Overdose: The Corrupting Effects of Easy Money

Paper by Johan Norberg, prepared for the XII. International Gottfried von Haberler Conference, Vaduz, May 20, 2016

Abstract

Since the financial crisis, central banks all over the world have tried to stimulate the economy by flooding markets with easy money. Ironically, financial crises is often the result of easy money as they make people take bigger risks and move into more exotic investments to get some return on their money. The US housing bubble and the euro crisis – that we are currently trying to recover from – was to a large degree the result of easy money. The risk is that we are right now building up the same kinds of bad investments and bubbles, which will result in another crisis.

Introduction

Since the beginning of the Great Recession, central banks all over the world have tried to stimulate the economy by supplying the world with easy money. This stimulus has been unprecedented with negative interest rates and quantitative easing. Since 2008, the world's major central banks have flooded the market with cash and expanded balance sheets by around $10 trillion.

Interest rates are lower than they have ever been. When Andrew Haldane of Bank of England said this a couple of years ago, a colleague challenged him: "How do you know they weren't lower in Babylonian times?" So Haldane asked a team of research assistants to look at the long-term, and the conclusion was that interest rates have not been this low for at least 5,000 years.[1]

And they are also much lower than in recent decades. Interest minus inflation was on average 5 percent during the 1980s, 4 percent during the 1990s, and 2 percent under the early 2000s. Now they are zero or lower. We are in the middle of an unprecedented experiment with the most important price in the economy, and it is implemented and sustained by government institutions for political reasons.

We are drowning in cheap money, and everybody make use of it. Since the financial crisis of 2008, supposedly a time of deleveraging, total credit to the private non-financial sector has *increased* from 226 to 270 percent of GDP in the euro area and from 230 to 248 in the US.[2]

But easy money changes behavior, it punishes savers and rewards borrowers, it creates bubbles in certain assets and make investors take bigger risks in order to get any returns. The irony is that the financial crises that we are trying to recover from with easy money – the US housing bubble and the euro crisis – was to large degree a result of the corrupting effects of cheap money.

[1] Andrew G Haldane, "Stuck", Speech at Open University, Milton Keynes, 30 June 2015.
[2] Bank for International Settlements.

Artificial booms

The role of central banks is often described as taking away the punch bowl just as the party is starting to get going. As soon as investors and markets grow too happy, central banks must hold back – only what they must keep down is not blood-alcohol content but inflation levels. Theirs is an important task because governments are invariably tempted to finance their spending by printing more money.

The printing press may look less intimidating than the taxman, but in reality it is worse. Creating more money not only entails an indirect tax in that it reduces the value of citizens' savings but also, and more importantly, undermines the price system by giving businesses incorrect information about demand. The additional money created does not end up everywhere at the same time but percolates into the economy in certain places where it leads to price increases, which businesses interpret as an increase in demand, causing them to hire more people and step up production. Only after a while do businesses realize that the prices of everything else have also risen and that their costs are increasing even though they are not selling any more than their competitors. In fact, the price increase did not indicate an increase in demand, only a deterioration in the value of money. As a consequence of these incorrect market messages, resources have thus been brought to places where they should not have ended up, meaning that the businesses now have to cut down on production and lay off people.

It is important to get the printing press under control, but that is not quite what central banks do. Instead they aim to control price increases. Their formal objective is a steady increase in consumer prices, often at around 2 percent per year, or something along those lines. The Austrian economists Ludwig von Mises and Friedrich Hayek identified a problem inherent in such a policy. In a dynamic economy with constant innovation in technology and business models, the prices of goods and services often decrease. Let's assume that the real underlying cost of all goods and services falls by 2 percent owing to increased efficiency, but that this development is counteracted by an increase in the money supply so that the price tags in stores actually indicate a price increase of 1 percent. In this situation, the central bank is likely to grab hold of the wrong end of the stick by concluding that there is no inflation worth mentioning, and this will prompt it to cut interest rates.

But if interest rates are too low it no longer pays to save, meaning that there will be an increase in consumption – for example of homes, which are not included in our inflation indexes. Companies will want to borrow more to make bigger investments, in parts of the economy that would never have been given a boost without the increase in the money supply. This means that the stabilization of consumer prices may give rise to various asset bubbles.

James Grant, publisher of the financial newsletter *Grant's Interest Rate Observer*, notes that the price of a basket of goods exposed to international competition had fallen by 31 percent in the 20 years to 1886, before the United States had a central bank. Since the 1990s the country has experienced another period of technology breakthroughs and strong competition that should have pushed prices down. Indeed, cheaper imports from Asia and enhanced efficiency in U.S. corporations, for instance the new logistics of Wal-Mart, did cause prices to fall. This made the central banks believe that there was no actual inflation and that there was thus no need for them to hold back. But there was inflation. It just did not show up in the consumer-price index, but in real estate and on the stock market. Grant, who warned of the real-estate bubble as far back as 2001, points out that "falling prices are a natural byproduct of human ingenuity. Print money to resist the decline, and the next thing you know, there's a bubble."[3]

The combination of low interest rates and high growth creates a sense of security, and this is when you start doing dangerous things. Especially when you know that the whole system is propped up by the government and that banks and markets have an implicit government guarantee. Suddenly everything seems like a lucrative investment, and that is the moment you start making lousy investments. If things look too good, you start doing things that will make them worse.

As Ludwig von Mises warned in 1944:

> "True, governments can reduce the rate of interest in the short run. They can issue additional paper money. They can open the way to credit expansion by the banks. They can thus create an artificial boom and the appearance of prosperity. But such a boom is bound to collapse sooner or later and to bring about a depression."[4]

Pre-emptive Keynesianism

In a speech on December 19, 2002, Fed chairman Alan Greenspan said that central banks could not possibly tell a bubble from a non-bubble while it was expanding. What they were capable of, however, was "dealing aggressively with the aftermath of a bubble," for instance by pumping liquidity into markets, a policy he had pursued since Black Monday 1987.[5]

In a sense, this is the opposite of the usual job description for central banks. It means that the Fed does not take away the punch bowl when the party takes off. Instead it treats the guests to its own bowl, filled to the brim with cheap credit, and it does not cut the supply until consumer prices start to show signs of being under the influence. But if this puts a damper on the atmosphere, the Fed immediately announces an afterparty and brings out even larger bowls to avoid losing momentum. In the market, this policy has been dubbed the "Greenspan put." Buying a "put" option means that you agree to sell something in the future at a predetermined price – if there is a crisis, Mr. Greenspan will make sure that your investments still fetch a reasonable price, as if you had bought such an option.

In each individual case, at the time of each crisis, it does seem necessary to stabilize financial markets and rebuild confidence. The alternative could be a recession, widespread manufacturing bankruptcies, and high unemployment. Politicians, voters, and the media all demand rapid action to minimize all problems. At the same time, however, each time there is a rescue operation, the risk of a new crisis increases. If somebody puts up a safety net, more and more people will try ever-more advanced acrobatics; if the Fed always steps in to cure hangovers, people will be boozing uncontrollably. Mr. Greenspan and his successor Ben Bernanke both said it straight

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[3] James Grant, *Mr. Market Miscalculates: The Bubble Years and Beyond*. Mount Jackson,VA: Axios Press, 2008, page 122ff.

[4] Ludwig von Mises, O*mnipotent Government: The Rise of the Total State and Total War*. Spring Mills, PA: Libertarian Press, 1985. First published 1944, p. 262.

[5] Alan Greenspan, "Remarks at the Economic Club of New York", New York City, December 19, 2002.

out: the Fed will never do anything to reduce the value of stocks or homes, but if prices start plummeting it will step in and tidy everything up.

In late 2000, Ed Yardeni, the chief investment officer of Deutsche Bank Securities, said he was not worried there would be a deep crisis after the Dotcom Crash: “I am less concerned because I believe that the Fed is our friend.”[6] Mr. Yardeni was right. His friend was there to support him, and that strengthened the conviction of investors that they did not have to assume full responsibility themselves.

The financial strategist George Cooper, who wants to rehabilitate a Keynesian analysis of the financial market, sees similarities between the interventionist economist John Maynard Keynes’s desire to stimulate demand in times of crisis and the behavior of the serial rate-cutters at the Fed – interestingly, however, he thinks the latter are more Catholic than the Pope in this respect. Keynes believed that an economy should be stimulated to escape from a deep depression. The Fed and the politicians of today have systematically stimulated the economy to keep it from ending up in a recession in the first place. This is what Mr. Cooper terms “preemptive Keynesianism.” The difference is subtle but important.

Recessions send important messages to market players, telling them that their investments have failed and that they have borrowed too much. This forces them to give up bad projects and get out of bad investment positions, moving the money to more productive parts of the economy. If the central bank and politicians step in every time to save the economy, this will lull borrowers and lenders into a false sense of security which will make them take ever-greater risks. They will be pushing a growing mountain of debt in front of them, and eventually the stimuli will not be large enough to prevent a collapse.[7]

Many have spoken admiringly of how Mr. Greenspan would sit in his bathtub perusing statistics of manufacturing, inventories, and trade to understand what was going on in the economy so that he could determine the appropriate price of money. After ten years at the Fed, Mr. Greenspan had doubled the number of data series monitored by his institution to over 14,000, including a complex system to monitor inventories that his colleagues joked only their boss understood. This enabled him to spot economic shifts long before anyone else and quickly change the direction of monetary policy.

This adulation is an expression of the dream of the planned economy – the idea that an enlightened man in a bathtub understands the market better than all of the millions of market players and that he will be able to use his insights to steer them in the right direction.

The US housing bubble

After the end of the dot-com boom and the terrorist attacks of September 11, 2001, Alan Greenspan got a chance to prove his ideas. The Federal Reserve responded aggressively. At the beginning of 2001, the Fed funds rate was 6.25 percent; at the end of the year, it was 1.75 percent. In June 2003, it was reduced to 1 percent.

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[6] Peronet Despeignes, “‘Greenspan Put’ May Be Encouraging Complacency.’’ *Financial Times*, December 8, 2000.

[7] George Cooper, *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy*. New York: Vintage Books, 2008

But there was in fact no collapsing economy in need of being propped up. Only two months after 9/11, the stock exchange was back at a higher level; and in 2002, the United States saw economic growth of 1.6 percent. Fed chairman Alan Greenspan has admitted that at least the last rate cut, was not necessary:

> "We agreed on the reduction despite our consensus that the economy probably did not need yet another rate cut. The stock market had finally begun to revive, and our forecasts called for much stronger GDP growth in the year's second half. Yet we went ahead on the basis of a balancing of risk. We wanted to shut down the possibility of corrosive deflation; we were willing to chance that by cutting rates we might foster a bubble, *an inflationary boom of some sort, which we would subsequently have to address.*"[8] [my emphasis]

One percent was the lowest the rate had been in half a century, and in August the Fed promised it would remain at that level "for a considerable period." In December, promises were again made about very low interest rates for a long time to come. The Fed ended up keeping its benchmark rate as low as 1 percent for a full year; and once it finally began edging it upward, it did so in tiny, cautious steps even though the wheels of the economy were by then turning very fast. Only in June 2004 did the Fed funds rate reach 1.25 percent, and it took almost two more years to attain 5 percent.

As Mr. Greenspan admitted, the Fed took a conscious risk, and the result did indeed turn out to be an inflationary bubble of some sort. It is true that people were not keen on general consumption as unemployment was rising at the time, and they had just gotten their fingers burned on the stockmarket – but if you pump new money into the economy, it will always end up somewhere or other. This time it went into real estate, spurred on by also by mortgage deductions, guarantees from government-subsidized enterprises like Fannie Mae and Freddie Mac and government requirements for banks to lend to poorer consumers.

The overall effect of easy money for borrowers was that, over a period of two and a half years, inflation reduced the value of their loans by more than the total cost of interest. In other words, borrowing was not just free – you were actually paid to borrow.[9]

As far back as August 2001, James Grant noted with concern that U.S. home prices had increased by 8.8 percent over the past year even though the Dotcom bubble had burst and the economy was virtually in recession. "What could explain a bull market in a non-earning asset in a non-inflationary era?" he wondered – replying himself that the reason was simply that credit was too easily available at too low interest, and that we did not realize there was hidden inflation in the background.[10]

It is hardly surprising, then, that further rate cuts stoked the fire. The economist Robert Samuelson suddenly discovered that his wife understood the housing market vastly better than he did. Houses in their neighborhood were being sold for one-fourth more than he thought they were worth, but his wife was not in the least surprised.

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[8] Alan Greenspan, *The Age of Turbulence: Adventures in a New World*. New York: Penguin Books, 2008, p. 228.
[9] Lawrence H. White, ''How Did We Get into This Financial Mess?'' Cato Institute Briefing Paper no. 110, November 18, 2008, p. 3.
[10] James Grant, *Mr. Market Miscalculates: The Bubble Years and Beyond*. Mount Jackson,VA: Axios Press, 2008, page 129.

Americans had started exploiting the low interest rates to take out new and bigger loans. My home was no longer my castle, but my ATM. Since homes were suddenly worth more, their owners could go back to the bank and borrow even more money against the same collateral. In the past, most people used to take out loans that they would actually pay off on, but now more and more borrowers were obtaining loan agreements under which they would only have to pay interest or at least would not have to pay back any of the principal until after a decade or so.[11]

Between 2000 and 2005 the value of U.S. single-family homes increased by $8,000 billion. A financial worker living outside Atlanta, Georgia, was pleasantly surprised to realize that he could buy his dream home even though he was unable to sell his old home as it was being renovated. He simply took out an interest-only mortgage at the end of 2001 and became the owner of two homes. One year earlier he would have had to pay around 7 percent interest, but now the loan cost him only 2.8 percent. And that was before deductions. He felt as though he "was getting a house for free."[12]

An increasing share of U.S. home purchases were pure speculation. People bought, perhaps renovated a bit, and then sold quickly at prices that had risen in the meantime. Many started to earn a living from "flipping" real estate in this way. On June 23, 2005, the TLC television network first aired a reality series called *Property Ladder* where viewers get to follow a person or group who have the idea of buying a home, fixing it up, and then trying to sell it on more expensively. Three weeks later, the Discovery Home Channel started showing *Flip That House*, which is about someone who has just bought a house, often in south California, and does what it takes to sell it quickly at a good profit. And ten days after that, on July 24, 2005, the A&E Network premiered a new TV series with a not entirely dissimilar name, *Flip This House*, whose subject is a company based in Charleston, South Carolina, which is in the business of – wait for it – buying, fixing, and selling.

Investors also started hunting for risk. If you get no interest worth mentioning on bank deposits or safe bonds, you start looking for riskier investments that may give you a higher return. Often they invested in exotic securities tied to the real estate market – mortgage-backed securities and collateralized debt obligations that were often no more than regulatory arbitrage – they were built to get triple-AAA ratings and so resulted in smaller capital requirements than other investments.

And if the return was too small they did not mind borrowing a lot to make sure their tiny return would at least be multiplied many times over.

"Investors said, 'I don't want to be in equities anymore and I'm not getting any return in my bond positions,' " explains one financier:

> "Two things happened. They took more and more leverage, and they reached for riskier asset classes. Give me yield, give me leverage, give me return."[13]

It was a lot of fun while it lasted. But in the end, of course, interest rates climbed back, housing prices came down, and all those securities blew up and almost took the banking system with it.

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[11] Robert J. Samuelson, "The Boom in My Backyard", *Newsweek*, December 30, 2002

[12] James Grant, *Mr. Market Miscalculates: The Bubble Years and Beyond*. Mount Jackson,VA: Axios Press, 2008, p. 135.

[13] Gretchen Morgenson, "How the Thundering Herd Faltered and Fell", *New York Times*, November 8, 2008.

The euro crisis

Just like the Fed, the newly created European Central Bank implemented a loose monetary policy in the early 2000s, determined to counter the consumer price pressure from globalization and new technologies. But the euro in itself also contributed to a dramatic reduction in interest rates for most countries, because markets began to ignore differences between countries. They knew that someone would now bail out banks and governments if there were a problem: Germany.

Everybody knew that there was a moral hazard problem with the euro system. Therefore, it was necessary to implement restrictions on debt and deficits, so that governments did not use the guarantees to run up huge debts. This was the reason why the Stability and Growth Pact was created – so named because the Germans wanted to call it "Stability Pact" and the French wanted a "Growth Pact". According to this, no euro country could have a deficit over 3 percent of GDP or a public debt over 60 percent of GDP.

That political considerations were more important to eurozone politicians than those rules and principles was revealed immediately. Despite massaging all the numbers, 6 of 12 countries that adopted euro coins and notes in 2002 did not meet the pact's requirements. The year after, Germany and France broke both the debt and deficit rules, and blocked any punishment. After that, the pact was rendered meaningless.

Before the Euro system was created, investors usually kept one eye on the recent financial history of European governments. If they had a history of recklessness and defaults on debts, markets demanded higher interest rates to lend to them. The euro system changed this. Now they were all under the same credit umbrella, and so all governments could borrow liberally at a low rate.

Interest rates for governments started to converge in 1995, in anticipation of the new currency four years later. At that time, the yield on a Greek ten-year bond – the interest rate to borrow for ten years – was 18 percent, for Italy it was 12 percent, for Spain and Portugal it was 11 percent. That is a powerful incentive not to borrow too much. In 2005, the yields for all these countries were just below 4 percent, the same as Germany's. This was a triumph for the euro, boasted ECB president Jean Claude Trichet at the time. "Yields are driven by common news", he pointed out at a conference in New York, "and only a very small fraction can still be explained by local risk factors".[14]

As Herbert Spencer put it, the ultimate result of shielding men from the effects of folly, is to fill the world with fools, a corollary is that the ultimate effect of shielding men from the effects of local risk factors is to *fill the world with local risk factors*. During these years, many countries in southern Europe lost ground on the exports market, especially to Asian countries. These countries now had the choice of reforming to create real growth, or to borrow cheaply to keep the old system in place. It was a no-brainer. Citizens and governments borrowed – to consume, to expand the public sector, increase wages and start big infrastructure projects. Even though the interest rate on the public debt collapsed, the Euro zone as a whole registered a budget deficit every year, even in the most spectacular boom years.

Government expenditure increased by around 6 percent annually 1997-2007 in Spain,

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[14] Jean-Claude Trichet, "European Financial Integration and the Management of Inflation Expectations by the European Central Bank". Speech at the seminar "The Euro: One Currency, One Financial Market", New York, 19 April 2005.

Portugal and Greece. It increased by 4 percent annually in Italy – while the economy shrank. Most importantly, they rapidly increased unit labor costs, an important measure of competitiveness. In Italy, unit labor costs increased by 30 percent 1995-2007, by 40 percent in Spain and Ireland, 42 percent in Portugal and 61 percent in Greece.

This hurt their exports and growth, especially since the eurozone's most important economy, Germany, made labor market reforms and held its unit labor costs down during the same period. The countries with the largest increases in labor costs also got the largest current account deficits among EU countries – they bought more than they sold. It was paid for with loans, private and public. Between 2000 and 2010 Portugal increased its public debt from 49 to 93 percent, France from 57 to 82 percent, Italy from 109 to 118 and Greece from 103 to 145 percent.

The problem with socialism is that sooner or later you run out of other people's money, as Margaret Thatcher famously put it. This time, European governments ran out of their children's and their grand children's money. And if you spend resources that you don't have on things you don't need, then you are going to have to pay for it by giving up the things you need in the end.

The private sectors also borrowed like mad. When the ECB created one euro-wide short-term interest rate it was extremely low for rapidly growing countries like Spain and Ireland, and that inflated huge housing bubbles. The average Spanish mortgage rate had collapsed from 18 to around 5 percent after the introduction of the euro, and debt in proportion to income doubled for the average Spaniard between 1997 to 2006. At its peak, Spain built more than Germany, France and Italy combined.

When the bubbles crashed, so did the banks, and so did the governments. This balance-of-payment crisis could have been solved if prices and wages had been reduced to the levels of ten years ago, before they were inflated. That would have increased exports, reduced imports and attracted more capital from abroad. But regulated labor markets stopped costs from coming down rapidly in most crisis economies, except in Ireland and the Baltic countries. And bailouts reduced the pressure to reform those economies.

The bailout bubble

Easy money is a dangerous drug, and overdoses are common. It is one of the most important factors behind the crises we are now trying to recover from. And yet, governments and central banks are trying to help the recovery along by flooding the market with even more liquidity.

Interestingly, The Bank for International Settlements, the central banks' central bank, but without the power that also forces them to bow to political considerations, has warned about these risks for a long time. It says that low interest rates did not just contribute to previous booms and busts, but even today results in large-scale misallocation of capital that may plant the seeds of the next crisis.

In its 2015 report, BIS writes that easy money is not just a consequence of low growth, but also a cause:

> "Rather than just reflecting the current weakness, low rates may in part have contributed to it by fuelling costly financial booms and busts. The result is too much debt, too little growth and excessively low interest rates. In short, low

rates beget lower rates."[15]

Easy money can help market participants to regain their animal spirits, just like another drink can help you get back into party mood and postpone the hangover. But the mechanism by which that happens reveals the problem. It supplies struggling companies and governments with liquidity and helps them along, without the restructuring and reform they would have needed otherwise. This distorts the market, since a recession is a period when we discover that many business models do not work, so we must wind up operations that do not work and let capital and labor move to the areas that work better, so that they can start lifting the economy. Trying to keep everything afloat prolongs the pain.

It also distorts incentives, as it punishes safe income streams and encourages financial innovation. In emerging markets, it has resulted in a huge inflow of capital, which has fuelled unsustainable credit booms. In rich economies, the tiny return on capital has encouraged investors to take on more risk and leverage. They extend durations and they move into more exotic and risky securities. It has diminished banks' ability to profit from conservative money lending, and it has made it impossible for many pension funds and insurance companies to receive the income to match their liabilities. In the last few years, investment-grade spreads have narrowed faster and more than in previous cycles.

All of this makes our economic institutions more vulnerable to shocks. If sentiments change rapidly, capital flows could reverse quickly. People could scramble for the exit and higher-yielding assets can be dumped simultaneously. And what will happen to all those government bonds where people have parked their cash, despite minimal yield? Government bonds are more expensive than they have been in 5,000 years, and those governments are already deep in debt and have huge unfunded liabilities. If investors abandon those bonds in droves we might see a rapid interest rate rise that trigger losses in other places. What will central banks do then? It will be difficult to respond with even looser monetary policies.

We have tried to solve a crisis created by easy money and huge debts, with even cheaper money and even more debt. It's enough to remind you of a story in the satirical newspaper *The Onion,* on July 14, 2008:

> "A panel of top business leaders testified before Congress about the worsening recession Monday, demanding the government provide Americans with a new irresponsible and largely illusory economic bubble in which to invest.
> […] The manner of bubble isn't important—just as long as it creates a hugely overvalued market based on nothing more than whimsical fantasy and saddled with the potential for a long-term accrual of debts that will never be paid back, thereby unleashing a ripple effect that will take nearly a decade to correct."[16]

[15] The Bank for International Settlements, 85th Annual Report. Basel, 2015, p. 8

[16] "Recession-Plagued Nation Demands New Bubble To Invest In", *The Onion,* 14 July 2008.