The great distortion

Patrick Minford argues that the traditional orthodoxy of fiscal caution is dangerous in today's zero interest rate world

What does the current developed world economic situation demand in the way of fiscal and monetary policy responses? I will argue in this article that the conventional wisdom of fiscal balance and monetary policy stabilisation needs to be thrown out until the monetary environment is brought back to normal.

We must begin from the widespread dissatisfaction the public expresses about current policy, not least with the persistence of 'austerity' policies since the financial crisis. This dissatisfaction has led to demands by some for a return to socialist policies and an abandonment of 'capitalism'; this is now the political position of the British Labour party, just as it is of some Democratic presidential candidates on the left of the party, such as Bernie Sanders, even though the US Democratic party has traditionally supported the general capitalist economic model.

So what is this opposition to capitalism all about?

The last big peacetime crisis of capitalism was created by the Great Depression of the 1930s. The current crisis has been created by the Great Recession starting in 2008.

After the Great Depression major changes were made in western countries' policies, as urged by Keynes. Governments became far more active in fiscal policy in preventing slumps in demand; monetary policy was relegated to a support role, setting interest rates to allow demand to be regulated by fiscal policy.

As is now well-known, these policies led after WWII to high and persistent inflation, so that today central banks target inflation and fiscal policy is generally held in control to prevent government debt getting too large.

Today's financial crisis and the Great Recession has in turn forced big changes in western countries' policies. We now have introduced heavy regulation of bank behaviour, combined with aggressive printing of money at zero or even negative interest rates, 'Quantitative Easing' (QE), in the attempt to create renewed growth.

Furthermore, these policies have been accompanied by sharp fiscal contraction, with 'austerity' the main fiscal aim of most western governments. The living standards of western households have fallen sharply; and it is because of this that there is widespread disappointment with capitalism, fuelling 'populist' revolts such as the election of President Trump and Brexit.

To anticipate, I will be explaining how it was a failure of monetary policy that caused the Great Recession, and that avoidance of future ones depends on a radical overhaul of monetary policy rules.

Fiscal policy must step in with a bold expansion designed to push interest rates back towards normality, decisively ending the zero lower bound episode

I will also argue that to put a full end to the Great Recession as it continues to drag on in the form of weak recovery and renewed recession, in spite of continued but ineffectual efforts from monetary policy, we have to endorse a self-limiting fiscal expansion, and within it tackle the discontents of average households that now fester, through more and better government spending and liberalising tax policies. Through these measures we will get the capitalist economy working effectively again and satisfying its critics with this improved performance.

The unnecessary financial crisis courtesy of central bank mistakes

To understand how the financial crisis occurred, we must first consider how monetary policy was conducted until 2008. In the early 1990s central banks started to embrace inflation targeting, together with associated 'central bank independence' so that supposedly spendthrift governments should not impose inflationary financing on them.

These new policies led to a period of low inflation which in turn we know encouraged firms to keep prices and wages stable: price and wage durations lengthened, meaning that output was increasingly dominated by demand shocks because these did not provoke the rise in prices that would have choked off demand and so contained the needed rise in output.

This was a 'New Keynesian' world, in the sense that prices and wages did not respond, much as Keynes argued they would not in the modern capitalist world of large companies and powerful unions. As it turned out the 1990s were an era of moderate demand shocks; also productivity growth was steadily positive.

The era became known as 'The Great Moderation', with low and stable inflation and moderate positive growth. In retrospect it looks like a time of unusually benign shocks: small demand shocks and positive productivity and other supply shocks.

As it proceeded from the 1990s, monetary policy began to encourage strong credit growth, especially in the US. Public policy also entered the mix, with the US government encouraging mortgage loans to poor families, to be underwritten by 'Fannie' and 'Freddie', two public institutions able to buy mortgages. It seemed that with real wages having stagnated, 'getting poor people onto the housing ladder' could be an alternative route for obtaining the 'trickle down' effect of growth.

With low inflation successfully engineered, central banks disregarded the growth in the monetary and credit aggregates which accelerated into the 2000s. As dollars became more plentiful, the central bank of China bought them to prevent the yuan appreciating against the dollar; and easy money spread to China through this channel.

World growth increased, with China reaching 13% at one point; world growth peaked at over 5% and world commodity and oil prices soared as excess capacity was used up. By 2007 these prices had hit high peaks, with oil at $150 a barrel.

It was plain that growth must be arrested, if only by lack of resource capacity, even though final prices were slow to generate downstream inflation with firms still setting long price durations and so reacting slowly to cost increases.

Central banks were finally realising the threat of rising inflation by 2007, when the mortgage crisis burst, with various banks reporting defaults on their bought-in packages of mortgages. The interbank market seized up, with uncertainty about which banks borrowing in it might be at risk.

Interest rate rises were put on hold and central banks went into crisis-prevention mode: various banks were rescued by central bank loans plus concerted take-over by other banks. This early era of bank bail-out created a political backlash, especially among US Republican politicians.

It succeeded in stabilising bank liquidity so that by the middle of 2008, it seemed as if a full-scale banking crisis had been averted. Then out of the blue in September 2008, Lehman went bankrupt; shortly afterwards, AIG, the world's biggest insurance company went down with it. The financial crisis had occurred with a vengeance.

Could central banks have averted it? The answer is plainly: yes. Lehman could have been saved by a coordinated package of take-over by other banks (among whom Barclays was keen to buy parts of Lehman) and loans injected by central banks, plus general liquidity provision to the interbank market, where Lehman's problems originated.

It seems that central bankers lost their nerve in the face of a political climate increasingly hostile to bank bailout; not just in the US but also the UK, where Barclays was expressly forbidden from buying Lehman in the talks led by the Fed that attempted to prevent the bankruptcy.

Even among central bankers, such as Britain's Mervyn King, a school of thought had arisen that banks needed to be taught a lesson, to avoid in future the 'moral hazard' of excessive lending, implicitly supported by the taxpayer. Other banks, whose cooperation was needed in any Lehman package, became increasingly alarmed that if their turn ever came, the central bank willingness to supply money would have run out.

So it was that after long discussions on Sunday September 14th, 2008, Lehman's bankruptcy was finally decided. No action was taken to close markets or provide special assistance. After AIG's bankruptcy, the full savagery of the financial crisis became clear and forced governments to intervene with large taxpayer bailouts, both in the US and the UK. World trade and growth collapsed overnight, as credit lines were extinguished. The Great Recession had begun.

It is plain that central banks could have averted it at two stages. First, monetary policy could have been tightened in the 2000s, so preventing the massive credit boom up to 2007. Second, central banks could have coordinated a rescue of Lehman along earlier lines.

However, central bank failure did not stop there. What was needed, given the general banking collapse, was an immediate liquidity injection into the banking system, together with the easing of any restrictions on banks' lending capacity. This could have caused a rapid turnaround from credit blight to credit expansion.

Unfortunately, central banks had taken from this whole episode the moral that banks, not they, had behaved irresponsibly; and that bank regulation should be sharply tightened to prevent future credit expansion to 'risky' clients. The fact that bank clients are in general risky, it being banks' role to extend risky credit, duly escaped central banks under this new view of the need for regulation to 'prevent future crises'.

Plans for this new regulation were drawn up in early 2008 and instead of being put on indefinite hold when the crisis struck in September, they continued to be rolled out and duly prevented the necessary snapback in bank lending.

So central banks now became the reason why recovery from the crisis was so slow. Of course for them there was the undoubted consolation that through it all their own bureaucratic role had been massively strengthened, to include bank regulation, as well as their continued independent execution of monetary policy.

QE and the Great Distortion

As part of this enhanced role, central banks developed the new tool of deliberate balance sheet expansion, printing money to acquire large amounts of government debt. This 'Quantitative Easing' was an extension of 'open market operations' in debt, but on a greatly expanded scale and in one direction only.

We know that at the macro level of monetary loosening QE has been effective, at least to begin with[1], though by now interest rates on safe government bonds have been driven to zero or close. How did QE work? By driving up the prices of assets, especially government long-term bonds demanded by pension funds, and the equities and corporate bonds of large companies that have low risk. So for large private sector agents such as these companies it has been cheap to borrow and raise equity.

Meanwhile capital remained expensive for SMEs for whom market risk drives down equity prices, and capital regulation with high SME risk-rating makes banks reluctant to lend to them. The effect of all this has been to distort the financial markets in favour of large dominant companies against their smaller competitors.

The effect on competition and productivity has been modelled by Liu *et al*[2]. Casual observation confirms that large companies now dominate great swathes of industry, and not merely in technology: concentration has never been higher. This, Liu *et al* argue persuasively, has damaged productivity growth, which has fallen since the crisis erupted- as illustrated by US experience shown in Figure 1, which is rather typical.

So we have had the Great Moderation in the 1990s, the Great Recession in the 2010s. Now we are having the Great Distortion of financial markets as QE and bank regulation take their toll. The various phases of monetary policy can clearly be seen in Figure 2 showing the UK's M3, monetary behaviour rather typical of most developed economies.

Figure 1. Labour productivity growth trend and its components, United States

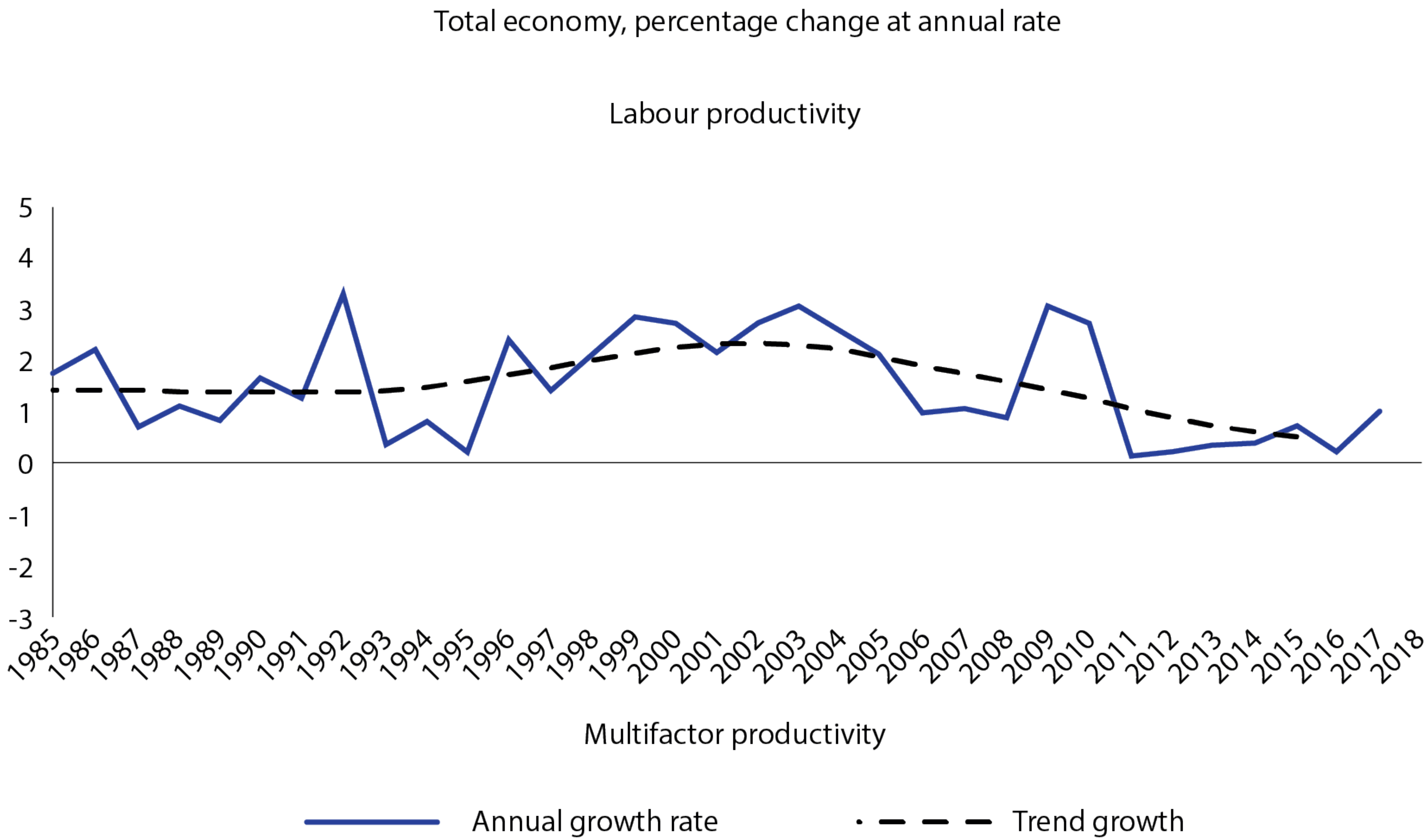
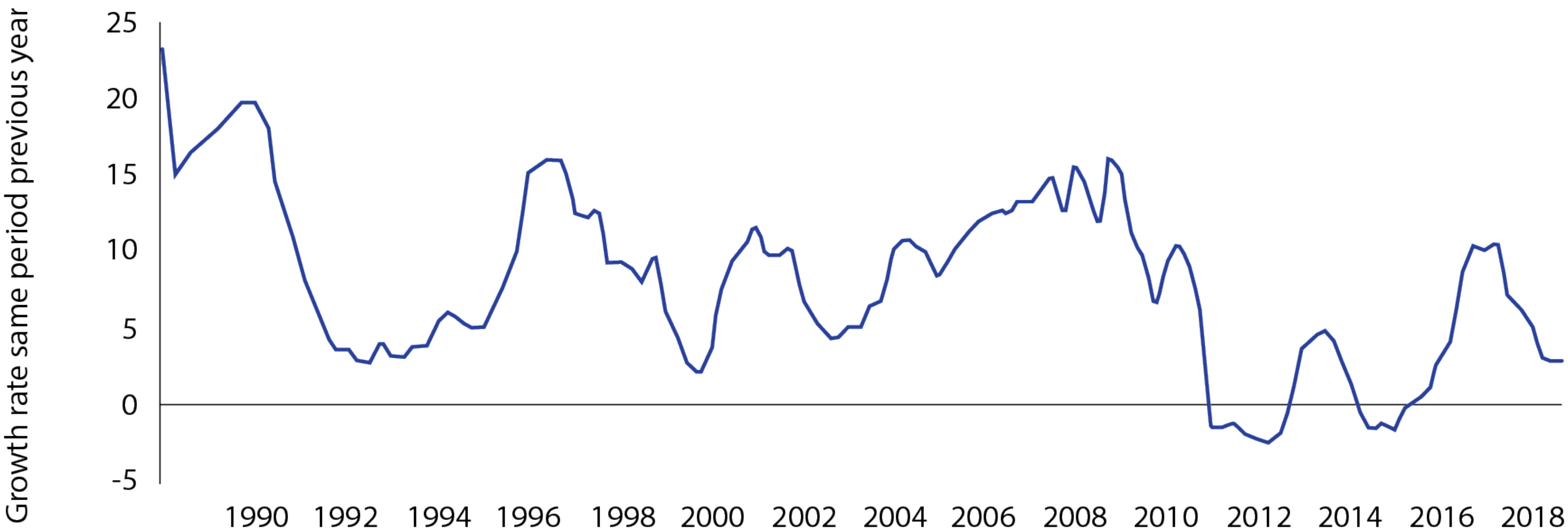


Figure 2. Monetary aggregates and their components: M3: M3 for the United Kingdom



Source: Organisation for Economic Cooperation and Development

How to dig the world economy out of the Great Recession created by central bank mistakes? The need for a bold but self-limiting fiscal expansion

The state of the world economy can only be described as weak and lacking in confidence, with low productivity growth. Interest rates on safe assets like government bonds range from zero on short-dated paper to a maximum of around 2% on very long-term bonds, but close to zero on most western countries' long-term bonds, with the US around 2% as the only exception. In Japan and the eurozone all rates are close to zero, while rates paid to banks on their central bank balances are actually negative.

On risky assets rates are generally positive, reflecting the risk premium; however, as noted above, large corporations enjoying dominant market positions are able to access capital at close to zero cost which is heavily distorting market competition. As for governments, they can raise capital at negative real interest rates, implying that they are being paid to borrow; they can even print money to finance themselves through QE.

These facts signal desperate times are with us. Monetary policy is a busted flush, with its latest tool, QE, actually damaging the situation. Can nothing be done?

The clue to what can be done is to be found in that last sentence of the earlier paragraph: that people will pay governments to borrow and spend. This mirrors the desperate plight of the private sector, unwilling to borrow enough at such low interest rates that the economy would surge and raise the rate of return to normal.

Because of the bailouts of banks and related financial costs, western governments have historically high debt/GDP ratios. Yet because of QE, as much as a third of this debt is actually simply money - the debts have been bought by central banks in return for printed money. In normal times we would worry that all this printed money would cause inflation; and we would be urging the central banks to sell their bonds and retrieve the money. Yet plainly we are not in normal times.

It is as if people were going around too emaciated to eat large stores of accumulated food that in normal times we would worry might cause obesity. The economy is too emaciated to use the huge supplies of money that have been printed.

Abnormal times require abnormal solutions. Fortunately all western countries have governments that can borrow, spend and cut taxes. As we have seen, they can do this at negative cost in debt interest; this means that future taxpayers will gain from the negative real interest cost on the debt, effectively only paying back less than the real value of the debt.

From society's viewpoint, provided the government can get a social return on its spending or its tax cuts that is positive, then this borrowing pays. Future taxpayers will have more income with which to pay off less than 100% of the debt. This means that there is no argument to be had with future taxpayers.

Meanwhile, current taxpayers will plainly be delighted if the government would take this action, bringing immediate direct benefits, but more importantly restoring the economy to functionality and confidence.

For those who feel concerned about adding to public debt ratios for fears of insolvency, this arithmetic provides reassurance. The truth is that if such fiscal policies work and push up interest rates once more to the normal real interest rates of the past, then any current rise in debt ratios will actually be reversed.

Here is a simple arithmetical example of what can happen. Suppose a country starts off with a debt ratio of 100%, of which say 60% is very long-term debt, say perpetuities, with long term interest rates at 1% p.a. Now assume it spends 10% of GDP borrowing on more very long-term bonds to spend and cut taxes over three years; and that this in time drives interest rates up to 3%.

Its stock of very long-term bonds will rise at first to 90% of GDP, with another 40% of GDP in short term bonds, making a total of 130% of GDP. But once interest rates rise to 3%, its debt ratio will fall to 70% of GDP, close to the 60% level considered prudent in the long run; this is because the long term debt is now being discounted by a rate three times higher than the current 1% (the value of a perpetuity is the coupon paid each year divided by the rate of interest).

For governments with long term debts the rise of long-term interest rates to normal devalues their existing debts, improving their solvency.

This example also shows that fiscal expansionism in these troubled times will bring its own termination and so can be thought of as self-limiting. Once interest rates get back up to normal, the normal solvency calculus will apply. New borrowing will once again be expensive in real terms, and should induce the usual caution over fiscal deficits.

It is important to realise that the case I am making here for fiscal expansion is strictly exceptional, to be ended once normality returns. It echoes Hayek's response to Keynes' work, *The General Theory of Employment, Interest and Money*; Hayek agreed that, in the very special circumstances of a stubborn depression, fiscal stimulus could be justified but he said there was not a 'general' case for fiscal 'activism', which Keynes was arguing for, on the grounds that the unaided economy might repeatedly fall into this state.

The same is true here. Usually, the economy works well without fiscal intervention. Any needs of stabilisation can be supplied by monetary policy. What has happened however is that monetary policy has laid waste the economy's usual robustness by dreadful mistakes, leaving only fiscal policy as the tool for the restoration of its robustness that we desperately need.

Once this restoration has occurred, we can also restore a powerful stabilising role for monetary policy, reacting in the future not so much to inflation as to Nominal GDP; as shown by Le *et al*[1] this shift of target implies a much stronger reaction of monetary policy to the sort of shocks involved in the Great Recession.

Conclusions

Monetary policy is powerless now to restore vigorous growth to the world economy, with interest rates, long and short, around zero. Fiscal policy must step in with a bold expansion designed to push interest rates back towards normality, decisively ending the zero lower bound episode.

With real interest rates negative, there is no threat to government solvency from this fiscal expansion, which will come to an end naturally once interest rates have normalised. Meanwhile the expansion can be used for necessary public spending and tax cuts that will stimulate supply-side growth.

I leave on one side here the details of what spending, what tax cuts and how great, in total, borrowing should be in the rest of the world. I would simply commend President Trump's tax cuts and Congress' willingness to agree with him to rising fiscal deficits. In the eurozone I would urge a general liberalisation of fiscal policy, backed up by an ECB pledge to buy the bonds of any government facing market pushback; in particular I would urge the German government to abandon its doctrinal opposition to fiscal deficits, at least until the Great Recession is over.

For the UK, the excuse of Brexit is there for a radical new direction in policy, to be backed up by fiscal liberalism. In recent work the Economists for Free Trade campaign group that I chair has set out proposals[3] for well-targeted spending and tax-cuts in the UK that raise spending power and strengthen corporate competitiveness.

We hope that Boris Johnson's government will be bold and carry out such a fiscal reform programme, that will underpin the various trade- and regulation- liberalising policies that will come, as I have explained before in these columns, from Britain leaving the EU. ■

Patrick Minford is Professor of Applied Economics at Cardiff Business School and Chairman of Economists for Free Trade (EFT), a group of leading economists

Endnotes

1. See Le et al, 2016: Le, M, Meenagh D, Minford, P, 'Monetarism rides again? US monetary policy in a world of Quantitative Easing' [https://econpapers.repec.org/article/eeeintfin/], Journal of International Financial Markets, Institutions and Money, 2016, vol. 44, issue C, 85-102

2. Liu, E, Sufi, A and Mian, A, 2019 - https://review.chicagobooth.edu/economics/2019/article/how-low-interest-rates-can-hurt-competition-and-economy

3. https://www.economistsforfreetrade.com/wp-content/uploads/2019/11/Evaluating-the-Conservative-and-Labour-Manifestos.pdf; see particularly section on 'Projecting the Effects of the Brexit Supply-Side Reform Policy'