (zero interest rates and asset purchases by the US Federal Reserve) has failed to revive the all-important driver of any recovery, which is "Main Street", Dr Brock told the event for fund managers and wealth advisers.

The Great Escape

Low interest rates should have stimulated a recovery, but it didn't work that way. Savers were older, and closer retirement horizons encouraged them to save, not spend. And they needed to save much more to reach the same retirement goals.

Business didn't respond because it was frustrated by apparent policy stasis in Washington and because "there really isn't anything to invest in", Dr Brock said.

A capital spending boom like the one which followed the utilitarian uptake of the internet in the 1990s cannot be "ordered in like a Thanksgiving turkey dinner". Corporate investment, he said, "is dead".

Instead, there has been plenty of borrowing for the wrong reasons, "which can create the asset market bubble – which is precisely what you don't want". Since 1985, all recessions in the West have been caused by asset bubbles bursting, he said, listing tech stocks and housing as examples. "Well, I sure don't want the Fed doing whatever it takes to create another asset bubble. But, boy, do low interest rates lead you in that direction."

The scenario too terrible to contemplate is the impact of rising rates on financial institutions. Dr Brock cited an example mooted by Fed board member Jeremy Stein, which illustrates how the relative poor value of assets bought with cheap money could become evident very quickly "when things start to go bad". In his example an insurance company wishing to take out a derivatives position starts a chain of transactions which leads to a pension fund desperate for yield lending out Treasury securities in exchange for junk bonds as collateral.

When rates go up, the value of such assets would drop like a stone, and "this could cause a panic ... a crisis far worse [than] the one we've been through", Dr Brock said.

Economist Horace Brock warns against zero Fed rates. PHOTO: NIC WALKER

The pool of safe assets overseen by US insurers is 500 times the size of that on the balance sheets of Goldman Sachs and Morgan Stanley, he said.

Dr Brock suggested the sculptor Rodin, who created *The Thinker*, be disinterred and commissioned to create a new statue to stand outside the Fed called *The Reacher*, to represent someone reaching for yield by exchanging safe assets for risky ones "to pay their bills". "You're going to read a lot more about that in the next few years," he said.

"If you're an insurance company CIO and you have been writing variable annuities for 30 years ... I'm guaranteed at least 2.5 per cent and up to 8 per cent depending on, quote, 'how the market goes.' Huge amounts of these things exist. Did any CIO writing these dream of six years of zero rates? The answer is absolutely not."

So, how do we get out of QE? Brock says the answer isn't in textbooks. If you think the Fed controls bond yields through purchases, you are wrong. "There is only one person that matters, who sets the price, and that's my mother," he said. "She holds $13 trillion privately of government bonds. She's the American household."

The net worth of American households is $78 trillion, and "if Mrs Brock notices inflation going way up ... she picks up the phone and says, 'Get me out of bonds.'"

Mrs Brock deals in "tri-tri-trillions and not bi-bi-bi-billions, like the wimpy little Fed," Dr Brock said, his jowls amplifying the effect. "You don't need QE to push yields down."

The tapering story isn't very important, he said. It's "hyped up". The real issue is what will happen as rates rise from 0 per cent over six years to 4 or 5 per cent.

If policymakers have a number of goals, they need the use of at least that number of levers to attain them. Using monetary policy alone, which is one lever, is not enough. "And this is precisely what you've all seen happen."

Fiscal policy, used correctly, is powerful. He suggested the US economy would have grown at 4 per cent instead of 2 to 2.5 per cent a year had the government not been cutting the fiscal deficit.

Counter to the Keynesian theory that fiscal and monetary policy can be used to modulate the business cycle, Dr Brock emphasised the key variable is growth. "Growth is what we need this minute," he said. "It has nothing to do with fiscal and monetary policy whatsoever." Change the incentive structure, however, and things get done.

"North Korea could have been growing at 5 per cent for 50 years, not minus 2, but if the reward for inventing Apple is to have your fingernails slowly pulled out I think you really won't want to invent Apple."