FINANCE OUTLOOK

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WHY MONETARY POLICY AFFECTS US ALL

From whether business can thrive, to the price of mortgages and housing market inflation, to the value of our pensions, to the chances of a new financial crash – what central banks do affects us all

In this issue of our Finance Outlook, we examine some of the ongoing discussion on monetary policy and the actions of central banks.

While there is a temptation to see monetary policy as a nerdish subject only of interest to the cognoscenti, the reality is that what central banks do affects all of our lives – and the functioning of our democracies. From whether business can thrive, to the price of mortgages and housing market inflation, to the value of our pensions, to the chances of a fresh financial crash, to how wealth is distributed, to the balance of power over our lives between our elected represented and central bankers, monetary policy affects us all.

This issue is intended to provide some background to our upcoming conference on monetary policy.

WHAT NEXT FOR MONETARY POLICY?

Speakers include Martin Wolf (FT), Sir Ed Davey (Shadow Chancellor, Liberal Democrats), Panicos Demetriades (former Governor, Central Bank of Cyprus), Professor Lucrezia Reichlin (London Business School), and others.

27 November 2019, 13:30 – 17:30

At: Portland Communications, 85 Strand, London WC2

For further details visit the Events section of our site – www.radixuk.org

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Inability or reluctance to use fiscal stimulus have left central banks to do the heavy lifting in many economies…

…how long can that last?

Over the last decade, our economies have, surprisingly, become significantly dependent on monetary policy and the actions of central banks. Much of that is due to governments' reluctance or inability to use fiscal measures to stimulate economic activity. Without central banks' intervention on the scale we have seen, it is likely that our economies would be in much worse shape.

Many governments, caught in the trap of low growth, low inflation and high debt public levels, simply don't have the fiscal space for stimulus. Others, like Germany and the Netherlands, do have the fiscal space but have been reluctant to use it.

The exception has been the USA where President Trump, early in his presidency, provided a large dose of fiscal stimulus and is now arguing that the Federal Reserve is not doing its bit to help.

Elsewhere, central banks have been left to do the heavy lifting which they have done through a combination of low interest rates and 'Quantitative Easing' – essentially buying up financial assets using newly created money.

Banks such as the ECB and the Bank of England have been credited with stabilizing economies through their actions. Monetary policy taking centre stage for such a prolonged period is unusual and has raised a number of questions:

The unprecedented prolonged dependence on monetary policy has raised many questions to which we don't know the answer

- Is monetary policy a better tool for taming inflation than it is for stimulating it?
- Should central banks be taking actions that have an impact on wealth distribution without proper political accountability?
- Has 'central bank independence' led to a damaging lack of coordination between monetary and fiscal policies?
- Do persistently low interest rates do more harm than good?
- Has the search for yield driven investors into higher risk assets thereby increasing the risk of financial instability?

Views are diverging on the merits of loose monetary policy to the extent that former central bankers recently published a memo expressing 'growing concern' around the ECB's policy choices.

Whatever the merits of past central bank interventions, the mood is growing that monetary policy may have reached its limits. It's the past rather than the future.

Central banks have run out of ammunition; the monetary era is over…

Anatole Kaletsky in a recent article[1] titled *"The Monetary Era is Over"* concludes that:

"Central bankers and senior economic officials now almost unanimously believe that monetary policy has reached its limits and that fiscal policy should be reinstated as the main tool for managing business cycles and supporting economic growth.

But many politicians, especially in Europe, still refuse to recognize that the monetarist era is over, and that Keynesian demand management is the only alternative.

Let us hope that changes before the next recession arrives.

Anatole Kaletsky
In Project Syndicate

Writing in the same outlet[2], Nouriel Roubini disagrees:

…or maybe not!

"It is naïve to think that policymakers would simply allow a wave of "creative destruction" that liquidates every zombie firm, bank and sovereign entity.

They will be under intense political pressure to prevent a full-scale depression and the onset of deflation.

If anything, then, another downturn will invite even more "crazy" and unconventional policies than we've seen so far."

Nouriel Roubini
In Project Syndicate

He suggests that the temptation to embark on "People's QE" or "helicopter money" – printing money to finance direct fiscal transfers to households – might be irresistible and wonders whether this would do more harm than good.

It is also worth noting that the helicopter money approach may not be viable for the ECB as it is likely to fall foul of European treaties.

DO LOW INTEREST RATES STIMULATE BUSINESS INVESTMENT?

In an article[3] in CityAM, we argue that low interest rates are not the determining factor in stimulating business investment.

[1] https://www.project-syndicate.org/commentary/monetarist-era-over-return-of-fiscal-policy-by-anatole-kaletsky-2019-10

[2] https://www.project-syndicate.org/commentary/limits-of-mmt-supply-shock-by-nouriel-roubini-2019-10

[3] https://www.cityam.com/central-bank-power-has-grown-to-mixed-success/

Businesses do not make their investment decisions primarily on the basis of interest rates

While all borrowers like cheap money, their investment decisions are based primarily on their view of future economic prospects – will such investments pay off?

In theory, low interest rates will make pay-off quicker and should therefore stimulate investment. But the process is far from seamless:

- Nobody knows how long low interest rates will last. Many businesses have therefore not modified the internal hurdle rates used to calculate returns
- Businesses have to balance mixed signals. Central banks implement loose monetary policy to stimulate investment, while the decision itself to loosen policy is taken as a signal of low confidence in the economy thereby chilling business investment
- Persistent low (and, in the Eurozone, negative) interest rates lower banks' profitability potentially making them more cautious

What we have seen as a result is that many large, quoted businesses have used low interest rates to borrow in order to undertake share buyback programmes – a lower risk approach to stimulating stock prices with few, if any, positive effects on the real economy.

MONETARY POLICY AND STOCK MARKETS

It has long been said that loose monetary policy benefits financial markets more than it benefits the real economy.

Will persistent bond-buying programmes lead to the continued "de-equitisation" of financial markets?

Analysts from Bank of America Merrill Lynch take an opposing view – that persistent bond-buying programmes will lead businesses to prefer debt financing to equity financing leading to "de-equitisation" of stock markets and continued de-listings.

> "If the future years are indeed one of constant QE from the ECB, financial markets are likely to undergo tremendous shifts in both their make-up and in the clustering of risks."
>
> **Barnaby Martin**
> **Credit Strategist**
> **Bank of America Merrill Lynch**

That, of course, assumes appetite for raising finance for investment purposes – a questionable proposition as we have outlined above.

CENTRAL BANK INDEPENDENCE IS UP FOR RE-DEFINITION

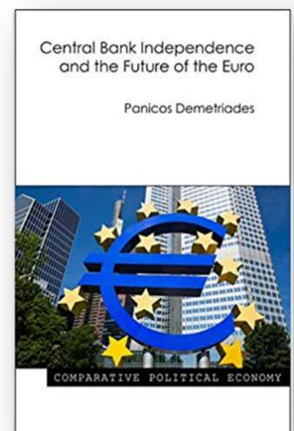
To what extent, in a democratic society, should unelected technocrats be given such wide-ranging freedom of action without political accountability?

In 2016, we published a paper questioning whether we should be reinterpreting the scope and meaning of central bank independence given the ever-broadening scope of central banks' activities and the social consequences of unconventional monetary policy.

To what extent, in a democratic society, should unelected technocrats be given such wide-ranging freedom of action without political accountability?

In 2016, the fact that we even raised these questions was met with wide dismay. Today, questions around central bank independence are the subject of constant debate and discussion – as well they should be.

Panicos Demetriades, Governor of the Central Bank of Cyprus during the financial crisis, and a speaker at our monetary policy conference, has just published a new book: *"Central Bank Independence and the Future of the Euro."*[4]



In it he examines the role of the ECB and its adoption of these new powers, which have led to legal and political challenges, high level resignations and the controversial removal of central bankers from their posts without due process.

He argues for a system that can generate stability if the Euro is to be preserved.

This book follows Sir Paul Tucker's *"Unelected Power"*[5], a scholarly review of the issues surrounding central bank independence. We reviewed the book in our September 2018 Finance Outlook[6].

About Radix

Radix is a cross-party think tank for the radical centre of contemporary politics. Its aim is to re-imagine the way government, institutions and societies function based on open-source, participative citizenship. To kick-start the thinking that is needed for politics to embrace technology, innovation, social and cultural change.

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[4] https://www.amazon.co.uk/gp/product/1788211545/ref=dbs_a_def_rwt_bibl_vppi_i0
[5] https://press.princeton.edu/books/hardcover/9780691176734/unelected-power
[6] https://radixuk.org/wp-content/uploads/2019/08/Finance-Outlook-September-2018.pdf