Message *to* Chairman Powell

By Richard C. Koo

Stop talking imbalances and start calling for more self-financing infrastructure projects.

U.S. Federal Reserve Chairman Jerome Powell said in a speech on June 20 that the last two recessions in the United States stemmed from "financial imbalances" and were therefore fundamentally different from previous downturns, which were mostly triggered by Fed tightening aimed at keeping inflation in check. He also asked what sort of monetary policy was appropriate in the world of a flattened Phillips Curve, where U.S. inflation remains low even as the unemployment rate has fallen to, at that point, 3.8 percent.

DEVELOPED ECONOMIES NOW PURSUED BY EMERGING MARKETS

Both the financial imbalances that are increasingly common today and the flat Phillips Curve are products of the fact that developed economies have entered what I call the "pursued phase" of development, where the return on capital expenditure is higher in the emerging (that is, pursuing) economies than at home. Once that point is reached, largely because of higher wages at home, businesses under pressure from shareholders to maximize the return on capital are forced to spurn domestic investments for higher-return alternatives in emerging markets. Furthermore, if one company starts utilizing cheaper labor abroad, all other companies in the same business are often forced to take similar measures in order to remain competitive. This is true regardless of how low the central bank takes interest rates.

Prior to this phase, when the return on capital at home is considered sufficiently high, an upward-sloping labor supply curve means that any increase in labor demand tends to lift wages. Higher wages, in turn, boost domestic consumption demand. This simultaneous growth in wages and

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Washington, D.C. 20002
Phone: 202-861-0791
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consumption prompts companies to invest in equipment to enhance both capacity and efficiency, producing further growth in domestic demand and higher inflation. During this era, which I have dubbed the "golden era" of economic development, the traditional Phillips Curve relationship between the unemployment rate and inflation is both valid and relevant for policymakers.

MONETARY POLICY IS KING DURING GOLDEN ERA

The golden era is also characterized by robust private-sector demand for loans inasmuch as rising wages inevitably stimulate businesses to invest in capacity- and efficiency-boosting equipment. Healthy private demand for loans also means monetary policy is highly effective during this era while fiscal policy, which can lead to the crowding-out of private investment, is discouraged. Rising wages and rapid growth in both consumption and investment mean the central bank must be vigilant in its efforts to keep inflation in check. In other words, monetary policy is both necessary and effective during this phase of development.

Traditional economics implicitly assumes that all economies are in this phase of development. That is why so much focus has been placed on the crowding-out effect of fiscal policy and the importance of the Phillips Curve in assessing monetary policy. Indeed, most recessions during the golden era occur when central banks tighten monetary policy to rein in inflation.

SHIFT TO "PURSUED ECONOMY"

However, the economy changes fundamentally when sustained wage growth prompts companies to decide that investing in emerging economies such as Mexico or Bangladesh will provide higher returns on capital than investing at home. When that point is reached, the labor demand curve flattens out even if the labor supply curve is still upward sloping. From this point onward, domestic wages began to stagnate as companies reduce investment to boost domestic productivity.

As wages stop rising, consumers start frequenting the discount stores they shunned during the golden era, forcing companies to engage in fierce price competition. With businesses no longer borrowing money to expand production at home, the monetary transmission mechanism also breaks down. This is because the absence of borrowers means that additional liquidity supplied by the central bank to the banking system never enters the real economy. All of these factors help to flatten the Phillips Curve.

ASSET BUBBLES

The problem is that the financial imbalances noted by Chairman Powell are much more likely to emerge in a pursued economy than in a golden-era economy. There are at least four reasons for this. First, households continue to save in preparation for an uncertain future, but the businesses that borrowed those savings in the golden era to finance capital expenditures no longer do so. Fund managers who are wary of taking foreign exchange risk on emerging market currencies must therefore invest household savings in the existing stock of domestic financial and real assets.

Second, funds borrowed for productivity- or capacity-enhancing investments are typically used to purchase items such as machinery, prompting money to flow out of the financial sector and into the real economy. But when money is used to acquire existing financial or real assets, the money itself remains in the financial sector and the only result is a transfer of ownership. For example, if one fund manager purchases equities sold by another fund manager, the seller must then invest the proceeds in other stocks or bonds. This means the money earmarked for investment never decreases.

It should be noted that corporate borrowings to buy back shares and to finance merger and acquisition activities do not help the monetary transmission mechanism either because these funds also stay with the financial sector and do not enter the real economy. The same is true for households borrowing money to buy existing houses.

Third, fund managers responsible for investing these funds are still expected to produce the kind of high returns seen during the golden era, even though such returns are no longer possible in a pursued economy. That expectation invariably pushes some managers to participate in asset bubbles, which offer superior returns as long as they continue.

Last but not least, the low inflation rates that characterize pursued economies force central banks with a golden-era mindset to ease monetary policy in order to meet their inflation targets, further increasing the pool of money that

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private-sector fund managers must invest in existing assets. These four factors tend to encourage the formation of asset price bubbles, the worst form of financial imbalance.

Fund managers who suffer heavy losses when a bubble collapses temporarily grow more cautious, but the tragedy is bound to repeat itself several years later as long as the fundamental problem of households saving and businesses not borrowing for real investments persists at the macroeconomic level.

POLICY RE-THINK NEEDED

Flow-of-funds data indicate that the private sectors in virtually all developed countries have been running huge financial surpluses for the last ten years. The fact that the U.S. private sector has been saving a net 5 percent of GDP on average during this period is probably the biggest reason why—despite seven Fed rate hikes—long-term U.S. rates have yet to rise significantly and the Chicago Fed's National Financial Conditions Index still does not indicate a tightening of financial conditions.

Long-term U.S. interest rates were similarly subdued—and the financial conditions index indicated similarly accommodative conditions—from 2004 to 2006, when the Greenspan Fed raised interest rates seventeen times to rein in the housing bubble. At that time, the Fed raised short-term rates by 425 basis points, but the long-term rates went up by only 60 basis points which was far from sufficient to rein in the housing bubble. This "conundrum" allowed the bubble to expand for two more years and ultimately resulted in the Great Financial Crisis, the worst economic crisis since World War II.

The above pre-crisis failure to rein in the bubble, together with the post-crisis failure to bring about inflation in spite of astronomical quantitative easing, indicate that neither monetary easing nor monetary tightening is effective in pursued economies. The private sectors in the eurozone and Japan have also been saving an average of 5 percent and 8 percent of GDP, respectively, over the last decade in spite of negative interest rates and miniscule bond yields.

The long-term solution to this problem of financial imbalances is to raise the domestic return on capital with structural reforms.

GOVERNMENTS SHOULD INVEST ACTIVELY

Throughout history, bubbles have formed in a wide variety of economic conditions. However, if the mechanism described above is responsible for the recent gains in stock and real estate prices in nearly all of the pursued economies, governments should take action to contain the growth of financial imbalances.

Macro-prudential regulation introduced in the wake of the Great Financial Crisis, however, is probably not enough to address this deep-rooted problem of a savings glut in the pursued economies. Even if these regulations succeed in preventing problems at some banks, funds seeking higher returns will eventually contribute to the formation of bubbles via the unregulated nonbank and shadow banking sectors.

The long-term solution to this problem of financial imbalances is to raise the domestic return on capital with structural reforms, including deregulation and tax cuts. A good historical example is the United States—the world's first pursued economy—which saw many industries overtaken by Japanese competition in the 1970s and 1980s and responded with supply-side reforms ("Reaganomics") centered on large tax cuts and deregulation. These measures ultimately lifted the domestic return on capital and helped restore economic growth.

However, it took more than fifteen years for Reaganomics to bear fruit—its effects were not felt in earnest until President Clinton's second term. And now that far more emerging countries have joined the ranks of the pursuers, a new round of reforms is urgently needed in the United States as well as in the rest of the pursued economies, a group that now includes Japan.

Until reforms are implemented and are producing results, it is essential that the government borrow and spend the private sector's surplus savings to prevent the formation of bubbles and their long, painful, and fiscally costly aftermath—otherwise known as balance sheet recessions. The government needs to act because if the private sector as a whole is saving money at near-zero interest rates, someone else outside the private sector must borrow and spend those savings to keep the national economy going.

A CORRECT POLICY APPROACH

At a time when the public debt has become such a major issue, any attempt to increase government borrowing is almost certain to encounter heavy opposition from those with a golden-era mindset. But in a pursued economy with a shortage of private-sector borrowers, saved funds naturally tend to flow into the debt of the sole remaining borrower—the government—pushing government bond yields lower

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to levels unthinkable during the golden era. This phenomenon can be observed in all of the developed economies today. Indeed, in all of these countries, the rapid increase in public borrowings after 2008 was associated with lower government bond yields (except in the eurozone during the so-called re-denomination crisis in 2010–2012) because private sector borrowers disappeared even faster.

That means that if policymakers in the pursued economies can identify and implement self-financing infrastructure projects that offer a social rate of return that is higher than today's ultra-low government bond yields, they can not only produce economic growth without increasing the burden on future taxpayers, but can also provide necessary infrastructure for future growth and prevent the private sector from squandering its precious savings on destructive bubbles.

During the golden era, strong private-sector demand for loans keeps interest rates high, making it difficult to find such self-financing infrastructure projects. But during the pursued era, the search for such projects is much easier because interest rates are drastically lower.

This means there is a correct policy mix for a pursued economy just as there is a correct policy mix for an economy in its golden era. Instead of the monetary policy-centric approach, symbolized by inflation targeting, that is appropriate for the golden era, pursued economies need to focus on fiscal policy, and particularly on the search for self-financing infrastructure projects, to keep the economy going while preventing further growth in the financial imbalances cited by Chair Powell. ◆