Former Australian treasurer warns of market "clean out"

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Former Australian Treasurer Peter Costello, now head of the country's $135 billion sovereign wealth fund, has warned that ultra-easy monetary policies are fuelling financial bubbles that will lead to a "clean-out" on world markets.

Costello's warning was made in an interview with the *Financial Times* yesterday and echoes others from those directly involved in the financial system, as well as media commentators and analysts.

Costello said rock-bottom interest rates and bond-buying programs by central banks had left both economies and markets vulnerable to a shock.

"What worries me is having expended all of their firepower, there is not much left for the next crisis, and there will be another crisis," he said.

Costello made clear his central concern was the potential fall in the stock and property markets that have been boosted to record heights by the inflow of money from the world's central banks—estimated to be around $7 trillion, with more to come—since world markets froze in the middle of March last year.

The former treasurer explained, "I am worried that we have unsustainable asset prices in some areas and when those asset prices fall—when the correction comes—what firepower have the central banks got left then? Nothing."

Costello singled out technology stocks in the US as being particularly vulnerable and warned of something similar to the bursting of the dot.com bubble in 2001. In fact, the outcome has the potential to be much more significant than the events of 20 years ago, because the level of speculation is far greater than it was then, fuelled by the quantitative easing programs initiated after the 2008 crisis and intensified in 2020.

Since the March nadir, the tech-heavy NASDAQ index has risen by around 90 percent. So far this year, market indexes on Wall Street have traded at record highs more than 30 times.

As if to underscore the warnings by Costello and many others, Wall Street experienced a significant sell-off yesterday.

The Dow, which had closed at another record high on Wednesday, ended Thursday down by 559 points, or 1.75 percent, after an intra-day decline of 668 points. The S&P 500 index dropped by 2.45 percent, with all of its 11 sectors in decline and the NASDAQ fell by 3.5 percent, bringing its decline to more than 5 percent so far this week.

The central cause of the increased nervousness is the continued sell-off of government bonds, lowering their price, and leading to a significant rise in their yield or interest rate (the two move in opposite directions).

During the day, the yield on 10-year US Treasury bonds, the bedrock of the US and global financial system, spiked to as high as 1.6 percent, compared to levels of around 1.3 percent earlier in the week, before falling back to 1.5 percent.

The major concern in financial markets is not so much the absolute level of interest rates, but the speed with which they rise. Ultra-low rates have fuelled an increase in speculation, promoting ever more risky ventures that are very sensitive to even a small rise.

The chairman of the US Federal Reserve, Jerome Powell, has committed the central bank to maintain low interest rates into the indefinite future and to sustain asset purchases at the rate of $120 billion per month, with an implicit guarantee that there will further stimulus in the event of market turbulence.

The European Central Bank is also looking to step up its purchases of financial assets to counter a sell-off of government bonds and a consequent rise in interest rates.

The chief economist at the European Central Bank (ECB), Philip Lane, said yesterday that it was "closely monitoring the evolution of longer-term nominal bond yields" and stated the institution's asset purchases "will be conducted to preserve favourable financing conditions over the pandemic period."

It is measure of the extent to which mechanisms, which operated in previous times, have been overturned by the inflow of cheap money and the divorce between the financial

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system and the underlying real economy, that any prospect for economic growth now threatens the stability of financial markets.

This contradiction was apparent in a media interview by ECB executive board member Isabel Schnabel yesterday.

"A too abrupt increase in real interest rates on the back of improving global growth prospects could jeopardise the economic recovery," she said.

The bond sell-off has extended to New Zealand and Australia. This week, the yield on Australian ten-year government bonds rose to 1.64 percent—the highest level in two years—prompting the Reserve Bank of Australia to intervene in the market by adding to its $A100 billion asset purchasing program, which is aimed at trying to keep interest rates down.

Following the lead of Powell, who has committed the Fed to maintain interest rates at virtually zero for the indefinite future, RBA governor Philip Lowe said he did not think economic conditions would support an increase in interest rates "until 2024, at the earliest."

This prompted a caustic comment by Costello, who said in his FT interview that asset prices could become unsustainable and inflation could rise well before then, before adding that "anyone who thinks they know what the conditions of the economy will be in three years' time is kidding themselves."

One of the major concerns in the US is that the Biden administration's proposed $1.9 trillion stimulus package, financed entirely by government debt, rather than taxation on corporations and the ultra-wealthy, will lead to a rapid increase in the supply of bonds, lowering their price and increasing interest rates, despite the efforts of the Fed to keep them down through its asset purchasing program.

Concerns over the effects of the stimulus measures on financial markets were voiced earlier this month by Lawrence Summers, treasury secretary in the Clinton administration and an economic adviser to Obama.

He warned they could "set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability."

Summers concerns have been supported, at least partially, by *Financial Times* economics commentator Martin Wolf in a column on Wednesday, which described Biden's package as a "risky experiment."

Wolf said it was "quite possible" that monetary and fiscal expansion on the scale proposed could "hugely overheat the US economy." He dismissed claims that a big upsurge in inflation was inconceivable because it had not happened for a long time as a "bad argument," noting that "many once thought a global financial crisis was inconceivable because it had not happened for a long time."

In a significant indication of the perplexity and uncertainty in the economic and political establishment, Wolf ended his comment not by setting out measures he thought should be undertaken, as he has often done in the past, but by declaring: "I pray that the Biden administration's gamble succeeds."

Others have advanced measures centring on the need for the Fed—and by implication other central banks—to put a brake on, if not entirely halt, its asset purchasing program.

In a comment published in the *Financial Times* this week, finance executive Richard Bernstein said the Fed should ignore the tantrums of the markets whenever withdrawal of support is mooted in the same way that some parents train babies to soothe themselves by ignoring their crying when they are put down to sleep.

He noted that monetary policy was "fuelling speculation" rather than supporting the lending policies needed to rebuild the US and the global economy.

As with a new baby, the Fed should not coddle bond investors' tantrums but "let the financial markets soothe themselves." Short-term financial volatility might cause some sleepless nights, but the Fed could "unleash the lending capacity of the traditional banking system by letting the yield curve steepen further."

Such a view is based on the assumption that the traditional metrics and norms still apply.

But they have been largely overturned by the injection of trillions of dollars into the financial system over the past decade and more, accelerating in the past year. This has created a mountain of speculative fictitious capital that is now the dominant force in the US economy.

Such is its inherent instability, that even the slightest threat to cut off its supply of essentially free money threatens to bring about not a passing tantrum, but a full-scale collapse. The freeze in the markets last March—potentially even more serious than that of 2008—was a warning of that prospect, and the continuing market turbulence, as exemplified yesterday, indicates the conditions that produced it are still very much present.

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