

0% interest rates are dangerous. Here's why...

David Stevenson

Money Morning, 16th January 2009

The Fed's been busy brandishing its machete again.

We all knew that more US rate cuts were on the way. What we didn't know until Tuesday evening was that the Federal Reserve would re-write its 75-year old rulebook, and slash official interest rates virtually to zero.

But now that its standard issue ammo's been used up, America's central bank only has one real option left - printing money. That's a huge gamble for the world economy – and bad news for investors...

The cost of borrowing is as low as it can go...

In one way, you've got to hand it to the Fed – it didn't muck about. Chairman Ben Bernanke has had zero interest rates in his gun sights for a while now. Now he's cashed in on November's round of economic horror stories – US retail sales fell 1.8% and housing starts hit a new record low – to do the deed.

And for the first time in 75 years, he's changed the way the Fed sets its 'target' rate, from a fixed number to a range of 0% to 0.25%. OK, that was almost a done deal, as fed funds have been trading at around 0.3% for several weeks, but it's still history in the making and fascinating stuff for monetary historians.

But what does it all mean for the rest of us?

Clearly there aren't any more interest rate bullets left. As The Telegraph's Edmund Conway puts it: "For the first time in modern history, interest rates are no longer a major tool. Borrowing costs are as low as they can go without causing bizarre malfunctions in the US financial system".

...but America's banks still don't want to lend

Of course, there've been plenty of "bizarre malfunctions" already, which is why the world economy's in such a mess. Yet as Dr Irwin Kellner at MarketWatch says, "you can have interest rates at zero and it doesn't really matter if the banks aren't lending to individuals, businesses or each other". And despite all the Fed's efforts at dangling virtually free money at them, America's banks still aren't taking the bait.

Ian Shepherdson at High Frequency Economics pulls no punches: "So here we are: rock bottom - it's an utterly desolate picture, which will persist for the foreseeable future as the wrenching adjustment in household finances continues."

This is the snag - 'de-leveraging'. Private borrowers are being forced by the recession to pay down at least part of the massive debts they built up so recklessly during the boom times. So even if the banks were in lending mode (which they're not), Americans can't afford to borrow more anyway. Nor, for that matter, can we Brits. "We have to pay penance for the over-living of the past decade", says Warren Koontz at Loomis Sayles.

In short, the massive rate cuts aren't working. So what's plan B, Mr Bernanke?

The Fed's answer: print money like water, electronically, via "quantitative easing". Basically the central bank can increase the amount of money splashing around the system by ramping up the size of its balance sheet. And it's already fired the first shots by increasing its assets (and correspondingly, its liabilities) by some \$1.3trn, with the promise of at least another \$700bn on the way.

Slicing through all the monetary technicalities – there are enough of those to cure virtually anyone's insomnia – the bottom line's very simple. The Fed, and the Bank of England, which is soon likely to join the printing party, can churn out as much extra folding stuff as they like.

Governments will take on more debt to bring back inflation

And even though central banks may not be able to persuade companies and businesses to take on more debt, there's one group of people who definitely won't be able to resist – the politicians. And we all know what governments – and yes, Germany's a very honourable exception – are like when they get the taste for a bit of Keynesian-style borrowing and spending. So presumably, together they can eventually – though we can't be sure of exactly how long it will take - 'succeed' in pushing the price of assets like property and shares, and also the cost of commodities, back up again. In other words, back to inflation again – not just in the States, but worldwide.

The trouble is that it's a very narrow tightrope. The central banks will need to turn off the money taps again as inflation bites. But by then, the chances are it will be too late. The politicians will have blown all that borrowed cash, and then been voted out of office, leaving the rest of us to pick up a very large bill.

So in the short term, for stock markets, it all adds up to a likely rally, as hopes rise that government largesse will drag economies out of recession. But corporate cash flows will stay under the cosh. S&P warned yesterday that a staggering 20% of all European and UK lower-grade firms are likely to default over the next two years. That's really bad news for company profits.

And when markets realize that the politicians' borrow and spend routine was just a short-term fix, down will come share prices again. The bear market still has a long way to run.