Ultra-Easy Money: Digging the Hole Deeper?

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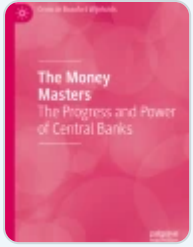
Abstract

The global situation we face today is arguably more fraught with danger than was the case when the crisis first began. By encouraging still more credit and debt expansion, monetary policy has “dug the hole deeper.” The fundamental analytical mistake has been to model the economy as an understandable and controllable machine rather than as a complex, adaptive system. This mistake also implies that the suggestion that central banks should necessarily reduce the “financial rate of interest,” in response to a presumed fall in the “natural rate,” is overly simplistic. In practice, ultra-easy policy has not stimulated aggregate demand to the degree expected but has had other unexpected consequences. Not least, it poses a threat to financial stability and to potential growth going forward. Further, “exit” threatens to be delayed in many countries, underlining the dangerous fact that the

global economy has no nominal anchor. Much better would be policies, introduced by other arms of government, that would recognize that the fundamental problem is not inadequate liquidity but excessive debt and possible insolvencies. The policy stakes are now very high.



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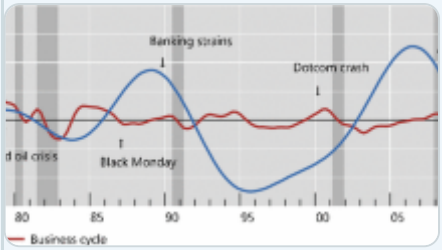

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Notes

1. For a record of these changes, which have affected all aspects of the conduct of monetary policy, see White [2013].

2. This was the term used by Ken Rogoff in his Adam Smith presentation to NABE in 2011. See Rogoff [2011].

3. The underlying model is that of Wicksell [1936]. He drew the distinction between the “natural rate” of interest and the “financial rate” of interest. The former is related to the expected rate of return on investments and the latter is a longer-term rate of interest set by the financial system under the influence of the central bank. The latter is observable while the former is not. When the natural rate is below the financial rate, the result will be a decline in the price

level and vice versa. In this model, a change in the price level is the only indicator of disequilibrium in the system.

4. As discussed briefly below, a wide variety of economic agents, both private and public, held “false beliefs” that led them to act imprudently. While this paper focusses on central banks, this should not be interpreted as indicating a wish to downplay the important role played by other agents.

5. My initial disagreements with this view were expressed many years ago. See Borio and White [2003] and White [2006, 2012].

6. It should be noted that fiscal policies in most AMEs erred in the same asymmetric way. Thus, government debt stocks ratcheted up, cycle after cycle, to essentially “unsustainable” levels in many countries.

7. There was a vigorous debate about such supply side issues in the pre-War period. See Selgin [1997].

8. Careful historical analysis indicates that the Great Depression was essentially unique in there being an association between falling prices (CPI) and a shrinking economy. See Atkeson and Kehoe [2004] and Borio and others [2015].

9. There is now a huge literature documenting earlier crises in which both the real and financial sectors have been affected. Common themes are some early piece of good news that justifies optimism, associated financial innovation, and a significant expansion of credit and debt. In addition to the classic reference, which is Kindelberger and Aliber [2005], also see Reinhart and Rogoff [2009], as well as Schularik and Taylor [2012].

10. However, in both the U.S. and the U.K. there was a marked increase in

concentration in the banking system. Otherwise put, the “too big to fail” problem got worse. For an explicit recognition that this problem has not yet been adequately dealt with, see Financial Stability Board [2016].

11. For a description of the many differences between the policies of the Fed and the European Central Bank, see Fahr and others [2011].

12. The Federal Reserve was the first and most enthusiastic advocate of such policies. The European Central Bank was much more reluctant, but eventually also subscribed. The Bank of Japan, under Governor Shirakawa, was also reluctant but, under the subsequently appointed Governor Kuroda, things changed dramatically. “Abenomics” subsequently included a massive increase in the size of the Bank of Japan’s balance sheet as one of its three “arrows.”

13. A large part of this is due to weak prices for commodities, energy in particular. However, other measures of inflation and inflationary expectations have also been weak.

14. Core inflation in the US is not much below 2 percent, and most estimates indicate the output gap is now quite small. Nevertheless, both market and survey based measures of inflationary expectations continue to decline.

15. For a fuller description of the various ways in which ultra-easy monetary policy might actually decrease consumption and investment, see White [2012].

16. See Buttiglione and others [2014]. For a similar analysis, see McKinsey Global Institute [2015].

17. For a general discussion of these issues, see Bank for international

Settlements [2016]. Also Borio and others [2015].

18. See Cecchetti and Kharroubi [2015] for a discussion of the effects on real growth of the expansion of the financial sector.

19. Andrew Smithers has repeatedly and convincingly made the following argument. For a manager whose bonuses are linked to stock market performance, it pays to issue bonds at low rates to either buy equity or increase dividends. Cutting investment frees up more cash to the same end. In a similar vein, Mason [2015] provides empirical support for the argument that "Whereas firms once borrowed to invest and improve their long-term performance, they now borrow to enrich their investors in the short run" He attributes this change to the shareholder revolution of the 1980s.

20. Borio and others[2015] provide estimates of the magnitude of these effects. They are not trivial, amounting to one-quarter of a percentage point off growth (annually) in the upturn and double that in the subsequent downturn.

21. For example, see Hoffman [2013]. Also the extensive discussion of these issues in Eurofi [2016]. Of particular note, to the extent that low interest rates push up the deficits of corporate pension funds with defined benefits, the corporation must fill the gap. This will be a direct charge on cash flow and profits. It is hard to avoid the conclusion that this will discourage investment.

22. The return on equity for institutions designated as Systemically Important Financial Institutions (SIFIs) has fallen dramatically in recent years. The irony is that, if public sector polices have rendered them unviable while leaving them still "too big to fail," the taxpayer will once again be on the hook.

23. The insights of those managing active funds have been overwhelmed by

these correlations and they have systematically underperformed ETFs. A recent survey indicates that passive funds now account for one-third of all fund assets in the U.S. Marriage [2016] and the associated FTfm special report on Exchange Traded Funds outline the associated dangers.

24. See BCA Research [2016], which contends “the corporate releveraging cycle is far more advanced than widely believed” and “overall corporate health looks only mildly better excluding the troubled energy and materials sector.” Also Authers [2016].

25. See Box ll.C in Bank for International Settlements [2016]. Perhaps the most remarkable anomaly has been the persistent and significant violation of the Covered Interest Parity condition, for euro/dollar and especially for yen/dollar. Against the backdrop of an excess of dollar assets relative to on balance sheet liabilities, foreigners are finding that dollar financing has become increasingly difficult. Moreover, with strong pressure from the Japanese government on Japanese financial institutions to raise returns by investing abroad, and the incentive provided by negative risk-free rates in Japan, this problem can only get worse. Other anomalies are the growing gap between corporate bond spreads in the Eurozone and CDS spreads, and the relative performance of the Nikkei and Topix in Japan. Both clearly reflect central bank asset purchases.

26. At the end of July, the Bank of Japan announced an expansion of its US dollar funding facility for Japanese banks, allowing them to roll over dollar loans for as long as four years. Presumably this was done in recognition of potential dollar funding problems and with the agreement of the Federal Reserve.

27. Der Nederlandische Bank organized a conference on this issue in Amsterdam in November 2015. The Council on Economic Policies, a Zurich think tank, has also cosponsored a number of such conferences with central banks, including a number of regional Feds. For a quantitative analysis of the magnitude of these effects, see Domanski and others [2016].

28. See the discussion in Group of Thirty (2015), for which I was the project director and draftsman. More recently, the Institute for New Economic Thinking (INET) and the Official Monetary and Financial Institutions Forum (OMFIF) have "proposed to work together to examine the roles, performance and governance of central banks."

29. China is a leading example, with the government now publically agreeing that there is significant overcapacity in many industries including steel, aluminum, cement, glass etc. Distribution networks, not least shipping, also suffer from overcapacity as indicated by the recent filing for bankruptcy by Hanjin Shipping in South Korea.

30. Recall the "taper tantrum" of June 2013 when Chairman Bernanke merely hinted at the possibility of a "tapering" of QE purchases in September.

31. From 2009 to 2015 Q3, U.S. dollar denominated debt owed by non-bank borrowers outside the U.S. rose about 50 percent to $9.8 trillion. It doubled to non-bank borrowers in EMEs to $3.3 trillion. See Bank for International Settlements [2016, pp. 12–13].

32. In August of 2016, the IMF's Article 4 review of China gave a stark warning about the quality of credit in China. See also Blundell-Wignal and Roulet [2014] who note that much of the EME borrowing has arisen in industrial sectors where the rate of return on capital has been falling in recent years.

33. For example, see Bank for International Settlements [2011].

34. See White [2015] for a discussion of the many shortcomings of the current "non-system."

35. Central banks have embarked, full speed ahead, upon what is the biggest, global macroeconomic experiment of all time. Contrast this approach with that of scientists involved in genetic research, in particular gene splicing. There, enormous importance is given to the need to protect against "unintended consequences." Similarly, all new drugs in AMEs must be tested, not just for their effectiveness, but also their side effects.

36. A closely related question is whether recent developments are caused by "secular stagnation" or are rather the product of successive "boom-bust" cycles with the downside effects perhaps exacerbated by the effects of easy monetary policies on the supply side of the economy.

37. Developments in China seemed to have exerted a significant influence on the FOMC's decision in September 2015 not to raise the policy rate. However, members of the FOMC at the time emphasized that this was not done in China's interests, but due to the associated knock on effects (perhaps aggravated by associated slowdowns elsewhere) on the United States itself. International concerns seemed off the table when the FOMC raised the policy rate in December, but seemed to return around the time of the Brexit vote in June of this year.

38. Central banks are part of government. Therefore, when central banks buy longer-term government debt with central bank liabilities, they are essentially replacing the government's longer-term, fixed rate obligations with short-term debt which tends to have a much lower rate of interest. Indeed, in some countries that rate is now negative. Accordingly, exit from QE will increase government deficits. So too will raising policy rates.

39. Representatives of Fed Up, an activist group, met with an unprecedented number of senior Fed officials at Jackson Hole in late August.

40. One reason people are prepared to buy sovereign bonds at negative rates is

that they expect even more negative rates, raising the possibility of future sales and a short-term capital gain. However, the moment that doubts arise as to the central bank's resolve to facilitate this, the appetite for bond purchases will disappear. The unprecedented increase in JGB rates in a few days in early August might have been an example of such a phenomenon. The proximate cause was the BOJ announcing a bond buying program that was less generous than the market expected.

41. Baranova and others [2016] suggest problems are less likely to arise from a shortage of collateral (in periods of stress) than from a reduction in dealer intermediation capacity. In effect, "collateral may be unable to reach those that wish to use it." This could result in fire sales and funding difficulties.

42. In both Japan and the Eurozone, massive increases in the base money provided by central banks have not led to significant increases in broad money. This is because the central bank purchases of debt have largely come out of the portfolios of banks. A "tipping point" for expectations could possibly arise when nonbanks begin to sell bonds in exchange for central bank money and measures of broad money do finally begin to increase.

43. When the Fed raised rates in December, long rates did not rise but fell. This is more consistent with Risk-Off behavior and market anticipations of slower growth not faster growth. Similarly, when the BOJ introduced negative policy rates in January of this year, the Yen rose (Risk Off) rather than fall. As a further sign of decreasing confidence, in only one week in August, the Financial Times had three major op ed pieces by respected observers (Amar Bhidé, Bill Gross and Eric Lonergan) all expressing views similar to those contained in this paper.

44. For example, Buiter [2009].

45. Off-balance sheet sovereign obligations, implicit in current legislation, are

huge relative to traditional measures of public debt. In a recent article, Miron [2016] calculates the size of the "fiscal imbalance" (FI) in a number of countries. By FI is meant the present value of future expenses less the present value of future revenues all expressed as a percentage of the present value of projected future GDP. The FI for the U.S. is 5.4 percent (Table 1, p. 24) and for France and Germany is 14.6 and 13.9 percent, respectively.

46. Given the inherent difficulties in choosing new projects and implimenting them properly, initial emphasis might be put on maintenance and enhancements of existing infrastructure.

47. Funke and others [2015] look at the political aftermath of past financial crises. Their database covers 20 AMEs over 140 years and the results of over 800 general elections. They argue in their Abstract that "Our key finding is that policy uncertainty rises strongly after financial crises as government majorities shrink and polarization rises. After a crisis, voters seem to be particularly attracted to the political rhetoric of the extreme right, which often attributes blame to minorities or foreigners." Normal business cycle downturns do not have the same political consequences.

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