The Death Spiral of Capitalism

By Martin Hutchinson   *Thu, Sep 11, 2014*

"The effect of a decade or more with negative real interest rates is likely to be devastating," writes this ever-bearish pundit. He expects the central bank response to the next financial crisis to resemble its response to the last one.

No less than six sovereign borrowers are now paying negative nominal interest rates on their 2-year borrowing in euros. In other words, they are making money by going into debt. In real terms, medium-term U.S. TIPS and British index-linked gilts have had negative interest rates for several years. Contrary to the views of the happy Keynesians around us, this is very dangerous indeed. If negative interest rates were to persist, the world's stock of capital would eventually disappear. Without capital, we'd be back up the trees.

You don't even have to be a decent credit risk to borrow money at negative interest rates in euros—France's 2-year bond yield has just turned negative. Since France hasn't balanced its budget since 1969 and is enduring a prolonged period of stagnation caused by having one of the world's largest public sectors, to rational investors it ranks as a credit with substantial risk. Of course, today's bond-market investors aren't rational; their brains are fogged by six-years-and-counting of monetary "stimulus."

Negative interest rates are damaging for savers, who can't earn a return on their money without taking undue risks. However, over time they are even more damaging to the financial system as a whole because they reduce the capital stock outstanding, thereby de-capitalizing the economy. If risk-free interest rates are minus 1% in real terms, then after a year the capital stock is 1% smaller than it had been a year earlier (absent substantial net new savings). Of course, some investors have earned positive real returns by taking risks, but over the business cycle as a whole, those returns will disappear, as the risks turn out to have been misguided.

You can see how this might turn out by considering the investment alternatives available today. Long-term government bonds yield a tiny positive return, but have no upside and a very substantial downside risk when interest rates rise (which may be purely in nominal terms due to a rise in inflation). Junk bonds have a higher yield but a huge vulnerability to a credit crunch. London housing and farmland have had an excellent run, but are hugely vulnerable to a downturn. Gold, oil and other commodities prices are generally at historically high levels—far above the cost of production for the more efficient mines—so must have a crash coming as new supply comes on stream while demand dries up.

Art, collectibles and other “positional” goods are at record high prices and will suffer badly when the supply of new billionaires slows. Hedge fund and private equity fund returns have been in a secular decline for several years, while the amounts of money devoted to these sectors has continued to rise. History and logic both suggest a period to come in which returns become negative while the market re-equilibrates.

The pattern is universal. Very low interest rates raise asset prices in the short term but do nothing to raise the long- term value of those assets. Hence, after a one-off revaluation which makes everyone feel rich, they are due for future returns that, at best, match the negative risk-free real rate and will substantially lag it if the cost of money rises to more normal levels.

There are thus two trajectories which interest rates and the capital stock may follow. On the one hand, it is possible that positive real interest rates will be restored relatively rapidly. In that case, much of the investment and price rises of the last half decade will prove to have been made in error. Asset prices will correct to their long-term real levels, imposing massive losses on investors. Because much of the activity—especially in the hedge fund and private equity fund sectors—has been undertaken on leverage, the losses will in many cases escalate as leverage wipes out investors who without leverage would merely have lost a substantial percentage of their money. The economy will go into a long and deep recession.

We have examined this scenario a number of times. It’s very unpleasant in the short term, but provided monetary policymakers don’t repeat the error of exceptional monetary stimulus once the markets begin to tank, it will impose only moderate long-term costs on the economy. Eventually, asset prices will stabilize, the remaining investors will recover their nerve, growth will recommence and prosperity and employment will return, albeit after a very nasty few years.

The other possible trajectory, which this column has not before examined, occurs if the world’s monetary authorities attempt to combat the beginnings of asset price decline by re-stimulating the money supply, driving real and even nominal interest rates even deeper into negative territory. As in 2009-12, if the monetary authorities follow this policy it is unlikely they will reverse it quickly, so real interest rates will remain negative. The overall negative real interest-rate period would extend for at least a decade, to late 2018, and maybe considerably longer.

Depending on how hard the authorities pump out the money supply, they may be able to stem the initial asset price decline by this means and make the initial recession less painful than it would otherwise be. However, in order to achieve this they likely will need to make real interest rates even more negative than they have been over the last six years. They might be able to do so by increasing inflation to a brisk trot while interest rates remain around zero, by imposing some kind of "reserves tax" on the excess reserves that banks are forced to keep at the Fed or simply by pushing nominal government bond rates to perhaps minus 2-3% along the entire maturity curve, while imposing taxes that prevent investors from withdrawing their money from the financial system altogether.

I have to say I think it likely that, if and when the crash comes, the authorities will resort to this kind of self-indulgent short-termist monetary policy, just as they did the last time. The chances of them "getting religion," returning to monetary austerity and suffering through the inevitable asset-price-collapse recession seem small, although obviously if the crash coincided with the next U.S. Presidential election there's some chance a new administration might try austerity in order to blame the previous guys for the resultant pain.

The effect of a decade or more with negative real interest rates is likely to be devastating. Each year, the world's capital stock will be smaller than the previous year's. Consequently, the volume of new productive investments will decline year by year, as will wage rates as a continual oversupply of labor can only be matched with a diminishing stock of capital. Since global population continues to increase, and is likely to do so for at least several decades, the result will be a continued downward pressure on wages. That would be similar to that we have seen in developed economies in the last couple of decades, but over the entire world population. Japan's experience after 1998 was mitigated by a decline in the workforce matching the decline in available productive capital; the rest of us will not have this fortunate benefit.

Information technology will allow for the replacement of some highly capital intensive processes with cheaper ones performed by automated systems, but this will still further reduce the demand for labor. Unemployment will soar, but the new unemployment will mostly be of the informal "dropping out of the workforce" type that is not properly reflected in the statistics.

Since money is so cheap, students will postpone their entry into the dreary world of the workforce by borrowing ever more astronomical sums to acquire ever more useless academic qualifications. Governments likewise will run larger and larger budget deficits, finding it easier as well as cheaper to borrow from money-printing central banks than to bring their extravagance under control or to burden further the struggling voter/taxpayers.

Savers won't save, because of the abysmal results from doing so, they will merely speculate, as even Las Vegas will appear to offer better investment opportunities than the distorted economy. Global leverage will increase, even as global output continues to decline.

Eventually we will arrive at the natural terminus: "The euthanasia of the rentier," Keynes' notorious term. The entire world's capital stock will be swallowed up by government and private debts financing useless, unproductive activities.

Economic activity and private production will be carried on at only the most primitive level, as the world's stock of productive equipment and energy sources have broken down. The global population will go into catastrophic collapse, not because of ecological disasters (though there will be plenty of those) but because of the economy's inability to operate at a sufficiently high level to feed it.

Whether we will arrive at this Keynesian nirvana, or whether we will reverse policy before we reach the point of final collapse, is beyond the forecasting capabilities of my crystal ball. The process of getting there will resemble nothing so much as the fall of the Roman Empire and the Chinese Qing dynasty, in both of which societies the returns on capital were artificially depressed, mostly by persistent inflation, which led to the capital stock declining, living standards rapidly decaying and the economy eventually collapsing.

Thus, however unpleasant the characteristics of the slump we must endure when interest rates are rectified, it is nothing to the long-term consequences of not doing so. The costs of monetary short-termism are great and increasing day by day.