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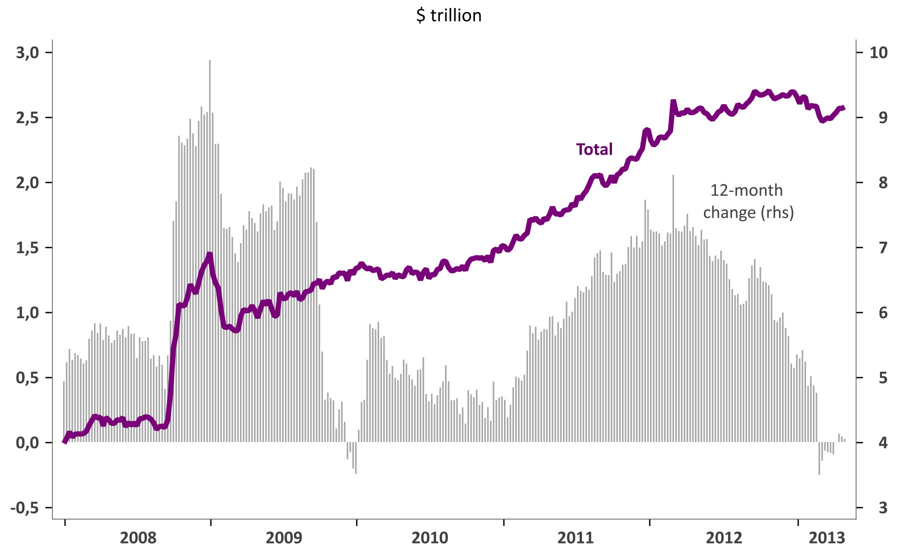
GLOBAL MACRO

Monetary Policy: Too Much Disparity to Be Effective

The reflation policies pursued by the major central banks don't seem to be paying off. Even with key rates at historic lows everywhere and widespread use of unconventional policy tools, lending activity remains flat and economic growth anemic. Moreover, although strong commodity prices and rising taxes have kept price levels up until recently, the inflation rate is starting to sag—in a serious way. A lack of monetary policy coordination, the inability of central banks to offset the impact of fiscal tightening, and the still-crippling effect of deleveraging on growth are the primary ingredients of this collective failure. They are also a cause for concern. If they persist, we may well be heading for a much longer crisis than is commonly assumed—and for creeping deflation that could lead economic policy-makers to act rashly. But let's be clear about one thing. The problem is not that central banks shouldn't be doing what they're doing; it's that their combined efforts haven't gone far enough.

Aggregate Balance Sheet of the Four Leading Central Banks



Sources: RichesFlores Research, Macrobond

Reflation Policies Off-Target

A shared assessment has emerged from the latest monthly round of major central bank committee meetings: unconventional policies and historically low interest rates have failed to produce the expected macroeconomic benefits. In the United States, disappointing economic data have led the Federal Reserve to consider stepping up its asset-buying program once again. Meanwhile, the European Central Bank has resigned itself at long last to a quarter-point cut in its main interest rate to 0.5 percent, and has even suggested it might take the deposit facility rate into negative territory, reflecting how hard it is to re-ignite the lending market. A week earlier, the Bank of Japan confirmed it would be injecting massive amounts of liquidity into the system. And even though the British economy's unexpected 0.3 percent growth in the first quarter has taken some of the pressure off, the Bank of England is likely to keep its options open for further quantitative easing at its Monetary Policy Committee meeting next Thursday.

Why So Ineffective?

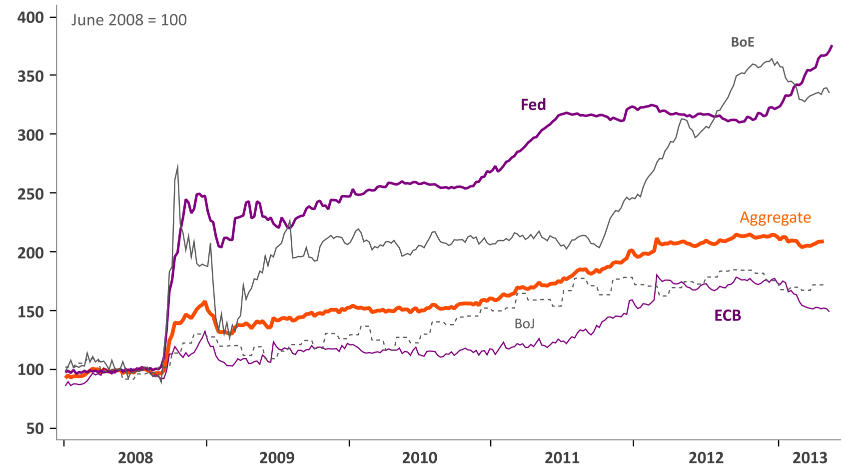
With central bankers giving the impression that they are basically playing it by ear, there are understandable doubts about whether current monetary policies actually are effective—and therefore defensible. But the most compelling explanation for why reflation policies haven't worked is that they haven't gone far enough to be able to counter the adverse trends under way. What follows is a review of the main reasons for this failure.

The global drive to inject cash into the system has been phased out too soon

To start with, the policies conducted have been too uneven and too uncoordinated. The Fed's efforts to increase liquidity have to a large extent been canceled out by the much more cautious policies pursued by the ECB and, until recently, the Bank of Japan. As a result, the monetary stance of the industrialized countries is not nearly as expansionary as it should be at this stage.

In the four and a half years since the onset of the crisis, the aggregate balance sheet of the Fed, the ECB, the Bank of Japan, and the Bank of England has increased by only half as much as the Fed's. It has stopped expanding since the beginning of last year and started shrinking in the last four months. **This shrinkage was unquestionably initiated too soon, considering that the international banking system still shows significant dysfunctional features and the economy as a whole is still on shaky ground.**

Balance Sheets of the Four Leading Central Banks



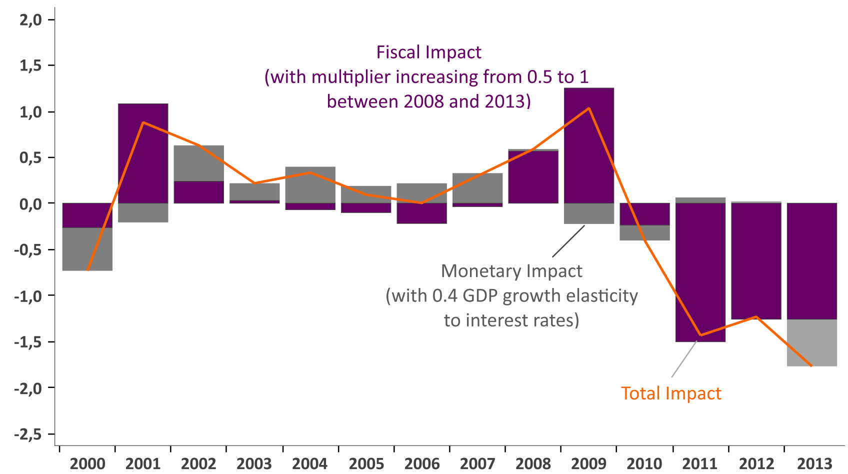
Sources: RichesFlores Research, Macrobond

The overall economic policy mix is too restrictive

The second reason for failure is that central banks have had a hard time offsetting the impact of the fiscal tightening under way across the industrialized world, excepting Japan.

The Congressional Budget Office (CBO) estimates that the recent tax increases and automatic budget cuts (the "sequester") will reduce U.S. economic growth by 1.5 percentage points this year—a shock comparable to the one caused by fiscal tightening in the euro area. All this has turned monetary policy support into a rather blunt tool. The U.S., for example, is saddled with an economic policy mix that is much less expansionary than what the Fed intended, and the euro area with a policy mix focused so heavily on retrenchment that it can be expected to shave about two percentage points off of GDP growth in the region this year.

Ex Ante Impact of Policy Mix on E.U.M. GDP (%)



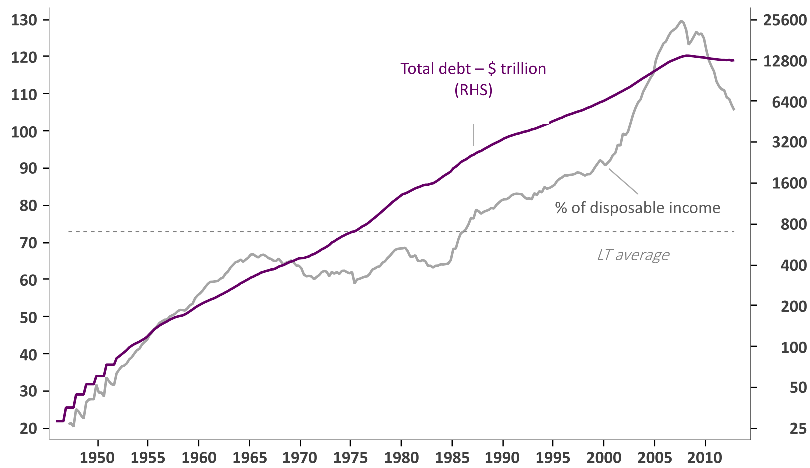
Sources: RichesFlores Research, Macrobond

The deleveraging process is still highly detrimental to growth

The large debt load accumulated by private-sector agents, especially households, likewise undermines monetary policy support, thus giving central banks an additional reason to continue with expansionary policies.

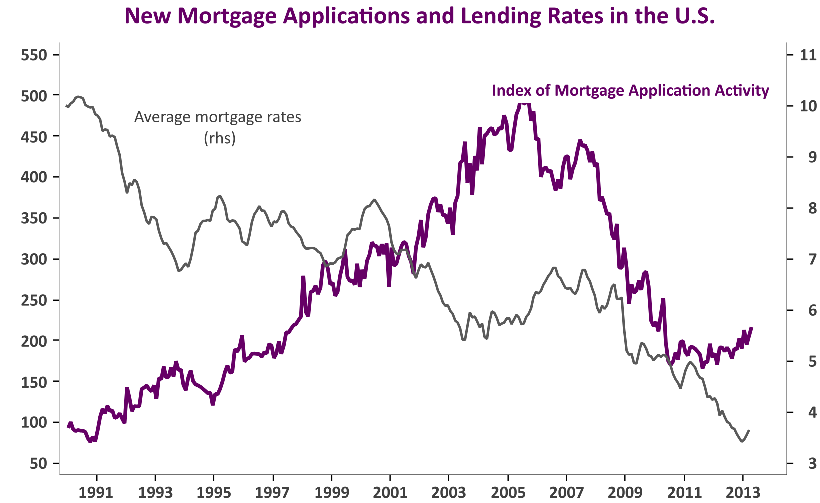
Although household debt service has gone down—even plummeting in some cases—the *stock* of debt has decreased only slightly in those countries where it had reached a critical level, chief among them the United States, Spain, Ireland, and the U.K. In the U.S., where a wave of foreclosures has accelerated the deleveraging process, the ratio of household debt to disposable income still stands well above its long-term average. In Europe, debt ratios have declined only modestly, since lower interest rates alone can't make a dent in the overall debt stock. The only good they have done is to reduce the share of household income eaten up by interest payments.

U.S. Household Debt



Sources: RichesFlores Research, Macrobond

As the chart shows, mere deleveraging can't be of much help. High debt levels have continued to act as a drag on both credit supply and demand, making it extremely hard to revive the lending market. This problem is particularly stark in the U.S.: even with a real estate recovery and lending rates at a historic low, mortgage lending has remained stubbornly flat.



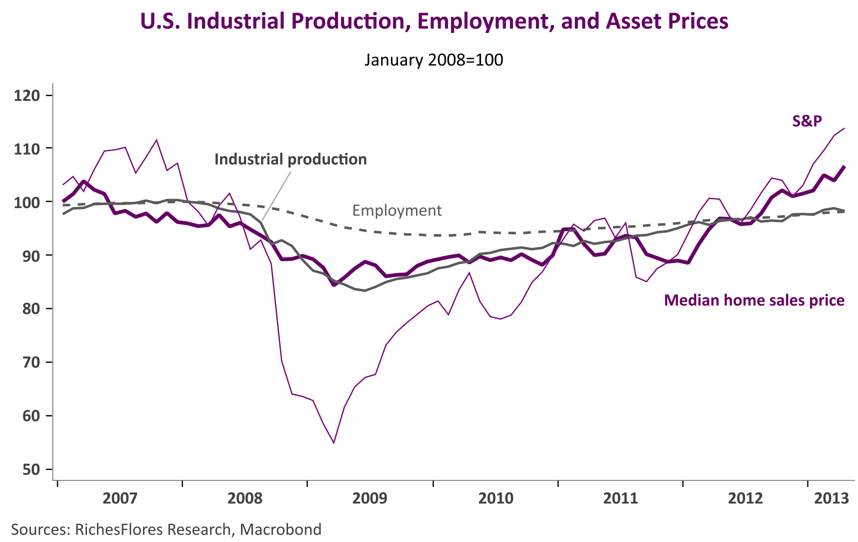
Sources: RichesFlores Research, Macrobond

The Ball Is In the ECB's Court

The result is a disturbing, global set of policy distortions. Because they undermine the effectiveness of monetary policy, they make it unlikely for the world economy and financial system to return to normal any time soon. They also heighten the risk of deflation. With the core inflation rate at 1.6 percent in the euro area and 1.7 percent in the United States, we may be well on our way to creeping deflation, especially since wages just about everywhere in the industrialized world (Germany excepted) show almost no sign of rising. **These indicators should be a cause for concern, not only because they highlight the weak state of the industrialized economies, but also because they mean that there are daunting obstacles to reviving the lending market.**

The situation is in fact disturbing for several reasons. First of all, it doesn't bode well for the world economy. Second of all, this is the kind of situation that tends to trigger rash, potentially disproportionate action by economic policy-makers. Last of all, it keeps the threat of Eurozone breakup constantly on the horizon.

Suppose the Fed—the central bank quickest to tackle the danger of deflation—concludes that injecting liquidity into the system has much more effect on asset prices than on the broader economy. **If its decision-makers feel they've run out of ammunition, they could wind up going overboard,** even at the risk of creating distortions that wreak medium-term havoc. Meanwhile, the Japanese, who up until recently showed little inclination to do anything about deflation, have abruptly reversed course—only to be accused of starting a currency war. The resulting climate of suspicion is clearly something we could have done without *(see the article "Tenkan!" dated May 2, 2013).*



It is high time to rethink the industrialized countries' economic policies from the standpoint of consistency. And in this area, the ECB has a weighty responsibility. A change in European central bank policy is not only essential for the euro area; it is becoming increasingly vital to the developed economies as a whole.

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