ADDENDA CAPITAL

Viewpoint
on Monetary Policies

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What to Do if the Well Runs Dry?

At its August 4th meeting, the Bank of England's (BoE) Monetary Policy Committee voted to cut the Bank Rate by 25 basis points to 0.25%. This rate cut, the first since March 5, 2009, was anticipated by the market. As well, in an attempt to stave off the drop in confidence and the increased uncertainty caused by the United Kingdom's vote to leave the European Union (Brexit), the BoE announced other quantitative easing measures (the purchase of government and corporate securities and a new funding scheme for commercial banks).

The British central bank Governor, Mark Carney, announced that more quantitative easing measures would follow if necessary but that unlike some of his counterparts, he is not in favour of bringing the bank rate into negative territory. By taking exception with negative rates, he confirmed his conviction that a high priority must be equally given to financial stability considerations as well as to measures that sustain growth and deliver inflation at the target. This position clearly sets him apart from his counterparts at the European Central Bank, the Bank of Japan and some other central banks in Europe, notably the central banks of Switzerland, Denmark and Sweden who have brought interest rates down into negative territory. The combined effects of these negative policy rates, often reinforced by aggressive security purchasing programmes by the central banks, have brought a number of countries' government bond yields into negative territory. As of September 15, approximately 9 trillion dollars of government bonds or 19% of total outstanding sovereign debt were trading at negative yields.

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Since the 2008 financial crisis, central banks all over the world did more than could have been expected to stimulate the economic recovery and attempt to prolong it. The financial repression[1] caused by low or negative policy rates along with the sometimes exponential expansion of the balance sheets of major central banks that began in 2008, continues to intensify.

Central banks have relied on financial markets to transmit the impact of this expansion of liquidity to the economy. Firstly, repressed policy rates have anchored the term structure of rates at a low level. By reducing the cost of credit, central banks aim to facilitate access to credit and thus provide a direct stimulus to interest rate sensitive spending: the purchase of durable goods, residential investments and business capital spending. This is the most direct conventional channel through which monetary policy attempts to influence aggregate demand. Rate reductions and non-conventional measures, such as the purchase of securities, also influence the value of financial assets. First of all, lower interest rates increase the value of the expected future cash flows from these investments. Moreover, the direct purchases of securities by central banks create additional demand for these assets thereby pushing their prices higher. As the value of financial assets rises, their owners are likely to experience a positive wealth effect which could incite them to increase their spending. Through this wealth effect, expansionary monetary policy may therefore find another channel to stimulate demand.

Unfortunately, it seems that the effectiveness of expansionary monetary policies has weakened. Firstly, the positive wealth effect on holders of financial assets is restricted to a rather small percentage of the population. Indeed, a substantial portion of savings is held by institutions, and is thus less visible and not easily accessible by beneficiaries of these assets. Moreover, a significant portion of financial assets is held by the wealthiest whose marginal propensity to consume is rather low.

Alongside this less potent wealth effect, population aging in several developed countries undermines the net impact of the stimulus provided by lower interest rates, especially when these rates are very low or negative, and continue to remain low for some time. In fact, as an increasing number of people are getting close to retirement or have retired, lower rates have a negative impact on the income of this growing segment of the population. Those who save to accumulate capital for retirement and choose to invest in low risk assets, have to save more when interest rates are low and hence will be forced to reduce their consumption. As well, due to the diminished returns on low-risk investments, those who are already retired and rely on their investment income for their consumption needs are also forced to reduce their spending or to deplete their capital at a faster rate than anticipated. This unintended and undesired outcome from low interest rates, is clearly stronger given the current demographic profile. After eight years of financial repression, the capacity of monetary policy to stimulate the economy is not as strong as it once was.

Given the muted impact of monetary policy on economic growth despite an unprecedented degree of intervention, we therefore question whether monetary policy is the appropriate tool. This question is all the more valid since, despite weak economic growth, the prices of a number of financial assets have increased substantially due to the abundance of liquidity. With an aging population and the slowdown – if not the exhaustion – of productivity gains, the reliance on monetary policy seems pointless. Even worse, relative to the underlying economy's growth rate, prices of financial assets are increasing at a dangerously rapid pace.

[1]We refer to financial repression when income generated by savings is lower than the rate of inflation. This happens particularly when central bank monetary policy keeps interest rates at lower levels than the rate would be in the free open market without such central banks' interventions.

The Recent Trend towards Lower Real Rates

A study published in December 2015 by staff researchers at the Bank of England[2] acknowledges that the long term real rate has decreased over the past 30 years. The study identifies many of the factors mentioned above, notably demographics, the slowdown in productivity gains and income inequality, which have impacted savings and investments during that period, and thus contributed to reduce the long term real interest rate by 450 basis points. The researchers in this study were able to identify and estimate the impact of several elements that could explain approximately 300 basis points of this decline.

The Helicopter or the Symptom of a Problem of Expectations

Despite eight years of strong monetary stimulus, real growth and inflation remain below the objectives set by the governments and central banks. At this point, it seems fitting to argue that there is still too much excess capacity given the distribution of income and wealth. The persistence of weak business investment will eventually eliminate this excess capacity. If the authorities acknowledge that the market mechanism is the solution to this problem, they must be aware that a return to the stronger post-war growth norm is unlikely given the current demographic environment and the weak productivity gains.

In contrast, if the monetary and fiscal authorities are really determined in their attempts to support more rapid growth and inflation, they may resort to "helicopter money" – a mechanism by which the central bank would fund a higher public deficit, resulting from higher infrastructure spending or from greater purchasing power redistribution (tax cuts and increases in transfer payments) to the poorer segments of the population who have the highest marginal propensity to consume.

Have we reached the Limits of Activism?

The prolonged period of financial repression and the negative level of interest rates in several countries are proof that monetary policy has been used to its maximum, even maybe excessively, since the financial crisis. Until now, central banks have chosen to spur growth and inflation and accepted the risks for financial stability that may arise as a consequence of that choice. We should question the diagnosis and the prescription since global growth remains sluggish and inflation remains low after eight years of this medicine. Although a massive injection of liquidity is the undeniable prescription remedy to end a financial crisis, we have doubts on the validity of prolonging this treatment several years after the crisis has been contained.

As we examine the components of growth in several large countries, we notice that the slower pace of growth these past few years is due to three elements: business investment, exports and public spending. Firstly, capital expenditures are presently much weaker relative to their previous trend. Second, since the financial crisis, the trend in many countries that rely on exports has been much less supportive than in the previous period of rising globalization[3]. Third, public expenditures in goods and services and fixed assets are lower than in previous periods.

Can we look forward to a resurgence of these three elements currently responsible for the weakness in aggregate demand? As for private sector investments, we must recognize that corporations continue to optimize. In an environment in which sales are not growing rapidly and the current production capacity is more than sufficient, the corporate sector optimizes profitability by reducing production costs as much as possible or by consolidating the industry by buying out competitors. As long as there is no improvement in demand or a shortage of labor or wage inflation, it is highly unlikely that the corporate sector will increase the pace of investments. This is the problem of the chicken or the egg. It is therefore very unlikely that corporate investments will ignite growth in the near term.

[2]Lukasz Rachel and Thomas D Smith, Bank of England, Staff Working Paper No. 571, Secular drivers of the global real interest rate, December 2015, 63 pages http://www.bankofengland.co.uk/research/Pages/workingpapers/2015/swp571.aspx

[3]See the Bank of Canada study on the causes of the slowdown in global trade at http://www.bankofcanada.ca/wp-content/uploads/2015/05/boc-review-spring15-francis.pdf

The likelihood of an imminent strengthening in foreign trade also appears rather weak. During the 90's and up to the financial crisis, international trade grew at an average rate of 7% per year in real terms while the global economy grew at an average rate of 3.6%. During the Great Recession that resulted from the financial crisis, world trade collapsed by 37% in nominal terms and by 18% in volume.

At the beginning of the recovery and until 2011, world trade improved to some extent. Since 2012, world trade has been growing at a 3.1% rate in real terms, which is similar to the real global economic growth rate of 3.2%. We must conclude that the powerful forces of globalization that prevailed during the two decades prior to the financial crisis have withered. This resulted from the natural evolution in the integration of the global production process, which has reached a certain degree of maturity and saturation. There is also the fact that China, the second largest economy, is attempting to rebalance its growth in order to be less reliant on foreign trade and investments. Finally, the relatively sharp drop in the price of oil had a strong negative income effect on oil exporting countries, which in turn caused a decline in their imports, thus reducing world trade. Although world trade will probably regain some vigour, it is unlikely that it will become the engine of growth that it was during the peak of the wave of globalization before the financial crisis. The current populist and protectionist political context is also not conducive to a resurgence of global trade.

Public sector spending is the third element. Governments made huge concerted efforts to kick start the recovery following the financial crisis. Without these efforts, the Great Recession could have turned into a depression. As government indebtedness rose sharply and quite rapidly, authorities felt compelled to return to budgetary austerity. After a few years of austerity and faced with a lackluster economic recovery, the popular consensus in favour of capitalism, monetarism and globalization has eroded. In reaction to stagnating salaries and increasing inequalities, the electorate now supports politicians whose programs are more socialist, Keynesian and protectionist in nature. The political timing to engage in public spending on infrastructure, transfers and training for workers most affected by globalization seems appropriate. To revitalize the economy in the short term, a return to a more balanced combination of fiscal and monetary stimulus measures would perhaps be more effective. However, on a longer term basis, demographics and inequalities will remain ever-present and sizable challenges.

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