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Financial & Fiscal Features Newsletter

Fiscal Competition & Economic Freedom

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

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Low interest rates contribute to weak labour markets

by Gordon Kerr and John Butler, with Enrico Colombatto

A new measure of Unemployment and Labour Market Conditions gains support at the Annual Jackson Hole Conference. Doubts continue about European QE as near -zero interest rates may actually be preventing employment from picking up.

In the latter part of August, the cream of the world's central bankers convened at the annual Kansas City Fed gathering at Jackson Hole, Wyoming. Every year the Conference has a theme. Last year's was "Quantitative Easing (QE): when and how it would end." This year's topic was unemployment, under the rather grandiose title "Re-Evaluating Labour Market Dynamics".

Ms Yellen, chair of the Federal Reserve, seemed at last to acknowledge one of this Newsletter's recurring concerns; namely, that official unemployment data mislead because they ignore the number of citizens so disaffected with prospects that they no longer register as looking for work. She is warming towards a new Fed Board-developed Labour Market Conditions Index (LMCI), which takes account of workforce participation rates and various other measures. She considers LMCI a better indicator of employment market strength or weakness than the raw unemployment percentage. By the new measure, unemployment is still substantially

(continued on next page)

Concerns about Repo Market Disruptions

by Gordon Kerr and John Butler, with Enrico Colombatto

The Repo market is becoming less attractive due to new Leverage Ratio rules. Doubts remain as to whether this can prevent reoccurrence of credit seizing up should insolvency worries reappear in the financial sector.

In August, concerns were reported that the US repo market, one of the largest engines of liquidity in global capital markets, was experiencing disruptions to its otherwise smooth functioning owing to a reduction in repo activity by banks. Banks explained this by citing increased capital costs under the recently introduced Leverage Ratio (see our February Newsletter).

Before considering this further, since repo transactions can be confusing, let us set out an example. A repo counterparty is an investor who might hold a 5-year US Treasury bond, and enters into a contract with, say, a bank to sell and buy back the bond, usually on a very short-term basis. The sale and repurchase price are pre-agreed, and the differential constitutes the return to the provider of cash. Banks have been encouraged to play the role of repo cash provider (otherwise known as Reverse repo Counterparty) as the market for derivatives, particularly interest rate

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CENTRAL BANKS

... Low interest rate, weak labour markets (cont'd from p1)

above the pre-crisis level. Accordingly, Ms Yellen remains concerned about the present strength of the US recovery:

"the recent behavior of both nominal and real wages point to weaker labor market conditions than would be indicated by the current unemployment rate";

Nonetheless, she indicated that interest rates would rise if future, stronger than expected, labour market data were reported.

Similar concerns are now paramount among UK central bankers. The Bank of England now overtly links its 'forward guidance' about the timing of interest rate increases to evidence of growth in wage levels.

The ECB's President Mario Draghi had absorbed the summer's deterioration in European data suggesting that another slowdown is underway. Only this time, it is impacting primarily the core, France and Italy, and even Germany. Its Finance Minister Schäuble recently said that 'the ECB have already done enough' so Germany is firmly against more stimulus at this stage.

President Draghi's speech put labour market worries at the forefront of Europe's problems. In Europe there was a second surge in unemployment 3 years after the financial crisis. From early 2011, when it became apparent that a number of countries would, without bailouts, default or renege on sovereign debt, heavy job losses drove up the Eurozone average to levels that have only recently topped out. Draghi took the opportunity of the profile of this occasion once again to express doubts whether unleashing QE in the Eurozone would make any difference to labour market conditions, because national governments have failed to implement substantive structural reforms.

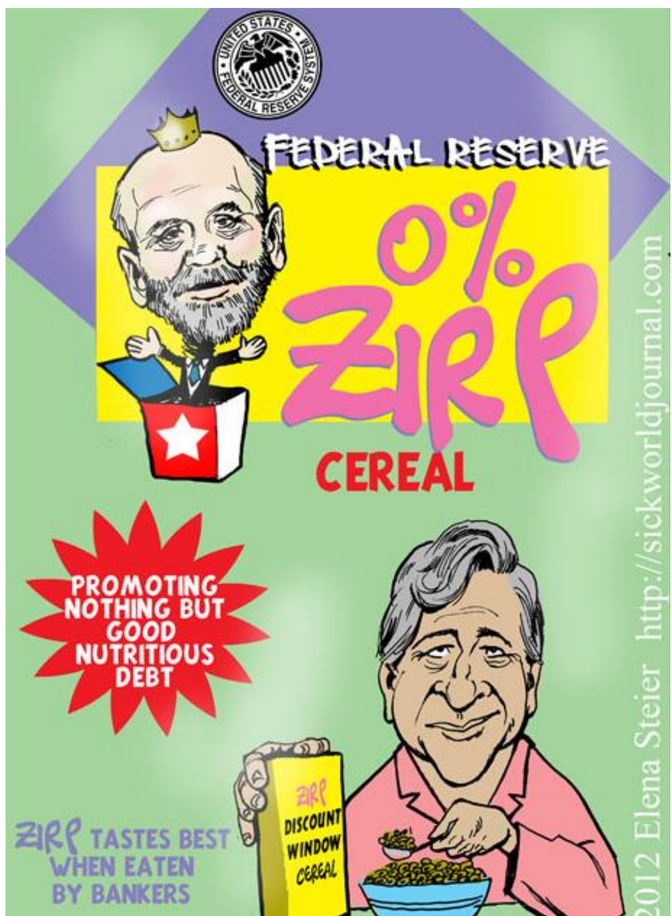
Like a physical trainer addressing a group of failed slimmers after 3 years of group therapy, he berated that he has done all he could do in the group sessions, those dissatisfied with their progress should look to themselves.

Although these presentations reveal doubts among leading central bankers that near zero interest rate policies (ZIRP) may not result in economic stimulus, there is still a gulf between these doubts and the scepticism about ZIRP policies, doubts that have been strongly expressed by the Bank for International Settlements (see our July Newsletter).

An even stronger counter-view is beginning to gather mainstream support; namely, that ZIRP is a primary cause of the continuing weak labour market conditions. The reasoning is as follows. By reducing the cost of borrowing money substantially below its 'market' level, capital goods for businesses have become disproportionately cheap compared with the cost of employing people. When weighing up the cost/ benefit of, say, installing a machine to sell tickets in train stations compared with employing staff to do the same job, low interest rates reduce the cost of the machine option. Businessmen make such decisions using discounted cash flow analysis, whereby future costs are assessed a present value using average market interest rates over the term. So ZIRP has a double whammy effect; not only is the borrowing cost of the machine lower, but by applying a discount rate of close to zero to the employee option, the present value cost of the stream of wages is increased. This may go some way towards explaining the trend of low to moderate-income jobs being replaced by machines in areas such as supermarket checkout services as well as transport ticketing.

> *Capital goods for businesses have become disproportionately cheap compared with the cost of employing people.*

This is a classic "misallocation" as–per Austrian economics. It follows that, when rates rise, firms will find their overall operations burdened by excessive (now expensive) capital equipment. What they will then want are more productive employees. However, the lack of skilled workers – those out of the labour force for several years tend to be less productive – will make competition for skilled labour intense, wage pressures will rise, and the combination of excess capital capacity and rising wage pressures will intensify the stagflation we have already seen to date (see our July Newsletter).



... Repo market disruptions (cont'd from p1)

swaps (IRS), has grown.
Banks have been lured to the repo market by the modest net interest income generated by being the repo cash provider against very low credit risk, and also because repos provide a steady source of government bonds that are useful for other hedging activities of the bank itself.
So why are they now pulling back? Even though the Basel Capital weighting applied to banks' holdings of non-defaulted government bonds is zero, such holdings are indeed caught by the Leverage Ratio. Therefore, there will be a cost from the new rule's effective date of 1 January 2015.
But is the pullback entirely attributable to new regulations, as claimed in the mainstream press? We are not so sure. There also appears to be a shortage of available collateral (Treasury bonds) in the maturities most popular with market participants. Perhaps this results from the Federal Reserve's mopping up of so much of the US Treasury security market via its QE programme. Therefore, banks providing cash into the transaction now face the prospect of losing money, should the price of the underlying scarce security (e.g. a 5-year US Treasury) keep rising. In these circumstances, it is hardly surprising that banks would prefer to deposit their cash with the Federal Reserve at a better rate of return and without the negative Leverage ratio consequences.

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Under normal market conditions, repo provides a cheap and easy way to releverage an asset. If the trend described in the previous paragraph persists, does it presage the start of wholesale reductions in systemic leverage? We doubt it. The thrust of 'legal' financial innovation, especially since the outbreak of the crisis, has been for banks to find new ways of leverage through collateral transformation, swapping collateral with each other in ways that either slip by, or are tacitly approved by regulators. One such example is asset rehypothecation, which we discussed in our January Newsletter.
Finally, is this repo market disruption an 'unintended consequence' of the new Leverage Ratio regulations? The prevailing view appears to be negative. A small number of senior US Reserve bank governors have long memories of the 2008 crisis, and fear a recurrence of the repo market seizure. Sceptics may take the view that those bank governors are overly focussed on the symptoms of that crisis rather than on its cause. As has been amply documented, at the peak of the crisis (before any talk of bailouts), repo and other markets froze up because a number of insolvent counterparties reneged on obligations to deliver cash or collateral, triggering a collapse in confidence upon which these interbank markets rely. Shrinking the repo market will not prevent a recurrence of system wide crisis when such insolvency worries resurface.

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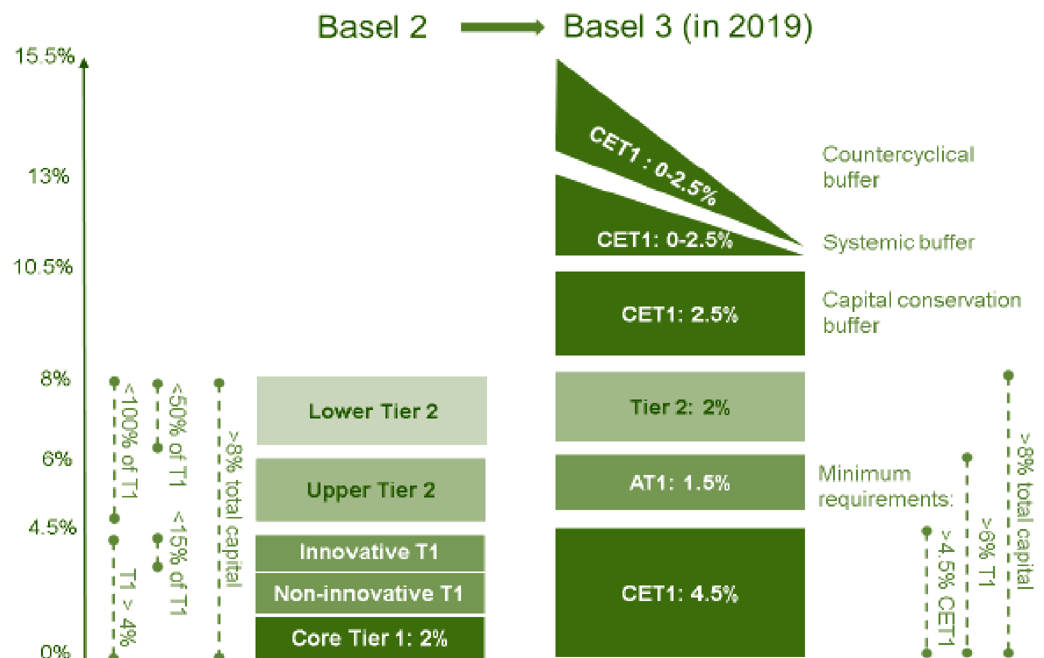
(Infographic: Citi Research)



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