The exhaustion of central banks

Gilles MOËC

AXA Group Chief Economist

gilles.moec@axa-im.com

30 January 2020

A 40 year journey back to fiscal dominance

- Since the 1980s we have been operating under a "monetary dominance" regime, where central banks held the keys of cyclical stabilisation and fiscal policy had been increasingly thought to be irrelevant.

- But with the decline in the natural interest rate, central banks need to dig deeper and deeper into unconventional territory to provide the same stimulus. This is touching its limits with the current global downturn, either because monetary policy has lost the "ideological battle" – negative rates are increasingly seen as counterproductive – or because of institutional hurdles.

- Fiscal policy needs to take the lead. But "fiscal dominance" will mean low interest rates for long. Indeed, the difference with the 1960s/1970s is that (i) debt is today much higher and (ii) inflation is weaker. Governments will need low funding costs to erode accumulated debt.

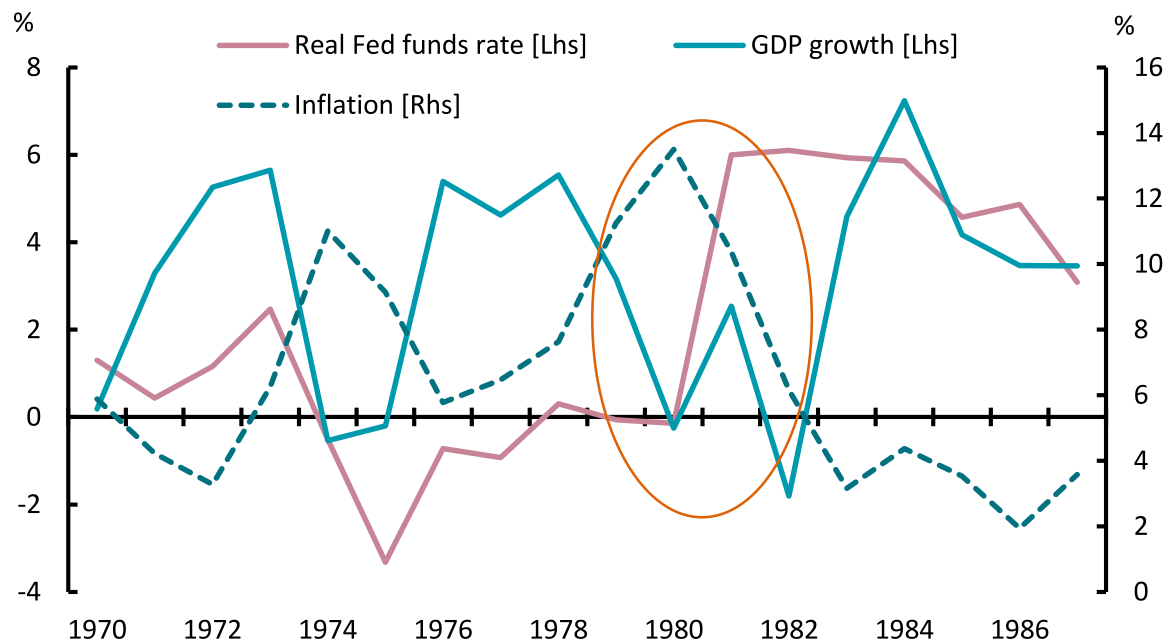
Once upon a time in America

Volcker made modern monetary dominance possible

Under the post WW2 Keynesian consensus, fiscal policy reigned supreme as a cyclical stabilisation tool. Monetary policy was a mere auxiliary. Ultimately this triggered the inflation spiral of the 1970s. The neo-Keynesian school saw monetary policy as a much more nimble tool, but first inflation had to be tamed. This was done in 1980 at the cost of a major recession.

Real interest rates had to remain fairly high for a number of years to anchor inflation expectations. This made fiscal policy even less effective because of the risks of debt snow-balling.

US - Monetary stance and inflation/growth trade off



Source: Federal Reserve, BEA, AXA IM Research

The Taylor rule magic (1)

Once inflation is tamed, monetary policy becomes an effective cyclical stabilisation tool

Two simple equations:

$$\text{Inflation} = \alpha\,(\text{GDP} - \text{GDP}^*) + \beta\, p^*$$

$$\text{Fed Funds} = \text{equilibrium interest rate} + 0.5 * (\text{inflation} - p^*) + 0.5 * (\text{GDP} - \text{GDP}^*)$$

Once expected inflation (p*) has been anchored to the central bank's target, inflation "simply" moves in line with the cycle (the output gap, GDP – GDP*).

The central bank "simply" needs to adjust its policy rate to the output gap and the deviation from target of actual inflation.

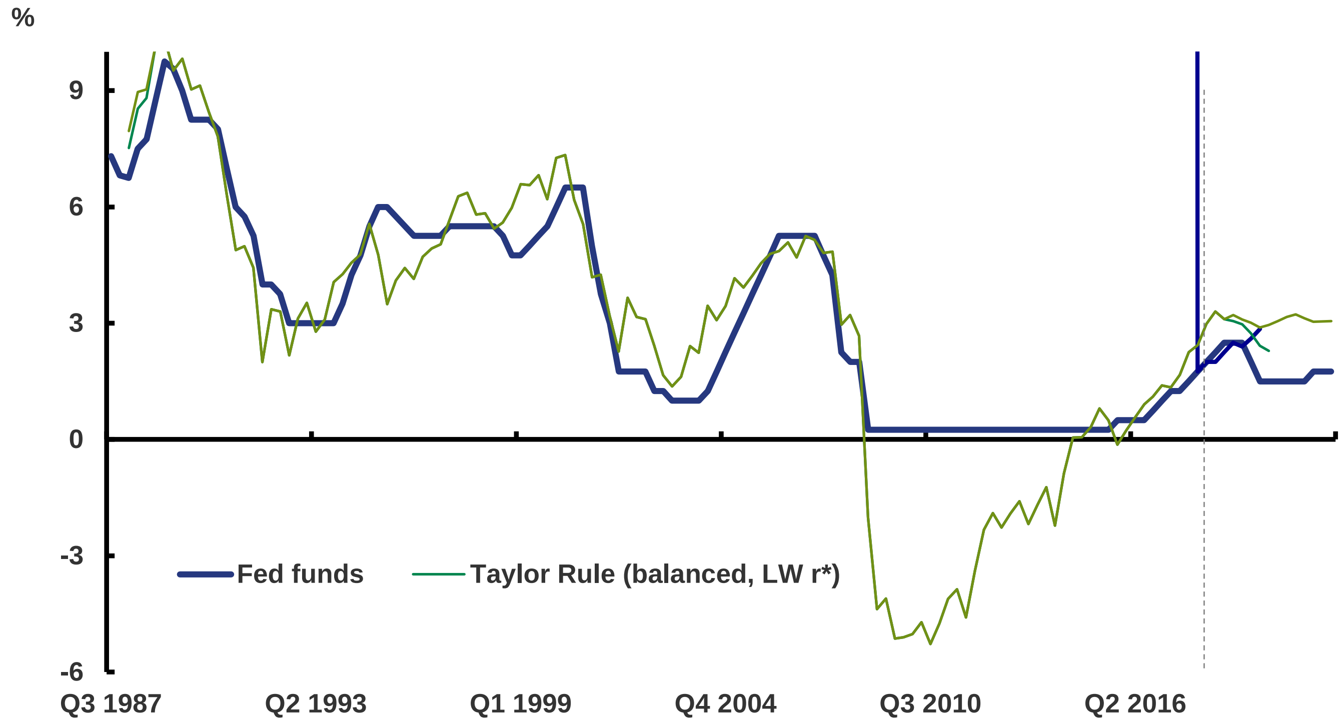
There should be no contradiction between cyclical stabilisation and pursuing price stability: in case of economic slowdown, monetary policy can become accommodative because inflationary pressure is falling.

The Taylor rule magic (2)

Monetary policy becomes an effective cyclical stabilisation tool

Since 1987, the Fed has by and large followed the Taylor rule and has been effective in minimizing cyclical shocks and in keeping actual inflation in line with its target….until recently.

Taylor Rule projections of Fed Funds Rate

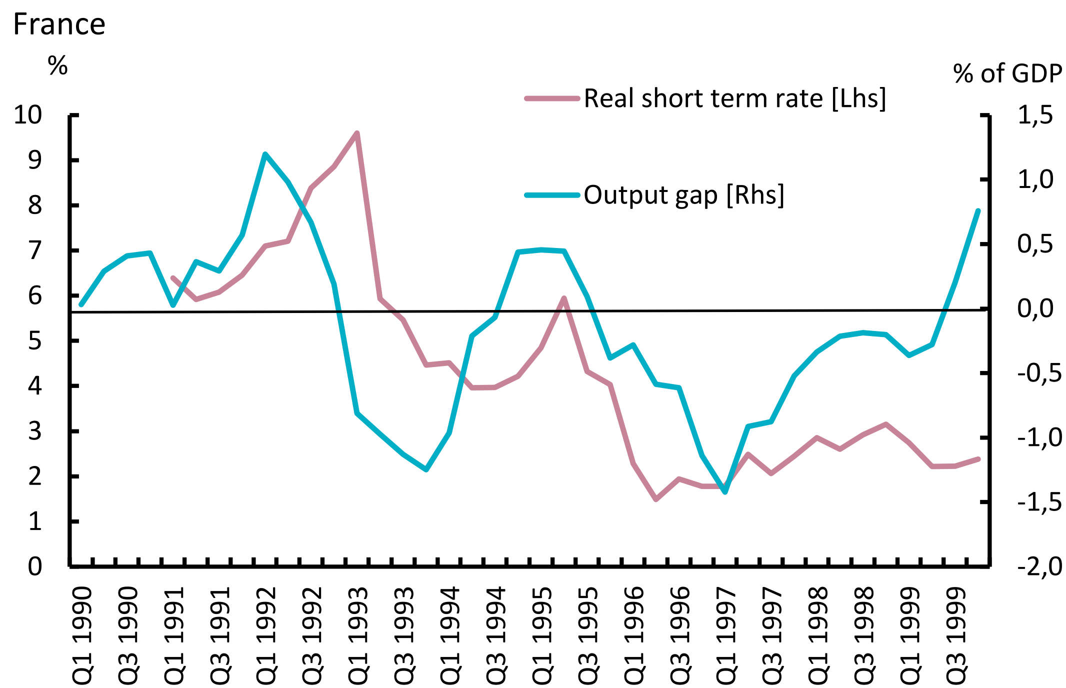


Source: AXA IM Research

It took more time in Europe

Too many objectives until monetary union

In Europe monetary policy until 1999 was polluted by a plethora of objectives, such as FX stability and ensuring convergence to the qualification criteria for euro membership. France for instance in the 1990s had to deal with nasty episodes of pro-cyclical monetary policy. But one could see the whole purpose of monetary union as precisely setting monetary policy up for cyclical stabilization. Mario Draghi brought this to its purest form from 2011 onwards.



Source: OECD and AXA IM Macro Research, as of 10 Oct. 2019

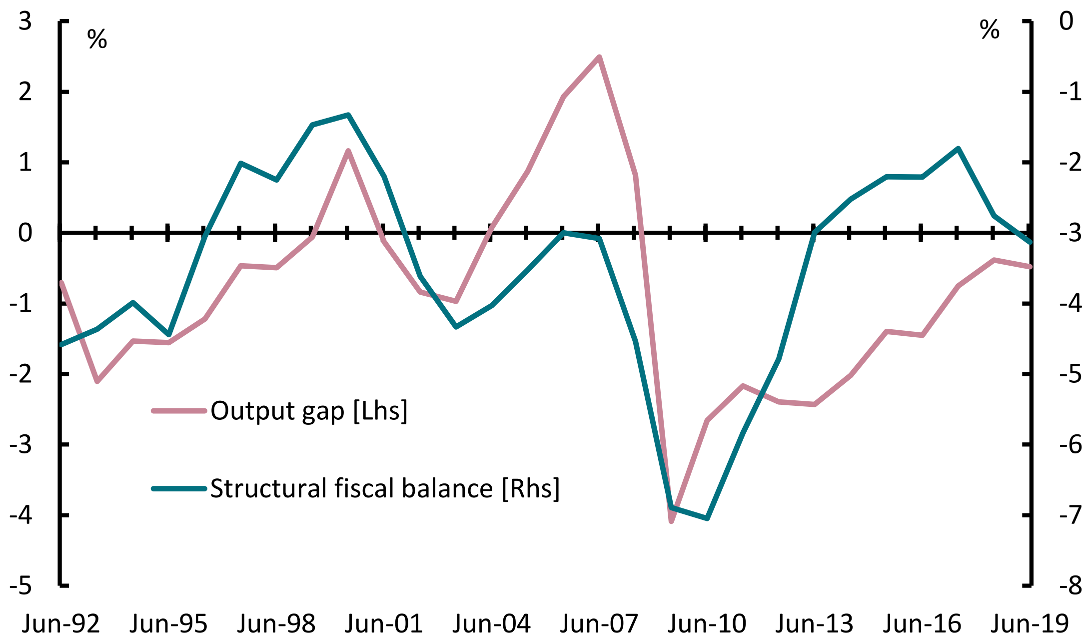
Source: INSEE, AXA IM Research

2011-2012: Monetary policy's finest hour

The fiscal policy error of 2010

Given the depth of the 2008-2009 fiscal both monetary and fiscal policy became strongly accommodative. However, the intellectual mood had moved so much against the stabilization capacity of fiscal policy that in 2010 it was widely believed that the global economy would be able to withstand a 'return to austerity'. This proved disastrous. Monetary policy was left as the 'only game in town' but rose to the challenge in the US, the Euro area and Japan.

All OECD countries: Pro-cyclical fiscal stance after 2011



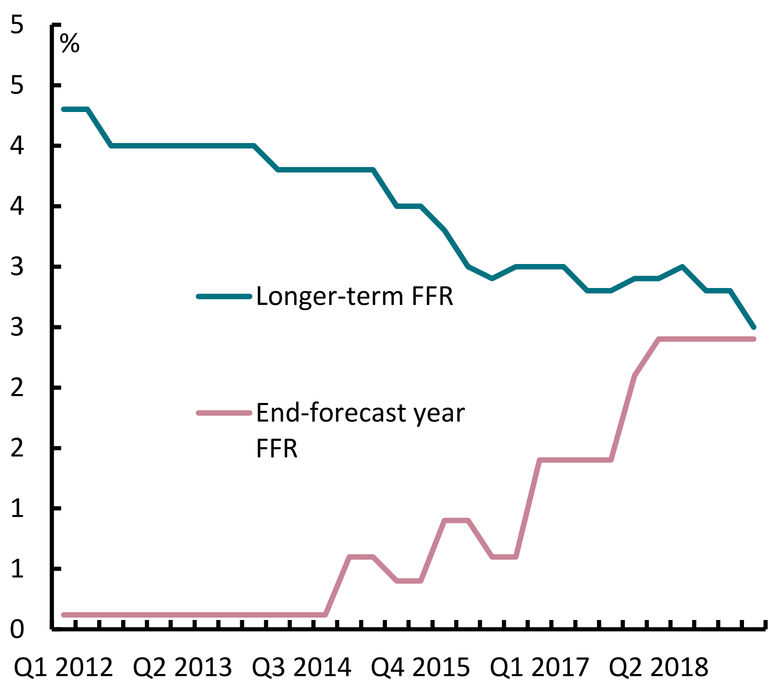
Source: OECD, AXA IM Research

Bleak message from the Fed

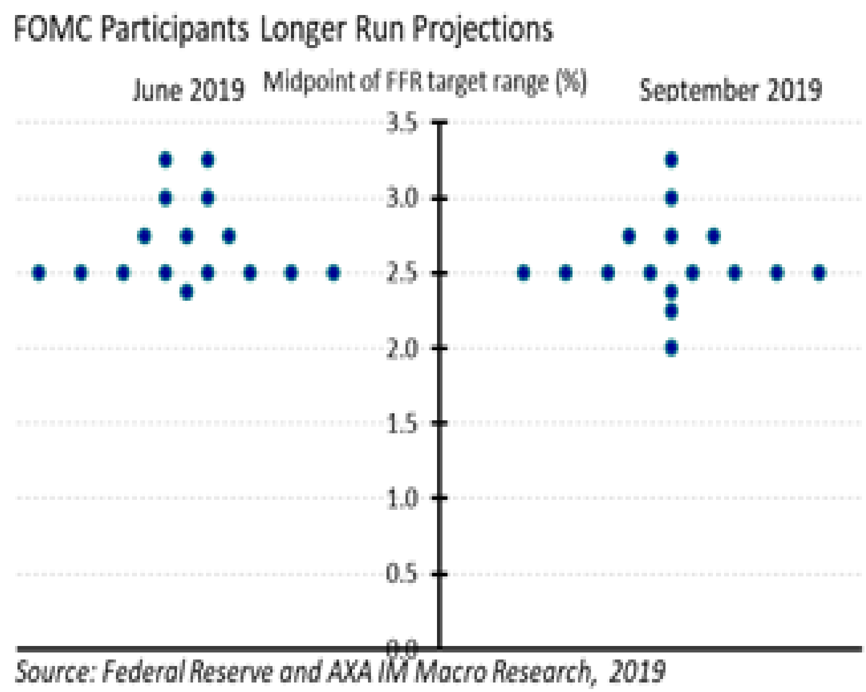
Low rates are not just a cyclical accident.

During the Fed's "normalisation period", the market was focusing on their short term message – gradual tightening towards one 25 bps hike per quarter. But at the same time the Fed was gradually revising down its estimate of the equilibrium interest rate.

The Fed's own estimate of the equilibrium interest rate has been falling



Some FOMC members see it as low as 2 %



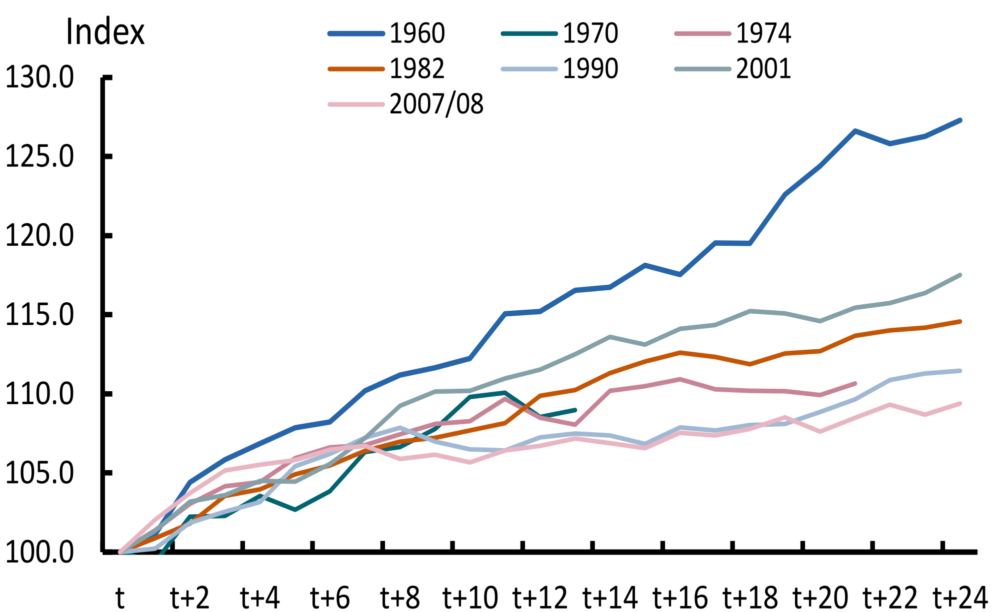
Source: FED, AXA IM Research

Equilibrium rate lower (1)
Slow productivity, high debt

Ultimately the real equilibrium rate cannot be too different from potential growth, which is itself the combination of labour and capital supply with productivity. Even in the US – which has led innovation in the developed world since the 1990s – the current productivity cycle is the weakest since the 1960s. Moreover, high accumulated debt tends to reduce the equilibrium interest rate.

Larry Summers has a point with his "secular stagnation"….

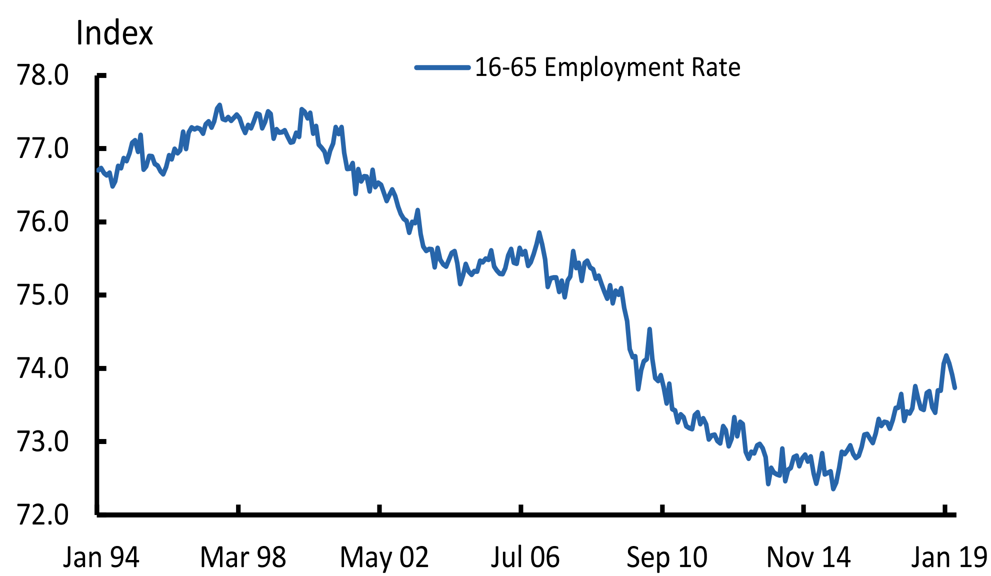
US Productivity Recovery



Source: Datastream, AXA IM Research

US population grows…but participation has fallen

US Employment ratio



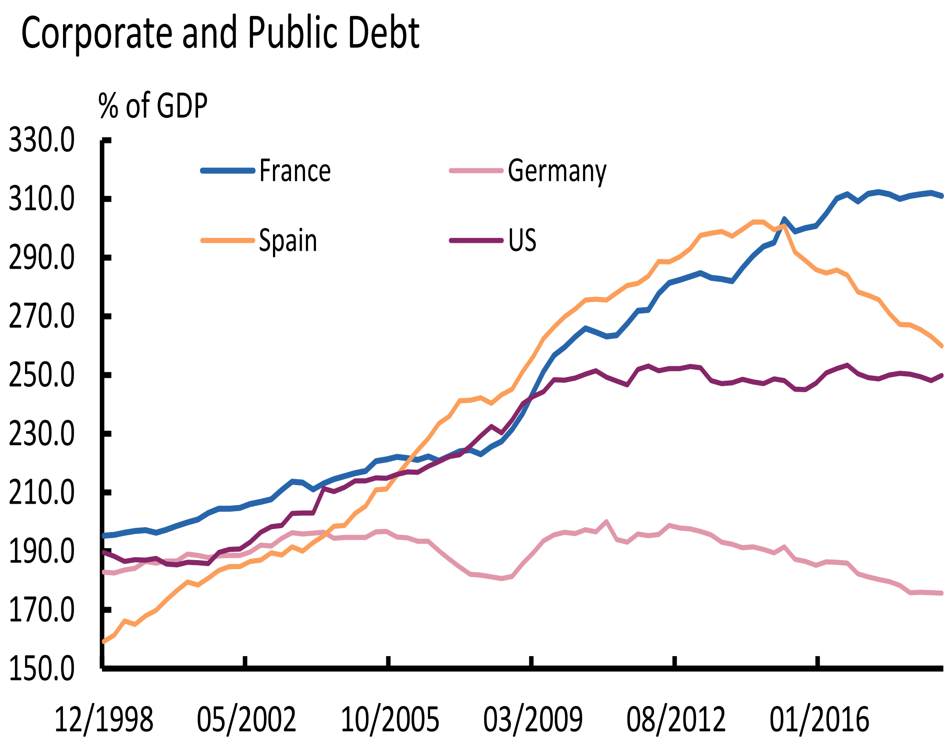
Source: Datastream, AXA IM Research

Equilibrium rate lower (2)

Labour supply constraints – higher preference for saving

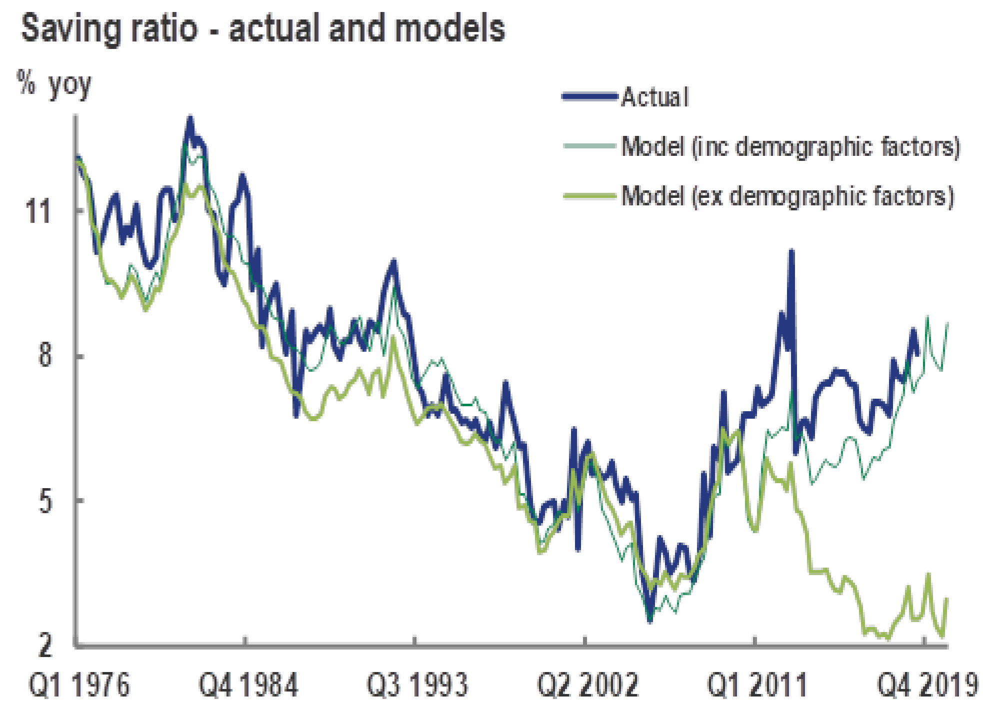
Even in the US where the demographic situation remains decent the economy needs to deal with weak participation rates, while ageing is now having a significant effect on saving.

More debt, almost everywhere



Source: Datastream, AXA IM Research

Demographic factors now explain a large part of US consumers' saving behaviour



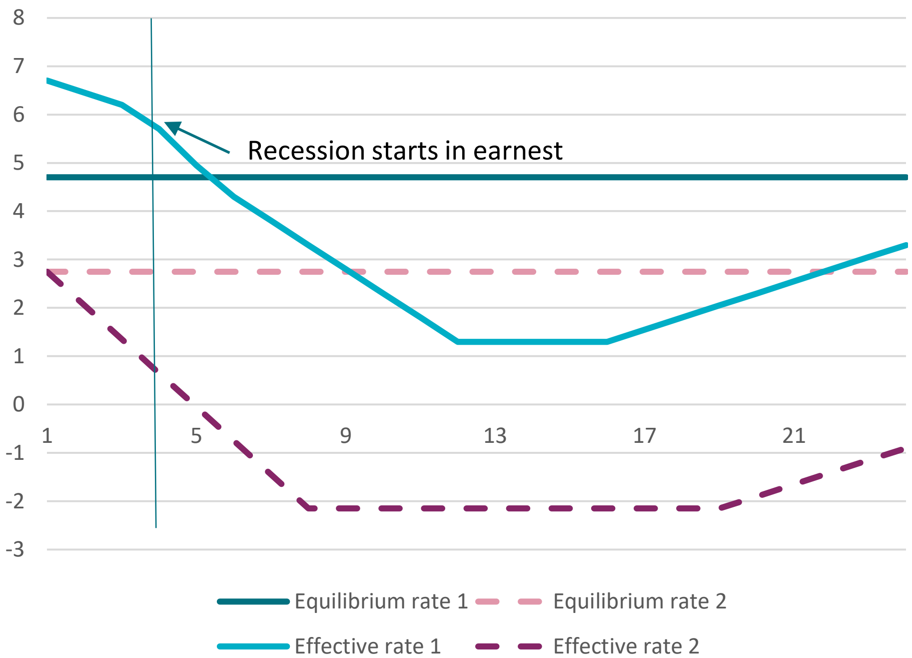
Source: Datastream, AXA IM Research

The uncomfortable arithmetic of easing policy in a low equilibrium rate regime

Low rates are not just a cyclical accident.

On average in recession times the Fed cuts by 500 basis points in total, from a starting point which is above the equilibrium rate. Effective rates can thus remain in positive territory even at trough when the nominal equilibrium rate is close to 5%. This no longer holds when the equilibrium rate is as low as 2.7%...forcing the Fed into aggressive easing, especially if the starting point for the effective rate was not above equilibrium.

What would the usual 500 bps easing look like in the current configuration?



Policy options:

- *Cut faster, before signs of recession are blatant*
- *Keep rates low for longer: pre-commit to accept inflation over-shooting in the future*
- *Engage in unconventional policy (QE becomes a "fact of life")*

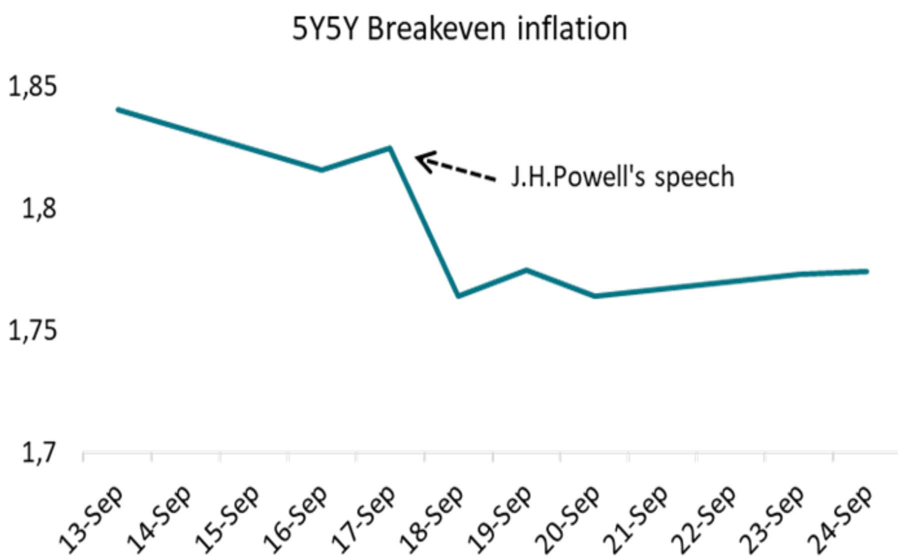
Source: AXA IM Research

It is not working

Markets did not believe in the Fed’s and ECB’s latest moves

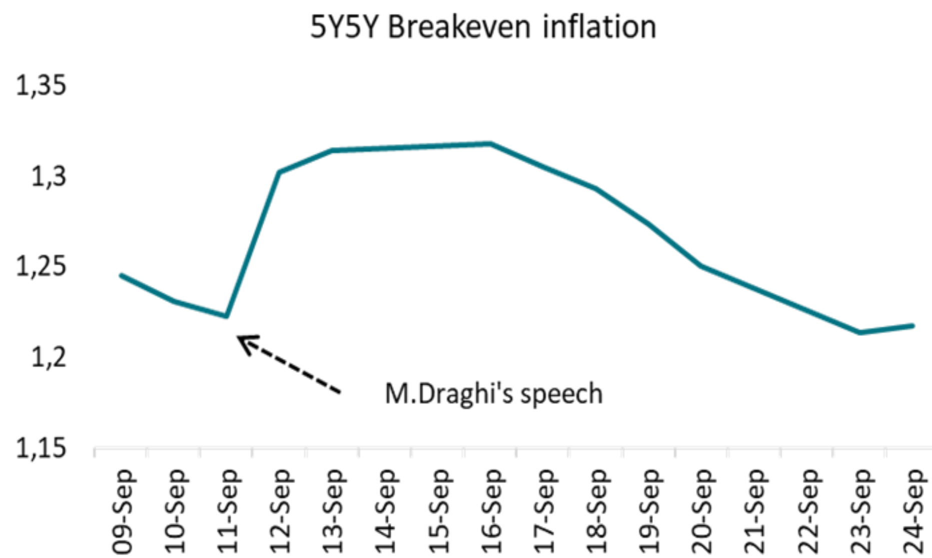
Jay Powell has delivered a “hawkish cut” which has failed to revive inflation expectations in the US. Draghi’s package triggered a nice uptick in inflation expectations, which has faded by now. We think at least in Europe investors are increasingly sensitive to the arguments of those – such as Larry Summers – who now believe the monetary stimulus has reached counter-productive territory.

Market-based inflation expectations suggest Jay Powell was not very convincing



Source: Bloomberg, AXA IM Research

…while the Draghi-led reflation trade did not survive more than a few days



Source: Bloomberg, AXA IM Research

Are negative rates counter productive?

Larry Summers' Jackson Hole shocker

Higher savings ratio. In principle, lower interest rates have an ambiguous impact on consumption. The substitution effect (households bringing forward their consumption) is positive while the income effect (households, who are net creditors, receive less interest payments) is negative. Usually the net balance is positive. However, when interest rates are negative, households may "over-react" and raise their saving because they are psychologically adverse to see their nominal interest income fall and not just slow down (Kahneman's endowment effect). Summers adds a twist with "target saving behaviour": assuming households save to achieve a certain level of future income, expectations of negative interest rates would make them lift their saving effort.

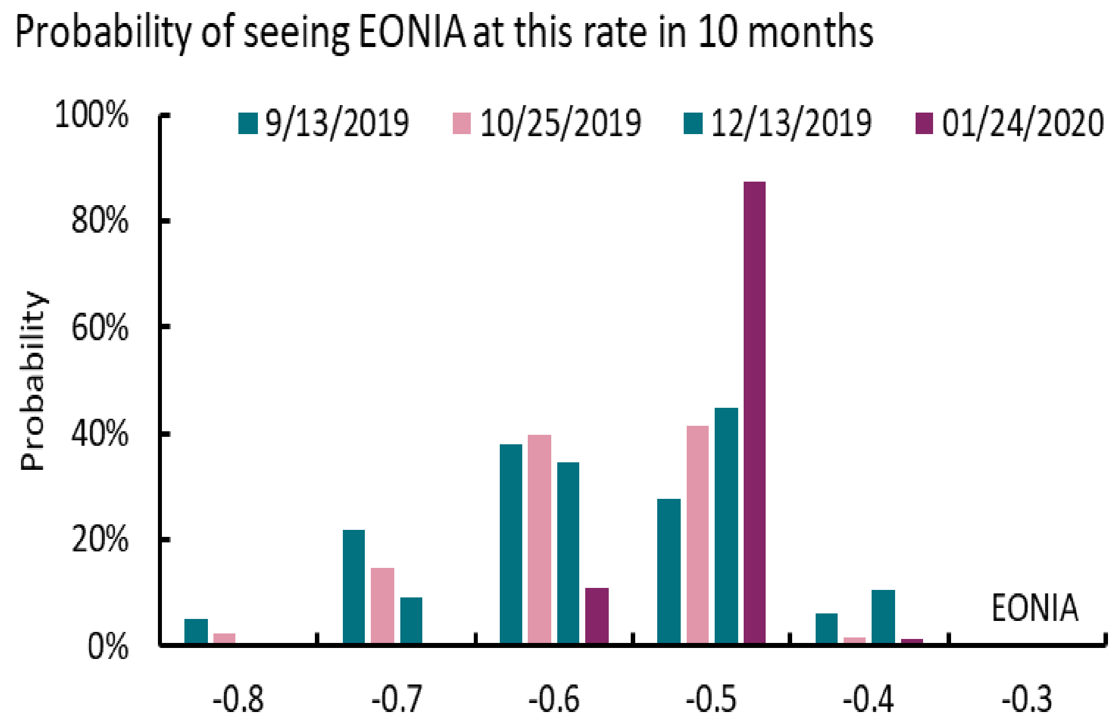
Bank lending contraction. While the "pure" interest rates may well be negative, banks may be (and usually are) unable to pass it to actual borrowers. More generally, Summers argues that deteriorating bank profitability in a context of negative rates may ultimately lead to a decline in aggregate lending.

Capital mis-allocation. As long as firms can find non-reproducible assets with a non-negative return (e.g. land, or precious metals, or know-how, patents and copyrights owned by rival firms), they should rationally decide to take loans to buy such assets rather than increase their productive capital This would help explain why firms are at the same time taking loans AND hoarding cash (for imminent M&As or to buy-back their own equity). In short, negative rates are conducive to bubbles. Summers again adds his own twist on the capital allocation issue with the "zombification" theme. Ultra-low to negative interest rates allow unproductive firms to survive. This impairs the usual "creative destruction" process which would ultimately raise the overall productivity level of the economy.

Source: Bloomberg, AXA IM Research

Is the ECB's forward guidance credible?

Not a lot of market pricing for the "or lower" component of forward guidance

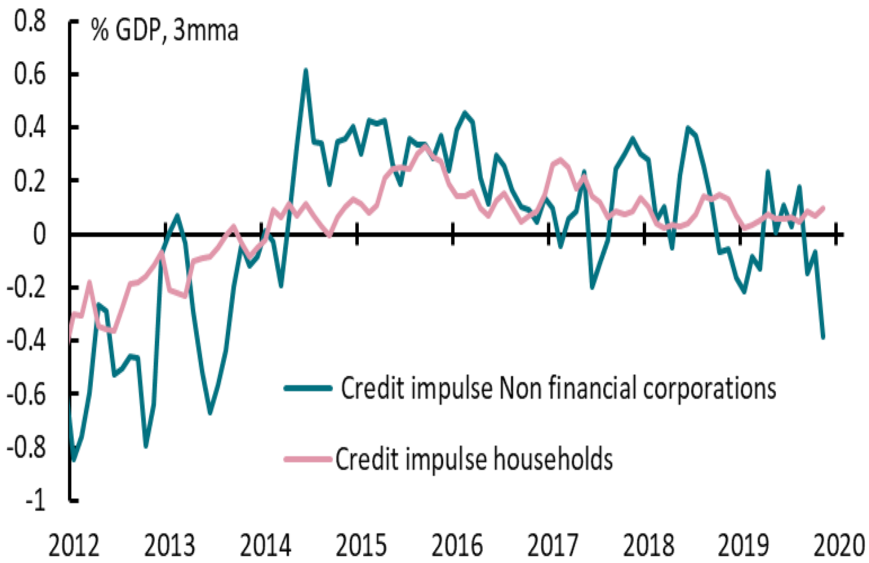


Source: Bloomberg and AXA IM Research, as of 24/01/2020

Is the monetary stimulus going where it should (1)?

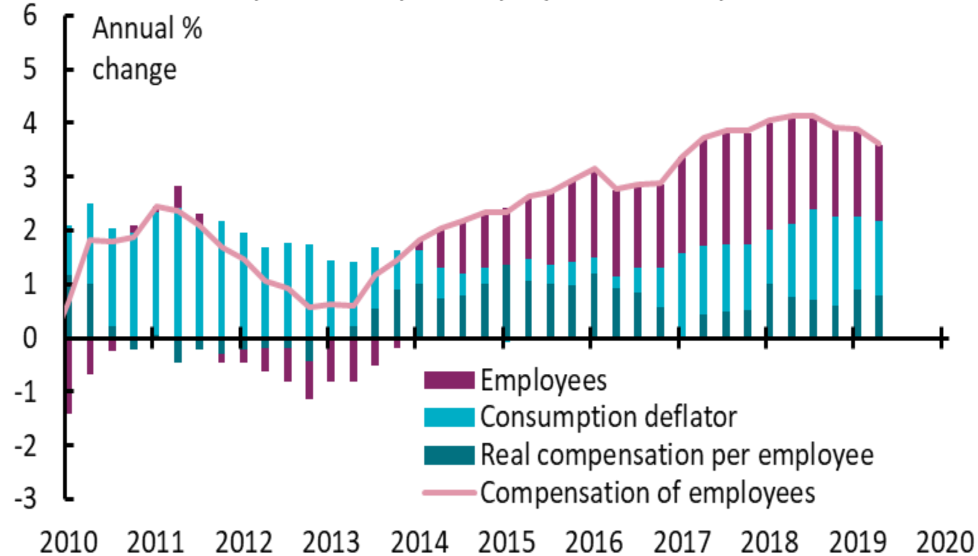
“Too much” lending to households – not enough investment

Euro area - Dynamic of credit origination



Source: ECB and AXA IM Research, as of 24/01/2020

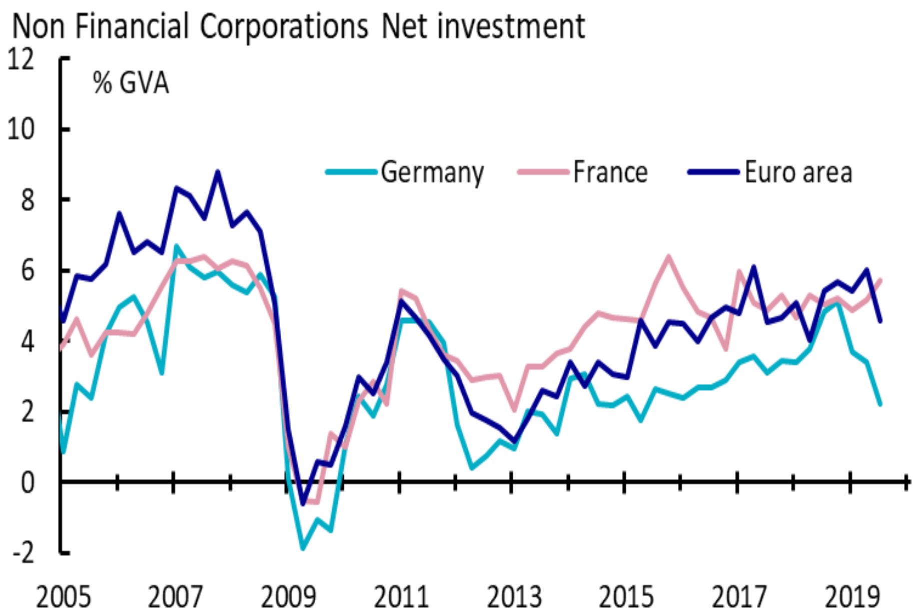
Euro area - Compensation per employee and components



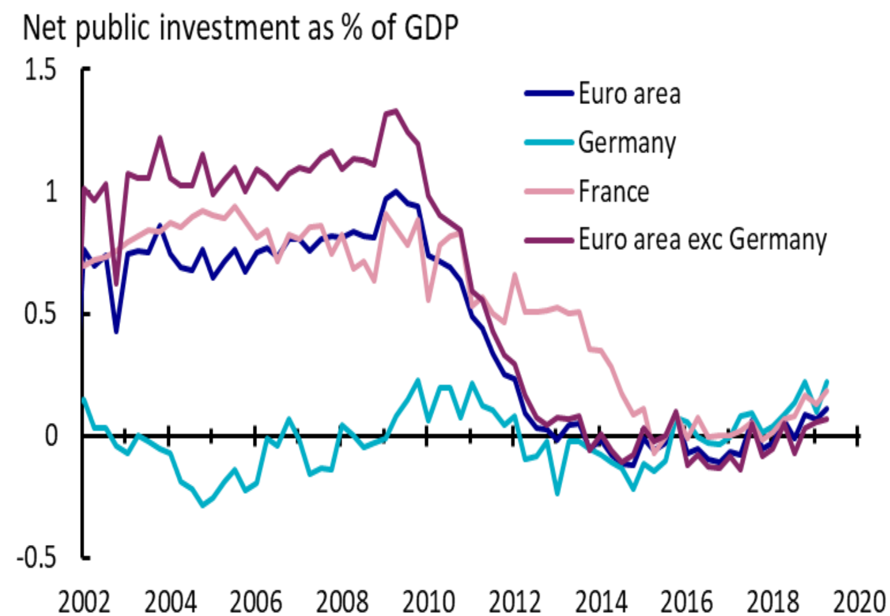
Source: ECB and AXA IM Research, as of 24/01/2020

Is the monetary stimulus going where it should (2)?

“Too much” lending to households – not enough investment



Source: Eurostat and AXA IM Research, as of 24/01/2020



Source: Eurostat and AXA IM Research, as of 24/01/2020

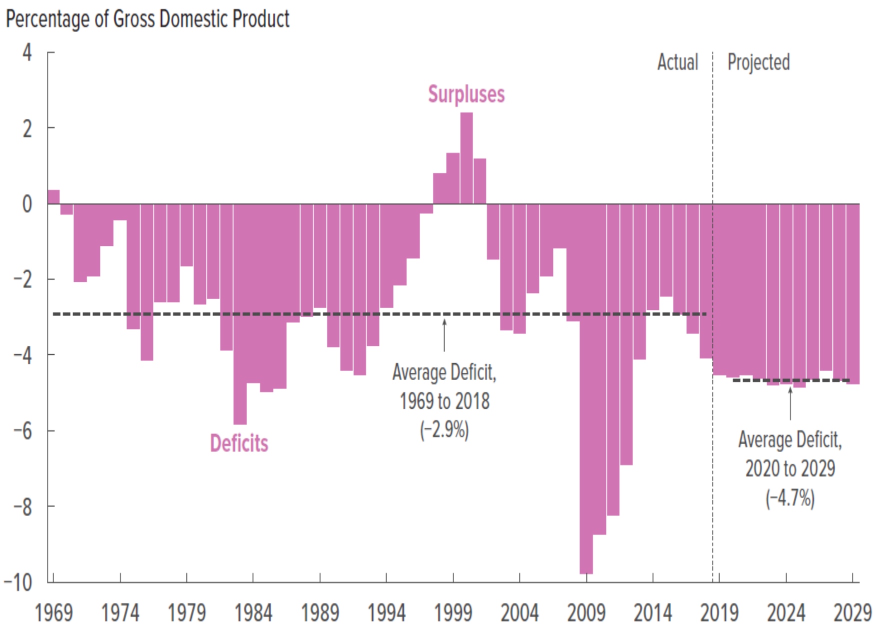
Limited fiscal space/appetite

Those who can won't, and those who want can't

It is very unusual for the US to be deprived of any fiscal capacity when the cycle is about to turn, but Donald Trump has already used up its fiscal room for manoeuvre with an ill-timed tax cuts package

In the Euro area, Germany has significant fiscal space…but is very reluctant to use it.

Even without additional fiscal stimulus, the overall US deficit will remain huge



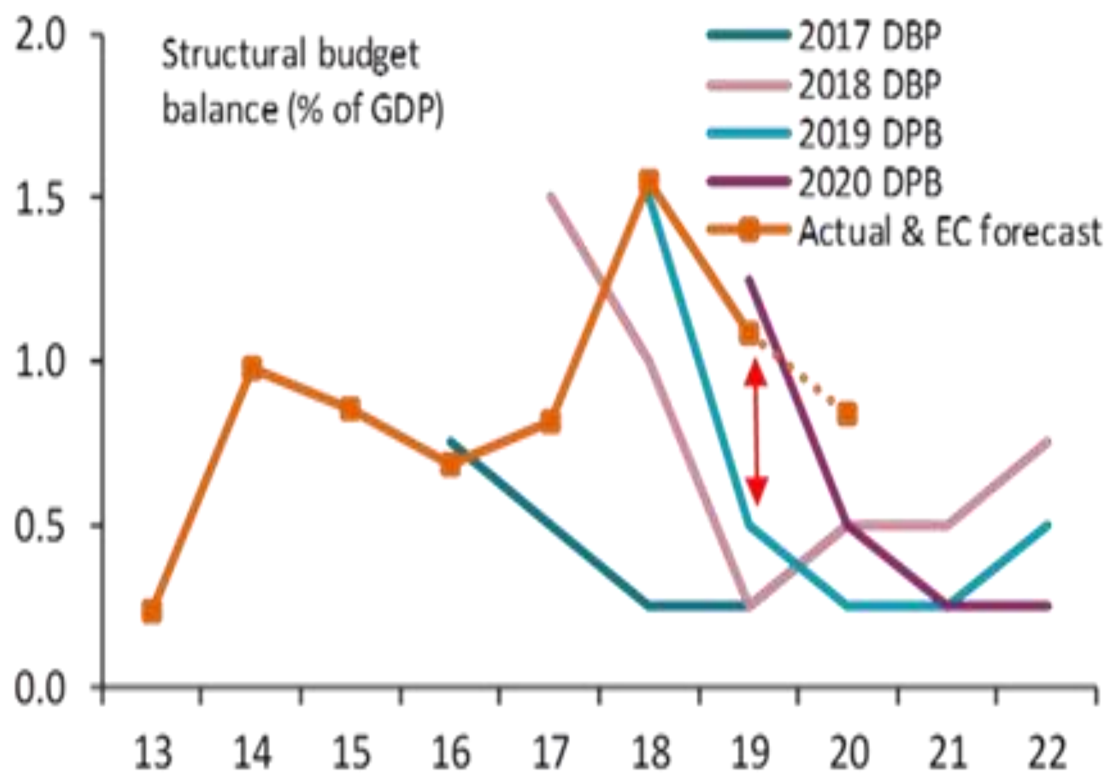
Source: CBO, AXA IM Research

- Political/institutional constraints around a fiscal push in Germany:
- *"Schwartz null" – no deficit whatever the macro circumstances are – is a political commitment, it is not legally binding. We expect automatic stabilisers to be allowed to play in 2020.*
- *"Schuldenbremsen" – cyclically adjusted deficit capped at 0.35% of GDP – is a constitutional constraint. This is the real hurdle.*

European hesitations

Small fiscal stimulus ahead – but beware of implementation

There are some encouraging noises about some fiscal stimulus in Germany but implementation has recently fallen short of intentions.

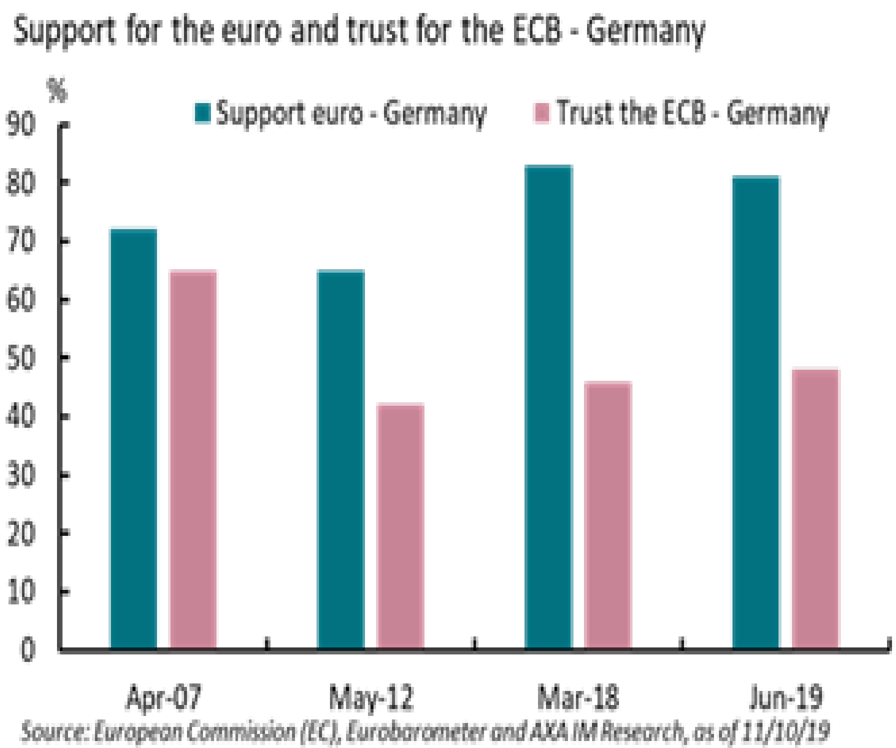


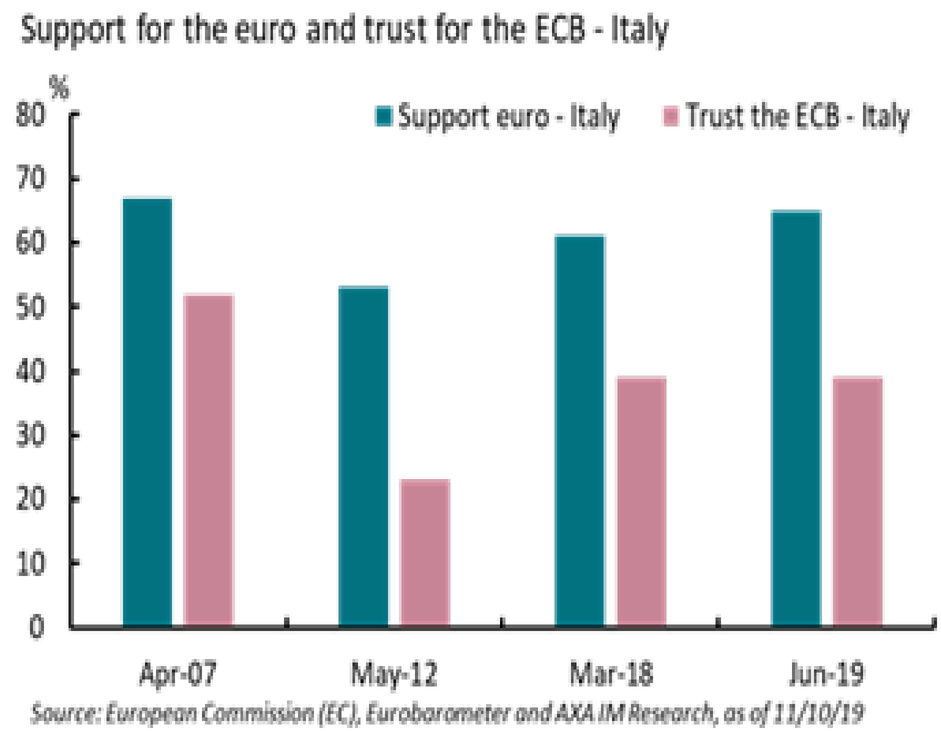
Source: D-Statis, AXA IM Research

ECB has become very controversial

Attachment to single currency higher – but less support for the ECB

Focus for tighter integration in the Euro area should be on fiscal policy : the ECB has not recovered from the controversies of the last 10 years



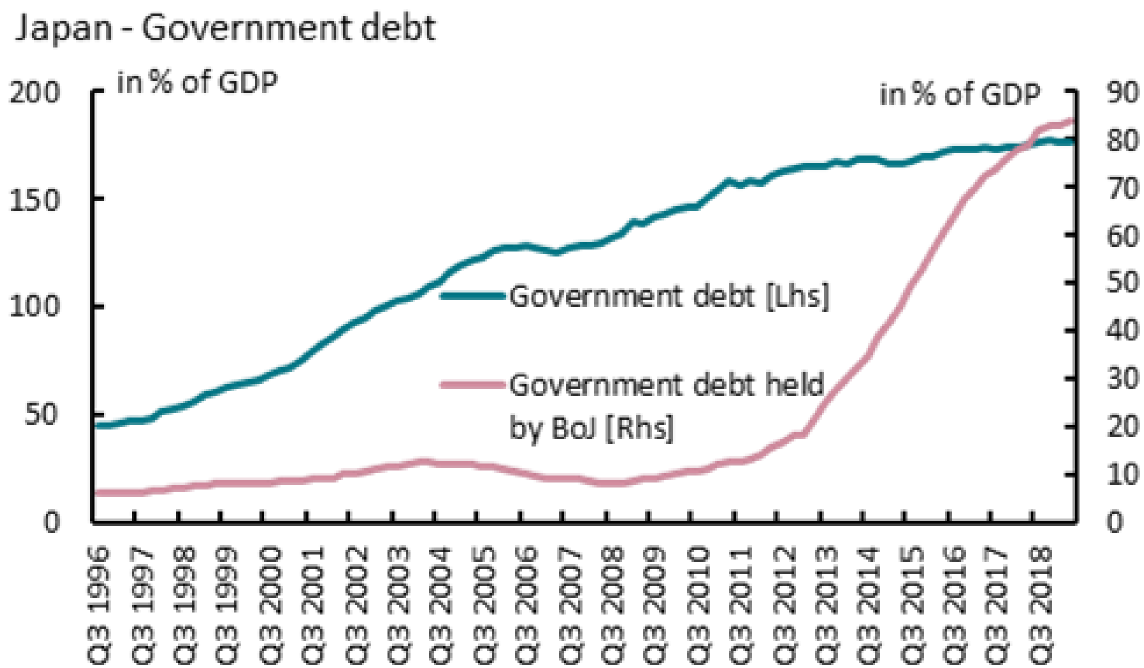


Source: Eurobarometer, AXA IM Research

Japanification is not so easy institutionally

The stock of purchases by the BOJ exceeds the ECB's cap by far

Ultimately open-ended QE is not credible as long as the ECB operates with a cap on its holdings of government bonds of 33% of eligible debt. The BOJ experience suggests that QE may have to be operational for a very long time and results in the end in a de facto merger of the balance sheet of the central bank with that of the government.



Source: Bank of Japan and AXA IM Macro Research, as of 24/10/19

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.