Why Central Bankers Should Be Humble

By William White

Creating a nightmare of unintended consequences.

A number of central banks in the advanced market economies, not least the U.S. Federal Reserve and the European Central Bank, have announced their intention to re-examine the analytical framework that guides them in the conduct of their monetary policy. Early indications imply that the fundamental results of these enquiries will be "more of the same."

What will not be questioned will be the primary objective of monetary policy. It will continue to be price stability. Nor will questions be raised about two other fundamental assumptions that have underpinned monetary policy in recent decades. First, it is taken for granted that ever-easier monetary conditions will suffice to stimulate aggregate demand. Second, easy monetary conditions have no significant unintended consequences for the economy.

Unfortunately, both of these assumptions are wrong. This implies that "more of the same" policies would also be wrong and likely dangerously wrong. At the very least, consideration of the uncertain economic implications of their policies should foster greater humility among ever-more experimental policymakers. This conclusion is strengthened by the recognition that post-crisis monetary policies have had political implications as well. These policies have widened wealth inequality, threatened the political "independence" of central banks, and have reassured governments that "business as usual" is a sustainable strategy—unintended and undesirable consequences.

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EVENTUAL INEFFECTIVENESS

There is a fundamental intertemporal inconsistency arising from the repeated use of monetary easing to stimulate demand. Initially, lower policy rates encourage private spending to be brought forward in time, with purchases being financed by debt accumulation. Over time, however, the weight of the debt burden accumulates and the effectiveness of further monetary easing declines. This is the feedback effect referred to by Alan Greenspan as "headwinds." However, what were in his time only headwinds have now grown to gale force.

Far from declining in the aftermath of the crisis that began in 2008, the ratio of global debt (households, corporates, and governments) to global GDP at the end of 2018 was 40 percentage points higher than it was in 2007. It is also a fact that the post-crisis recovery in the advanced market economies has been the weakest in the post-war period. Moreover, in virtually every year since the crisis, the growth rate of GNP projected for the next year by the International Monetary Fund and OECD has significantly overestimated the actual outturn. Forecasts for inflation have been similarly overestimated. In the emerging market economies, growth has been relatively more vigorous but is increasingly showing signs of weakness as debt levels ratchet higher.

In addition to the "headwinds" of debt, other arguments support the view that monetary easing might

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be less effective than many suppose. In *The General Theory,* economist John Maynard Keynes expressed his reservations: "If, however, we are tempted to assert that money is the drink that stimulates the system to activity, we must remind ourselves that there may be several slips between the cup and the lip." Ever more experimental policies raise levels of private unease, constraining "animal spirits" and leading to less spending, not more.

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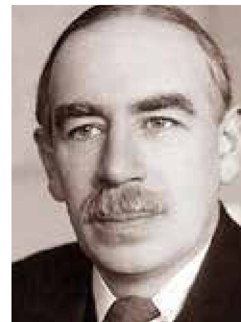

Nor is theory clear that ultra-low rates should induce more consumer spending. If consumers have a predefined goal for wealth accumulation, such as to ensure a comfortable retirement, then a lower rate of accumulation implies they must save more, not less. Uncertainty about the reliability of pension promises would have the same effect. Similarly, ultra-low rates lower the disposable income of creditors (such as older people living off investments) and raise the disposable income of debtors. Since the former group almost certainly has a higher marginal propensity to consume than the latter, aggregate consumption might fall.

Finally, the argument that lower rates increase "wealth," and therefore induce more spending, seems to suffer from a fundamental analytical flaw. Lower rates provide accounting gains, but they do not create "wealth" if wealth means the capacity to have a higher standard of living in the future. Higher house prices, for example, constitute an increase in "wealth" for homeowners only if you ignore the higher (implicit) cost of living in that house in the future.

Investment might also fail to respond to ultra-low rates. To the extent that future consumption is expected to be held back by the "headwinds" of debt, investment to meet future demand might also be expected to be weak. Closely related, company pension schemes (defined benefits) are hurt by low rates and this can be a contingent liability weakening future cash flow and investment. Further, there is growing evidence that low rates encourage mergers and acquisitions and increase levels of corporate concentration. Absent an adequate degree of competition, there is no need to invest to strengthen one's competitive position.

Finally, economist Andrew Smithers has long contended that low rates have encouraged corporate managements in the United States and United Kingdom to cut investment and to borrow in order to raise cash to finance share buybacks. These actions raise share prices and the value of share options owned by management, to their advantage. In contrast, the longer-run interests of the corporation, and the economy, are badly

served if the stock of productive capital does not expand. Corporate and government policies should be directed to changing this "bonus culture." This would raise fixed investment in turn, and lessen the perceived need for monetary stimulus with all its unintended consequences.

UNINTENDED CONSEQUENCES

Widely used neoclassical macroeconomic models rule out unintended consequences by assumption. Policy delivers what it promises. Yet concerns about unintended consequences of policy have surfaced repeatedly in the history of economic thought. Hyman Minsky suggested that "stability breeds instability." Friedrich von Hayek emphasized the importance of "malinvestments" and the inherently uncertain response to policy of "complex systems."

The first side effect to consider is the possibility that ultra-low rates might threaten financial stability. If margins are being squeezed, as most evidence indicates, the business models of many financial institutions are threatened. Pension funds and insurance companies are most at risk because they have especially long liabilities whose value rises as rates fall. But banks, in recent years, have also seen their profits squeezed by tightening lending margins and sometimes negative rates charged on reserve holdings. It is no coincidence that banks almost everywhere are cutting staff, and that the ratio of market value to book value is at record lows for banks in Europe and Japan.

In response, financial institutions of all sorts have embraced ever more risky assets in their search for yield. The most recent Global Financial Stability Report from the International Monetary Fund documents these risks and then speculates about the economic impact should some of these risks materialize. Alarmingly, their simulations indicate that, in the event of a downturn half as severe as 2009, $19 trillion of corporate debt would be owed by companies whose debt service requirements exceeded their profits. The knock-on effects on financial institutions could be significant. A related issue has been increased purchases of less liquid (and higher yielding) assets by financial institutions that still promise daily redemptions for their liabilities. This threatens "fire sales" that could well be exacerbated by disorderly trading conditions.

In fact, there are many grounds for worry about disorderly trading conditions. Since the onslaught of the crisis, waves of risk-on/risk-off behavior have been driven by changes in central bank policies. Liquidity has already

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declined in many markets, with concerns rising about prospective illiquidity in others. Moreover, the process of "price discovery" has atrophied while recurrent "flash crashes" and enduring market "anomalies" (such as the persistent violation of the law of covered interest parity) indicate that markets are not functioning properly. The Fed's loss of control over the U.S. repo rate in September 2019, and the *ad hoc* response since, all strongly suggest a potential for market disorder.

A last concern about financial stability refers to an intended consequence rather than an unintended consequence of monetary stimulus. Post-crisis policies have contributed to much higher prices for financial assets. There are now $17 trillion of negative-yielding sovereign bonds, while corporate spreads (over sovereigns) are exceptionally low, especially for bonds just above or below investment grade. The price of U.S. equities indicates a cyclically adjusted price-to-earnings calculation that is almost double the historical median, while the St. Louis Fed's stress index is well below even pre-crisis levels. House prices (and household debt levels) are also at unprecedented levels in a large number of countries. Should any or all of these prices begin to fall, the scope for a cumulative downturn is large.

A second unintended consequence has to do with potential effects on the supply side of the economy. While standard macroeconomic

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theory says monetary policy has no lasting effects on the "real" economy, the facts say otherwise. There is now ample evidence that easy monetary conditions since the crisis have encouraged banks (particularly less-well-capitalized banks) to make "evergreen" loans to "zombie" companies. As well, the "search for yield" provides buyers for their bonds. This maintains excess capacity in the low productivity growth sectors (especially retail and construction) that grew particularly rapidly in the pre-crisis period. This phenomenon is consistent with the observation of continuing disinflationary pressure together with low rates of growth of measured productivity.

Easy monetary conditions also disrupt the flow of new financing, diverting real resources toward companies that might never succeed in distributing profits to shareholders. The negative market reactions to recent IPOs at WeWork, Lyft, and Uber indicate a growing recognition of this fact. Moreover, many such firms subsidize their products in search of market share and eventual monopoly. In this way, they also contribute to disinflation and (potentially) a vicious circle of still-easier monetary policy in response.

A third set of worrying side effects has been the spillover to emerging markets. The increase in global debt ratios since 2008 is almost wholly due to the expansion of debt ratios in the emerging markets from 110 percent in late 2008 to over 190 percent in early 2019. A recent World Bank report describes this development as "the largest, fastest, and most broad-based increase of debt" in emerging market economies in the last fifty years. As a result, the IMF has recently asserted that 40 percent of low-income countries are now either "in distress" or at "high risk" of distress.

Capital inflows to emerging market economies from 2004 to 2014 led to sharp upward pressure on their currencies. That pressure was strongly resisted through foreign exchange intervention (raising bank reserves in domestic currency) and easier monetary policy than otherwise. Domestic credit expansion rose sharply, funded by both domestic and foreign sources, and emerging markets began to exhibit many of the unintended consequences seen in the advanced markets. Most notably, significant threats to financial stability can be identified.

The migration of domestic lending to non-banks ("shadow banking") in both China and India is now a source of major concern. Moreover, property developers and state-owned enterprises have become prominent borrowers, even though their internal rates of return have been falling. Finally, much of the emerging market corporate debt is denominated in dollars. This has left them vulnerable to higher debt service requirements (as the U.S. dollar has risen since 2015) as well as liquidity risk if maturing loans cannot be easily rolled over in dollars. A similar exposure faces emerging market banks that, according to the BIS, now have dollar assets in excess of $3.5 trillion.

WHERE TO GO FROM HERE?

It is tempting to say that post-crisis monetary easing should simply be reversed. However, one cannot ignore the implications of those past policies. In particular, the build-up of debt encouraged by easy money leads directly to a "debt trap." As central bankers become increasingly aware of the need to renormalize monetary policy, they become increasingly fearful that doing so will trigger the crisis they wish to avoid. The late Paul Volcker, in his autobiography, identified the problem clearly: "Ironically, the 'easy money' striving for a 'little inflation' as a means of forestalling deflation, could, in the end, be what brings it about."

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Recognizing global economic vulnerabilities, much attention is now being paid to how policy might react to a renewed global downturn and potentially deflation. Recognizing the monetary dilemma, many, including the IMF and OECD, are suggesting that fiscal policy should be used more vigorously than before. These views deserve support, but with an important caveat. Fiscal expansion will support growth and tax revenues, yet might still raise sovereign debt ratios going forward. These ratios are already very high in many countries, and will be pushed higher—perhaps much higher—by the need to mitigate and adapt to climate change. To reduce the likelihood that this might lead to an eventual fiscal crisis, governments should reaffirm their commitment to medium-term fiscal targets. This implies a commitment to fiscal tightening, but only once the economy is firmly in expansionary mode again and only when monetary policy is also on the road to normalization.

Much less attention is being paid to the possibility that there could be a return of global inflation. Unemployment rates in most large countries are at or near

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record lows. Unfavorable demographic trends, together with climate change and deglobalization, could also imply a secular slowing of potential growth and eventually upward pressure on inflation. A slowing of the disinflationary impulses arising from underpricing by new companies seeking market dominance would amplify these inflationary forces. In those circumstances, monetary tightening would seem the first requirement, both to resist inflation and to reduce the impact of the undesired consequences of easy money to date.

In each of these alternative scenarios, risks to sustainable growth can easily be identified. However, a common thread is the threat posed by high private sector debt levels. In the disinflationary or even deflationary scenario, revenue growth will fall and spending will be cut back to enable debt service to continue. The Keynesian "paradox of thrift" will exacerbate the downturn, perhaps sharply. In the inflationary scenario, rates will rise and put similar pressure on the heavily indebted, perhaps even triggering a subsequent downturn. Central bankers will have to thread their way through avoiding this outcome and a perhaps sharp rise in inflation.

These risks associated with high private sector debt levels imply that we need to put much more emphasis on facilitating orderly debt restructurings going forward. Disorderly debt defaults, without the cooperation of creditors, always involve much greater costs than orderly defaults in which creditors and debtors work together. Unfortunately, recent work by the OECD, the IMF, and the Group of Thirty make it abundantly clear that the laws and judicial procedures for restructuring debt continue to be highly unsatisfactory almost everywhere, but particularly in emerging market economies.

These identified inadequacies apply to private non-financial debt (households and corporations) in many countries and still more to private financial debt (especially banks that are too big to fail). Above all, they apply to sovereign debts where there are no agreed criteria for the need to restructure, nor any international treaties to force action when action is required. Dealing with these problems is a challenge that governments should start to address now. It is a dangerous delusion to suppose that central banks, by promoting still more debt creation, can somehow mitigate this need for action by governments. ◆