MORE MONETARY EASING: NO ECONOMIC IMPACTS AND MOUNTING COSTS AND RISKS, SO WHY DO IT?

Central bankers drive financial markets and captivate the economics media: stocks, bonds and foreign exchange values gyrate in response to changes in monetary policy, central bankers’ public statements, and in anticipation to what they may say. Last week, when ECB Chairman Draghi and U.S. Fed Chairman Powell, indicated clear easing biases, bond yields fell and stock markets jumped. Japanese bond yields went further negative as the BoJ remained committed to its ongoing massive Quantitative and Qualitative Monetary Easing (QQE) and Yield Curve Control (YCC) program. These market responses make sense.

But, beyond all of the market hype about central bank policy, how would more monetary easing by the ECB or U.S. Fed (or the maintenance of the BoJ’s ongoing massive QQE) actually help the central bankers achieve their objectives of stronger economic growth and 2% inflation? Will easing more now dilute the potential efficacy of aggressive stimulus that will be needed at some future date when central bankers face recession or financial crisis?

Under current circumstances, with massive excess reserves in global banking systems, artificially low and negative policy rates and a scary proliferation of negative yields on government debt securities, the effectiveness of further monetary ease is murky at best, and the downside costs and risks are mounting and deserve consideration (Charts 1 and 2).

Chart 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

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What are the transmission mechanisms through which more monetary easing would be expected to actually stimulate? There is clear evidence that the unprecedented monetary ease in recent years has not generated the acceleration in aggregate demand as predicted by the central bankers and their macroeconomic models. Central bankers argue that if they had not pursued such monetary ease, economic performance would have been much worse. Maybe, but such assessments are based on their macroeconomic models that have had poor predictive track records and have proved unreliable. Revisionist history is in the eyes of the beholder.

The efficacy of further rate declines or QE to stimulate economic growth requires that monetary easing stimulates the credit channels and boosts private sector expectations (and maybe reduces the local currency) that generate an acceleration of spending, investment, and aggregate demand. Under current circumstances this seems highly questionable. Further cuts to negative policy rates in Europe and Japan would involve distortions as well as potential benefits, while rate cuts by the Fed would have an immaterial impact on borrowing rates and the real costs of capital. **More QE would only add to excess reserves in banking systems and would be very unlikely to stimulate more credit supply or economic activity (Chart 3).**

Jumpstarting expectations in the real economy may prove much more difficult than stimulating financial markets. **Weak economic conditions reflect factors that are nonmonetary in nature and well beyond the scope of monetary policy to remedy, including the slower growth in China and global trade, disruptions and tensions stemming from the bruising U.S.-China trade negotiations and U.S. President Trump’s erratic behavior, Brexit, and now the Middle East flare up.** Central bankers want to help and that is admirable. But monetary policy is an aggregate demand tool and is incapable of offsetting supply constraints on the economy. Moreover, these supply constraints will not last forever. Central bankers’ efforts to reinvigorate expectations may backfire, which would diminish their credibility and undermine their longer-run policy strategy and flexibility. These risks should not be taken lightly.
Meanwhile, prolonged negative policy rates and enlarged balance sheets, and the proliferation of negative bond yields pose mounting costs and potential risks to real economic performance and financial stability (Chart 4). They distort financial markets and economic activities and provide poor incentives for misguided fiscal policymakers. Central bankers are encouraged to realistically reassess the channels through which monetary policies would actually stimulate credit and economic activity, consider current policy in the context of their longer-run goals and carefully weigh the costs and risks of further easing.
The U.S. and the Fed

In this analysis, we distinguish between what the Fed is likely to do — ease rates (Fed to lose “patience” and cut rates this year, June 6, 2019) — and what it ought to do.

Economic performance has softened markedly from its robust 2018 pace, with real GDP growing slightly below the Fed’s 1.9% estimate of potential growth and core inflation decidedly below the Fed’s 2% target at 1.6%. While the fundamentals underlying the consumer are solid, the combination of slower global growth, trade policy tensions, and an inventory overhang is weighing on industrial production while growth in business investment has also softened (Jerome Powell, Economic Outlook and Monetary Policy Review, Speech at the Council on Foreign Relations, June 25, 2019).

Although the Fed has effectively achieved its dual mandate, highlighted by the lowest unemployment rate in fifty years, it is very concerned about the persistence of sub-2% inflation. While it is obvious that the low inflation is actually favorable for economic performance, particularly since technological advances and product innovations continue to suppress the official quality-adjusted measures of inflation, the Fed is nevertheless very concerned. We note that since 1995, core PCE inflation has averaged 1.7% and this has not harmed economic performance.

There is no scientific basis for the 2% inflation target or anything magical about it — following lengthy debate, the Fed settled on 2% inflation for its official Longer-Run Strategy in January 2012, choosing a point target rather than a range and rejecting suggestions for a lower target — and because other leading central bankers officially had already adopted 2% targets. The Fed considered 2% sufficiently low to be associated with price stability but sufficiently above zero to provide a buffer.

The Fed’s primary concern is that lower inflationary expectations will bring down interest rates and reduce the buffer from the zero lower bound, which would constrain the ultimate flexibility of the Fed to respond appropriately to an eventual recession. The constraint imposed by the effective or zero lower bound (ELB or ZLB) was a prominent theme at the Fed’s recent Strategy Conference.

Although a recession does not appear imminent - the Fed continues to forecast sustained real GDP growth close to its estimate of longer-run potential - the Fed sees heightened uncertainties and risks, and Fed Chairman Powell has made it clear that the Fed would go to great lengths to avoid a recession. The Fed perceives that the sub-2% inflation gives it flexibility to ease and the moderate pickup in wage gains and stronger productivity suggest that labor markets may have more slack than standard unemployment rate measures suggest.

The Fed is considering cutting rates as an “insurance policy”. But this seems to involve excessive fine-tuning and it is uncertain whether near-term rate cuts would achieve the Fed’s objectives. Moreover, it may impinge on the effectiveness of future Fed policy in response to a recession or financial crisis. Since the 2008-2009 financial crisis, the monetary policy transmission mechanism has not functioned with its prior efficiency: changes in interest rates have had muted effects on credit and nominal GDP has not accelerated as predicted (Chart 3). While housing activity has responded fairly predictably to changes in mortgage rates, historically low interest rates have not stimulated business investment anywhere close to predictions by the Fed’s macro models, and the wealth effect on consumption has diminished.

Noteworthy, the Fed now acknowledges that its earlier QEII and QEIII had much less impact on interest rates than it had earlier touted. While QEIII certainly stimulated financial markets, real GDP growth remained lackluster and inflation stayed below 2%. (In 2012, when Chairman Powell was a Fed Governor he argued against QEII) The dramatic increase in the Fed's base money (MB) - Fed reserves plus currency - did not generate any material pickup in credit availability or lending and was not put to work in economic activity, instead remaining as excess reserves in the banking system. This was reflected as a sharp decline in the money multipliers (M2/MB). The supply of credit appears to have been constrained by the Fed’s paying interest on excess reserves (IOER), its regulations on bank capital requirements and other factors. The nonfinancial sector’s demand for credit may have been adversely affected by some negative tax and regulatory
Persistent inflation of 2% or higher requires an acceleration of nominal GDP growth from its estimated pace of 3.8% in the first half of 2019, unless there is an unforeseen negative supply shock. In general, inflation approaches the extent to which nominal aggregate demand exceeds the real capacity to grow. Accordingly, even if the current pace of real growth is sufficient to generate new jobs and meet the Fed’s “maximum employment” mandate, achieving and maintaining 2% inflation requires that monetary policy must be capable of stimulating stronger aggregate demand.

So, if the Fed now lowers interest rates a few notches, as is now widely expected, would that stimulate real growth and/or boost inflation above its 2% target? With bond yields and the costs of capital already close to historical lows and the yield curve mildly inverted, actual stimulus seems unlikely. Easing may boost financial markets, but not likely expectations in the real economy.

We note that the Fed’s macroeconomic model (FRB-US) presumes that the monetary policy transmission mechanism is working seamlessly - that lower rates and/or more QE stimulate credit and aggregate demand - even though those channels have not been working as predicted. Similarly, research by scholars that simulate the impacts of monetary easing also rely on Fed-type models (FRB-US and DSGE models) without digging into the financial intermediation process and how further monetary easing would affect credit and economic activity in the current environment of very low interest rates and an inverted yield curve. (Even the Fed admits that these macroeconomic models do not adequately capture the intermediation process.)

The Fed’s own quarterly forecasts do not provide any guidance on whether stimulus would work: in reality, its quarterly Fed funds rate forecasts are not true forecasts, rather they are estimates of what FOMC members estimate to be the most appropriate policy rate consistent with their economic and inflation projections. Accordingly, we should not expect the Fed to raise its economic and inflation forecasts in response to further interest rate cuts.

Besides keeping the economic expansion going, the Fed’s biggest concern is the ELB, and how it may limit the flexibility to ease as needed when it does face recession or severe financial stress. The Fed has already indicated that negative policy rates are not a viable alternative, which leaves QE as the primary policy tool. The Fed presumes that in a period of recession or financial stress, QE and forward guidance would work through the “expectations channel” and boost economic activity. Nevertheless, the Fed should now plan for the longer run: it must consider how an insurance easing now would impinge on future monetary policy effectiveness and it should undertake a serious reassessment of its various monetary and financial and regulatory policies and make appropriate changes with a goal of maximizing the probability that countercyclical monetary policy will work when the cycle turns negative. This includes a realistic assessment of the appropriate size of the Fed’s balance sheet, IOER and regulations that pertain to bank capital requirements.

Europe and the ECB

Eurozone economic performance is weak, with real GDP growth below estimates of 1.5% potential growth, and inflation well below the ECB’s 2% target. But, as Berenberg Economics has carefully documented (ECB: to QE, or not to QE, June 14, 2019), the sources of Europe’s weakness are an array of real and political factors that are non-monetary in nature: the economic slowdown in China and globally with weak international trade volumes; heightened uncertainties and tensions emanating from the U.S.-China trade war and President Trump’s erratic and unpredictable behavior; Brexit; Italy’s unique politics that stifle pro-growth policy initiatives; and other more traditional factors like burdensome tax and regulatory burdens.

The nagging negative trade and political factors are effectively supply shocks that are obviously beyond the scope of the ECB’s monetary policy. It is nearly universally agreed that the best news for Europe would be an end to the U.S.-China trade wars and reduction in related trade tensions and uncertainties, and a solid rebound in China’s economy. Toss in a friendly, seamless resolution to Brexit, and Europe’s economy would bounce back.
nicely. Berenberg’s assessment of these factors underlies its forecast of a pickup in economic growth in the second half of 2019 and it does not think it is necessary for the ECB to ease at this time (Chart of the week – Eurozone: bottoming out amid the storm, June 21, 2019).

Financial market excitement about more monetary easing is understandable, but is it realistic to expect more monetary easing would actually stimulate growth or lift inflation with policy rates negative and ample excess reserves already in the banking system, particularly if the inhibiting factors are not monetary in nature?

Undoubtedly, the ECB has played a critical role as the financial backstop for the EU, and financial and economic conditions very likely would have been much worse if it had not responded aggressively to the earlier financial crises. The ECB’s initiation of QE beginning in March 2015 helped ease severe financial stresses that re-emerged following the earlier financial crises that had required assertive action by the ECB. Besides lowering interest rates and boosting confidence, the ECB policy likely kept the euro lower than it would have been otherwise, which contributed to healthy export growth, particularly in 2017.

But from the current situation, it is hard to see how more monetary easing would actually stimulate stronger growth or materially lift inflation. It is widely understood that the economy is being harmed by the global slump, trade tensions and Brexit uncertainties, and other nonmonetary channels. The ECB’s policy (deposit) rate is minus 40 basis points and the ECB and EMU national central banks maintain very large balance sheets (in the aggregate totaling 40% of GDP) that involve large amounts of excess reserves (Charts 1 and 4). Financial conditions are strikingly easy: there is ample financial liquidity and European banks are lending, with healthy growth in outstanding loans to households and businesses. Interest rates are stunningly low, with a sizable portion of outstanding government debt with negative yields (Chart 2): yields on nearly all sovereign 5-year government notes in the EMU have negative yields and yields of 10-year government securities are negative in Germany (-31 bp), the Netherlands (-14 bp), Austria (-4 bp), and close to zero in France. Despite its well-known problems, Italian 10-year bonds yield 2.13%, strikingly close to U.S. 10-year yields.

Under these circumstances, what are the channels through which more QE would stimulate things? Higher stock valuations may generate a wealth effect and increase the propensity to consume but the impact of lower costs of capital on business investment would be muted, and there is no reason to expect a boost to expectations. Further QE would likely lower the euro, which would advantage European exporters and raise import prices, temporarily lifting inflation, but also reduce consumer purchasing power. In all likelihood, these positives would be offset by sluggish global growth and trade volumes and U.S.-China related trade tensions and uncertainties and political challenges.

One concern of further QE is its potential negative impact on the profitability of commercial banks stemming from reinforcing artificially low interest rates. This would cut into their already under-capitalized financial structures and indirectly influence bank lending.

There are broader concerns. Prolonged negative policy rates and government bond yields are unhealthy on many dimensions, distorting private business and household economic and financial decisions and harming economic performance over time. Negative yields on sovereign bonds would further suppress government debt service costs and facilitate misguided fiscal policy behavior - the type that has triggered European financial crises in the past. The ECB must consider how its monetary policies are contributing to the negative interest rate environment, and to what end?

The ECB’s interest in supporting and helping the European economy is understandable – it is so important to Europe’s economy and finances – but rather than ease monetary policy further at this point, its biggest 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 in achieving the economic outcomes and stability that everybody desires. Financial markets and the public would benefit from such clarity. In the past, ECB President Draghi has described the important role other policymakers must
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play in achieving healthier economic performance. Before he leaves office, conveying such a message would be very timely.

The BoJ and Japan

Japan’s economy is fundamentally sound but since mid-2018 its growth has subsided, largely in response to the adverse consequences of China’s economic weakness on Asian economies and trade, and its inflation remains mired around 0.7%, below the BoJ’s long-standing 2% target. Japan’s real domestic demand grew 1.1% in the year ending 2019Q1, while exports fell 2.7% and imports fell 1.9%.

Japan’s improving fundamentals have reflected some of the pro-growth initiatives of the Abe Administration. Employment has been growing despite the declining population, reflecting the rising labor force participation rates of women, older citizens and a sizable influx of foreign workers. Productivity and real GDP per capita have been rising, reflecting ongoing improvements in business efficiencies. Profits have risen significantly.

Since Japan’s bouts of deflation in the 1990s, the BoJ has implemented different forms of interest rate policy (ZIRP) and QE. These initiatives have been designed to rid expectations of deflation that encourage saving rather than spending and to stimulate growth. In recent years, the BoJ has highlighted rising wages as an intermediate objective, emphasizing that wage increases are a critical element in healthy economic performance and reflect inflationary expectations - and based on a notion of a Phillips Curve, will generate higher inflation.

In 2013, the BoJ launched aggressive QQE in which it began purchasing large amounts of JGBs, corporate bonds and ETFs on the Nikkei stock exchange. That program was enhanced in 2014. In January 2016, the BoJ reduced its policy rate from 0% to -0.10% and in September 2017, it imposed its YCC program that targets the yield on 10-year-JGBs at 0% with a 10 bp leeway (in July 2018, that band was widened to 20 bp).

As a consequence of ongoing asset purchases under QQE, the BoJ now holds 45% of all outstanding government debt. Persistent high deficit spending has lifted government debt to 200% of GDP. The BoJ is buying the equivalent of more than 100% of the government’s deficit spending on the secondary market, so the BoJ’s share is rising. It also holds a reported 75% of all outstanding ETFs on the Nikkei.

The vast majority of the BoJ’s bloated balance sheet and virtually all of its new asset purchases are reflected as excess reserves in the banking system (Chart 4). Commercial banks holding excess reserves lend them back to the BoJ or buy JGBs directly - contributing to the historically low yields. Presumably, they also buy corporate bonds whose yields have fallen to very low positive levels.

The Nikkei soared from early 2013 through mid-2015 (it rose 95%) reflecting QQE and strong increases in corporate profits, but since then as profits have continued to rise, the Nikkei has not kept pace. The resulting decline in P/E’s on the Nikkei is striking amid the BoJ’s ongoing large scale purchases of JGBs and ETFs.

Since 2013, Japan’s economy has grown at a 1.3% average annualized pace - slightly below its growth pace during 2002-2007 - which reflects its potential growth plus the favorable responses to Abe’s pro-growth initiatives rather than the BoJ’s massive amounts of QQE and negative policy rate. The BoJ’s large scale asset purchases have not been put to work in the economy and the historically low interest rates have not materially stimulated growth in bank credit and nominal aggregate demand has not accelerated (Chart 3).

Note that Japan’s economic performance over the years has been more sensitive to non-monetary factors than to the BoJ’s monetary policy: the Abe Administration’s labor market initiatives have increased the supply of labor and its corporate governance initiatives have contributed to business efficiencies; the controversial VAT hike in Spring 2014 had large unanticipated negative effects on consumer spending and business investment and generated recession; and China’s economic weakness and the global slowdown in 2015-16 generated an industrial slump in Japan, and the same effects are now harming its economy.
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**The BoJ’s QQE and the ultra-low interest rates have lost their punch.** Supporters argue that the BoJ’s policies have contributed to economic performance and without the QQE, the economy would have faltered and the BoJ needs to maintain its asset purchases and YCC program until inflation is comfortably at 2%. This assessment understates the positive contributions of tax and regulatory policies on real economic activity and also understates the mounting distortions of the BoJ’s holdings, negative policy rate and resulting negative bond yields.

Japan’s banking system has been crippled and the credit allocation process has been distorted by the BoJ’s QQE and YCC. The negative JGB yields reduce the government’s borrowing costs and facilitates more deficit spending - the largest portion of the rise in government spending is for old-age pensions. (At the same time, the negative yields are imposed on the national Postal Savings system and pensioners’ returns.) Such financial repression damages economic performance.

**Concluding remarks**

**There are no physical limits to central bank rate cuts or balance sheets, but there are limits to the effectiveness of central bank easing.** Unless economies fall into recession, near-term monetary easing by the Fed and ECB is ill-advised and would involve mounting costs and risks. The BoJ should begin taking steps to rein in its QQE and YCC.

The weaker-than-desired economic performance and low inflation are driven by nonmonetary factors beyond the control of central bankers. Moreover, there are ample excess reserves in the banking system and policy rates are already negative in the EMU and Japan and very low in the U.S. Credit is readily available and the costs of capital are near historic lows. Central banks should reassess the benefits and costs of current policies and further easing - including how easing now may impinge on the efficacy of future easing in response to recession or financial crisis - and consider policy initiatives that may improve the effectiveness of their monetary transmission mechanisms.

**The ECB is in a particular bind because it plays the critical role of being Europe’s financial backstop while the factors that have harmed European economies and added uncertainties and risks are beyond its scope.** With its policy rate already negative and balance sheet bloated, a careful assessment of the costs and benefits of further easing clearly suggest that the ECB should delay renewed QE. The ECB should also set out a plan to lift its official policy rate back to zero.

The Fed needs to come to grips with its unhealthy relationship with financial markets and its excessive focus on managing the real economy (The Fed and Financial Markets: Suggestions to Improve an Unhealthy Relationship, May 2, 2019). It should dampen market expectations that it will ease further. To enhance credit channels and the future potential efficacy of monetary policy, the Fed should announce that it will allow further passive runoff in its balance sheet and significantly reduce the rate it pays on IOER. It should reassess the merits of its 2% inflation target based on a long view of U.S. historical experience with low inflation and bouts of deflation, and reconsider the merits of targeting a range rather than an arbitrary rate.

The BoJ should acknowledge that its QQE and YCC policies have not played a significant role in boosting Japan’s economic performance in recent years while they have imposed unnecessary financial repression on Japan’s banks and markets while supporting the government’s deficit spending. The BoJ should end its YCC program. This would have no impact in the near term. It should also announce a schedule for reducing the magnitude of its asset purchases, including unwinding its purchases of ETFs on the Nikkei. Any rise in market rates in response would be healthy for financial markets and not harm economic performance.
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