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MONETARY POLICY AND THE GLOBAL ECONOMY

At this moment, most of the economies in Europe and North America suffer from many uncertainties after the big recession and subsequent government measures to combat the continuing negative outcomes. Uncertainty is not desirable for the rapid and sustained recovery of economic growth (4+% per annum rate) needed for the job formation that will reduce exceptionally high un-employment levels (in the U.S. in excess of 15% combining underemployment and unemployment). Some forecast the low rate of job formation will persist and "full employment" (5% un-employment) will not be reached for 5-7 years. Politically the duration of these labor conditions is problematic in an already unhappy electorate.

In most of the major economies a belief seems to exist that monetary policy, transfer payments and reduction of taxes are the principal policy decisions to revive or sustain economic growth. The policies fail to recognize the simple truth: small business job creation is the key to overall job and real business investment growth. Personal consumption does not drive economic growth (at least in the U.S.). Do the low interest rates created by monetary policy help? In the U.S., the law mandates that the goals of monetary policy must be to maintain a healthy level of economic activity and low inflation. At present inflation is low but deflation and growth are the concerns. Hence, the Federal Reserve has engaged two periods of quantitative easing to keep rates low and encourage lenders to shift assets towards loans.

The fiscal policies of investing in infrastructure programs to create jobs and stimulate growth appear largely rejected in favor of short term transfer payments to the unemployed to encourage personal consumption. Indirect measures in business tax reductions may encourage investments, but so far little effect has been seen from historically low interest rates. These measures are resulting in massive deficits and an increase in indebtedness with the objective of recovery and growth, but without any future "investment" returns like infrastructure projects provide and simultaneously create short term and long term jobs.

Political forces encourage monetary policy to keep interest rates low so both private and public sectors have access to debt. However, we appear to be reaching the "liquidity trap" where as rates approach zero, still no borrowing occurs due to the uncertainty and risk of debt generated spending. Looking at the equation of $MV = PQ$ (money supply times velocity of money equals the price of money times quantity of production or GDP), the central bank increases the money supply but the velocity slows (spending slows) and prices remain stable or fall (deflation) and the economy (GDP) fails to grow or even declines. Borrowers are risk averse (both consumers and business) and under these conditions would rather create liquidity and build cash to give flexibility under negative contingencies. Public borrowers, especially state and local governments are in such fiscal distress that borrowing except for specific revenue producing projects is virtually impossible. In addition to this impasse, the cheap money (low interest rates) may create other risks by encouraging speculation (note the recent rise in gold and silver prices) on leverage or flows of currency (foreign exchange risk) around the globe in the "free market." Now as of the year end, regardless of the theory or research we know about, financial markets appear dysfunctional and as a result more or less stagnant (very "modest") growth.

What is the recent track record of these monetary and fiscal policies? Japan has both low interest rates (1%), huge deficits to support infra structure program and has economic growth under 1% for 20 years. In the US, little of the enormous deficit spending (and growing sovereign debt levels) is building infrastructure and most has gone for transfer payment supporting services and unemployment benefits while interest rates have been kept in the 1% range. These policies are implemented by both monetary expansion (monetary base) and debt (lower taxes and programs with deficits funded by debt), but what are the limits of debt sustainability without inflation or loss of capital flows or crowding out of the private sector?

Is this time different? The work of Reinhart and Rogoff (This Time is Different—Eight Centuries of Folly (2019)) suggests that in fact monetary policy and the leverage encouraged by "currency debasements" cause financial crises and economic collapse. In 2020, are we different or are we laying the foundations for perpetuation of a series of crises? Is this a case of a failure to endure short-term financial and social pain for longer term economic gain out of political expediency?

Investors must be convinced that the enhanced economic performance will allow debt support and reduction over time (debt sustainability). The gamble: stable growth or bubble? Investors are fickle and often fragile and prone to a “crowd” influence. There is the risk that they will rather suddenly decide to start selling sovereign debt as happened in Russia and Asia in 2008. Certainly they must never believe that monetary policy will shift to inflating away the value of debt. Such flight of capital has the potential of negative exchange rate adjustments. Looking at the U.S., is this possible for a “reserve currency” like the dollar? How much leverage and interest coverage based on GDP is enough?

In the past year, several European Countries (Spain, France, and U.K.) have adopted more fiscally restrictive policies on pension and services only to be faced by massive strikes and demonstrations and calls for new elections. Greece is in economic crisis after it used debt to fund generous state programs without modernizing a failed system of taxation is facing a population unwilling to suffer the painful remedies. Can the EEC and IMF with the support of wealthy states (Germany, USA) restore these states (PIGS: Portugal, Ireland, Greece and Spain) without seriously damaging their own economic union? Policy makers are speaking in positive and constructive terms, but are they delusional? The global economy’s future stability and growth depends on their success in rebuilding confidence and reducing uncertainty. What, if anything, can monetary policy do about this?

We live in a flat, interconnected world where all nations want to maintain or improve our standard of living. To do so each nation must find its comparative competitive advantages as enhanced by their infrastructure and geography. Some of these advantages are historic and geographic, for example, Switzerland as a banking center or Germany for manufacture or Canada for natural resources. Even in these cases to maintain advantages, especially in services, infrastructure must be continuously enhanced. Included must be the financial strength of the nation and that means prospective debt coverage and financial confidence of debt holders and trading partners. Ultimately, the central bankers and their monetary policies must make this their long run stability goal. Short term management of inflation, exchange rates and economic growth must all be cast in this light. My fear, at least in the U.S., is this over-riding goal has been forgotten with the fiscal and monetary policies adopted in the past three years. Politics not prudence is dominating economic policy. I hope it is not too late for policy makers to ask these questions. The recovery is fragile, modest and reversible with many participants—nations, industries, companies and citizens still suffering for the foreseeable future.