

Zero Interest Rates - What Next?

With UK interest rates rapidly heading towards 0% and US Fed Funds having already achieved such status, many investors are asking the same questions: Will it work? Where do we go if it doesn't? We attempt to shed some light below.

The Big Picture

In the world of monetary policy, the "biggest tool in the bag" available to central bankers is the setting of base rates. As the sole supplier of local currency, central banks set the price of money and supply at that price. When prices fall, demand increases - so when money is "cheap" demand for money rises.

Ultimately it is the banking system that determines money supply. By issuing a new loan, money is created. When loans are repaid or written off as bad debts, money is destroyed. All other transactions within an economy merely redistribute the money. When used for the purchase of new goods such as a new car this shows up in GDP numbers (which is the measurement of new production). When money is used to purchase old (or second-hand) things this shows up in asset prices.

Completing the picture is the link between asset prices and the "real" economy. When asset prices rise, this tends to lead to an increase in economic activity. Witness the explosion in housing construction projects over recent years as property prices increased for evidence if needed.

Quantitative Easing - What's That?

Fast forward to current reality. Circumstances are challenging and certainly not normal. The banking sector is not creating money, despite the lowest interest rates known. Banks are seeking to protect their balance sheets.

The Chancellor is hoping that lower interest rates will gradually help the situation. Cheaper money has the effect of lowering the banking sectors' cost of funds creating bigger profits and ultimately making banks more inclined to provide new loans. But can he wait and what happens if interest rates get to zero? You can be sure that the hot topic at the Bank of England is that of Quantitative Easing.

Under Quantitative Easing the central bank would use its own balance sheet in order to create money. With interest rates at zero, the quantity of money can be potentially infinite. The new money is used to buy existing securities, typically from banks, pumping liquidity into the banking system, whilst raising the prices on assets and thereby lowering yields and longer term interest rates.

If all else fails, the bank can bypass the banking system entirely, print money and transact directly with the general population, buying any assets it cares to take onto its balance sheet. In extremis, it could print money then subsequently give it away, evoking memories of Friedman's notorious "helicopter drop" of cash, which is where Ben Bernanke gets his nickname of "Helicopter Ben".

So will it work? Without a doubt, as policy-makers try to assist the economy to gain traction. As asset price declines led us into the recession, we should expect them to lead us out. As rates head towards zero, the central bank will keep expanding its balance sheet. Then watch out for the return of inflation!

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