Cheap Money: the Good, the Bad and the Ugly

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Global financial crisis in 2007-2008 is probably the most significant shake in the global economy in recent decades. The crisis was complicated and comprehensive and the underlying causes can among other things be attributed to cheap money. Cheap money is like a chameleon, while it is important to the economy, it can also have adverse economic impacts which may even result in a wide-spread financial crisis. Interestingly cheap money while being the cause of crisis can also be the ultimate cure for the crisis.
The purpose of this article is to critically analyse the role of cheap money in the economy in light of the global financial crisis in 2007-2008 and it argues that cheap money can help an economy only where it has been properly applied. The article will first introduce financial crisis and cheap money, then will discuss how the cheap money had contributed to the global financial crisis in 2007-2008 and will finally analyse the manner in which cheap money can be applied correctly.

As commonly accepted financial crisis is a situation in which the supply of money is exceeded by the demand for money. This means that the liquidity is quickly evaporated because available money is withdrawn from banks, forcing banks either to sell other investments to make up for the shortfall or to collapse (Business Dictionary 2016). In literature many theories have been evolved explaining the causes of crisis, the most fundamental being macroeconomic imbalances, yet the exact causes of crisis remain a controversial matter. Financial crisis is like water; it takes different shapes and forms. Reinhart and Rogoff (2009) recognize two types of crises: those classified using strictly quantitative definitions; and those dependent largely on qualitative and judgmental analysis.

A financial crisis will have negative macroeconomic and financial impacts on the economy which would be visible through basic economic indicators i.e. Gross Domestic Product (GDP), Inflation, Balance of Payment (BOP), and Employment and will ultimately contribute to an economic crisis.

It is important to analyse how these basic economic factors behave in a financial crisis. A financial crisis indicates a fall in real GDP. During the financial crisis 2008, GDP fell in most of the countries in the world. According to Central Bank of Sri Lanka (CBSL) (2009) real GDP growth in Sri Lanka fell from 6.8% in 2007 to 3.5% in 2009. At the height of the recession in 2009, GDP fell by 2.6% in a single quarter in the UK. Japan (8.7%), Italy (6.9%) and Germany (6.8%) also suffered greater total contractions in GDP (Parliament UK, 2011).

A financial crisis will result in low inflation or deflation. During an economic downturn people spend less, so the aggregate demand for the goods and services falls which will generate a downward pressure on the general price levels of goods and services. In 2008 the annual rate of inflation in UK was about 5%, but with the effect of global financial crisis the inflation rate fell at 1% as per Consumer Price Index while Retail Price Index indicated a deflation of 1.5% (Office for National Statistics, 2015). In Sri Lanka inflation fell from 22.6 in 2008 to 3.4 in 2009 (CBSL, 2009).

During a financial crisis along with the GDP the percentage of employment will fall. For example, with the crisis in 2008 the unemployment rate in the UK started to rise sharply and marked 5.5% (Office for National Statistics, 2014), the highest rate since early 1999.

BOP consists of two accounts i.e. current account and capital account. In a financial crisis the deficit in current account will show a reduction because during such time consumer spending falls and therefore the spending on imports will decrease. However, when the crisis affects the whole globe the demand for exports will also be decreased resulting in deterioration in the current account. Further in a crisis the exchange rate depreciates and it will make exports cheaper and imports more expensive.
Thus it appears that a financial crisis has negative effects on the basic economic factors and since they are highly interconnected and correlated, it has the ability of sinking the entire economy.

Now let's see what role does cheap money play in an economy. Cheap money is the credit available at low interest rates. The government can lower the reserve ratio when economic activity weakens so that the banks can lend extra money at lower rates, without loss of profit. Since the cost of borrowing is lowered the borrowings will be encouraged and will have a stimulative effect on economic activity.

Cheap money will encourage spending as well as investment. As the interest rates are low the opportunity cost of money falls and the people will not hold on to money. Since the cost of borrowing is cheaper consumers and businesses will tend to take loans for the purposes of spending and investment. Further, when the interest rates are low the economy is blooming and the people are more willing to take risks. Consequently, the investment will be increased. When the investments are utilized in blooming sectors, the GDP will be increased and it will result in new employment opportunities. As a result the economic growth will be steady and rapid. Moreover, as a result of lending by the banks, M2 money supply in the economy will be increased resulting in excess of liquidity which will make it more attractive to buy assets. This will persuade the business to expend more on capital goods and house-hold to spend more on homes and consumer durable goods. Where the demand for the assets increases without the supply being increased, their price will go up and the higher asset price will increase the wealth of household and business, encouraging the consumers to spend more. On the facet of the banks and lending institutions it increases their profits, their ability to lend and positively affects their balance sheet.

Cheap money is like a double edged sword; as much as there are benefits there are costs associated with. As discussed earlier loans add new money to the money supply and when too much money in the system chases a fixed amount of goods and services, their price levels increase resulting in inflation. As the lower interest rates increase the consumer spending on imports it will increase the import expenses of the country but since demand on exports will not be increased simultaneously it would result in deficits in balance of payment. An increase in the supply of a currency will depress its price thus decrease the exchange rate of local currency, where there is a floating exchange rate. Exports would become cheaper and imports would become expensive resulting in a deficit in current account. When interest rates are so low they will confine the flow of money into a particular sector of economy like the stock market which won't necessarily contribute to the economic growth and expansion. As a result, the GDP will be lowered and unemployment will rise.

If an economy lowers interest rates for lending, then it has to lower the interest rates for savings simultaneously. When the interest rates for savings are low the savings will be discouraged and the depositors will seek to take their savings back and to invest them in other markets. At that time the banks need to have the sufficient liquidity to pay them back, otherwise due to fear all the depositors will seek to withdraw their money at the same time resulting in the bankruptcy of banks.

Above analysis reveals that cheap money causes negative impacts on an economy if it has not been properly tamed. But if well appropriated it can have many advantages on financial systems.

Financial crisis in 2007-2008 was originated from a house bubble in USA and threatened to sink the entire global economy with its far reaching spillover effects. Global financial crisis consisted of 5 distinctive stages: the meltdown of the subprime mortgage market in U.S; spillovers into the broader credit market; the global economic liquidity crisis characterized by the fallout of Northern Rock, Bear Stearns and Lehman Brothers with counterparty risk effects on other financial institutions; the commodity price bubble, and the ultimate demise of investment banking in the U.S (Orlowski 2008). The extended period of low interest rates in the United States of America contributed primarily to the financial crisis in 2007. As a result of the terrorist attack 9/11, the United States increased the government and consumer spending. To deal with this U.S. Federal Reserve, led by Alan Greenspan, lowered interest rates from 6.5% in May 2000 to 1.75% in December 2001 creating an excess of liquidity in the economy.

Consequently, borrowing became cheap and banks willingly lent money to a particular set of customers with no income, no job, and no assets (NINJA) who couldn't meet thorough standards usually required by lending institutions, to fulfil their lifelong dream of a home. The demand for the houses increased with a stable supply, the price of the houses went up. The investors continued to invest in the housing market and they didn't remember; everything that goes up will come down eventually. In 2003 the interest rates were further lowered to 1%.

Bankers overwhelmed with profits, decided to make Collateralized Debt Obligations, thus a big secondary market for the origination and distribution of subprime loans developed. In October 2004, the Securities Exchange Commission (SEC) relaxed the net capital requirement for five investment banks which freed them to leverage up to 30-times or even 40-times of their initial investment (Singh 2009).

In the last quarter of 2005 a silent storm appeared; the prices of the houses fell, affecting new homes and many subprime borrowers started to default their debts. Shadow banks had no capital to absorb losses and as most of the banks had lent money to shadow banks the banking system was adversely affected. Subprime lenders started filing for bankruptcy and the news spread like a wild fire arising curiosity among the community. In late 2007 the problem went beyond the territories of Unites States of America creating a global financial crisis. Bubble symptom affected Europe. The economies in many countries in Asia were also significantly affected, even the ones without bubble symptom as the financial markets are highly integrated at the global level.

In order to solve the financial crisis in 2008 the Federal Reserve and the European Central Bank used the method of qualitative easing. In qualitative easing Central banks pump money directly to the economy by buying assets like government bonds, so that the liquidity in the economy will be increased. In the UK the Bank of England created money and use them to buy government bonds. What is expected was that this would increase the price of the government bonds; so they will become less attractive to invest in. So the companies who sold the bonds will invest the proceeds in other companies or lend them but will not invest them again in bonds. If the people are willing to lend more, the interest rates will be fallen accordingly. There will be more money in the economy so the economy will be enhanced. However for some analysts the businesses and individuals didn't react as expected but the economy could have gone more deep into the demise if this method has not been followed.

By contrast in order to solve the financial crisis in 1970, which had arisen as a result of taking off of U.S Gold standard by Richard Nixon and the OPEC oil price rise that resulted in a combination of high unemployment and low economic growth with higher rate of inflation (Stagflation) which can be termed probably as the worst crisis since the great depression, Arthur F. Burns the then president in US Federal Reserve increased demand through demand pull inflation which is the opposite of qualitative easing. This method has been praised as effective and long lasting.

However, one cannot argue that the method followed to overcome the crisis in 2007-2008 is unsuccessful. The best way to the trigger the economic growth after a financial crisis is to make cheap money available in the economy to increase investments. But what is important is that the regulators shall make sure that the excess of liquidity invest in the booming sectors of the economy that will directly contribute to the increase of the GDP and employment thereby resulting in positive economic growth. For that purpose, there shall be adequate financial sector regulations and supervision.

Further the banks shall be regulated in order to prevent lending to unworthy customers and shall be required to keep sufficient liquidity. After financial crisis new regulations were made in most of the countries to prevent sham. Banks shall now include structure investments on their balance sheets which will compel them to maintain more liquidity.

In conclusion it can be stated that cheap money is an important financial instrument that shall be used carefully subject to proper laws and regulations. Cheap money is important to any economy to achieve economic growth and to enhance the economy. It is the easiest and most effective method to increase investments. But where it is not properly regulated it will make long lasting, non-curable effects. It is the duty of the financial regulators to take advantages of cheap money without letting it go out of control. To that end every actor in the economy; from commercial banks and other financial institutions to borrowers, from investors and business people to ordinary citizens and each and every other person involved in the economy shall be properly regulated.

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