Retirement Income
JOURNAL

What's Holding Back the World Economy?

By Joseph E. Stiglitz and Hamid Rashid *Thu, Feb 11, 2016*

Neither monetary policy nor the financial sector is doing what it's supposed to do. The flood of liquidity has gone toward creating financial wealth and inflating asset bubbles, rather than strengthening the real economy, write our guest columnists.

Seven years after the global financial crisis erupted in 2008, the world economy continued to stumble in 2015. According to the United Nations' report *World Economic Situation and Prospects 2016*, average growth rate in developed economies has declined by more than 54% since the crisis. An estimated 44 million people are unemployed in developed countries, about 12 million more than in 2007, while inflation has reached its lowest level since the crisis.

More worryingly, advanced countries' growth rates have also become more volatile. This is surprising, because, as developed economies with fully open capital accounts, they should have benefited from the free flow of capital and international risk sharing – and thus experienced little macroeconomic volatility. Furthermore, social transfers, including unemployment benefits, should have allowed households to stabilize their consumption.

But the dominant policies during the post-crisis period – fiscal retrenchment and quantitative easing (QE) by major central banks – have offered little support to stimulate household consumption, investment, and growth. On the contrary, they have tended to make matters worse.

In the US, quantitative easing did not boost consumption and investment partly because most of the additional liquidity returned to central banks' coffers in the form of excess reserves. The Financial Services Regulatory Relief Act of 2006, which authorized the Federal Reserve to pay interest on required and excess reserves, thus undermined the key objective of QE.

Indeed, with the US financial sector on the brink of collapse, the Emergency Economic Stabilization Act of 2008 moved up the effective date for offering interest on reserves by three years, to October 1, 2008. As a result, excess reserves held at the Fed soared, from an average of $200 billion during 2000-2008 to $1.6 trillion during 2009-2015. Financial institutions chose to keep their money with the Fed instead of lending to the real economy, earning nearly $30 billion – completely risk-free – during the last five years.

This amounts to a generous – and largely hidden – subsidy from the Fed to the financial sector. And, as a consequence of the Fed’s interest-rate hike last month, the subsidy will increase by $13 billion this year.

Perverse incentives are only one reason that many of the hoped-for benefits of low interest rates did not materialize. Given that QE managed to sustain near-zero interest rates for almost seven years, it should have encouraged governments in developed countries to borrow and invest in infrastructure, education, and social sectors. Increasing social transfers during the post-crisis period would have boosted aggregate demand and smoothed out consumption patterns.

Moreover, the UN report clearly shows that, throughout the developed world, private investment did not grow as one might have expected, given ultra-low interest rates. In 17 of the 20 largest developed economies, investment growth remained lower during the post-2008 period than in the years prior to the crisis; five experienced a decline in investment during 2010-2015.

Globally, debt securities issued by non-financial corporations – which are supposed to undertake fixed investments – increased significantly during the same period. Consistent with other evidence, this implies that many non-financial corporations borrowed, taking advantage of the low interest rates. But, rather than investing, they used the borrowed money to buy back their own equities or purchase other financial assets. QE thus stimulated sharp increases in leverage, market capitalization, and financial-sector profitability.

But, again, none of this was of much help to the real economy. Clearly, keeping interest rates at the near zero level does not necessarily lead to higher levels of credit or investment. When banks are given the freedom to choose, they choose riskless profit or even financial speculation over lending that would support the broader objective of economic growth.

By contrast, when the World Bank or the International Monetary Fund lends cheap money to developing countries, it imposes conditions on what they can do with it. To have the desired effect, QE should have been accompanied not only by official efforts to restore impaired lending channels (especially those directed at small- and medium-size enterprises), but also by specific lending targets for banks. Instead of effectively encouraging banks not to lend, the Fed should have been penalizing banks for holding excess reserves.

While ultra-low interest rates yielded few benefits for developed countries, they imposed significant costs on developing and emerging-market economies. An unintended, but not unexpected, consequence of monetary easing has been sharp increases in cross-border capital flows. Total capital inflows to developing countries increased from about $20 billion in 2008 to over $600 billion in 2010.

At the time, many emerging markets had a hard time managing the sudden surge of capital flows. Very little of it went to fixed investment. In fact, investment growth in developing countries slowed significantly during the post crisis period. This year, developing countries, taken together, are expected to record their first net capital outflow – totaling $615 billion – since 2006.

Neither monetary policy nor the financial sector is doing what it’s supposed to do. It appears that the flood of liquidity has disproportionately gone toward creating financial wealth and inflating asset bubbles, rather than strengthening the real economy. Despite sharp declines in equity prices worldwide, market capitalization as a share of world GDP remains high. The risk of another financial crisis cannot be ignored.

There are other policies that hold out the promise of restoring sustainable and inclusive growth. These begin with rewriting the rules of the market economy to ensure greater equality, more long-term thinking, and reining in the financial market with effective regulation and appropriate incentive structures.

But large increases in public investment in infrastructure, education, and technology will also be needed. These will have to be financed, at least in part, by the imposition of environmental taxes, including carbon taxes, and taxes on the monopoly and other rents that have become pervasive in the market economy – and contribute enormously to inequality and slow growth.