Talking point

Down the rabbit-hole

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These days, financial market commentaries are often laced with expressions such as "topsy-turvy" and "Alice in Wonderland". Recently, even Bank of Japan Governor Kuroda described the need for unconditional faith in the inflationary impact of Japanese monetary policy with a reference to Peter Pan, quoting Peter as saying that (in his world) "the moment you doubt whether you can fly, you cease forever to be able to do it".

It is probably no coincidence that increasing use is being made of metaphors from the world of fairy tales. Indeed, this reflects the widespread despair about how to explain the latest developments in the financial markets. This uncertainty spread when not only central bank deposit rates but also government bond yields fell below 0% and thus really turned the world on its head – at least relative to the way it was explained to most of us in introductory economics courses. According to them, interest is the price paid for delayed consumption. However, one basic assumption of consumption theory is that people attach a higher value to the consumption of a good in the present than to consumption of the same good in the future. Hence they have a time preference and are by no means willing to postpone consumption and pay money for their patience to boot, i.e. accept negative interest rates. This was the rationale for the so-called zero lower bound for nominal interest rates. But considering the prospect of later life as a pensioner it may be perfectly rational to pay a premium now for the option of having funds for consumer spending in future. What this boils down to is accepting a negative rate of interest. This premium cannot be substantially higher than the costs of privately storing and insuring the corresponding amount of money, though. This means that there is such a thing – as long as cash exists – as a zero lower bound for interest rates; however, it is likely to be just a tad below zero.

Following the ECB announcement on quantitative easing, though, 10-year Bund yields saw their nosedive accelerate in the first few months of the year. At its worst, the section of the German yield curve covering maturities up to 8 years dipped below the zero level, an occurrence that pure economic theory says should not happen, so a sense of despair set in nonetheless.

This holds all the more so especially since negative yields are hardly to be reconciled with the implications of neoclassical growth theory, at least as long as GDP growth rates are assumed to trend positive. According to the Golden Rule of Accumulation attributed to Edward S. Phelps, in a state of economic equilibrium the marginal productivity of capital equals the rate of return and thus roughly also the rate of GDP growth. So how was it possible to explain a 10-year Bund yield of merely 0.08% (as of April 20) on prospective medium-term nominal GDP growth of 2-3%?

A new hypothesis was soon to be found: the liquidity glut in the wake of the ECB's QE purchases totalling EUR 60 billion per month. The contradiction with the time preference theory of interest could supposedly be resolved by the expectation that further central bank purchases in the face of a relatively limited supply would pave the way to further declining yields. The resultant capital gains would compensate for waived consumption. This is a variant of the greater fool theory, with the central banks assuming the role of the greater fool, as it were, via their QE programmes. Nonetheless, in this interpretation there is a lower bound at -0.2%, the rate level that the ECB is not able to go below in its purchases on account of self-imposed rules.

Other explanations given for rates sliding further into negative territory were liquidity considerations, regulatory reasons and internal investment guidelines, which provided institutional investors such as banks, insurance companies or even central banks with virtually no alternative but to continue investing in government bonds. On top of this, many other investment options had been hit by ratings agency downgrades.

One could perhaps also argue that for foreign investors expectations of exchange rate gains could compensate for negative yields. Indeed, on the basis of covered interest rate parity the euro would be expected to appreciate versus the US dollar, for instance, in order to compensate investors for holding 10-year Bunds that yield roughly 150 basis points less than their US Treasury counterparts. But, once again, this is only how the theory goes. In practice, foreign investors have usually hedged their currency exposure when investing in the eurozone. So they have tended to factor in a depreciation of the euro.

From mid-April there was a huge sell-off in the markets, with yields temporarily climbing to 1%. This time – after prior explanations that the ECB-induced liquidity glut had been the reason for lower yields – it was claimed that the dearth of liquidity, while perhaps not the root cause, was at least to blame for reinforcing the process – even though nobody seriously believed that the ECB would reduce its purchasing programme prematurely on account of minimally better growth and inflation data. Purely economics-based explanations cannot resolve this contradiction, especially since all analysts agree that we are in uncharted terrain, so past experience can only be drawn upon to a very limited degree. Behavioural economists describe this condition as the loss of mental models. Humans require mental models in order to structure their environment and find their bearings. If the expectations resulting from these mental pictures are refuted too often by reality, a person (investor) will search for new guidance and thus become vulnerable to systematic misperceptions. A crucial role is played here by the virtually irresistible compulsion to find an explanation for every single process – no matter how random. People then also tend to accept rather abstruse suggestions that anyone with an intact mental model would have dismissed. Since many people think the same way such explanations are parroted by the thousands – thanks not least to the internet and the blogosphere – thus further raising the willingness to accept them as plausible. This is where "isolation and confirmation effects" play tricks on our perceptions. In our need (to find explanations) we focus on one – often relatively unimportant – aspect and feel our position is confirmed if others emphasise the same aspect, even if they are ultimately stabbing in the dark in just the same way. This throws open the floodgates to herd behaviour in the markets, as nobody wants – for lack of personal convictions – to miss out on a trend, with the direction being virtually arbitrary. The growing tendency for forecasters to follow the trend is very easy to see by looking at the monthly development of the yield forecasts for 10-year Bunds in three and twelve months' time and the current yield when the survey is conducted. On the investor side, measures taken by regulators and risk managers, such as reducing proprietary trading or using value-at-risk models, have resulted in nobody having the liquidity any longer – even on corresponding convictions – to be able to oppose a given trend. Defeating their intended purpose, such measures have led to greater volatility. It is to be feared that market fluctuations, as observed of late, will add to investor uncertainty and further hamper the already relatively low transmission of QE into the real economy, meaning that ultimately this will tend to prolong the ECB's QE programme. However, even this deliberately cautious assessment may also have been a victim of the isolation effect.*

* Parts of this article are based on an op-ed entitled "Collectively disoriented" authored by Deutsche Bank Chief Economist David Folkerts-Landau and published in the Frankfurter Allgemeine Zeitung on June 8, 2015.

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