Over Easy

Can monetary policy become self-defeating?

George Cooper, Chief Investment Officer

Low interest rates are supposed to stimulate economic activity. Very low interest rates are supposed to stimulate economic activity even more. This linear thinking, which dominates monetary policymaking, is now being questioned.

For two and half decades Japan has been trying to push inflation higher by holding interest rates at close to, or recently, below zero percent (See Figure 1). The policy has not worked, the latest Japanese Consumer Price Inflation rate stands at just 0.2% year-on-year.

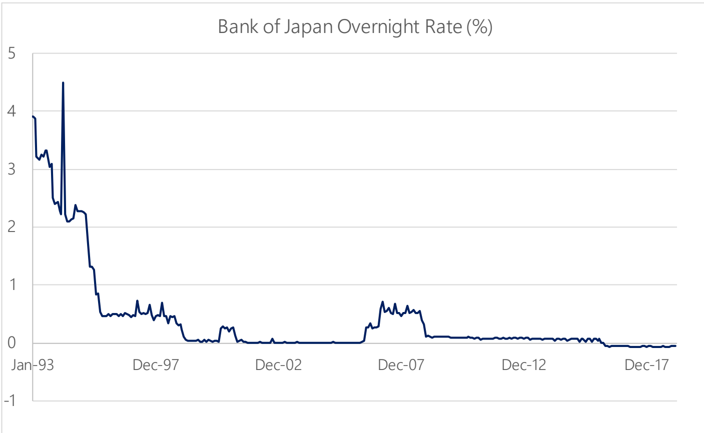

Figure 1 Source: Bank of Japan

The Japanese experience has demonstrated the practical limitations of monetary policy.

A decade ago, as a result of the Global Financial Crisis, all of the world's other major central banks followed the Japanese lead and sharply moved interest rates lower. Interest rates in the Eurozone have been negative for almost five years now (Figure 2). The situation in the UK and many other developed economies is not dissimilar.

The latest data from the Eurozone economy suggests Europe is following the same trajectory as Japan, also heading into a deflationary trap. The latest business activity indicators across Europe are showing a deceleration of activity despite the low interest rate environment (Figure 3).

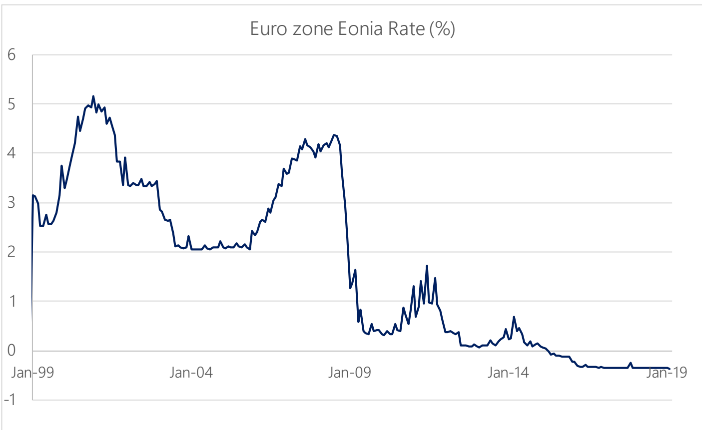

Figure 2 Source: European Money Markets Institute

Disentangling cause from effect in economics is always problematic. We know Japan and Europe have both experienced low-growth, low-inflation regimes and we know policymakers have responded to this by imposing low-interest rate policies. We also know that the low interest rates have not reignited either growth or inflation in the way policymakers expected. Conventional wisdom explains the apparent impotence of monetary policy using a counterfactual argument. It is assumed the low interest rate policies are working to stimulate economic activity, in accordance with economic theory, but that the external forces supressing economic growth are too strong for monetary policy to cope with.

In other words, if the monetary policy were not suppressing interest rates to the degree they are, economic activity would be much lower than it currently is. This is an argument based on an assumed counterfactual.

Most people now accept communism as being a discredited economic model. But some still cling to their faith, claiming it was never implemented rigorously enough. This counterfactual reasoning is problematic. It suggests a policy that is manifestly failing should be tried with even greater vigour, when perhaps the policy itself needs changing.

So far, conventional wisdom on monetary policy has also followed counterfactual logic. Low interest rates stimulate economic activity, even lower interest rates stimulate economic activity even more. So, if the monetary stimulus is not working, it's because we haven't done enough of it.

Counterfactual reasoning can encourage policymakers to dig themselves ever deeper into a hole of their own making, leading to policy mistakes that may last for decades.

When confronting policy failure, diehard monetarists, like diehard communists, often claim their policies have not been tried hard enough.

Fortunately, some economists are now beginning to question this monetary policy logic. The Bank of International Settlements has a long and impressive history of thinking outside the box on monetary policy issues. They were one of the few institutions to warn early and vocally of the building financial instability ahead of the Global Financial Crisis.

Last month the BIS published a paper – "The expansionary lower bound: contractionary monetary easing and the trilemma" – challenging the prevailing wisdom on monetary stimulus.

The paper argues there is an Expansionary Lower Bound (ELB), an interest rate below which further monetary easing begins to shrink rather than expand economic activity.

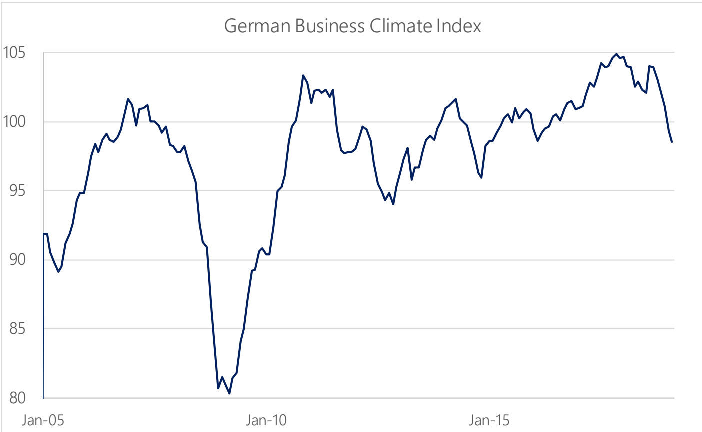

Figure 3 Source: IFO Institute

The paper discusses two scenarios in which lowering interest rates may cause a contraction of economic activity, both of which are relevant only to emerging market economies.

The scenarios will be familiar to anyone who has observed emerging market debt crises.

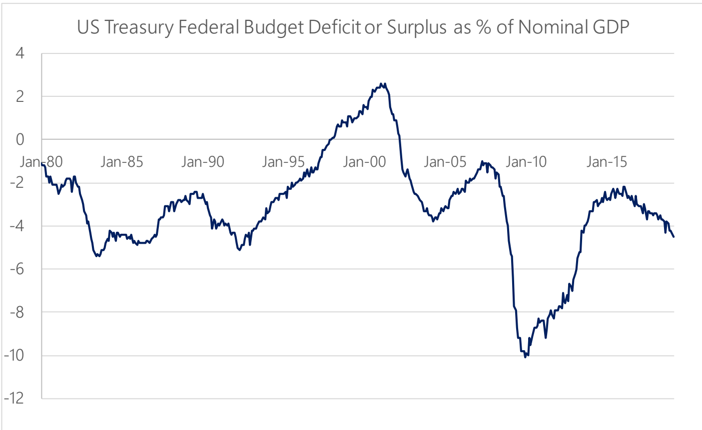

Figure 4 Source: US Treasury

The banking system of the emerging economy is assumed to have borrowed heavily in a foreign currency, typically US Dollars, while lending in its own domestic currency. From this starting point, an aggressive lowering of domestic interest rates causes the domestic currency to depreciate relative to the Dollar. As a result, banks' foreign liabilities rise in value relative to their domestic currency interest receipts. Banks struggle to fund their foreign currency obligations and therefore begin contracting their lending activity. Since a lowering of interest rates further depresses the value of the currency of the emerging economy any further interest rate cut leads to a contraction rather than an expansion of credit in the economy.

The second model is a variant on the first involving foreign investors. Foreign investors are assumed to have loaned money in the domestic currency of the emerging economy by purchasing local currency bonds. If the easing of monetary policy drives down yields on those foreign held bonds to unattractive levels the investors begin selling. This creates a need for the private banking system to purchase the bonds, which they do so by curtailing their domestic lending. In this way foreign selling of bonds crowds out domestic loan origination as interest rates are lowered.

The processes described by the models used in the BIS paper have been well understood for a long time. What is new is that the BIS is explicitly linking these processes to excessively easy monetary policy by introducing the concept of an Expansionary Lower Bound on interest rates.

If the BIS paper has a fault it may be that it is insufficiently ambitious. The authors constrained themselves to discussing emerging market economies by making inter-country lending, exchange rate movements and interest rate differentials central to forming the Expansionary Lower Bound. These factors are unimportant in large developed economies which borrow in their own domestic currency. Nevertheless, as discussed, both Japan and the Eurozone show the low-interest rate, low-growth symptoms consistent with an economy operating below the Expansionary Lower Bound. This suggests the ELB condition may not be confined to emerging economies.

It is not difficult to imagine scenarios where lowering interest rates could have an unexpected contractionary effect in developed economies. One potential model involves demographics and pension funding:

The developed economy has a demographically aging population. The economy has adopted a funded pension scheme model, requiring workers to accumulate savings ahead of retirement. Rules are introduced to ensure prospective pensioners save sufficiently for retirement. Those rules calculate net-present-value of future pension liabilities using long term interest rates.

As interest rates are lowered the valuations of future pension liabilities appears to rise. This causes workers to divert a greater share of their current income from consumption to pension savings. The excess of savings in pension schemes causes long term interest rates to fall even further, creating the need for even more pension savings.

In this scenario, companies will find it easy to borrow money. But at the same time, they may be faced with a deficit of final demand, caused by the sacrifice of workers' income into pension contributions. Despite being able to invest, companies may find they have no incentive to do so.

Therefore, in an extremely low interest rate environment, the low returns on pension savings may remove enough domestic demand as to make further interest rate cuts contractionary.

Doubtless it is possible to imagine many other connections, operating through banking and financial system, whereby artificially low interest rates and flat yield curves make it commercially unattractive to extend loans.

Interestingly the BIS paper concludes by noting *"the presence of the ELB calls for an active use of the central bank's balance sheet, for example through quantitative easing and foreign exchange intervention. Furthermore, the ELB provides a new rationale for capital controls and macro-prudential policies, as they can be successfully used to relax the tensions between domestic collateral constraints and capital flows. Fiscal policy can also help to overcome the ELB, while forward guidance is ineffective since the ELB increases with the expectation of looser future monetary conditions."*

The necessity for fiscal policy to step in to take the strain once an economy has hit the Expansionary Lower Bound of interest rate policy is noteworthy. We have written previously and critically on Modern Monetary Theory which also argues for fiscal stimulus. However, calls for greater fiscal stimulus are, we think, likely to grow ever louder in coming years. Although we are critical of the logic behind MMT, at present, there is merit to the arguments for fiscal stimulus – especially in the Eurozone.

Conclusion

The concept of an Expansionary Lower Bound to monetary policy, a minimum interest rate below which further rate reductions become counterproductive, is a persuasive idea. The experience of both Japan and Europe suggests the ELB may be generally applicable to both developed and emerging economies.

The United States currently has the world's best performing major economy. The Federal Reserve has likely just completed a modest rate hiking cycle while President Trump has implemented a significant fiscal easing (See Figure 4). The European economy, by contrast, remains lacklustre and may even be falling back into recession. The ECB continues its extreme monetary easing with negative interest rates and at the same time EU rules are preventing meaningful fiscal stimulus.

If, as we suspect, there is an ELB in both the US and Eurozone economies, the growing disparity in performance between the two regions may be partially explained by their relative policy mixes. The recent interest rate hikes by the Federal Reserve may have been boosted economic activity, by taking interest rates from far below to only slightly above the ELB. While, on the other hand, the ECB continues to run a counterproductive policy with interest rates far below their own ELB.

Whether by accident or design, the Federal Reserve and President Trump may have happened upon the right policy mix of fiscal easing combined with modest monetary tightening. Meanwhile Europe remains hampered by an over-easy monetary policy and an over-tight fiscal policy.

Hopefully the Eurozone will find a mechanism to relax the self-imposed austerity required by its internal fiscal rules. Until it does so we expect the US economy will continue outperforming.

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