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How Central Banks Cause Financial Crises

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The leaders of the world's largest central banks don't seem overly alarmed by the risks that unconventional monetary policy poses.

Janet Yellen, in a speech at the Economic Club of New York in March, assured investors that the Fed could, if necessary, "put additional downward pressure on long-term interest rates and so support the economy" by using "forward guidance about the future path of the federal funds rate and increases in the size or duration of our holdings of long-term securities."

She minimized the risks by noting: "While these tools may entail some risks and costs that do not apply to the federal funds rate, we used them effectively to strengthen the recovery from the Great Recession, and we would do so again if needed."

That hubris extends to other central bankers who have faith that accommodative policies can stimulate the real economy with little risk of asset bubbles or increased financial volatility. The reality is that policies aimed at lowering long-run interest rates by large-scale purchases of government and corporate bonds pose significant risks and have done little to increase real GDP growth or private investment.

The desired wealth effect is, in fact, a pseudo wealth effect that will disappear when rates rise.

With yields on longer-term bonds reaching record lows, there is increasing pressure on pension funds and insurance companies to take on more risk in the reach for yield so that promised future benefits can be met. Meanwhile, savers are earning next to nothing on their assets and the forgone interest income means that consumption possibilities diminish unless households take on more debt.

Low or negative rates have also led to huge amounts of new debt taken on by corporations (mostly for stock buybacks) and by governments. If interest rates rise by even a small amount, longer-term bond holders will take large losses.

Indeed, duration risk for U.S. Treasury bonds is at a 15-year high of 6.49, as reported by Barclays. That means a 1 percentage point increase in rates would reduce the value of a bond

portfolio tracking Barclays' U.S. Treasury Index by 6.49%. Duration risk is even higher, at 7.71, for a portfolio holding 7-10 year Treasury securities.

When foreign central banks lower long-term rates via quantitative easing, investment funds flow into the U.S. bond markets chasing higher yields. In the process, bond prices rise in the United States and yields fall. Under the Bank of England's new QE program, just announced by Governor Mark Carney, the BOE will purchase 60 billion pounds ($80 billion) in U.K. government bonds by the end of this year and 10 billion pounds ($13 billion) in corporate bonds over the next 18 months, beginning in September.

The immediate impact of the BOE's policy surprise has been to push yields on government debt to a record low, with 10-year gilts falling to 0.644%. That outcome, together with negative rates in Japan and Europe, has increased the demand for U.S. government debt -- without any action by the Fed. The yield on 10-year Treasury bonds now stands at an all-time low of 1.37%.

The expectation of further accommodative monetary policy in England and the uncertainty of Fed policy mean further financial turmoil. Stock prices and other asset prices ultimately depend on real economic growth, not on monetary stimulus. Without structural changes, including entitlement reforms, political pressure will be on central banks to carry the load.

That is a dangerous policy path. The manipulation of interest rates by central bankers to support asset prices and fund government debt is a recipe for disaster. Holding rates too low for too long helped usher in the Great Recession. Now rates are even lower.

The BOE's decision to enter the corporate bond market is unprecedented. Although the European Central Bank has a corporate bond-buying program, the BOE move was unexpected. The aim is to flatten the yield curve by lowering long-run corporate bond rates, and also to spur sterling bond issuance. Along with its QE program, the BOE lowered its benchmark short-term interest rate by 25 basis points to 0.25%, and has also set up financing for banks to borrow at very low rates.

The problem is that if inflation heats up, nominal interest rates will rise and asset prices decline, including the prices of assets on the balance sheets of central banks. Although that possibility appears remote at this juncture, the longer that central banks experiment with unconventional policies, the higher the risk of future financial turmoil.

Even without inflation, central banks are distorting *intertemporal* prices (i.e., interest rates) and politicizing credit allocation -- favoring big government, big business and big investors. Central banks have lost independence by bowing to financial markets and the insatiable appetite of governments for cheap credit.

Establishing a "Club for Financial Stability" whose members adhere to the rule of law -- and thus to a monetary rule to limit the power of central banks and ensure long-run price stability -- would go a long way toward creating financial harmony. The classical gold standard is one such rule that allowed predictability in the value of money over the long run, while markets -- not central bankers -- determined interest rates.

Meanwhile, mild deflation brought about by robust economic growth was not detrimental, and there was no need for QE.

It is time to rethink current monetary arrangements and to examine alternative monetary regimes. Central bankers have too much power and too little humility regarding the limits of monetary policy.

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