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Take the Tough Medicine Now

Jonathan Wellum (http://www.cardus.ca/contributors/jwellum/) | December 2, 2013 | **Discipline** (http://www.cardus.ca/topics/discipline) , **Economy** (http://www.cardus.ca/topics/economy) , **Markets** (http://www.cardus.ca/topics/markets) , **Politics** (http://www.cardus.ca/topics/politics)

Within the world of monetary policy, the past five years have been unprecedented. A **report this month** **(http://www.mckinsey.com/insights/economic_studies/qe_and_ultra_low_interest_rates_distributional_effects_and_ri** from McKinsey & Company warns: "The collapsing of a housing bubble in the United States, the failure of a number of major international banks, the near collapse of the euro system, and the deep recessions across advanced economies have spurred major central banks to take unprecedented measures that have significantly expanded their balance sheets."

In layman's terms, central banks have printed enormous amounts of money and driven interest rates to historic lows.

The discussion paper raises a number of significant findings. One finding of particular interest is the substantial "distributional effect" of record low interest rates. Obviously, the beneficiaries of ultra-low interest rates and quantitative easing (QE) are those with the largest debts. Since governments are the biggest debtors they are the largest beneficiaries. On the other hand, savers and capital accumulators are harmed the most as their investment income has plummeted.

Between 2007 and 2012, governments in the United States, the United Kingdom, and the Eurozone collectively benefited from the lower interest rates to the tune of USD $1.6 trillion. Meanwhile, households within these same countries collectively lost USD $630 billion in net interest income. It is this massive benefit to governments that should deeply concern us—making it easier for bloated governments to go further into debt is sheer folly. Without artificially low interest rates and accommodative central banks willing to "monetize" large swaths of government debt by printing money, governments would be more constrained and there would be greater financial discipline imposed on governments through higher interest rates.

Yes, companies have also benefited by refinancing their debt at record low interest rates and improving the value of their respective balance sheets. But in the case of businesses this leads to more efficient capital allocation and wealth creation. Unfortunately when it comes to government, easy monetary policies have furthered reckless spending and not long-term investments in the economy. Further, the ultra-low interest rates have provided many governments adequate cover to obscure their weak financial conditions—to kick the can down the road.

[(http://www.cardus.ca/blog/wp-content/uploads/2013/11/2013-12-02-kickingthecan.jpg)](http://www.cardus.ca/blog/wp-content/uploads/2013/11/2013-12-02-kickingthecan.jpg)

Consider the province of Ontario for a moment. Ontario's fiscal problem is much deeper than most residents think. In fact, with only 13.5 million people, Ontario will be one of the top 10 issuers of debt in the world in 2014!

The Ministry of Finance Public Accounts of Ontario provides us with some scandalous statistics. Ontario's total provincial debt is over $280 billion and growing at a rate of approximately $15 billion per year. Based on our provincial GDP of $670 billion our provincial debt to GDP ratio is 42%. This is one of the worst debt situations for any province or state, excluding national governments, anywhere in the developed world. During the last decade Ontario's debt has doubled in size from $139 billion in 2003 to its current level of $280 billion. Within the next 5 years 44% of the outstanding debt, or $123 billion comes due and must be rolled over. When annual deficits are added to the outstanding amount of maturing debt, the total value of money the province will have to raise and roll over will approach $200 billion! In 2014, over $45 billion of debt matures. When you add the expected deficit for the year, Ontario will have to finance approximately $60 billion in 2014! It is this amount of money that will make the province one of the largest issuers of debt in the world. Even worse, the government has no plan to address the debt problem, which would require massive changes to our health care and education programs, both "untouchable" issues.

But what happens when central banks are forced to taper their money printing and interest rates increase, even by a little? Anyone can service massive levels of debt when rates are ultra-low. But this is the problem: unprecedented monetary policy helped create the debt bubble in the first place, and now allows the continued parabolic growth of debt, especially in the hands of governments.

Economists and central bankers, most of who have never worked in the private sector nor have had to make a payroll, need to take more notice of the long-term impacts of QE and the ultra-low interest rates. The distributional effects and risks are massive and growing.

Rewarding debtors—reckless debtors—at the expense of savers will not place us on a long-term road to economic prosperity.

It is time to end QE, allow interest rates to be set in the context of competitive capital markets, and take the tough medicine now.

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