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Chicken or the egg?

Which came first, the financial crisis or low interest rates?

Obviously the financial crisis.

But what created the financial crisis?

Low interest rates?

Well…

A government dreams of having unlimited funding. They are not alone, I suppose we all do. The only difference is, a government, if the central bank is not independent, can make it happen by dragging interest rates to zero.

And I believe they are doing just that. Since 1987 they have used every crisis as a reason to drop interest rates further, thus lowering the funding cost of running the government and allowing them to service larger and larger amounts of debt.

Imagine you have a credit card where the effective rate of interest is zero. The only condition is that one day the bank might stop extending credit. The temptation would be to spend 'till the cows come home', hoping that that day of reckoning will never come. Such is your desire to 'help' and alleviate suffering around you (and to get status and power), that you now support 100 families with this magical credit card.

This is the unnatural compulsion a government faces. They can borrow and borrow at extremely low interest rates on the condition there is no inflation. Why wouldn't you?

The US government is estimated to be on the hook for anywhere from $140 trillion upwards in funded and unfunded liabilities.[1] They have maxed out the credit card so much that it is doubtful they could wean themselves off debt funding should inflation emerge, even if central banks raise interest rates to combat it (don't hold your breath, you might go blue!)

Most countries in the world are in a similar dilemma. Japan is the poster child for this.

Financial assets have followed suit; at zero interest rates forever, assets have infinite value! No wonder the asset prices have departed from reality.

This is the backdrop to what I believe is the biggest question posed to global macro pundits: why is there no 'real economy' inflation on the horizon? No inflation in the presence of out-of-control money creation is the fairy godmother economy – it will keep on granting wishes.

Governments can expand their debt with low interest rates as far into the horizon as they can see, without consequence. Asset bubbles don't burst because they are met with a wall of central bank liquidity. Runaway government debt should have resulted in inflation which can be viewed as a tax that currently is not levied. It is costing nobody anything!

Damn… it is a free lunch!

1 https://www.youtube.com/watch?v=EPjrFjAxwlw, http://www.usdebtclock.org/

But wait, why? It goes against everything we know about economics. There is no free lunch.

I think there are two main reasons for no 'real economy' inflation.

1) Structural deflation drivers
2) Declining velocity of circulation

The big structural deflation drivers of low cost off-shore labour, deregulation, globalisation and the disintermediation via the internet (e.g. Amazon) have created a lot of 'good' deflation. Governments have unwittingly cannibalised this windfall by inflating to counteract this good deflation (we all want lower costs if our salary stays the same!) resulting in a wash, i.e. no or low inflation. However I believe the effects of this are already baked into the cake.

Velocity of circulation? Well we know the mass of money is expanding which is inflationary on its own, so the answer to insipid inflation has to be a declining velocity of circulation?

Remember the old chestnut MV= PQ? Actually I think of inflation more as a convex function – inflation snowballs, so I would describe more as:

$MV^n = PQ$ but it is a moot point.

Where V is the velocity of money circulation. V HAS to be decreasing at some rate.

Engineered or not, the best way to ensure no velocity of circulation is to have a recession or a depression.

In a boom the only way I see velocity falling is to give it to the rich. They won't spend it on anything except financial assets and art (which would explain the financial asset boom incidentally).

Want inflation? Want velocity of circulation? Expand money supply and give it to the lowest socio-economic group. They will spend it in a month! Then we will see inflation as velocity and supply rise together!

In fact, if governments really want to finesse it they give the tailwind to the rich and then tax 'em!

That is happening as we speak…

So why not sit back and enjoy the free lunch?

Unfortunately there are dire second order consequences of extremely low interest rates.

1) It breaks the financing link between society and government.
2) It drives inequality.

Government exists to provide services to society. It is kept in check by the willingness of society to keep on funding the government or not depending on how well they think it is serving them.

Take away this accountability and you untether government from its people. If interest rates are low enough, fund all expenditure with debt where possible. This allows for the possibility of tyrannical hierarchies to thrive. E.g. Trump reduced corporate taxes whilst increasing the deficit. It leaves governments open to create more and more debt and to expand power without restraint.

Inequality is also an unfortunate consequence of low interest rates.

It makes the rich richer and the poor poorer and totally decimates the middle class.

The more people dropping into the social security net means more requirement for government funding which in turn creates more need for government debt. This suits governments in a bizarre way, they have more captive voters. Anyone recall the Mad Max movie where a warlord controlled the water spigot? He had total power and control.

But this is a self-defeating cycle.

Permanently low interest rates will drive inequality which will eventually cause GDP to roll over in real terms, which in turn will cause governments to pursue fiscal spending to help boost it which creates an even bigger debt problem!

And another crisis will magically appear, hopefully one that the powers that be can blame on someone or something else.

The developing world's go-to financing solutions have become the developed world's.

Eventually though, inflation will start to leak into the real economy.

And contrary to popular opinion, this inflation can emerge in the presence of a recession or depression, for example Zimbabwe and Venezuela both experienced hyperinflation in the presence of a depression.

This is when the absurdity of central banks having twin goals of full employment and price stability will become apparent.

They will have to pick their poison.

My guess – they want full employment regardless of inflation so they will subdue the natural rate of interest which in turn will fuel more inflation.

If it is a convex (snowballing) function, it will get out of control VERY quickly.

Theories are now ubiquitous that rising government deficits are good for the economy and society and can be sustainable in the long term.

I am not buying it.