Addicted to cheap money

A seismic reversal of financial markets is on the cards, with falling bond and stock prices

WHEN A new coalition government is formed, the 34th government in Israel's 67 years, it will face a full plate of challenges. One of the major ones will likely not be that four-letter word repeated numbingly during the election campaign – Iran. Instead it will have to deal with a serious affliction affecting banks, businesses and households – an addiction to cheap plentiful money.

In the wake of the 2008 global economic crisis, central banks in the West tried to counter the global recession by massively expanding the money supply and lowering interest rates to near zero. The US Federal Reserve, under Ben Bernanke, expanded the money supply by 13 percent in 2012, and 8 percent in 2013. Bernanke's successor Janet Yellen and her deputy, Stanley Fischer, former governor of the Bank of Israel, continued Bernanke's policies, expanding the money supply 9.5 percent in 2014. Both are aware the US economy is still in intensive care and have kept interest rates low.

The Bank of Israel has done the same. It slashed interest rates from 5 percent in December 2006 to 0.10 percent (essentially zero) in February. Israel's money supply grew a massive 22.7 percent in 2014.

Today, Israel, America and Europe are hopelessly addicted to cheap money and near-zero (or below-zero) interest rates. At some point, those interest rates will have to rise and the mountain of money will have to stop growing.

How can this U-turn be achieved without creating another massive financial crisis and, in Israel, without bursting the housing bubble? Bank of Israel Governor Karnit Flug and the new finance minister will need to coordinate their policies carefully at a time when the Bank of Israel and the Cabinet have not always seen eye to eye.

America, Europe and Israel have all run out of ammunition to fight sluggish economies. In its February monetary report, the Bank of Israel said, "The interest rate tool is nearly fully exploited." Dr. Nadine Baudot-Trajtenberg, deputy governor of the Bank of Israel, has hinted that it might actually resort to negative interest rates (i.e., you get less money back at year's end than when you deposited it). In Switzerland, the central bank has done this; it imposed negative interest rates to keep its Swiss franc from getting too expensive relative to dollars and euros. And, indeed, when you adjust for inflation, real short-term interest rates are already negative in Israel.

Sometimes, tragically, ill persons treated with painkillers become addicted to them. This is what has happened to Israel, the US and Europe. In Europe, the European Central Bank has announced that it, too, will begin a program known misleadingly as "quantitative easing" (QE, or buying bonds to inject liquidity and expand credit). I prefer a different term: MB (money bonanza). It is a bonanza for the financial services industry.

Banks and businesses have become addicted to near-zero interest rates. It has enabled many of them to make profits through financial speculation – it's hard to lose when you borrow money for almost nothing. But low interest rates have done little for the real economy, to spur real investment, infrastructure and capital formation. They simply benefit what the world's smartest investor, Warren Buffett, calls the "money shufflers."

The main idea of cheap money was to spur investment. But why would businesses build more factories when the current ones can make more output than they can sell?

Even companies that make real products, instead of shuffling money, benefit. Teva, Israel's largest global company, recently bought back some of its high-interest dollar bonds (issued years ago when interest rates were high) and instead will sell bonds in Europe, where interest rates are much lower. In doing so, Teva will make some $170 mil-

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lion in lower interest costs.

This is, of course, smart finance. But, it is worth noting that small investors and households do not have the same opportunities. According to Mike Dolan, writing in The New York Times, "companies have made a killing by borrowing for next to nothing just to buy back their own shares, boosting the equity prices further in the process."

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Households, too, have become addicted to cheap money. In Israel, credit card debt rose 15 percent in 2014. Household debt not related to housing rose 11 percent.

At some point, central banks in Israel, the US and Europe will have to start raising interest rates when the huge bulge of money they created begins to generate inflation. Banks, businesses and households will have to break their cheap-money addiction. It will not be easy.

Once, the global bond market was sleepy and small. Today, after governments and companies flooded the market with bonds, it is enormous – larger than the capitalization of global stocks and equally or more volatile – amounting to over $80 trillion, about the size of annual world GDP. When interest rates rise, as they must, bond prices will fall simply because the relation between bond yields and bond prices is inverse. This effect, alone, will cause huge paper losses to bond holders, especially pension funds and other funds belonging to pensioners.

In its February monetary report, the Bank of Israel itself admits that "one of the main risks to financial stability due to low interest rates is that, when interest rates rise, borrowers will find it hard to repay their loans."

The current interest rate on a variable rate mortgage (tied to the prime rate) is now 1.7 percent. In December 2006 it was 5.85 percent. At 1.7 percent interest on a million shekel 30-year mortgage, the monthly payment is NIS 3,550. At 5.85 percent, the rate in 2006, the monthly payment would be NIS 5,900, or 67 percent higher.

How many mortgage holders will then be unable to make their payments? Will Israel then have a sub-prime mortgage crisis? How can the Bank of Israel break the money addiction and raise interest rates, when the time comes, without causing a financial crisis? The Bank of Israel reported last year that for the poorest 10 percent of the population, monthly mortgage payments are almost 30 percent of income. This is already hard to sustain. If that proportion rose to, say, 50 percent, many could not make their payments.

A large proportion of Israel's mortgage debt is "variable rate," meaning the interest rate is linked to the market interest rate and rises when market rates rise. And, the sheer size of total mortgage debt itself is a threat – 262 billion shekels, double the amount in 2007, and with more than 50 billion shekels in new mortgages added annually.

Interest rates are closely linked to Israel's housing crisis because they strongly influence the demand for mortgages. The Bank of Israel admits that its near-zero interest rate policy has fueled soaring housing prices. It claims that low interest rates are needed to keep the shekel-dollar exchange rate from strengthening and ruining Israel's export industry. Basically, the Bank is saying to the government, "Hey, we can't do everything. Housing is your problem."

The Bank of Israel's Research Department recently reported that it now takes 148 average monthly salaries to buy a dwelling, or 12 years' work, compared with 66 monthly salaries in the US. Mortgages are cheaper than in the past, but houses are far more expensive.

Just before the election, the State Comptroller released a 285-page report on the housing crisis. It shows that between 2008 and December 2013, housing prices rose 55 percent because of "a shortage of housing starts relative to the increase in the number of households."

However, the former chief economist in the Ministry of Finance, Dr. Michael Sarel, places the blame for soaring home prices squarely on low interest rates. He told the business daily Globes, "The main cause of higher demand for housing is the low interest rates… when interest rates rise, in Israel and abroad, demand for housing will fall and the price of housing will fall too." Sarel quit last year, in protest against former finance minister Yair Lapid's ill-fated plan to exempt new apartment purchases from the 18 percent Value Added Tax, claiming this would only increase demand and home prices, rather than reduce them.

Addiction to cheap money is crashing headlong into a long-run global trend – aging populations and declining savings.

According to studies by three investment banks, Barclays, Goldman Sachs and Morgan Stanley, there has been a global glut of savings owing to a 30-year expansion of workers in peak saving years (the "baby boomers"). This glut helped lower bond yields and interest rates. But this global savings boom is ending as the baby boomers grow older and retire, and shift from saving to spending. In the next few years, the banks predict that an end to the savings glut will bring "a potentially seismic reversal of financial markets," with falling bond and stock prices. In Israel, too, the number of people aged 65 and over will double by the year 2035.

AMERICA, EUROPE AND ISRAEL HAVE ALL RUN OUT OF AMMUNITION TO FIGHT SLUGGISH ECONOMIES

There are two ways to cure a money addiction. One is "cold turkey" – a well-coordinated, carefully staged global increase in interest rates by central banks in the West so money cannot ruinously flee from one country to another. This is highly unlikely.

Another approach is that "each country tackles its own addiction, in its own way and in its own time." This is more likely and more dangerous. Cheap money has already flowed from the West to Asia, helping to infect China and Singapore with the same housing bubbles that America suffered.

Can we sleep soundly at night? According to the Bank of Israel, "steps taken by the superintendent of banks in recent years have reduced [the] risk [to commercial banks through mortgage default]."

Somehow, I am not reassured. ■

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