BACK TO BUSINESS

THE VIEW
RICHARD HARRIS

Cost of low rates

In order to maintain stability, governments have to bail out greedy people who get themselves into trouble by over-borrowing at low interest rates

It is heartening to see 90-year-old Alan Greenspan, the former governor of the US Federal Reserve, back in the limelight.

In his 2007 book, *The Age of Turbulence*, he talked about how he used rational analysis all his life to study the markets – and how he got it right. Then in his 2013 book, *The Map and the Territory*, he says behavioural economics and human emotions drive markets at the margin – and how previously he got it wrong. It was lucky that he got the books in that order – or his career may not have been so successful.

Nevertheless, it is refreshing to see an intelligent and experienced gentleman reflecting on his time – because we are all products of our age. It was he who kept interest rates too low for too long in the naive belief that the instinct of self-preservation would encourage market participants to behave responsibly. Not a bit of it. When the red mist comes down, even sensible market participants go barmy.

Greenspan gave an example of a line of people waiting for a new gizmo at the Apple store. If you were the 1,010th person in line, he asked, how much would you pay to be 100th or even first in line? If the cost of moving up the line is near zero, you will be happy to pay for it – but then the supply of new gizmos would run out, so the cost of moving up the line increases sharply.

But if you liken the cost of moving up the line to the level of interest rates, there is currently little cost to get ahead. The supply of money is limited only by the supply of printing presses, paper, green ink – and memory chips. The cost of moving up the line by borrowing a lot more is limited to whether your lender thinks you (or the government) can pay the loan back. So in recent years, lenders have been very generous.

People behave irrationally if they think free money will last forever.

What happens when a country a lot bigger than Greece trips and stumbles?

Take Hebei Financing Investment Guarantee Corp, a Chinese state-owned body established to guarantee loans made by shadow banks to small businesses that could not get loans elsewhere. The firm guaranteed 50 billion yuan (HK$60.51 billion) of these loans but effectively defaulted in January.

If the shadow bank loans go sour, it will default on the wealth management products, which provided it with the funds to be lent in the first place. These products were sold to private individuals as "high-yielding" funds.

The shadow banks now have the gall to write to the Hebei government to ask for a bailout of the corporation. No doubt with the help of an onion held closely to its eyes, the letter casts the spectre of a decline in social stability following such a great "loss of blood and sweat money". A tactic that will no doubt press the buttons of a government desperate to ensure a stable people.

Again, governments (you and I) are being asked to bail out greedy people who have got themselves into trouble by over-borrowing at low interest rates. If it also sounds familiar to the Greek people, it is.

Market participants will behave irrationally if they think free money will last forever. We are now in the highlands of an economic cycle after a very long period of low interest rates but without seeing the high economic growth and inflation that we would normally expect.

But as they say in the Scottish play, "by the pricking of my thumbs, something wicked this way comes". An enormous rise in debt levels has been lurking in the undergrowth. Debt is the snake in the grass that destroys wealth in the blink of an eye; with the suddenness of an earthquake.

Debt destroyed substantial wealth in the 2008 global financial crisis; it has crushed the Greek people; and it is choking the Chinese economy. Greenspan recognises that the debt build-up is not rational – it is behavioural, because in good times there are no real limitations. This nest of vipers has continued to hatch unseen and unmeasured.

Of course, this is how fiat money works – we trust paper money because we have confidence in the US Treasury. There is a reason why US dollar bills say "In God We Trust". But what happens when a country a lot bigger than Greece trips and stumbles, causing a big sell-off in US treasuries?

The interconnectivity of the world means contagion will be swift. It may be that Trusting in God might be the only answer – all others pay cash.

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Illustration: Henry Wong