

Monetary Policy and Asset Prices

In the developed economies, even as economic growth remains sluggish, the equity markets are singing a different tune. The S&P 500 index of equity prices in the US was at a record high last week, gaining almost 200% since early 2009 (output in the US actually fell in the first quarter of 2014). DAX, the index of German equities, is at an all time high even as German growth is forecasted to be barely 1%, and unemployment remains a major problem in the euro zone. The FTSE All World Index is also at a record high. And, the VIX index of volatilities implied by prices of traded options evidences very low volatility; in other words, risks in current market prices are low.

One reason for the boom in equity prices is that interest rates in developed economies have been at an all time low, and inflation is nowhere in sight. In fact, both the euro zone and Japan are more worried about deflation, and targeting an inflation rate of around 2%. Of the two, chances of Japan succeeding seem higher than the euro zone, partly because the yen exchange rate has fallen from a level of 80 in 2012 to around 100 yen to a dollar where it has remained for a year. In the meantime, the euro has been stabler, hovering in \$ 1.30s. (The VIX index is low for major currency pairs also.)

The deflation concerns of the European Central Bank were reflected in the monetary policy changes a fortnight back. The short term borrowing rate for banks was brought down by 0.1% to 0.15% -- and the ECB will *charge* banks 0.1% on funds deposited with it. (Negative interest rates have most recently been seen in Denmark and Sweden also.) The aim obviously is to encourage banks to lend. This is also the purpose of the € 400 bn Targeted Long Term Refinance Operation (TLTRO) of the ECB under which banks can borrow for 4 years, at just 0.25%, to refinance incremental loans to small and medium businesses. The ECB is also preparing to buy new, high quality asset backed securities.

The ECB's TLTRO is similar to the Bank of England's Funding for Lending refinance program introduced two years back. There is one major difference between the two, however: unlike the former, the latter refinanced mortgage loans also. The unintended result has been a worrying increase in real estate prices in the UK, which has aroused the Bank of England's concerns. The International Monetary Fund, in its annual review of the UK economy, has recommended that the Bank of England needs to take "targeted and timely" action to cool the housing market.

In many ways, the experience of the Bank of England over the last 11 months, under a new Governor, should be salutary for other monetary policymakers. Less than a year back, its "forward guidance" to financial markets was that the policy rate of 0.5% was likely to be maintained until 2016. (To be sure, few central bankers speak in plain English: some years back, interpreting Alan Greenspan's ponderous pronouncements, had become a niche specialization for market participants. And no wonder: as he himself once commented "if you think you have understood what I said, then I did not say what you think I did" – or words to that effect.) It now looks like UK interest rates may need to be increased two years earlier than forecasted: apart from the overheated housing market, economic growth has recovered (and unemployment has fallen) much faster than the Old Lady of Threadneedle Street was expecting. The real economy obviously needs to learn the macroeconomic models!

The easy money policies have not only fuelled equity prices, but other asset markets are also booming. Huge, covenant-lite, high debt equity ratio loans are readily available for takeovers of businesses by private equity funds. Greece recently raised 5 years debt at less than 5% p.a. Structured finance (asset backed securities) is back in fashion. Is the world economy going "back to the future" of 2007? Believers in the wisdom of the markets emphasise that current conditions are significantly different: or is it merely the "This time is different" syndrome playing for the umpteenth time? The reality is that financial markets have short memories. (Closer home, what was the gap between the Harshad Mehta and Ketan Parekh inspired booms in equity prices?)

One reason for the disconnect between asset prices and the real economy could well be the “moral hazard” which the so-called “Greenspan put” has created in financial markets: the belief that, in the event of a major problem, central banks will come to the rescue – as they did after the Lehman collapse. The other side is that, apart from the state of the real economies, in the last few weeks alone the geopolitical risks have gone up significantly. In Ukraine the rebels have shot down a military plane killing 49 people and the confrontation may once again become headline news; in Iraq, the Sunnis are rapidly advancing towards Baghdad and the conflict may soon suck in Iran and others; the territorial disputes in the East China Sea continue to simmer. As if all this were not enough, western media reports suggest that an NSEL kind of problem, on a much larger scale, if not a crisis in shadow banking, may be brewing in China – and, oil prices have gone up!

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