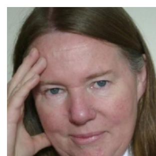
Interest rates rise to highest level since 2009 – are there any silver linings?



Geoff Meeks *and* **J. Gay Meeks** *discuss the potential effects of rising interest rates on income distribution and mergers and acquisitions.*

The media is understandably full of the unwelcome effects of rising interest rates around the world. But little is being said about other effects that are beneficial. While acknowledging the economic pain suffered by many from the rate rises, here we give two examples on the credit side – one in relation to income distribution, affecting prospective pensioners and first-time home-buyers, another in relation to market efficiency with respect to huge sums being spent on mergers and acquisitions.

Comment on effects of interest rate changes is usually in terms of *nominal* rates, which determine the cash the borrower has to hand over each year, and which track real interest rates if inflation is unchanged. We mostly follow that practice here, with the caveat that measuring and discussing interest rates is tricky when inflation rates are changing. The lender may get a gain from a rise in the interest rate, but incur a loss if the inflation rate is increasing, eroding the purchasing power of the principal when it is repaid.

Some losers from rate rises

Familiar borrowers who are adversely affected by increased interest rates include home-owners with variable or short-term fixed rate mortgages, firms heavily reliant on debt finance, and government. Andrew Bailey, Governor of the Bank of England has acknowledged the impact of the Bank's interest rises on poorer indebted mortgagees: 'I recognise the hardship this will cause for many people in the UK, particularly those on the lowest incomes, often with little or no savings…' Desmond Lachman of the American Enterprise Institute has lamented the impact of interest rate rises on stock markets (share prices reflecting the impact on firms' interest payments):

> Since the start of the year [2022], US equity prices have fallen by around 25 per cent, bond prices have declined by more than 20per cent, …These declines have resulted in a cumulative loss in household financial market wealth of some $15tn.

And the UK Office for Budget Responsibility, reviewing the state of Government finances, reported in 2021 that 'Every one percentage point rise in interest rates would increase [Government] debt interest spending by £20.8bn.' – a figure which would otherwise be a welcome addition to, say, the NHS budget, or other Government programmes for the most vulnerable.

Some winners from rate rises

In contrast, the end of the period of ultra-low interest rates can bring relief to those trying to build a future pension. Paul Johnson of the Institute of Fiscal Studies commented: 'Low interest rates as you save and low annuity rates at the point of retirement make it staggeringly hard to save enough to acquire a decent pension.' (A similar challenge has confronted would-be first-time home buyers trying to accumulate enough savings for a mortgage deposit, especially as the low interest regime has stimulated rapid growth in house prices, inflating the mortgage deposit required. While existing home-owners have benefitted from the boom, prospective ones have lost out.)

How far interest rates have sunk in real terms, and how hard it can be to fill a pension pot by saving is illustrated by NS&I's Index-linked Savings Certificate, often regarded as a safe investment suitable for someone nearing retirement: it has been paying an interest rate of 0.01% (alongside indexing the principal). When a saver reaches pension age and looks to swap their pension pot for a guaranteed income until death – an annuity – the prevailing interest rate is again crucial. In Paul Johnson's words again: 'In the 1990s, £100,000 would have bought a 65-year-old an income for life of about £10,000 a year. Today [2019] it will buy little more than £4,000 a year.' The recent rises in interest rates have brought some relief: £100k will currently buy an income of around £6k. Johnson continues: 'very low interest rates have also played a central role in killing off the sort of salary-related "defined benefit" occupational pensions that many employers used to provide'. These schemes guaranteed pensions for life, and are a great source of security for the beneficiaries. But in the private sector, many have been abandoned.

One of the funds which has not been 'killed off' is the Universities Superannuation Scheme (USS), for academics, but even so they are affected by the interest rate (disclosure – we were ourselves contributing members of the Scheme). The very low interest rates in the March 2020 valuation of the USS fund contributed to a funding hole (liabilities exceeding assets) of £14bn. In April 2022, the managers of the scheme slashed the benefits for future pensioners, 'reducing the threshold at which workers stopped receiving defined benefits from £60k to £40k … guaranteed future pensions for the average lecturer were cut by one-third.' However, the subsequent interest rate rises reduced the cost of future pension promises (see the numerical illustration below) and, along with increases in the value of the scheme's assets, meant that by the time the benefit cuts had been implemented the funding hole 'had shrunk from £14bn to £1.6bn'. It may be possible to restore some of the recently eliminated benefits now that interest rates have risen.

Another caveat. Sometimes the prices of financial assets held by pension funds tend to rise when interest rates fall. So in the pensions case, asset price rises might to some extent compensate for liability increases caused by the interest rate fall. But, for example, at times of crisis, when share prices have fallen sharply and the authorities artificially depress interest rates in the hope of bolstering confidence and activity, pension fund assets shrink just when the liabilities are recorded as increasing because of the depressed interest rate. Asset and liability changes are again mutually reinforcing when, to dampen an overheating economy with a share price boom (asset values rising), interest rates are increased (decreasing liabilities). The finer points of pension fund valuations, are discussed in our earlier blog, which forewarned of the volatility of the USS fund. For example, illustrating the powerful role of interest rates, we noted that, in 2009, to pay £10,000 pounds to a pensioner 60 years later, you would have needed £1,043 with the 2009 interest rate, but £3,369 just a year later when the prescribed interest rate had roughly halved).

Interest rate policy

What lies behind such large swings in interest rates, producing seemingly arbitrary large scale redistribution between winners and losers of income and wealth? In the wake of the 2008 financial crisis, central banks wisely adopted ultra-loose monetary policy, resulting in substantial reductions – of the order of 2% – in interest rates. Without the intervention, the financial system was in danger of collapse. The intervention was expected to be short-lived. However, for various reasons the authorities found it convenient to continue rigging interest rates, fearful of restoring them to their level before central bank intervention and thereby upsetting borrowers, some of whom we identified above. There had developed an 'asymmetric monetary policy', whereby the authorities supported markets when they plunged but failed to dampen them when they were prone to bubbles. Rana Foroohar observes that central banks have in recent years 'in some profound way manipulated the market'. They have pumped in 'unprecedented amounts of money'. And 'both interest rates and balance sheets need to be normalized.'

Some consequences for market efficiency

Normalising interest rates could mitigate a problem which has led to costly inefficiency in the huge market in mergers and acquisitions. Rigging the market gave some borrowers an 'exorbitant privilege' at the expense of groups we have mentioned – savers, buyers of annuities, members of some pension schemes. The company sector responded to the low interest regime. The global stock of non-financial corporate bonds doubled in real terms between 2008 and 2019 to $13.5 trillion. Among the beneficiaries were merging companies: the privilege meant that a merger funded by subsidized debt could bring a benefit to shareholders even if it proved inefficient, an outcome observed in many mergers. Debt-finance came to overtake share exchange as the preferred funding mechanism for mergers and acquisitions. Commenting on a study from the Federal Reserve Bank of New York, the *Financial Times* (2022) wrote: 'The trillions they were able to raise at alluringly low rates were often ploughed into [mergers and acquisitions] […] These dealmaking sprees turned out to be disastrous for those companies…'

The private equity industry has seized the opportunities for financial engineering arising from central banks' interventions to force interest rates below the level they would reach in a free market. Kaye Wiggins commented: 'The US Federal Reserve's decisions to cut interest rates to zero […] ensured private equity's continued access to cheap debt for new deals'. 'Ultimately the lifeblood of private equity is cheap debt', said Bryce Klempner, partner at consultant McKinsey.' A later comment reinforced the point: 'They all think they're geniuses because their companies are doing really well', quoted Wiggins from one commentator, who went on: 'But if it weren't for central bank policy, things would be very different'.

Our new book, *The Merger Mystery: Why Spend Ever More On Mergers When so Many Fail?*, explores how the combination of low interest rates with tax privileges, moral hazard, misaligned incentives, and accounting tricks has resulted in a booming but dysfunctional market for mergers and acquisitions. Manipulated interest rates have added to the distortions and inefficiency which characterise the mergers and acquisitions market.

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