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Hitting the Limits of Monetary Policy

Even ECB President Mario Draghi admits he's running out of options.

By Michael Heise
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Last week, the European Central Bank announced its latest round of interest-rate cuts and a further expansion of its already sizable asset-purchase program, known as quantitative easing. This came barely three months after the ECB already had extended QE and cut its deposit rate back in December, an indication that such tactics are having a diminishing effect on the economy. ECB President Mario Draghi has signaled that we've perhaps reached the limits of what monetary policy can do to help the European Union reach its target of 2% inflation.

This should come as no surprise. Interest rates at zero or below, combined with an expanded central-bank balance sheet through QE, has been a strategy employed by central banks in the eurozone, U.K., Japan and the U.S. to increase liquidity and raise both market expectations of inflation as well as actual inflation. But so far, the new monetary-policy paradigm hasn't had the desired effect on these economies. Inflation and inflation expectations around the world today are much lower than central banks would like.

The prevailing doctrine is that the real interest rate, which is the difference between the observed interest rate and the rate of inflation, needs to be reduced to the point where it establishes an economic equilibrium with full employment. Since central banks can push headline rates into negative territory only to a limited extent, they also need to stoke inflation through unconventional measures like QE. Eventually, consumption and investment activity should pick up, and more jobs should be created, until full employment is restored. Or so the theory goes.

But success is by no means guaranteed. Economics textbooks pinpoint various situations in which monetary policy can fail to work. Even John Maynard Keynes, the father of modern anticyclical-demand management, highlighted certain conditions that could render monetary policy ineffective. As he pointed out, a central bank can expand the money supply all it likes, but if the funds are simply hoarded in the banking system or by households, economic activity doesn't accelerate.

Besides this so-called liquidity trap, monetary policy can also become ineffective when companies fail to increase their capital spending in response to falling interest rates and growing liquidity. Economic uncertainty can lead to an investment trap in which investors adopt a wait-and-see approach.

What's important to understand is that the transmission of monetary stimulus into real economic activity isn't based on stable and reliable economic relationships. Low interest rates and a generous supply of liquidity drive up the prices of assets such as equities, bonds

and real estate. But these gains can only be sustained if the real economy improves at the same time. Otherwise a liquidity boom on stock markets can quickly implode again.

This is what happened at the beginning of this year, when negative news about the Chinese and U.S. economies caused a crash on global stock markets. If consumers don't spend more as a result of rising asset valuations and low interest rates, the impact of monetary policy is at best a temporary boost to financial prices. Meanwhile, as low returns fuel fears that retirement provisions may prove inadequate, many people may be inclined to save more, further impeding spending.

Loose monetary policy also depends on the credit channel. If businesses and households are reluctant to borrow more, the impact of monetary policy will be muted. The additional liquidity created by QE will remain in the banking system instead of flowing into the real economy.

Subdued credit growth is typical following a financial crisis, including the one in 2008, which in many countries exposed excessive private-sector debt levels. A prolonged period of deleveraging tends to follow, as corporations, banks and households repair their balance sheets. This phase, known as a balance-sheet recession, also renders monetary policy much less effective.

Under such conditions, negative interest rates or additional liquidity injections won't restore full employment. Other policy instruments are needed, such as an increase in productivity-enhancing government infrastructure spending, tax incentives to boost business investment, and improved regulation and liberalization of markets to help job creation. After years of monetary easing, it's obvious that attention must now shift to such policies. Central bankers, including Mr. Draghi, have rightly been calling for more support on this side.

Monetary-policy strategies still need to be rethought. The cracks in its transmission mechanisms are glaringly obvious, and explain why such programs haven't achieved their objectives. Simply increasing the dose of an ineffective medicine risks exacerbating its undesirable side effects. In this case, long-term saving plans suffer, funded pension systems come under pressure, investors take on higher risks, money markets no longer work and financial markets become hypersensitive to tweaks in interest rates.

Central banks don't have the power to control growth and inflation at all times. If the advanced economies want to achieve a stable equilibrium with full employment, they need other economic policies. Too much has been left to central banks to sort out. It is time for burden-sharing.

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