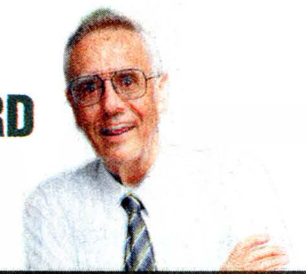
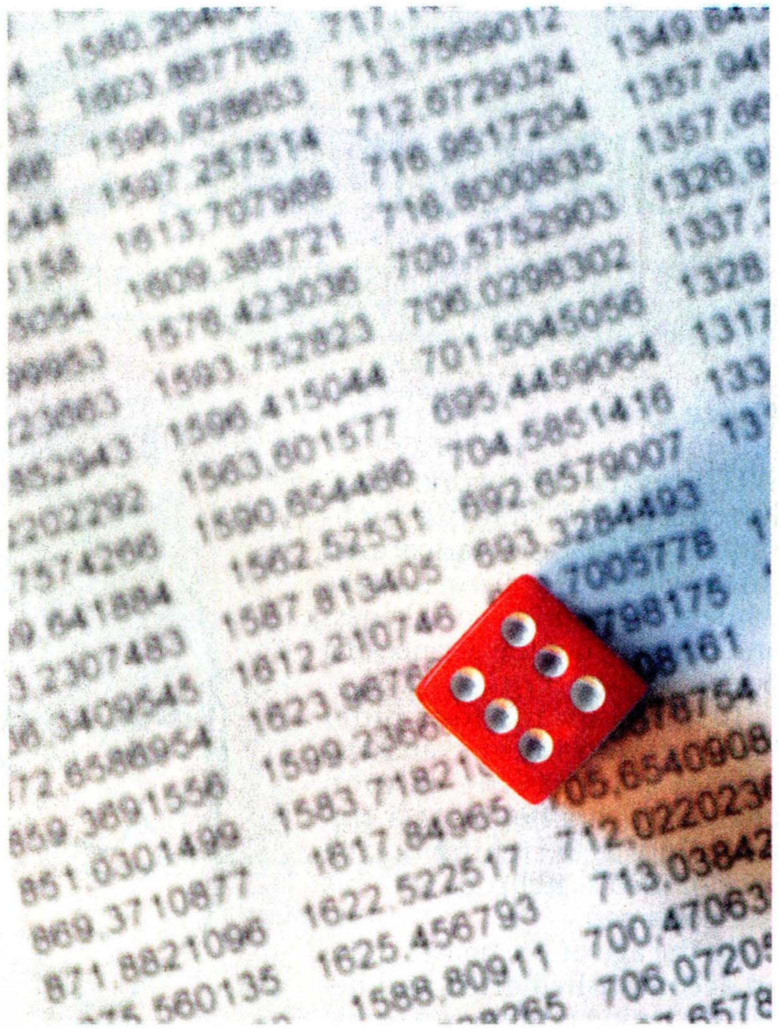
Publication: The Sunday Times, Classified, p C18
Date: 1 February 2015
Headline: We live in exciting times

THE LAST WORD



Dr Larry Haverkamp
lhaverkamp@smu.edu.sg

We live in exciting times



WE have had more economic excitement since January 1 than we usually see in a decade. First was the 60 per cent drop in oil prices in just six months. No one predicted that and we are still trying to figure out the effects.

Next, was the Swiss taking the cap off their currency, causing the Swiss franc to zoom 40 per cent higher before settling up 20 per cent, where it is today. Keep in mind that a 0.5 per cent move in currencies is big. Twenty per cent in a day is once-in-a-lifetime although, admittedly, we have been seeing once-in-a-lifetime events about every week recently!

Third was the European Central Bank deciding to act like the Americans and undertake Quantitative Easing on a grand scale. QE is increasing the money supply when interest rates are very low. It worked so well in the US that the Europeans figured: "We should do that too!"

Since 2008, the US has increased its money supply by an astounding 400 per cent. No other country has come close – except Zimbabwe, Africa – but it produced hyper-inflation there.

For the US, QE could not have worked out better. The so-called "bad" inflation of high consumer prices didn't happen. Instead, prices increased by the ideal figure of 2 per cent per year, which keeps optimism in the system without getting too near deflation or runaway inflation.

The US saw much higher asset prices, however, like for stocks and property. Stocks are at 20 times earnings, and property has hit new highs in key cities like New York City, San Francisco and London. Asset inflation is considered "good inflation" because it makes stock and property holders wealthier, which encourages spending and raises the country's GDP.

Will the European Union be so fortunate with their QE experiment? It is too early to say but the Europeans have an abundance of hope based on the US experience.

Greek tragedy

Fourth, the latest excitement has been Tsipras. What? Or who? Yes, it is who and we are talking about Alexis Tsipras, the recently elected Prime Minister of Greece who says the Greeks owe too much debt and he has a solution. Don't repay it. The rich Europeans, especially Germany, can show some kindness, some understanding and especially some forgiveness to their struggling Greek brethren. Germany's unemployment rate is only 5 per cent. Greece's is 25 per cent. Have a heart, Germany.

But whoa. There is a reason for the difference in prosperity. Every German wakes up in the morning and says: "I vant to build a machine. Today I vill build a machine. Maybe two."

When a Greek wakes up in the morning, he rolls over in bed and goes back to sleep. No machine gets built, which explains the difference in productivity between the two countries.

Germans understand this and ask: "Why should we support Greeks and their lifestyle? Let them repay their debts like they promised. If we did start forgiving the debt, it could start a bail-out stampede from the other big borrowers like Portugal, Spain and Italy who will want the same deal."

Unlike the last time they did this – four years ago – if Greece defaults on its debt and drops out (or is kicked out) of the European Monetary Union and must go back to its old currency, the Drachma, it won't be such a big deal. The other nations will likely say: "Nice knowing you, Greece. Goodbye and good luck but especially goodbye."

Was that enough excitement for you? Well, it should be. Let's not forget that we live in a part of the world where watching a 0-0 football match is considered fun.

> *Quick***Quote**
>
> **"The process by which banks create money is so simple that the mind is repelled."**
>
> John Kenneth Galbraith, economist, 1908-2006

Advanced lesson

I can hear you saying, "I want more!" OK, you want it. You got it. Here is a brief lesson in the mysteries of how Central Banks create money out of thin air.

As it turns out, no money is printed, and there is no lorry full of notes which pulls up to commercial banks and unloads. The money increase is done by the Central Banks (like MAS) which buy bonds from commercial banks (like DBS, OCBC or UOB). The bonds are typically packages of thousands of home loans called mortgage-backed securities.

The banks send these bonds over to the Central Bank and receive cash in return. But they don't receive notes. Instead, they receive permission from the Central Bank to write on their books "cash received". Think of it as "pretend cash" since it is only an accounting entry.

Banks can make loans with this pretend cash, which makes it so similar to real cash that no one can tell the difference. That's all it takes. New money has been created and it can be billions of dollars.

In a way, it is remarkable that by simply making an accounting entry – writing a number on their balance sheets – the Central Bank and commercial banks increase the supply of money.

After that, commercial banks will hopefully put the new money to use by lending it to companies and households. When they do, it has a chance of boosting the economy and perhaps increasing the rate of inflation slightly.

An adjunct professor at SMU, Dr Haverkamp contributes this column weekly to help our readers understand money matters better.