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Financial & Fiscal Features Newsletter

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In this issue:

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Further Volatility and Weakness in Financial Markets

by Gordon Kerr and John Butler, with Enrico Colombatto

Despite abundant and increasing evidence of loose monetary policies being the cause of emerging market economies moving from boom to bust, there are none so blind as those who refuse to see.

In our September's NL, we pointed out that market developments have begun to validate our repeated warnings that loose monetary policies have not only achieved none of their stated goals, they have caused damage. At first, they inflated a bubble in bonds and 'fixed' asset prices such as houses and commodities. The latter one has popped. The precipitous drops in the exchange rates of a raft of emerging market currencies against the US dollar, we stated in September, are a result of the declining demand in developed economies for the commodity-based exports of the emerging ones. Since its publication, mainstream financial media have reported a slew of news clearly support-

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Central Banks – Digging Deeper and Deeper into a Cashless Hole

by Gordon Kerr and John Butler, with Enrico Colombatto

Central Bankers want to abolish cash in order to be able to set substantially negative interest rates.

Despite the failure of the press to criticise their policies, leading central bankers know that loose money policies have failed. The Bank of England's (B of E's) Andrew Haldane, when asked by a UK Parliamentary scrutiny committee in June 2013 what he thought was the greatest risk to financial stability, bravely stated:

> *"Let's be clear. We've intentionally blown the biggest government bond bubble in history."*

He was immediately rebuked and stripped of his post as Head of Financial Stability. On September 18th, now as merely the B of E's Chief Economist, he performed a U-turn and hit the media headlines by announcing his membership of a growing chorus of global financial luminaries who see 'the solution to the crisis' as a combination of negative interest rates and the abolition of cash.

Since Harvard economist Ken Rogoff published a paper to this end in April 2014, the cause has been taken up by Citibank chief economist Willem Buiter, Nobel laureate

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FINANCIAL MARKETS

(cont'd) Volatility and Weakness...

ive of our conclusion, and yet much of the media merely engages in intellectual gymnastics to present this as consistent with their mantra: A global economic recovery is lurking just around the corner if central bankers can only stay the course.

To start with, the Federal Reserve blinked and did not raise interest rates. Then, during the last week of September, the MSCI basket of emerging market currencies registered another sharp fall. Remarkably, the Wall Street Journal cited, as a major reason for this softening, the fact that the US Department of Commerce had (the previous Friday) revised upwards to 3.9% its figure for US second quarter growth. Have the mainstream media now concocted a view of the world economy as one in which Malaysia is competing for market share with the US? The US is doing better, so is it hard luck for Malaysia?

Have the mainstream media now concocted a view of the world economy as one in which Malaysia is competing for market share with the US? The US is doing better, so is it hard luck for Malaysia?

In April we observed signs of liquidity drying up in the secondary US bond markets. We explained that this was an entirely predictable consequence of the combination of the Federal Reserve's QE programme and the lack of genuine economic recovery. A true recovery would naturally be accompanied by a surge in new issuance of corporate bonds. All that has happened over the last couple of years is that banks and financial intermediaries with access to the Fed's "repo" operations have bought whatever qualifying corporate bonds were liquid (available) at market prices, then sold them on to the Fed at par to bank the profit. The *Financial Times* also spotted the reducing level of bond market liquidity, but rather than see it as eerily reminiscent of what occurred in the last few months leading up to the 2008 complete failure of financial markets, they put a positive spin on it. They published an article, written by a senior executive of PIMCO, which praised new bank regulations as bringing about better capitalised banks who have been, thanks to new regulations, disincentivised to trade bonds. This reduction in bank bond market activity has resulted in less liquidity, so the markets are safer and the only concern will be modest increases in borrowing costs for issuers. Readers please be warned; expect this line to be repeated all the way to the next major event – the higher spreads may rise, the safer and more secure the financial markets will be becoming, or so we will be told.

Expect this line about safer markets to be repeated all the way to the next major event – the higher spreads may rise, the safer and more secure the financial markets will be becoming, or so we will be told.

But at least some mainstream media expressed worries about developments in the US corporate bond market at the end of September. Investment grade corporate bond spreads over US Treasuries widened to 1.62%, up from 1.31% at the end of 2014 and 1.14% at the end of 2013, when confidence in the recovery story was strongest. For junk bonds the spread widening is greater – spreads averaged 3.82% at the end of 2013 but had widened to 5.88% at the end of September.

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(cont'd) Digging Deeper and Deeper...

CENTRAL BANKS

Paul Krugman and Peter Bofinger, a member of the German Council of Economic Experts.

Readers are urged to take the possibility of cash abolition very seriously. A number of governments are already explicitly seeking this outcome. Denmark has unveiled plans to allow petrol stations, shops and restaurants to refuse cash and insist on electronic payments.

Many countries have lowered the maximum permitted limit on cash transactions. France used the Charlie Hebdo atrocities earlier this year as a pretext to reduce its limit for cash transactions from €3,000 to €1,000, be-

cause the terrorists were partly financed with cash.

The arguments in favour of this are fairly obvious. After nearly 7 years of LIRP (low interest rate policy) and ZIRP, (zero…), which failed to stimulate economic recoveries, surely it is obvious that we need to do more? Therefore, let's have some NIRP (negative…). Mainstream commentators have been seduced into accepting NIRP as a natural progression because banks in some countries have successfully 'flirted' with negative rates, but only at very modest levels. For example, in January an array of Swiss banks introduced charges (negative interest rates) of about 0.7% per annum on deposit balances of above €100k.

John Butler has written about the potentially negative, unintended consequences of negative interest rates in a report from 2012, citing research from the New York Federal Reserve on the topic. He describes the tendency toward NIRP to be an indication of 'pathology'. Indeed, smart central bankers know that there is a point at which depositors will resist NIRP. Should rates go to, say, -5% then companies offering a safe-deposit cash box service will probably spring up charging only 4% on large balances. Banks will then overtly fail (despite liquidity lines etc.) because customers' demands to withdraw large deposits will be tantamount to bank runs which, given the degree of present bank leverage and the mismatching (timewise) of assets and liabilities, banks will be unable to honour.

Therefore, central bankers know that they can only

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METAMORPHOSIS OF A BofE HIGH OFFICIAL

CENTRAL BANKS

(cont'd) Digging ...

really implement NIRP if cash is abolished.

However, as Kevin Dowd explains in his latest paper, not only is NIRP nonsense in macroeconomic terms, but the broader social and economic consequences of the abolition of cash are, frankly, terrifying. If enacted, such policy would have a grave and disarming impact on poverty, destitution, property rights, civil liberties, and will fundamentally affect the relationship between the individual and the state.

If enacted, negative interest rates policy would have a grave and disarming impact on poverty, destitution, property rights, civil liberties, and will fundamentally affect the relationship between the individual and the state.

But at the most preliminary of levels, why would any sane central bank experiment with NIRP? US data shows that recovery is by no means a sure thing. Real GDP per capita rose only from $49.5k in 2007:Q4 to $50.9k in 2015:Q2. The number of employed males aged 25-54, compared to the total number of males, fell from 87.3% in 2007:Q4 to 84% in 2014:Q4. Such data attest to the failure of LIRP and ZIRP, and imply that NIRP is a last, putative, desperate roll of the dice exposing its promoters to Einstein's definition of insanity – repeating the same action in the hope of a different result.

In the real practical world, the absence of cash would push many poor and destitute over the edge. A world without cash assumes everybody would have the requisite digital technology and skills required to operate it. It assumes the digital system works without failure, when the evidence of systemic failure under pressure abounds. And for the really poor it would be bad news. Think of beggars on the street. You might throw them a dollar or euro when passing, but how many besuited, kind souls will stop for long enough at a train station to get out a mobile and ask the beggar for his electronic details in order to transmit that euro? We should not need to focus on the vulnerable. The policymakers behind these initiatives are crossing the line from intellectual dishonesty to Orwellian totalitarianism. NIRP will pressurize everyone to maximise short-term consumption and forget about long term savings. We should eat, drink and be merry. For central banks to be championing this kind of policy shows how bereft their thinking and actions to date have truly been.

Perhaps the most welcome consequence of such high profile, pro-loosening, economic experts calling for the banning of cash is that they might actually be hitting the self-destruct button. As Alistair McLeod of GoldMoney writes:

"*NIRP makes the hidden tax of monetary inflation, of which the public is generally unaware, suddenly very visible. Already ZIRP has created enormous unfounded pension liabilities…but how do you value pensions with NIRP? Anyone with savings, which is the majority of consumers, is due for a very rude awakening.*"

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