Are central banks sowing the seeds of a greater crisis?

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IN 1931, John Maynard Keynes feared bureaucratic tinkering had prompted and prolonged the Great Depression. "We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand," he said.

There are similarities 80 years on, as central banks in the US and Europe pour unprecedented sums of newly created money into ailing banks to stimulate stagnant economies. But in trying to keep interest rates artificially low and encourage banks to lend, bureaucrats are engaging in "the biggest economic experiment in history", says William White, former chief economist of the Bank for International Settlements in Basel. Their tinkering is sowing the seeds of a greater economic crisis.

Before Christmas, the US Federal Reserve decided to add another $US1 trillion to the financial system in monthly instalments this year, on top of the $2.3 trillion already injected since late 2008. It said it would keep pumping new money into the financial system until unemployment fell to 6.5 per cent or inflation reaches 2.5 per cent. The Bank of England has tipped in £375 billion since 2009. In Australia, the Reserve Bank has been reluctant to lower rates too much, but global economics are forcing its hand.

Economists typically object to government interference in markets, but not the price and quantity of money. Only one of the 12 voting Federal Reserve governors dissented in December, arguing that further quantitative easing, expanding credit in the hope of expanding an economy, was "unlikely to add to economic growth without unacceptably increasing the risk of further inflation".

Outside the confines of central banking, economists are more divided. John Stone, a former head of Australia's Treasury, says QE is "irresponsible verging on the criminal", pointing to the prospect of damaging "currency wars" (competitive devaluation to spur domestic exports) between the major currency blocs.

Roderick Deane, former deputy governor of the Reserve Bank of New Zealand, says it is a "highly worrisome policy designed to avoid addressing the fundamental issues of extremely large national fiscal deficits". He criticises growing interest in the phenomenon among left-wing parties.

QE takes the pressure off government borrowing by giving banks the money to hoover up new public debt issues.

Fear of inflation is growing, reflected in a sky-high gold price and the search for inflation-proof assets. Steven Howard, a fund manager at Vanguard in Melbourne, says investor concern about inflation is growing in Australia. "We started an inflation-proof bond fund last year and it quickly accumulated $300 million, mainly from institutional investors and independently wealthy people," he tells Inquirer.

But, despite ominous projections, inflation remains low in the West. And consumer surveys and financial market traders do not foresee an outbreak in the near future, even if debt-laden governments would benefit from it.

Economists are at pains to point out QE is not "money printing". Stephen Grenville, a Lowy Institute fellow and former deputy governor of the Reserve Bank of Australia, says QE is unlikely to spur significant inflation while unemployment in the US and Europe remains high.

In theory, banks could lend out their newfound cash, potentially stoking inflation, but "the public is not interested in borrowing further and the excess money gravitates to the commercial banks which, unwilling to lend, deposit it back with the central bank," he explains. "The net effect is both sides of the central banks' balance sheet expand, but not much else."

Central bank balance sheets may have exploded (the Fed's has tripled to almost $US3 trillion), but the growth in money in circulation in the US, Europe and Britain, the epicentres of experimental monetary policy, is broadly unchanged.

John Cochrane, a finance professor at the University of Chicago, says "the Fed is a like a frenzied conductor in front of an orchestra that is ignoring him", pointing out interest rates have fallen so low that money and bonds have become essentially the same thing, "little pieces of paper that pay no interest".

"So it matters little banks have $US2 trillion of bank reserves on their books rather than short-term bonds," he says.

The evidence QE has had much effect is weak. Interest rates on US long-term government debt, which influence the level of interest rates around the developed world, were a little over 3 per cent when the first round of QE began in late 2008 and a little over 3 per cent when the second finished in mid-2011. Grenville reckons the perception central banks are "doing something" probably has more impact.

Others disagree. Steve Millar, a fund manager at Blackrock, says actual interest rates would be higher "but for the Fed's financial repression, which has corrupted the bond market".

"We laughed at the Japanese in the 1990s and now we're doing the same," says John Kay, one of Britain's foremost economists. The Japanese government pioneered "quantitative easing" decades ago, but is yet to endure any price inflation, its economy still in a multi-decade funk.

For Kay, QE is less about supporting economic growth than keeping the world's banks afloat and underpinning the status quo of global banking. "Only a small fraction of British banks' assets actually sustain the real economy", he says, pointing out less than 10 per cent of their £7 trillion of assets were loans to British non-financial companies.

"Without QE, a big share of global banks would have gone under over the past few years," he adds. The extra cash from central banks helps boost their capital levels and shifts the risk from holding potentially dubious pools of mortgages to the central bank, and ultimately to taxpayers.

William Coleman, a professor of economics at Australian National University, is also relaxed about inflation, pointing out central banks can reverse their purchases by selling the assets back and writing off the superfluous cash they have generated. "If the global economy suddenly improves it is incumbent on these banks of the world to unwind these measures," he says.

But the pressure on central banks to keep rates low for the foreseeable future will be great. Without an outbreak of inflation that forces rates up, the advanced world appears to be trapped in a low-interest-rate environment.

Cochrane says losses incurred by central banks if rates rose - because the values of bonds and mortgage securities are inversely related - would be immaterial compared with the impact on the public and banking sectors. "If interest rates returned to more normal levels the US government's debt repayments would shoot up from around $US200bn a year now to $US800bn a year, which is clearly not feasible.

"Higher rates would also wipe out a big chunk of America's 'too big to fail banks', which are not well capitalised and could not withstand big losses on their bond holdings," he adds.

"If stock prices go down people go home and kick the dog, but if bond prices collapse there's typically a wholesale financial crisis."

A 1 per cent increase in interest rates would wipe about 6 per cent off the value of most bonds. The global bond market, with almost $US100 trillion in debt outstanding, dwarfs the total value of stocks, and rates would have to rise far more than one percentage point to return to normal levels.

In the meantime, White, now chairman of the OECD's economic and development review committee, worries about the unintended consequences of ultra-low rates, especially as they are doing little to revive growth.

"Since the war, in successive recessions central banks have had to lower interest rates by ever greater amounts to get the same bang for their buck, and now they have reached zero," he says. "Quantitative easing is a more powerful dose of the same increasingly ineffective medicine."

In advanced countries, household debt levels have risen dramatically over the past 50 years, reducing the power of lower rates to encourage more borrowing.

White says low interest rates distort the economy in ways that are hard to predict, including encouraging poor lending and investment decisions and fanning asset price bubbles that ultimately lead to a crash.

"Keynesian economics has made policymakers obsessed with encouraging consumer demand, but they have ignored the longer-run ramifications of easy credit and low interest rates. The most important price in the economy has been held low, probably far below its natural rate, for longer than any time in history including the 1930s," he says.

Uncertainty is causing financial markets to oscillate more frequently between risk aversion and risk seeking, as correlations between the returns of different asset classes increase. "The old rule about diversifying your investments is becoming obsolete," White says. "There's a lot of money to be made if you can get the timing right, but it's not for the faint-hearted."

The global financial crisis was a reminder that economies are complex and dynamic, where the severity of crises is in inverse proportion to their frequency and their timing is unpredictable.

Thinkers outside economics from Voltaire to George Bernard Shaw have said paper money backed only by government fiat would ultimately end in tears, with rampant inflation. So far, central bankers and the bulk of the economics profession have proved them wrong. But in economics, as in nature, a snowball can prompt an avalanche.

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