The Ultra-Easy Money Experiment

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Mainstream academics and policymakers presume a structurally stable world in which probabilities can be assigned to future outcomes – ignoring uncertainty, stock accumulations, and the financial imbalances of the real world, writes a former Canadian central banker.

The world's central banks are engaged in one of the great policy experiments in modern history: ultra-easy money. And, as the experiment has continued, the risk of failure – and thus of the wrenching corrections and deep economic dislocations that would follow – has grown.

In the wake of the crisis that began in 2007, policy rates were reduced to unprecedented levels, where they remain today, and measures were taken to slash longer-term rates as well. Nothing like it has ever been seen before at the global level, not even in the depths of the Great Depression. Moreover, many central banks' balance sheets have expanded to record levels, although in different ways and for different rationales – further underscoring the experimental character of the monetary easing now underway.

The risks implied by such policies require careful examination, particularly because the current experiment appears to be one more step down a well-trodden path – a path that led to the crisis in the first place.

Beginning with the sharp monetary-policy easing that occurred following the 1987 stock-market crash, monetary policy has been used aggressively in the face of every economic downturn (or even anticipated downturn) ever since – in 1991, 1998, 2001, and, with a vengeance, following the events of 2007. Moreover, subsequent cyclical tightening was always less aggressive than the preceding easing. No surprise, then, that policy rates (both nominal and real) have ratcheted ever downward to where they are today.

It can, of course, be argued that these policies produced the "Great Moderation" – the reduction in cyclical volatility – that characterized the advanced market economies in the years leading up to 2007. Yet it can also be argued that each cycle of monetary easing culminated in a credit-driven "boom and bust" that then had to be met by another cycle of easing. With leverage and speculation increasing on a cumulative basis, this whole process was bound to end with monetary policy losing its effectiveness, and the economy suffering under the weight of imbalances (or "headwinds") built up over the course of many years.

The Swedish economist Knut Wicksell raised concerns about such problems long ago. He suggested that a money rate of interest (set in the banking system) that was less than the natural rate of interest (set in the real economy) would result in inflation. Later, economists in the Austrian tradition noted that imbalances affecting the real side of the economy ("malinvestments") were of equal concern.

Later still, Hyman Minsky contended that credit creation in a fiat-based monetary economy made economic crises inevitable. Finally, many economists in recent decades have identified how excessive leverage can do lasting damage to both the real and financial sides of the economy.

Looking at the pre-2007 world, there was ample evidence to warrant such theoretical concerns. While globalization was holding down inflation, the real side of the world economy was exhibiting many unusual trends. Household saving rates in the English-speaking economies fell to unprecedented levels. Within Europe, credit flows to peripheral countries led to unprecedented housing booms in several countries. In China, fixed capital investment rose to an astonishing 40% of GDP.

Moreover, similar unusual trends characterized the financial side of the economy. A new "shadow banking" system evolved, with highly pro-cyclical characteristics, and lending standards plummeted even as financial leverage and asset prices rose to extremely high levels.

The monetary policies pursued by central banks since 2007 have essentially been "more of the same." They have been directed toward increasing aggregate demand without any serious concern for the unintended longer-term consequences.

But it is increasingly clear that ultra-easy monetary policy is impeding the necessary process of deleveraging, threatening the "independence" of central banks, raising asset prices (especially for bonds) to unsustainable levels, and encouraging governments to resist making needed policy changes. To their credit, leading central bankers have stated repeatedly that their policies are only "buying time" for governments to do the right thing. What is not clear is whether anyone is listening.

One important impediment to policy reform, on the part of both governments and central banks, is analytical. The mainstream models used by academics and policymakers differ in important respects but are depressingly similar in others. They emphasize short-term demand flows and presume a structurally stable world in which probabilities can be assigned to future outcomes – thus almost entirely ignoring uncertainty, stock accumulations, and the financial imbalances that characterize the real world.

Recalling John Maynard Keynes's dictum that "the world is ruled by little else" but "the ideas of economists and political philosophers," perhaps policymakers need new ideas. If so, the immediate prognosis for the global economy is not good. The latest fashion in policy advice is essentially still more of the same.

The call for "outright monetary financing" involves raising government deficits still further and financing them through a permanent increase in base money issued by central banks. Targeting the level of nominal GDP (or the unemployment rate, as in the United States) is a way of convincing financial markets and potential spenders that policy rates will remain very low for a very long time. All of these policies run the risk of higher inflation and/or still more dangerous economic imbalances.

Sadly, a fundamental mainstream reassessment of how the economy works is by no means imminent. It should be.

William White, a former deputy governor of the Bank of Canada and a former head of the Monetary and Economic Department of the Bank for International Settlements, is chairman of the Economic and Development Review Committee at the Organization for Economic Cooperation and Development (OECD).