With a Steady Hand

Essays on Long-Term Investing

Number 7

Repressive Easing

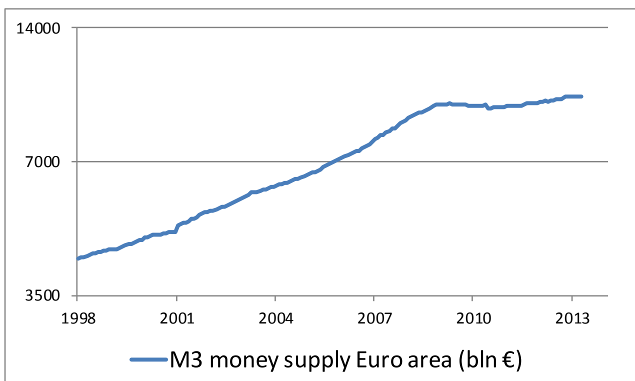
By Karl-Heinz Thielmann

Strange things are happening in the world: the central banks have been pumping money into their national economies without having any noticeable effect on the real economy. Harsh criticism has, however, come thick and fast from the majority of analysts, who claim that this policy has damaging consequences. They are moving from one negative scenario to the next - from visions of rampant inflation to a never-ending economic crisis. An odd coalition of central bank critics has formed, ranging from high-profile hedge fund managers to anti-globalisation activists. Ben Bernanke and Mario Draghi have been assigned the role of the villains and are now already being held responsible for future economic disasters.

But is the current "quantitative easing" monetary policy really so dangerous for the global economy? Economists and journalists mainly base their criticism of the allegedly negligent monetary policy on rapidly expanding central bank balance sheets, which seemingly have got out of hand. These are admittedly extremely inflated. The central banks have turned on the money pumps to their upper limit. But what is the real cause? Is it really the collective negligence of central bankers across the world?

Speed Read:

- "Quantitative easing" currently keeps interest rates low; "financial repression" is forcing capital markets to provide governments with funding.
- Both policies are connected and they are widely criticised for their negative effects. However, less attention is dedicated to potential alternatives and their consequences.
- The big industrial nations are caught in a debt trap. Tax increases or reductions in government spending are very unpopular, devaluing the debt through inflation would lead to economic disaster.
- At the moment, "repressive easing" seems to be the only politically enforceable way to deal with the problem of government debt, because at least it keeps the financing costs low.
- However, the reasons why "repressive easing" is accepted are a general misunderstanding of the economic character of public debt and a lack of thinking in opportunity costs by many investors.



Source European Central Bank.

Wrong - because they are actually only reacting to a very problematic trend. The circulation of money has become increasingly sluggish and monetary expansion has basically come to a standstill. The M3 money supply (i.e. the money supply in its broadest definition, which also includes money creation by banks), has hardly grown in the Euro area in recent years.

Is this monetary policy ultimately even restrictive? Also wrong - the quasi-stagnation of M3 reflects mainly one thing - helplessness. The increase in

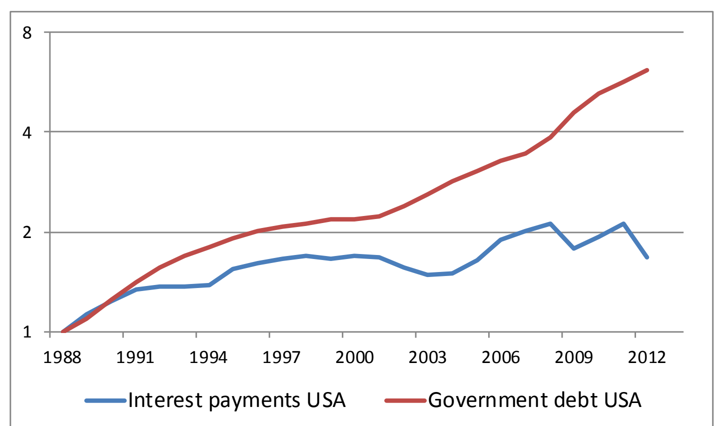
central bank money is trickling away and not resulting in credit expansion; it is failing to reach the economy. Instead, the capital markets have turned into a catch-basin for surplus money. In particular the market for "safe" government bonds has materialised as a black hole absorbing central bank liquidity. In spite of the extremely low interest rates, which are below the inflation rates, these securities are in high demand.

It is relatively irrelevant whether the central banks have drastically intervened in the market, as is the case in the USA and Great Britain, buying treasuries or gilts outright, or whether their intervention has been limited to the bonds of crisis states, as is the case for the ECB. One factor has been decisive for the run on government bonds: over the last decade, many private investors have been massively forced to mainly invest in securities with a minimal default risk. And of course the government securities of the major industrial nations fall into this category.

This process of “financial repression” started just over 10 years ago, when the stock crash after the bursting of the dotcom bubble resulted in severe losses among some institutional investors, including pension funds and life insurances. Financial regulators worldwide reached the conclusion that these investors should be forced to make relatively stable investments with a minimised price risk in the future. As a result, many of the major institutions started concentrating on first-class government bonds for their core investments, regardless of the yield.

And this was only the beginning. Since the financial crisis, the equity capital regulations for banks (Basel II, etc.) have turned out to be particularly treacherous; they prescribe a different risk weighting for their asset portfolios, which have to be secured with varying quotas of equity capital. And what does not require any backing by equity capital? Correct - banks can place their money in "risk-free" government bonds with a minimum rating of AA without tying up any capital. So why bother taking risks by incurring credit exposures? If they only pay their savers 0.5% p.a. of interest, government bonds with a 1.5% p.a. return can be considered a lucrative deal. In this context, bankers would be insane to award loans that eat up their capital.

Quantitative easing provides the capital market with liquidity; financial repression ensures that the money is returned to the state at minimal interest rates. As a result, savers and risk-averse investors are being used to finance national budgets without them even noticing it. Private companies requiring financing are, on the other hand, at a disadvantage on the capital market. This cannot be right as it is leading to massive distortions and injustice. But what are the alternatives?



1988 = 100%; source: US Treasury

In the USA, government debt has increased more than six-fold over the past 25 years; the interest payments on government debt, however, have only doubled. Without financial repression, the USA would have gone bankrupt long since, just like Japan, Great Britain and perhaps also Germany. Should these countries cut government spending or increase taxes to put their economies back on their feet? This could possibly trigger a recession and would certainly be tantamount to political suicide for the governments concerned. In the USA, constructive

measures to support economic recovery appear to be fundamentally impossible. The polarisation of the political camps has resulted in one side rejecting expenditure cuts, and the other side blocking tax increases.

Or might it be worth trying to reflate the economy to put an end to the misery? Japan is currently implementing a reflationary policy, albeit an act of desperation after 20 years of stagnation. Reflationary measures would be an absolute disaster for the rest of the world, as shown by countless historical examples.

For better or for worse, we will experience "repressive easing" - a combination of "quantitative easing" and "financial repression" - over the next years. When major economies such as the USA have fallen into the debt trap and fiscal measures are prevented, the financing costs must at least be minimised. Otherwise negative forecasts made by prophets of doom will prove right.

"Repressive easing" is the product of the age-old contradiction between collective and individual rationality. The individual investor sees government bonds as an asset. Viewed in macroeconomic terms, however, these securities are tax payments that have been postponed to a later date. An investment in government bonds therefore only makes sense if an investor assumes that somebody else will have to take care of repayment. If future generations are those that have to pay, it makes government bonds all the more appealing, as the burden still seems relatively abstract today.

Permanently putting off the repayment of debts might be a solution that works for individuals, but not for a country or a monetary union. The phenomenon that tax evaders largely invest their black money in government bonds has already been observed in Italy. Tax lost through evasion was thus often recovered by the state and the tax evaders also felt more affluent because they a) had saved taxes and b) invested in safe government bonds. The result was a national illusion of wealth, which burst with the Euro crisis, when the mountain of public debt was brought to public attention, leading to doubt about the solvency of the state. In 2011, a central element of the Mario Monti government's first rescue package consisted therefore of massive tax increases which were, however, extremely unpopular with voters.

The majority of voters in the major developed economies are living in a similar illusion. They do not want to accept either a reduction in state benefits or a rise in tax payments. In addition, most people have become very nervous about inflation. But getting worked up about the weak interest rates would require thinking in terms of opportunity cost, which overchallenges many people.

"Repressive easing" is the political consequence of this illusion. If governments are not able to get their finances under control by increasing tax, cutting benefits or devaluing the buying power of money, because if they do so they will not be reelected, their only option is to turnaround their finances with artificially low interest rates.

This does not, however, mean that there is a general obligation for investors to participate. As long as they are not forced to invest in long-term investments, which are affected by financial repression either directly like government bonds or indirectly like life insurances, they can shop around for better alternatives. At the moment, they have to put up with low returns to maintain liquidity. Anybody opting voluntarily for long-term investments that bear only minimal interest can be considered foolish, ignorant or paranoid.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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Sources:

The data for the graphs was taken from these websites:
http://www.bundesbank.de/Navigation/DE/Statistiken/Zeitreihen_Datenbanken/Makrooekonomische_Zeitreihen/makrooekonomische_zeitreihen_node.html (time series: BBK01.TUS303) and
http://www.treasurydirect.gov/govt/reports/ir/ir_expense.htm

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