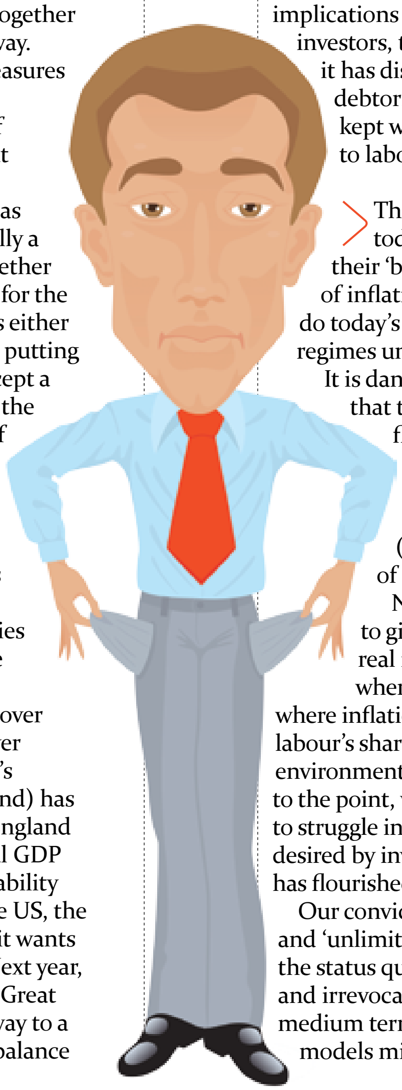
PICKING UP THE TAB FOR THE PARTY

What would be the implications of a wholesale shift in monetary regime with debtors being favoured above creditors? wonders David Bowers

Call me old-fashioned, but I can't help thinking that the words 'central banking', 'unorthodox' and 'unlimited' do not sit comfortably together. This is unfortunate because we have had a large number of 'unorthodox' and 'unlimited' policy initiatives in the past six months. And while each individual policy move may be eminently sensible, together they suggest a more profound shift could be under way. Rather than dismissing each country's monetary measures as an attempt to weaken its exchange rate (so-called 'currency wars'), could we, in fact, be on the brink of a wholesale shift in monetary regime – from one that favours creditors to one that favours debtors?

From a political perspective, this would not come as a surprise. After a credit bubble bursts, there is usually a creditor-debtor stand-off as politicians work out whether the debtor or the creditor is going to pick up the tab for the party. If the creditors do not oblige, then the debtors either opt for default or they try to inflate away the debt by putting political pressure on the monetary authorities to accept a higher level of inflation. To the extent they succeed, the real value of the debt gets eroded and/or the value of the assets on their balance sheet becomes inflated.

The past six months have seen some important shifts in central bank policy that seem to favour debtors over creditors. The European Central Bank's outright monetary transactions facility was set up last summer to help the indebted eurozone economies despite objections from creditor member states. The Japanese government has succeeded in encouraging the Bank of Japan to set a higher 2% inflation target over the medium term – a change that favours debtors over creditors. In the UK, Mark Carney (Sir Mervyn King's anointed successor as governor of the Bank of England) has already opened a debate as to whether the Bank of England should abandon its inflation target. While a nominal GDP target has its attractions, it does imply a greater variability of inflation than under a fixed inflation target. In the US, the Federal Reserve's 'forward guidance' proclaims that it wants to be 'behind the curve' for the foreseeable future. Next year, the generation of central bankers who delivered the Great Moderation and inflation targeting will have given way to a generation for whom vastly expanded central bank balance sheets will be the norm and central bank independence will be the exception.



The puzzle is why the creditors do not seem worried by these developments. Moreover, changes of monetary regime are not just a matter for bond investors; they have profound implications for the corporate sector and hence for equity investors, too. Inflation targeting is not a value-neutral policy; it has distributional effects that favour creditors over debtors. By focusing on price stability, central banks have kept wages under control – a factor that has contributed to labour's declining share of national income.

The question we need to ask is to what extent are today's most-loved stocks – favoured by investors for their 'bond proxy' characteristics – the product of 20 years of inflation targeting and a bond bull market? How much do today's most popular companies owe to the monetary regimes under which they operated?

It is dangerous to generalise, but our hypothesis is that the old monetary regime supported free-cash-flow-generative companies with strong creditor characteristics, companies that were 'labour heavy' (because labour costs have been capped by central banks' anti-inflation mandate) and 'capex light' (low dependence on external debt finance in a world of positive real interest rates).

Now, imagine that the old monetary regime starts to give way to a very different environment, where real interest rates are negative rather than positive, where the real value of debt is more likely to be eroded, where inflation expectations could be more volatile and where labour's share of national income starts to rise. Might such an environment favour a different kind of corporate model? More to the point, which of today's 'popular' business models are going to struggle in that new world? Which are going to become less desired by investors if the monetary framework changes? What has flourished under one regime may not survive under another.

Our conviction is that it is very unlikely that 'unorthodox' and 'unlimited' central bank policies will preserve or restore the status quo. Monetary policy is going through a fundamental and irrevocable transformation. As investors look to the medium term, they need to ask which corporate business models might flourish under the new monetary paradigm.

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