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Financial & Fiscal Features Newsletter

IREF
Fiscal Competition & Economic Freedom

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

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In this issue:

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BIS has doubts about monetary policy in the Euro area

CENTRAL BANKS

by Gordon Kerr and John Butler, with Enrico Colombatto

Latest BIS Report says that present monetary policies risk permanently destabilizing the global economy. It calls for A New Policy Compass, focussing on the 'Financial Cycle', not the Business Cycle.

Our recent Newsletters have drawn attention to two hardening trends of mainstream media coverage of economic news. Firstly, each announcement of positive GDP data, no matter how modest, has been expressed as evidence that the relevant European country is recovering. Secondly, there has been a reduction in the reporting of, and emphasis on, steadily ascending levels of public and private debt. Instead, discussion of rising debt levels has been replaced by analysis of low price inflation. These two points are linked. Rather than report the scale of the present problems, however, the media has accepted central bankers' invitations to concentrate on data pointing to 'turnaround'.

It is highly significant, therefore, that at the end of June, the Bank for International Settlements ("BIS") strongly questioned whether the "Advanced Economies" of the US and Europe are actually recovering. Its brutally frank Annual Report criticises the widespread deploy-

(continued on next page)

Banks remain fragile and imbalances persist

by Gordon Kerr and John Butler, with Enrico Colombatto

FINANCIAL MARKETS

The BIS notes that banks have been recapitalising, but in some countries problems with asset quality and earnings persist. The recent issue of a convertible bond for TESLA is a prime example of the behaviour of the financial markets, perhaps akin to the boom in subprime mortgages only a few years ago.

On the subject of banking and investment, the BIS notes that financial institutions have strengthened their balance sheets by issuing new equity and quasi equity issues (such as Contingent Convertible Notes; see March 2014 Newsletter). The BIS cautions, however, that banks in Europe may have reported recapitalisation merely by changing their risk-weighting models:

"... *[recapitalisation] progress has not been uniform, however, as some banks (especially in Europe) remain under strain. The reduction in Risk Weighted Assets reflected in some cases outright balance sheet shrinkage but in many others a decline in the average risk weight of assets. Given banks' track record of overly optimistic risk reporting, the latter driver raises concerns about hidden vulnerabilities.*"

As for future investment, there continues to be a dearth of opportunities offering reasonably low risk and attractive returns. In a circular fashion, this increasingly fraught search for yield explains

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Financial and Fiscal issues are increasingly intertwined in our world.

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*The **Institute for Research in Economic and Fiscal Issues** was founded in 2002 to establish an efficient platform to investigate fiscal and taxation questions. Eager to cross knowledge from economics, statistics, law studies and politics, IREF seeks to create a starting place for thoughts and proposals about taxation policy.*

CENTRAL BANKS

... BIS and monetary policy in Euro (cont'd from p1)

ment of "unusually accommodative" loose monetary policies, with the startling observation that "The return to sustainable and balanced growth may remain elusive."

Loose money entrenched?

Far from hailing monetary easing, the BIS fears that present policies are so extreme that they risk becoming 'entrenched', making it difficult for interest rates to be increased. It notes that governments have been 'lulled' and are showing no appetite for structural adjustments, resulting in rising levels of debt. Present monetary policies are failing to 'lean against' the financial imbalances that such policies have encouraged.

Such concerns are surely justified by recent US data not mentioned in the BIS report. European countries' struggles to return to moderate rates of growth have been well documented. The US, in contrast, has reportedly been recovering strongly, leading commentators to conclude that the ECB should follow the Fed's lead.

However, recent US official numbers suggest a different interpretation. We still may not know whether the first quarter American GDP fall of 2.9% was an outlier, but it is clear that consumer price inflation is now rising fast. Although presented in year on year terms as an 'on target' annualised rate of 2.1%, the data for March, April and May show index growth of 0.9%, which equates to an annualised inflation rate of 3.7%. Given that non-farm business productivity fell in Q1 by 3.2%, the combination of low growth and a surge in CPI does not imply a bright future for the US; rather a combination that could be seen as early signs of stagflation.

The BIS does comment that US corporate growth has "disappointed" since the 2007 crash. Companies have chosen to engage in share buy backs and merger and acquisition activity rather than to increase productive capacity. For the BIS this explains why, despite 'financial market euphoria', underlying investment remains weak.

Governments are showing no appetite for structural adjustments, resulting in rising levels of debt. Present monetary policies are failing to 'lean against' the financial imbalances that such policies have encouraged.

Why BIS matters

It is worth reiterating what the BIS is. Owned by 58 of the world's central banks its main purpose is to "serve central banks in their pursuit of monetary and financial stability". The BIS is therefore the highest-ranking supranational scrutineer of monetary policies. In attempting to encourage reconsideration of present policies by some central banks, the Report distinguishes between "crisis hit" countries (such as in Europe and the US), and those that avoided the financial crisis (emerging market economies). The BIS is particularly critical of the use of monetary stimulus in economies at the eye of the financial crisis storm:

"In crisis-hit countries, there is a need to put more emphasis on balance sheet repair and structural reforms and relatively less on monetary and fiscal stimulus: the supply side is crucial. Good policy is less a question of seeking to pump up growth at all costs than of removing the obstacles that hold it back. The upturn in the global economy is a precious window of opportunity that should not be wasted."

And indeed the BIS does appear concerned that such opportunities are being wasted. It notes that the G7 countries' combined public sector debt has increased dramatically since the crisis, averaging 120% of GDP.

The depth and lasting legacy of the financial crisis have not been appreciated by central banks, according to the BIS. It cautions that policymakers appear to have been thinking only along conventional 'business cycle' lines, normally spanning 8 years. It encourages central banks to think more about the concept of a 'financial cycle' lasting 15-20 years, which can end in an 'eruption'. By applying policies relevant to a normal business cycle at a time when a financial cycle was reaching a catastrophic end, central banks have brought about the present anomalous result: economies appear to be improving but private and public sector debt are at virtually unsustainable levels.

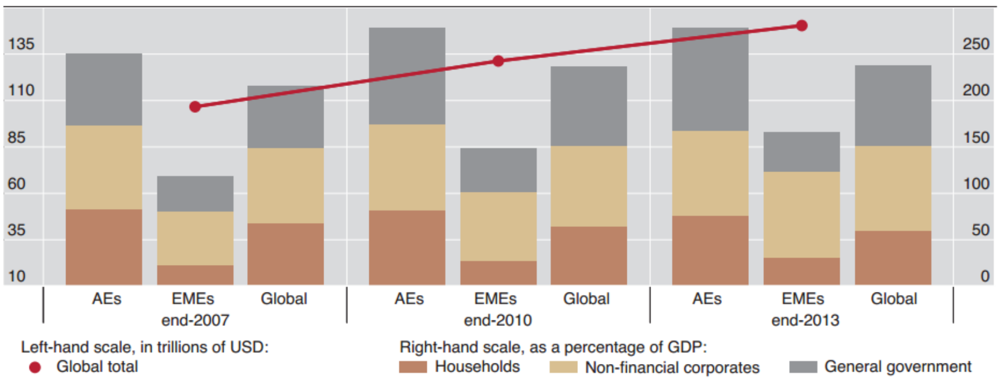
BANK FOR INTERNATIONAL SETTLEMENTS

Of even greater concern to central banks will be the BIS' warning that, by failing to focus on the financial cycle, there is a danger that too many monetary policy resources have now been misguidedly directed at short-term targets. This means that central banks will be unable to act if an ordinary recession arrives. In such circumstances central bankers will at some point realise that they have simply made matters worse:

"Thus, when policy responses fail to take a long-term perspective, they run the risk of addressing the immediate problem at the cost of creating a bigger one down the road.

Debt accumulation over successive business and financial cycles becomes the decisive factor".

"G7 countries' combined public sector debt has increased to an average of 120% of GDP."



The global sample of countries includes: Argentina, Australia, Brazil, Canada, China, the Czech Republic, the euro area, Hong Kong SAR, Hungary, India, Indonesia, Japan, Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Turkey, the United Kingdom and the United States. AEs = advanced economies; EMEs = emerging market economies.

Sources: IMF; national data; BIS estimates.

(infographic: BIS 84th Annual Report , p10)

FINANCIAL MARKETS

... Fragile banks, persistent imbalances (cont'd from p1)

why highly leveraged banks have been able to raise new equity instruments and why heavily indebted countries such as Greece have been able to borrow at yields as low as 4.5%.

And it is perhaps in the area of debt / equity hybrid investment opportunities where the financial imbalances of which BIS warns can most glaringly be seen. In the first half of 2014 one of the most noteworthy transactions was a $2bn convertible bond issue for US electric car specialist TESLA.

Convertible bonds are popular with small, fast growing but moderate credit quality borrowers. The bonds carry fixed coupons that are below the market interest rate, but confer upon investors an option to convert into shares at a pre-specified premium above the share price.

Bond. Convertible bond.

Convertible bonds are popular with small, fast growing but moderate credit quality borrowers. The bonds carry fixed coupons that are below the market interest rate for the borrower's conventional debt, but the bonds confer upon investors an option to convert into shares at a pre-specified premium above the share price on the date of issue. The appeal to the borrower's shareholders is the cash saving afforded by the lower coupon, and, if indeed the share price rises past the conversion trigger, the benefit of the debt disappearing when the bonds convert to equity. The dilution of incumbent equity holders is an acceptable price of these benefits.

For investors, the convertible coupon is regarded as attractive enough despite the discount to conventional debt returns, and because conversion is the bondholder's option, the structure ensures that bondholders have a prior ranking claim to their coupons *qua* debt holders, should the borrower's underlying business run into problems.

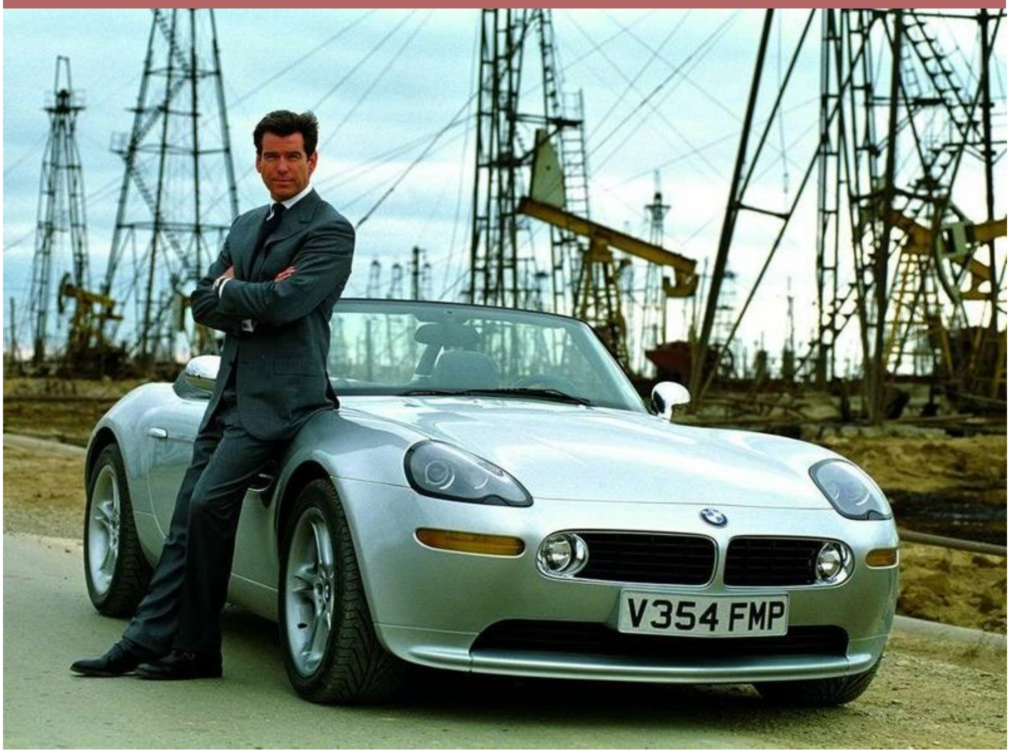
The TESLA terms were as follows. Bond maturity 2021 (7 years); coupon 1.25% (longest tranche); conversion premium 42%. The coupon of 1.25% was about half the US Government's cost of borrowing for the same 7 year maturity. Assuming no dividend, if the shares trade at, say, $100 today, no investor will convert until the market price reaches the conversion price of $142. Because the lion's share of market expectations of future growth is in today's share price anyway, these terms imply that the breakeven point at which it would be preferable to hold the bond rather than the stock would be about 33 years: (33 x 1.25 = 41.25), i.e. 26 years later than the 7 year maturity of the bond. Obviously, many investors believe that the shares will increase by more than 42% over 7 years. But those who hold that view strongly would surely own the shares and prefer the chance of the first 42% rise in price against the certain interest income of 8 ¾ %. The convertible appeals to those who think the shares may rise strongly (to above the $142 strike price) but are willing to give up the possible gain (from $100 - $142) in return for a modest income stream and protection against capital losses should the shares fall in price. Yet, if the low "B" rating (several notches into junk territory) is correct, the protection is actually weak, and the probability of bondholder losses cannot be ignored if the shares fall owing to poor business outlook.

Just as policymakers, commentators and students today struggle to explain why so much money poured into sub-prime mortgage loan investments at such slender contractual returns, at some not too distant future point we may look back and discuss this TESLA issue in similar vein..

High grade	AAA	Very high quality (+ gov't securities)	
	AA		
	A	High quality investment grade	
	BBB		
Junk	BB	Medium quality sub-investment	
	B		
	CCC	Low quality sub-investment	
	CC		

Just as policymakers, commentators and students today struggle to explain why, in the years leading up to the 2007 crash, so much money poured into sub-prime mortgage loan investments at such slender contractual returns, at some not too distant future point we may look back and discuss this TESLA issue in similar vein.

CAN CONVERTIBLE BOND CHARGE UP THE TESLA MACHINE?



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