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### **Monetary Policy Realities Facing the ECB, Fed and BoJ: More Easing Won't Stimulate Economies**

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*Financial markets crave monetary easing and hang on every word uttered by central bankers, but would more monetary easing by the ECB or Fed actually stimulate economic growth and push up inflation to their 2% targets? This brief assesses the non-monetary character of the factors constraining growth and the efficacy of the monetary policy transmission channels under current conditions, and argues that more monetary easing would not stimulate economies and only add to financial distortions and risks.*

Two fundamental reasons suggest that under current circumstances, the effectiveness of further monetary ease by the ECB, Fed and BoJ is highly questionable. First, economies in Europe, the US and Japan are being harmed by non-monetary factors that are beyond the scope of monetary policy. Secondly, with policy rates and bond yields already negative or low and with banking systems awash with excess reserves and financial conditions easy, standard monetary channels would not stimulate economic activity. Obviously, easing and forward guidance boost financial market expectations, but central bankers and their models significantly overstate their ability to influence business expectations and behavior, which is critical to economic performance.

Europe's poor economic performance stems from external trade issues—weaker growth in China, falling trade volumes and trade policy tensions—and local politics, including Brexit. These are “real” constraints while monetary policy is an aggregate demand tool. Similarly, Japan's improvement in economic performance has been sidetracked by its very large exposure to trade with China and Asia. The BoJ's massive quantitative-qualitative easing (QQE) and yield curve control (YCC) programs are not stimulating the economy, only distorting financial markets. In the US, bond yields and the real costs of capital are near historic lows and financial conditions are very easy. An “insurance ease” by the Fed almost certainly would not influence business confidence and product pricing decisions or stimulate aggregate demand.

Central bankers must be realistic about whether the channels through which further easing—financial intermediation, the wealth effect and boosting expectations—would actually work, and consider the costs and potential risks of easing further. This is a difficult splash of reality because central bankers have convinced the public, other policymakers and themselves that when there is a problem, it can be addressed by monetary policy.

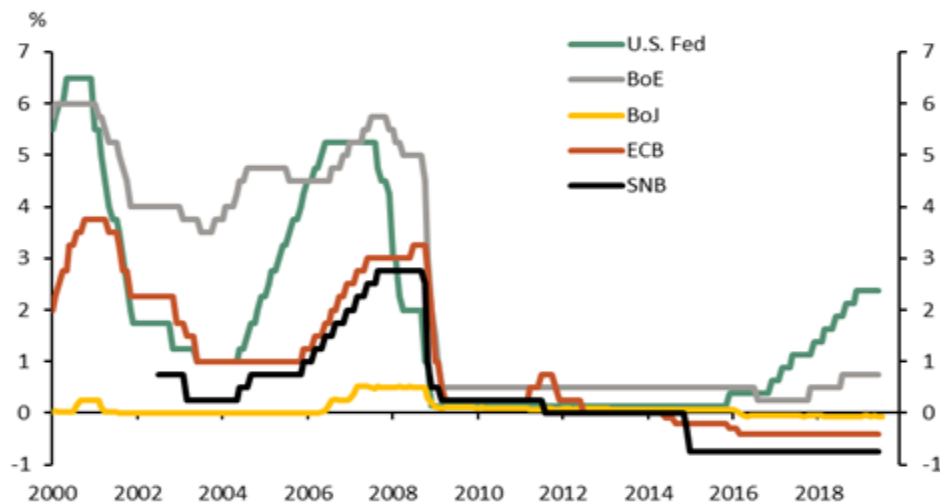


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Prolonged negative policy rates and enlarged balance sheets and the proliferation of negative bond yields in Europe and Japan distort the financial sector, harm financial institutions and increase the risks of instability and misallocate resources. Negative debt service costs provide poor incentives for fiscal policymakers. Negative rates also have unintended consequences for wealth distribution and inequality. Central bankers' efforts to boost expectations may fail or even backfire, harming credibility. Persistent excessive reliance on ineffective monetary policy easing risks central banks' credibility and independence. These costs and potential risks should not be taken lightly.

**Figure 1. Central Bank Policy Rates**



Sources: Federal Reserve Board, European Central Bank, Bank of Japan, Swiss National Bank, Bank of England and Berenberg Capital Markets.

### Europe and the ECB

Declining global trade, driven by China's slowdown, the prolonged US-China trade policy tensions that have raised uncertainties and disrupted global supply chains, Brexit and misguided fiscal and regulatory policies have been the key factors depressing Europe's economies, despite the ECB's easy monetary policy.

Unquestionably, the ECB has played a critical role as the financial backstop for the EU, and its aggressive responses to earlier crises were entirely appropriate. But the current challenges are neither financial nor a crisis. The ECB is in a real bind: it understands its limitations to address Europe's economic challenges, but knows that it is the financial backstop of Europe. Its policy (deposit) rate is minus 40 basis points and the ECB's QE has lifted its asset holdings to 40% of GDP, which has resulted in large excess reserves in the banking system (Charts 1 and 2). Financial conditions are strikingly easy, and bank lending to households and businesses is normal. The portion of government debt with negative yields is unprecedented (Chart 3), and Bloomberg reports a dozen European junk bonds have negative yields (Bloomberg 2019).



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Under these conditions, what are the channels through which further easing would work?

- Either further rate cuts or more QE would have a negligible impact on bank lending and financial intermediation. ECB easing may actually harm bank lending channels if by reinforcing negative rates it undercuts bank profits and aggravates their already undercapitalized financial structures.
- Boosting stock valuations may generate a wealth effect that modestly increases the propensity to consume. But at some point, concerns about what persistently negative bond yields suggest for expected rates of return on investment and potential growth may depress rather than support stock valuations.
- Already very low costs of capital have failed to support stronger business investment, and until global trade volumes rise and trade tensions and Brexit-related uncertainties lift, further monetary easing should not be expected to reinvigorate capital spending.
- Further QE would likely lower the Euro, which would advantage European exporters and raise import prices, temporarily lifting inflation, but it would also reduce consumer purchasing power.
- Presently, the ability of the ECB to stimulate the economy through the expectations channel, which is critical in the ECB's and the Fed's macro models and policy thrusts, is uncertain at best. Could the ECB credibly raise expectations of inflation to 2% and lift growth that would actually influence stronger growth and higher product prices? Very unlikely. In reality, economists and social scientists do not understand how expectations are formed, particularly in unique situations like the current one.

The ECB must be realistic and consider the costs and potential risks of further easing. Among other unintended side effects, negative yields suppress government debt service costs and facilitate misguided fiscal policy behavior—the type that has triggered recent European financial crises. Deeply negative German bund yields and Greek and Italian 10-year government bond yields at or below yields on 10-year US Treasury bonds are glaring caution lights.

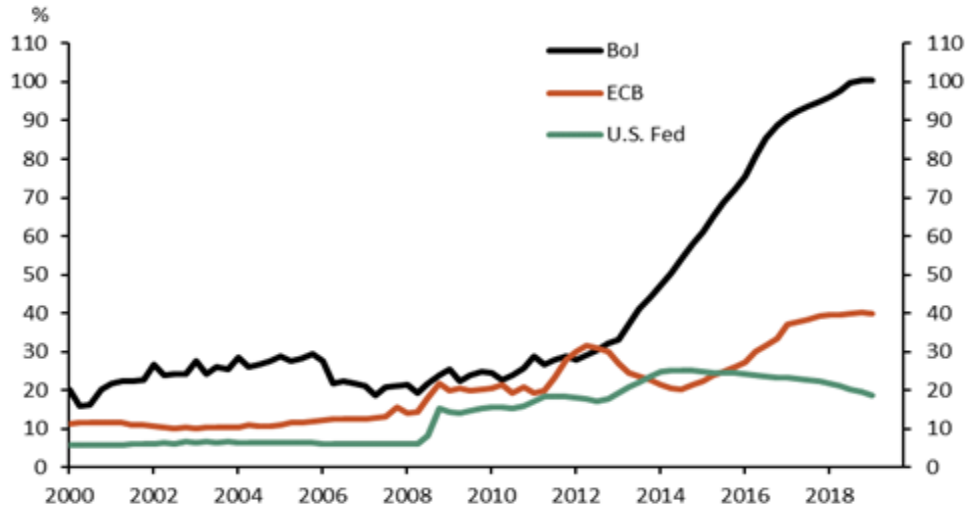
The ECB's most important contribution would be to instill in European fiscal and regulatory policymakers a clear understanding of the critically important role they must play in supporting healthy economic performance, and the limitations of monetary policy. Financial markets and the public would benefit from such clarity. ECB President Draghi has already described the important roles other policymakers must play. Forcefully conveying such a message before he leaves office would be very timely.



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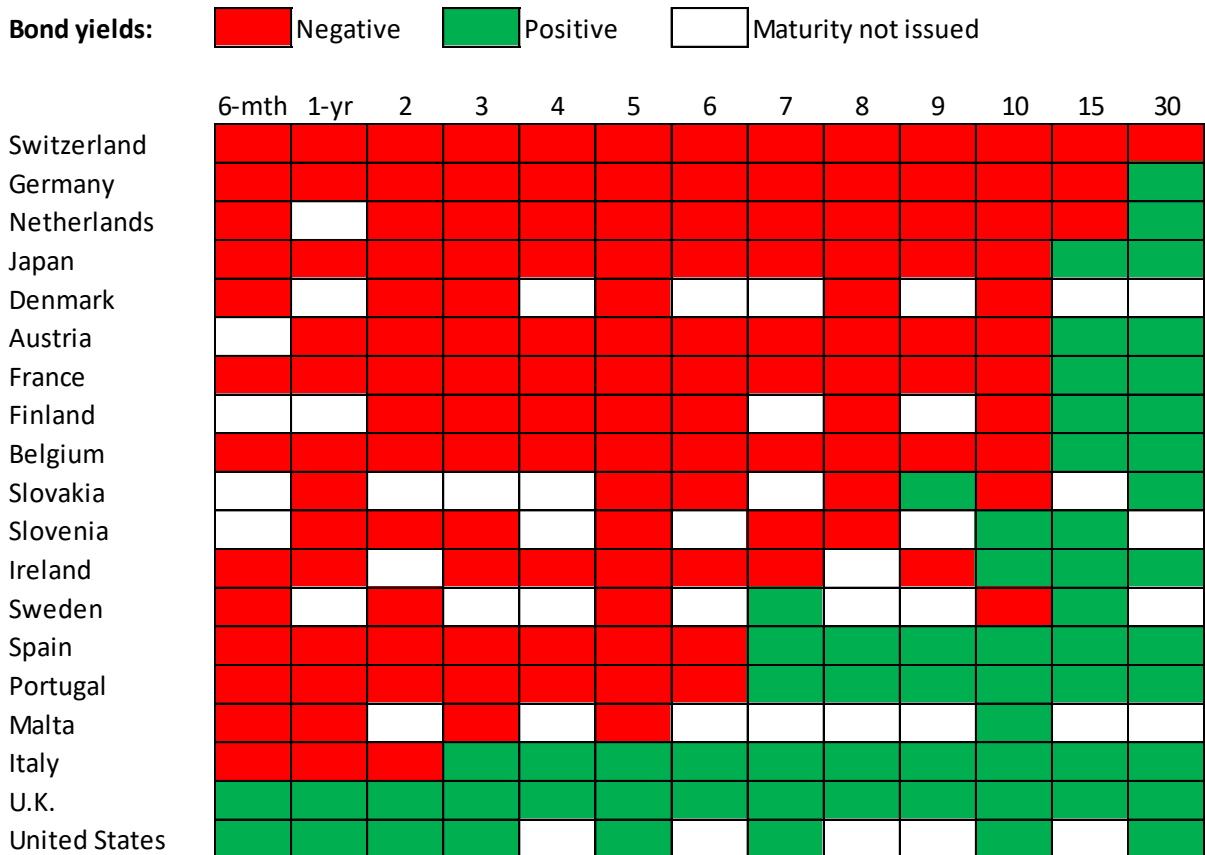
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**Figure 2. Central Bank Balance Sheet Assets as a % of GDP**



Sources: Federal Reserve Board, European Central Bank, Japan Cabinet Office, Bank of Japan and Berenberg Capital Markets.

**Figure 3. Proliferation of Negative Yields on Government Debt Securities**



Sources: Wall Street Journal, Bloomberg and Berenberg Capital Markets.



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### The U.S. and the Fed

Economic performance has softened decidedly from its robust 2018 pace, with real GDP growing around the Fed's 1.9% estimate of potential growth and core inflation at 1.6%. Labor markets and consumer fundamentals are solid, but slower global growth, trade policy tensions and an inventory overhang are weighing on industrial production and business investment. While the Fed forecasts real GDP growth to continue along its potential path, it sees downside risks, and Fed Chairman Powell wants to avoid recession. The Fed is very worried about inflation below its 2% target and the zero lower bound (ZLB) which would limit its flexibility to ease in response to an eventual economic downturn. The Fed perceives the sub-2% inflation provides it the flexibility to ease, particularly as moderate wage gains and stronger productivity suggest that labor markets may have more slack than standard unemployment rate measures suggest (Abraham and Haltiwanger 2019).

The Fed has effectively achieved its dual mandate, highlighted by the lowest unemployment rate in fifty years and inflation close to its longer-run target. However, even though it is clear that the low inflation, which is measured in quality-adjusted terms to reflect estimates of technological advances and product innovations, is actually favorable for economic performance (core PCE inflation has averaged 1.7% since 1995), the Fed's goal is to raise inflation to 2%. There is no scientific-basis for the 2% inflation target or anything magical about it, and the Fed settled on it in a rather arbitrary fashion in January 2012, following other global central bankers. The Fed's primary current concern is that lower inflationary expectations will bring down interest rates and reduce the buffer from the ZLB, which would constrain its flexibility to respond to an eventual recession (Federal Reserve 2019).

The Fed has signaled that it will cut rates as an "insurance policy". With actual economic data consistent with the Fed's June forecast of 2% growth in real GDP, the Fed seems to have temporarily abandoned its long-standing reliance on data-dependence. Moreover, a rate cut would involve excessive fine-tuning, and it may impinge on the effectiveness of future policy responses to recession or financial crisis. The Fed relies heavily on the "expectations channel" to boost economic activity and inflation (Brayton, Laubach and Reifschneider, 2014). Clearly, the Fed's monetary policy and forward guidance can stimulate financial markets, but its influence on business expectations and behavior has not performed according to the Fed's FRB-US model (Levy, 2018). At this time, it is highly unlikely that a modest insurance ease will lift business expectations or influence wage or price setting behavior, and will only reduce the buffer from the ZLB.

Like the ECB's and BoJ's experience, QE bloated base money (MB, reserves plus currency) but that was not put to work in the economy (Borio, Disyatat and Zhai 2016). Instead, it has piled up as excess reserves in the banking system, resulting in a sharp decline in the money multiplier ( $M2/MB$ ) while money velocity ( $GDP/M2$ ) has also declined as interest rates have fallen.



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Currently, with bond yields and the costs of capital already close to historical lows and the yield curve mildly inverted, actually stimulating nominal GDP growth seems unlikely.

Rather than cut rates, the Fed should reassess its financial and regulatory policies with an aim toward maximizing the probability that countercyclical monetary policy will work when the cycle turns negative. This includes a realistic assessment of the operations of the monetary policy transmission channels, the appropriate size of the Fed's balance sheet, IOER and regulations that pertain to bank capital requirements.

### The BoJ and Japan

Japan and the BoJ's unprecedented monetary easing provide important lessons for other nations and their central bankers (Bernanke 2017). The BoJ, which has engaged in various forms of zero interest rates and QE since the late 1990s, has been imposing a policy rate of minus 0.10% since 2016 and its aggressive asset purchases under QQE have lifted the BoJ's holdings of outstanding government debt (which itself has risen to 200%) to over 40% and it also holds a reported 75% of all outstanding ETFs on the Nikkei.

Japan's economy is fundamentally sound, benefiting from pro-growth initiatives of the Abe Administration, but since mid-2018 its growth has faltered, due to falling exports to China and Asia. Inflation remains mired around 0.7% and wages have declined in recent months. The overwhelming majority of the BoJ's asset purchases only adds to excess reserves and is not being put to work in the economy. Clearly, the BoJ's unprecedented monetary ease has lost its effectiveness. The resulting negative JGB yields have not lifted business expectations or wage or price setting behavior. Nor does it seem to be stimulating the stock market, as P/Es on the Nikkei have declined since mid-2015, despite the BoJ's dominant purchases of ETFs.

The BoJ's policies combined with negative bond yields has harmed banks and the financial intermediation process, and imposed negative returns on savers and generates misallocations of national resources. Its financial repression serves primarily to reduce the government's debt service costs and facilitate sustained deficit spending. Effectively, the BoJ has succumbed to fiscal dominance.

### Concluding Remarks

There are no physical limits to central bank rate cuts or balance sheets, but there are limits to the effectiveness of monetary easing. Leading central banks need to reassess the robustness of the monetary policy transmission mechanisms in their macro models that they rely on so heavily, particularly the presumed influence on business expectations, and seriously consider the costs, potential risks and unintended side effects of extending monetary policy beyond its natural scope.



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