

Cambridge Society for Economic Pluralism

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Q5. In light of recent conventional monetary and fiscal policy currently reaching their supposed limits, assess alternative ways to resuscitate the economy

The way in which Covid-19 emerged, it was quite obvious that economic policies were going to be *outré*. This has certainly been the case so far, at least in magnitude; the Bank of England introduced £745 billion in their Quantitative Easing programme (QE), the ECB uplifted their purchase programme (PEPP¹) to EUR 1,350 billion and the Federal Reserve launched QE infinity. This economic downturn - credence to its nature - required idiosyncratic and effective policies but as conventional policies dried up, monetary (and fiscal) powers became less and less useful, which caused authorities to flock to unconventional policies. This essay discusses such monetary policies and evaluates their success to justify implementation.

We first examine why existing tools are restrained and the desideratum for unconventional policies.

Due to reduced working hours, rising life expectancy amidst an ageing population, a “significant increase in the global supply of saving”² and increases in asset prices, incentives to save have generally fallen. This is in part due to the Financial Crisis with interest rates set to resuscitate the economy, but also due to the cyclical drift of the income and substitution effect - that is, with higher incomes the marginal propensity to save increases but with low interest, consumption increases. As Peter Costello, Treasurer at the Reserve Bank of Australia put it, the ‘law of diminishing returns applies to interest rates below a certain point’³, and with these rates persisting for more than a decade now, it is hardly surprising that policymakers turn to unconventional instruments.

As for fiscal policy, besides political bias or motivation, the main causes of concern are the implementation and impact lags; sometimes also a recognition lag which itself deceives potential benefits. In 1960, a proposal to John F. Kennedy to end a recession by cutting taxes was only recommended to Congress in 1962, and then passed in 1964, three years after the recession had ended.⁴ This also applies to monetary policy, although relatively speaking, monetary policy is generally much faster to implement, and (usually) independent of political restraint. Other issues preventing optimal fiscal responses stem from the nature of policies that uphold legislation, and of course the general debate in any expenditure - the loss in government revenue, or if borrowed, the debt burden. Either way, deploying such discretionary policies is a royal pain.⁵

¹ Pandemic Emergency Purchasing Programme, European Central Bank

² Wikipedia Contributors. (2020). “*Global saving glut*” Wikipedia

³ Kehoe, J. and McIlroy, T. (2019). “‘*Diminishing returns*’ from *more rate cuts*” Australian Financial Review

⁴ Principles of Economics. (2016). “*27.3 Issues in Fiscal Policy*” University of Minnesota

⁵ Instead, automatic stabilisers such as unemployment benefits could be propped up to provide stimulus, but as we saw with the CARES Act, the stimulus checks themselves took a relatively long time to transfer

Having established fiscal and monetary restraints, we now delve into unconventional forms of stimuli to resuscitate an economy.

I. Yield Curve Control (YCC)

An already-existing unconventional policy - QE - is used to purchase safe assets to relieve debt burdens of firms and governments, in an effort to stimulate investment. These are generally done by purchasing a set volume of bonds, for instance £500billion. YCC is similar, but differs in one major aspect; what YCC does, is that it promotes CBs to specifically commit to buy a specific amount of bonds that the market wants to supply at its target price, thus targeting long-term real interest rates by ensuring yields are capped ('targeted').⁶ In other words, what is targeted is the long-term 'prices' of bonds, rather than the quantity of bonds. This means that when short-run interest rates reach their minima (~0%), targeting long-run rates is far more effective to provide scope for inflation whilst for bond markets, the CB's target price then becomes the bond's market price offering reassurances to traders.⁷

Precedent suggests that YCC can be successful; during WWII, the Fed set a cap on 10-year government yields at 2.5 per cent which helped to their reduce their deficits and more recently, the Bank of Japan (BoJ) set their cap on 10-year Japanese Government Bonds (JGBs), which helped them control the yield curve (hence Yield Curve Control).⁸ This actually highlights another crucial advantage of YCC: prevent yield curve inversion by purchasing long-term bonds in order to keep investors invested. However, we must also note other side effects: in the US, inflation was also stipulated as a result of YCC, which actually led to the Fed disintegrating with the US Treasury in 1951 with it exceeding 17 percent.⁹ Interestingly for Japan, which lingered around deflation, inflation refused be their inadvertent salvation, but instead it fared well for the BoJ's holdings. If one looks at their balance sheet pre-YCC, it was already bloated with JGBs¹⁰ so you would think they need to sell and not buy. So why engage in YCC, buying more bonds? The answer lies in line with a similar tool previously used by CBs; commitment, otherwise known as forward guidance. How this works is that by declaring a stance on bonds with unlimited buying power, confidence erupts as traders acknowledge the credibility of the BoJ, as it could always purchase enough bonds to keep yields near zero (which was its original commitment).¹¹ As it turns out, this was more effective than QE and comparatively more stable.

In summary, YCC enables high investor confidence, opportunities for inflation - which is key in recessions, and keeps government debt affordable - also key in recessions, especially if governments borrow to fund fiscal policy.

⁶ Bank of Japan (2016). "*Price Stability Target*" of 2 Percent and "*Quantitative and Qualitative Monetary Easing with Yield Curve Control*." Bank of Japan

⁷ Belz, S. and Wessel, D. (2020). "*What is yield curve control?*" Brookings

⁸ AQR Capital Management. (2020). "*No Country For Old Measures*"

⁹ Concerns for inflation meant many Fed members pushed for independence, leading to The 1951 Treasury-Fed Accord

¹⁰ Exhibit A – Purchases of Government Bonds by the Bank of Japan

¹¹ Exhibit B – Ten-Year Government Bonds Yields near Zero with Yield Curve Control

However, as Dr Ben Bernanke suggests, this only works if the central bank can properly persuade financial markets that it would uphold its promise. For instance, if expectations of a smooth recovery, or in the case of a pandemic a vaccine is discovered, then inflation would rise before the period of pegging is over. This may entail that the central bank is stuck purchasing large amounts which ultimately, worsens the bank's balance sheet.¹² Moreover, in the current climate of volatility, the exposure to financial markets is probably best avoided especially if one sees how leveraged a bank could become. But one should also note that as long as yields stay positive, capital losses can be easily prevented so long as the bank holds assets to maturity.¹³ Therefore, what I conclude is that we should adopt YCC in complement with forward guidance, based on Japan's experience in 2016.

However, Japan's experience also entangled another unconventional policy – negative interest rates, which we dissect next.

II. Negative Interest Rates Policy (NIRP)

To evaluate the effectiveness of NIRP, it helps to understand how nominal and real interest rates work. Real interest rates are those which show you the intrinsic value in today's money, formally as nominal rates minus inflation as derived by the Fisher Equation. Therefore, if inflation is greater than nominal rates, real interest rates can be negative. However, that is not what we mean by NIRP.

NIRP implies negative nominal rates, so far tried by the ECB, Japan, Sweden and Switzerland. The results vary, hugely due to (a) exogenous factors (b) the length of implementation. In Sweden for instance, inflation rose from 0.9% in 2015, to 2% in 2018, and then to 1.2% in January 2020. However, this is highly coherent with the European economy with inflation at -0.3% in 2015 then to 2% in 2018 and finally to 1.4% in 2020.¹⁴ In Switzerland, NIRP was used to prevent currency appreciation but turned out to be “fundamentally inconsistent”.¹⁵ Its horror stories included spiralling inflation, penalties on foreign deposits of 41% and naturally, currency appreciations. This was mainly due to their failure of recognising exogenous factors; that is, the resilient influx of capital. What both cases show is that NIRP can be useful, but be immensely influenced by exogenous factors; it brought inflation but it also ran the risk of depriving households of their purchasing power, as their exchange rate weakened in line with rising inflation.¹⁶

So the main rationale for NIRP is to stimulate borrowing i.e. get banks to lend, get people to spend and get government expenditure to ease.¹⁷ Just from this, we can highlight many issues. Firstly, the issue of commercial bank profitability. If CBs impose reserve requirements, this would almost certainly hurt the financial sector, promoting systemic risk that arises from a lack of safe,

¹² Belz, S. and Wessel, D. (2020). “What is yield curve control?” Brookings

¹³ Wilcox, D. (2020). “The Fed has better tools than yield curve control” PIIIE.

¹⁴ Andersson, F.N.G. and Jonung, L. (2020). “Don't do it again! The Swedish experience with negative central bank rates” VoxEU

¹⁵ Mihm, S. (2019). “Switzerland Tried Negative Rates in the 1970s. It Got Very Ugly.” Bloomberg

¹⁶ The Swedish Krona depreciated by 20% from 8.5 to 11 to the Euro after NIRP was implemented. This depreciation contributed to an increase in Swedish inflation rate by 1 percentage point, making households poorer

¹⁷ As stated by the Ricardian Equivalence: namely that households aim to balance expenditure based on anticipation

interest-bearing assets despite moderate evidence so far.¹⁸ Secondly, suppose people do borrow, or rather investors look for alternative investments. This encourages more investment, therefore risking a liquidity trap and asset bubbles. Thirdly, which links in well with asset bubbles, is that this may leave ‘zombie firms’, firms that are rolling debt over. Fourthly, insurance and pension funds. If pensions cannot be retrieved sufficiently, retirement is delayed so unemployment goes up.¹⁹ And what’s to say people will keep money in their accounts and not just hoard cash? In fact, “safe sales have gone through the roof” in Europe, according to economists at Deutsche Bank and Aberdeen Investments.²⁰ Consequently, we can reasonably conclude that if negative interest rates were to be implemented, they need to be fully analysed but at the least, require a complement of fiscal policy in order to sway deficiencies.

III. Forward Guidance, Expectations and Regulations

As hinted earlier, forward guidance has a crucial role in controlling economic expectations, which can ultimately provide a path to recovery. Just as the Fed announced in August, this uncovers a new tool, targeting price levels. The way this works is that if a CB misses their inflation target in one year, then that deviation must be carried over sequentially. Despite the risk of miscalculation into the causes of real price levels i.e. is it a demand shock or supply shock (therefore, reduce output or increase output), this should help mitigate uncertainty and gain investor confidence. Further to that, by aggregating inflation expectations, a CB achieves lowered long-term interest rates, parallel to the effects of YCC, therefore raising credibility as uncertainty of deflation should theoretically be zero, provided the CB is reliable. This is because, the economy knows their CB will necessitate any discrepancies in inflation targets, thus reducing chances of deflation, all whilst redistributing income to borrowers.²¹

On the other hand, there arise some fairly obvious issues: first, the issue of public perception, second, the ease of implementing and communicating, the third, analysis of incorporating transition costs in a dynamic economy with imperfect information to match private sector expectations. Perhaps a way to mitigate some of these incongruities is to use this strategy, and at times of conflict, ease market regulations to soothe sentiment. For instance, suppose a recession, and resistance from the supply-side measured through the Purchasing Manager’s Index.²² If we adopt a strategy that temporarily removes obstacles marginally more than what its usual costs would be, this solves many of the issues mentioned; inflation to suffice targets (and therefore superseding public perception), target rigidity (to offset short-term concerns) and continuous output (to maintain expectations).

¹⁸ Exhibit C – Euro Area Large Banks: Net Profit Margin

¹⁹ Ceteris paribus, and elder workers are more likely to be held onto due seniority and experience

²⁰ Bryan, B. (2016). “*Safe sales are skyrocketing because of negative interest rates.*” Business Insider

²¹ Less repayments in absolute value so borrowers gain, reducing inequality

²² Also known as PMI, tracks the economic health for manufacturing and service sectors

Of course, removing any regulations can be beneficial by itself, but it also poses two common yet huge issues. One, systemic risk and second, the fiscal restraint we outlined earlier, bureaucratic procedures.

IV. Mercantilism and Sovereign Wealth Funds (SWFs)

Perhaps uncharted territory in an essay discussing monetary policies but the case for mercantilism and SWFs is very fascinating. What a mercantilist regime does is that it idealises exports through any means necessary, usually fiscal, and then upheaves any foreign competition. This seems strange but if one thinks about it, this is what China has used, and judging by their hyper IPO market suggests there may be incentives to do so after all. One major risk though, is that it would inevitably widen inequalities as the wealthier dominate developing countries, and that if everyone engages in some sort of mercantilism, it simply would not work.

This is where SWFs come in. These, independent of governments, could help sway investment strategies for central banks i.e. prevent currency appreciation or target inflation, which equips them with another tool, only this time, susceptible to risk of foreign markets.

Conclusion

In summary, all CBs who engage in any policies must carefully consider their strategy. With YCC for example, this would be the rate they target, the tolerance of targets, what guidance could be provided and if it actually helps to achieve policy goals. More importantly, these need to be thoroughly modelled precisely due to their nature, 'unconventional' but in any case, it would seem plausible to deploy any action at smaller scales, complemented with fiscal policies and then gradually adapt to stimuli.

End of Essay

[Word Count: 1981 excluding footnotes, appendices, and sub-headings]

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Author's Note

I would like to thank everyone at the CSEP for putting this essay competition together. With adherence to the word limit, I have outlined some potential ideas, which are by no means exhaustive.

Appendix

Exhibit A – Federal Reserve Bank of St. Louis (Aug. 11, 2020)

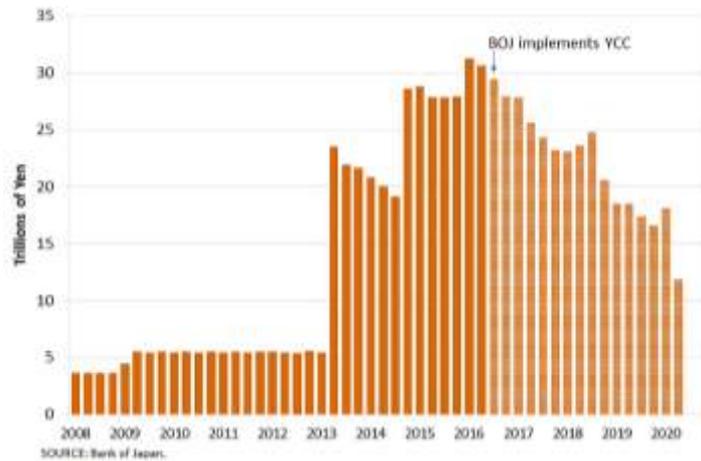


Exhibit B – Higgins, M. and Klitgaard, T. (2020).

Ten-Year Government Bond Yields near Zero with Yield Curve Control

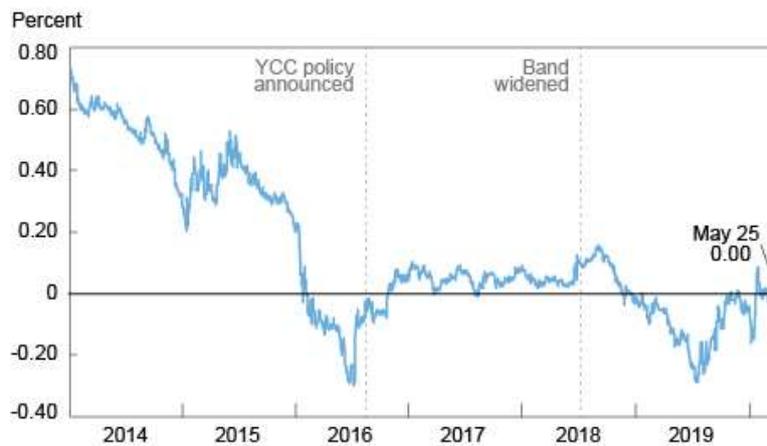
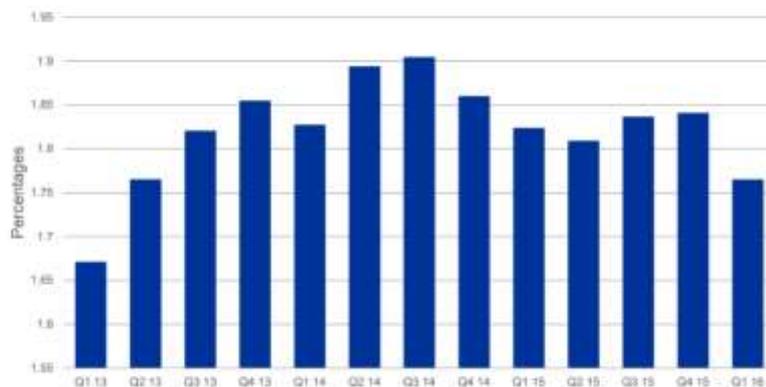


Exhibit C – European Central Bank (2016).

Euro-area large banks: net interest margin



Source: SNL Financial and ECB calculations