The long-term impact of low rates

By Edward Chancellor
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Ben Bernanke was on form at the annual central bankers' shindig at Jackson Hole. Ever modest, the Federal Reserve chairman lauded his own "unconventional" policy measures for bringing down long-term interest rates, easing financial conditions, reducing unemployment and assisting in the US economic recovery. What Mr Bernanke fails to consider, however, is the negative consequences of very low rates on the long-term growth prospects for both the developed and emerging economies.

A more thorough analysis of the Fed's monetary stance is provided by William White, former head of research at the Bank for International Settlements*. Mr White starts by observing what just about everyone in the world - with the notable exception of the current Fed chairman - acknowledges, that the Fed's easy money policy after the dotcom debacle resulted in reckless credit expansion, the inflation of housing bubbles around the world and the appearance of an overly leveraged and opaque shadow banking system. All this is history. But what of the even lower rates that have persisted since Lehman Brothers went belly up?

There are numerous evils to consider. For a start, the ultra low cost of borrowing removes any immediate incentive for governments to exercise fiscal discipline. Today's trillion dollar deficits are relatively painless - for now, at least. Mr Bernanke admits that low rates are intended to inflate asset prices and promote consumption. Inflated asset prices result in lower future returns for investors. The S&P 500 is currently very overvalued. GMO models suggest that over the next seven years the real return from US stocks will be close to zero.

While Alan Greenspan's easy money delivered us the global financial crisis, Mr Bernanke's policy of even lower rates may be damaging to the long-term growth prospects of the US economy. Low rates discourage saving - the US gross savings rate is currently around 10 per cent, which is 6 percentage points below GMO's estimated "prudent" savings level. Mr Bernanke's grand monetary experiment also creates uncertainty. Perhaps this explains why US companies, although flush with cash, refuse to invest. Very low interest rates also hinder the process of "creative destruction". Since the mid-1990s, Japan's zero-interest rate has kept businesses with poor profitability on life support while banks "evergreen" potentially non-performing loans.

Not only do low interest rates threaten future income growth for American workers, they promote social discontent. **As Mr White observes, leveraged speculators have been the prime beneficiaries of the Greenspan/Bernanke era of easy money.** Prudent savers, on the other hand, suffer from negative real returns on their cash and fixed income investments. Mr Bernanke's low rates are delivering what

Keynes gleefully termed the "euthanasia of the rentier class". Low rates have not even brought enduring benefits to the least advantaged, who have suffered most from the housing crisis and from subsequent high levels of unemployment. There is a growing sense that the distribution of economic spoils has become unfair.

Beyond the white marble halls of the Federal Reserve in Washington, it is universally acknowledged that low interest rates fuel asset price inflation. In the past decade, we witnessed real estate bubbles in several developed market economies. Now the risks appear to be shifting to emerging markets. The negligible cost of borrowing the world's reserve currency has encouraged investors to borrow in dollars and place the proceeds in countries with higher interest rates. Capital inflows from this global carry trade put upward pressure on emerging market currencies, threatening export competitiveness. Their central banks have responded with massive foreign exchange intervention. Since 2008, global foreign exchange reserves (excluding gold) have climbed by nearly $4tn. This extraordinary growth in forex reserves has loosened monetary conditions in several emerging markets, according to Andreas Hoffmann of Leipzig University. "The current low interest rate policy in advanced economies," writes Prof Hoffmann, "may have planted the seeds for new bubbles." Low interest rates in emerging markets have also encouraged an extravagant splurge of infrastructure spending.

Mr White concludes that the Fed's ultra-easy monetary policy provides "no free lunch". Or put it another way, Mr Bernanke's low rates have allowed us to continue gorging at the table, deferring the bill for the moment, but ever adding to the eventual tally.

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