The Day The Central Bank Powers Came To An End

Summary

- Central banks in the developed world have just about thrown everything and the kitchen sink at the forces of deflation, with fairly little to show for it.
- After the US and the UK, the Swiss have now been the third to throw in the towel.
- Is this a general retreat? Are we going to succumb under the forces of deflation? Is there nothing else we can do?

There are powerful forces of deflation swirling around much of the developed world, the origins of which can be traced, in no particular order, to:

Deleveraging after asset bubbles burst
The half baked design of EMU producing a strong deflationary bias
Chinese overinvestment and overcapacity
Rising inequality
Stagnant or even declining populations

In a highly leveraged environment, deflation is very dangerous. It can lead to outright Fisherian debt-deflation spirals, or even in milder forms, (as has been on show in Japan for the best part of two decades and more recently Italy, for instance) it can wreck havoc.

In much of the developed world, it has been up to central banks to combat these forces. Central banks have chosen to embark, first on zero interest rate policies and then on forms of unconventional monetary policies, that is, buying large quantities of assets.

The results of these have been rather moderate, and that can be little surprise. In the face of deleveraging, monetary policy becomes rather powerless as households prefer to pay off debt, rather than take on new debt, despite record low interest rates.

But the forces of deflation haven't been beaten and the unconventional monetary policies have unfavorable side effects. They also have their limits, and it seems that we've just been hitting one. The Swiss central bank (SNB) has ended its 1.20 floor to the euro.

This was really unconventional monetary policy, comparable to buying sovereign bonds. What the SNB did was buy unlimited amounts of euro in order to defend the 1.20 floor for the Swiss franc.

Switzerland is a small, open economy, so this policy made sense in times when its safe haven status made it very vulnerable for very large capital inflows. These flows can be so large as to wipe out the competitiveness of much of the Swiss export sector overnight, clearly the SNB could not stand idle letting that happen.

In principle, central banks can sell unlimited amounts of its own currency (like the SNB was doing), that is, they can buy unlimited amounts of assets (sovereign bonds, foreign currencies, whatever).

But, apparently, the SNB deemed there were limits to this, and they did have something of a point:

- The Swiss monetary base five-folded from 80B francs to 400B francs.
- Credit rose from an average of 145% of GDP to 170% of GDP.
- A real estate boom is ongoing, flat prices have risen 60% since 2007.

None of this seems to have reached some ultimate limit. The real estate boom precedes the currency peg by four years, the credit expansion is considerable, but not yet alarming and can be dealt with by other means. The rise in base money is not in and by itself very worrying.

But the prospect of the ECB embarking on full QE and the inflow of Russian (and Greek and Italian) money, together with the prospect of large losses on its foreign currency holdings made the SNB sufficiently uncomfortable that it ended the peg to the euro by surprise.

Switzerland may now well turn into the proverbial bird in the mine as this will unleash the full deflationary vortex into the Swiss economy, and we will have to see whether they can come out alive at the other side of this.

Switzerland is only a small country though, there is a wider picture here, which seems to be telling that the world's central banks will ultimately be powerless to stem the deflationary vortex that is threatening their economies. The Swiss were just the first to realize this.

Before we draw such dramatic conclusions we must first point out a few ifs and buts. The Swiss were the only ones practicing a special form of QE, the SNB didn't buy long-term bonds, it bought euros instead.

The advantage of this is that it has direct traction in the real economy via the tradable sector. But even so, it hasn't prevented deflation to set in.

The disadvantages are that it constitutes a direct 'beggar-thy-neighbor' policy (or, if you like, a first salvo in a 'currency war'), even if large enough purchases of sovereign bonds (or even the expectations of such) will more or less achieve similar currency effects.

But currency markets are large and liquid, and Switzerland is a small country. Bond purchases would have been easier, especially considering the fact that Swiss debt/GDP ratio is just 35%, one of the lowest ratios in the developed world.

It's curious that we might have reached the deep end of diminishing returns to QE just when the ECB seems to be embarking on this policy, even more so because the eurozone is where it could arguably have been of most benefit a few years ago.

QE effectiveness

There are three main transmission mechanisms of QE:

- Stimulating credit demand
- Producing a wealth effect
- Lowering the exchange rate

The first two work through lowering long bond yields, but when these yields are already very low not much can be expected here, especially where private sector deleveraging is the major problem.

Alternatives?

There is another mechanism which works on expectations. This is basically producing some sort of 'regime change,' such a drastic policy change that it affects inflationary expectations. This is what Japan achieved in 1932 by getting off gold and embarking on a reflationary policy that got them out of the economic depression.

In the words of Krugman, who, based on the Japanese experience in the 1990s constructed a model assessing the requirements for monetary policy effectiveness in a liquidity trap, this only works if central banks "credibly commit to being irresponsible."

The BoJ looked on course of doing this, until they were denied traction by an ill-timed tax hike. The Swiss managed to pull this off by drawing a line in the sand at 1.20 francs to the euro and in a more limited way, Draghi has pulled this off with his 2012 "whatever it takes," quelling a peripheral bond debt-spiral without actually having to intervene.

But Draghi's intervention didn't signal a drastic ('regime change') in monetary policy, it just signal that the ECB would be like any other central bank functioning as a lender of last resort. And the Swiss have given up their fight.

There are a few things monetary authorities could try to fight deflation, stuff like NGDP targeting or inflation targeting. In order to achieve credibility, massive actions are likely to be needed so it would be more of the same with the difference of an explicit effort to anchor expectations.

Perhaps this makes a difference, perhaps not, it's certainly difficult to say, and it would be interesting to see a country trying it. Japan does have a 2% inflation target but they greatly compromised their own credibility by the tax hike.

Helicopters to the rescue?

There is one card that monetary authorities could still draw, which would be some variant of Milton Friedman's famous 'helicopter money.' That is, central banks print money, which would finance a tax break for households ('helicopter droppings') and/or public expenditures (infrastructure, research, education, etc.).

Compared to the QE policy experience, this seems to have considerable advantages:

- It injects money directly into the veins of the economy.
- QE depends on further financialization of the economy, all these financial machinations aren't very effective, suffer from large diminishing returns and considerable side effects.
- Instead of purchasing paper, we could have gotten real stuff, stuff that is useful, infrastructure like bridges, roads, powerlines, a smart grid, research, education, pipelines, whatever.

Basically, we could have gotten more traction in the real economy at a fraction of the sums involved. Why? Because it is actually more like fiscal policy, and we know that fiscal policy becomes very effective in economies suffering from large output gaps and rates at the zero lower bound, certainly fiscal policy that is financed with new money.

But, unless despair sets in completely, we don't expect this to happen anytime soon.

Liquidate?

There is of course another alternative and that is to stop all the ways to combat these output gaps and actually embracing the resulting deflation. This is basically the position of many people who take their clues from Austrian economics.

What they have in common is a great belief in the efficiency of markets, these will automatically balance demand and supply and find the appropriate levels of prices, wages and interest rates to achieve that.

While we do not deny the efficiency of markets, it's simply an experience that these do not always achieve macro-economic equilibrium. The basic innovation of Keynesianism is simply to depart from the given that large output gaps and high unemployment can persist.

Let the excess capacity liquidate itself, say the Austrians. Well, that's possible, but we strongly doubt whether it's less harmful than efforts to reflate the economy, especially under conditions of high leverage.

We know from Japan how pernicious deflation can be once it has set, and we know from Fisher that markets can spiral down in self-reinforcing feedback loops called debt-deflationary spirals. Do we want to risk this?

As observers, we like economic experiments as they put ideas to the test, but this is one experiment we would be highly apprehensive about. We've seen in the early 1930s what those deflationary spirals can achieve.

Austrians tend to argue that rates are way too low as well due to central banks, below 'market rates,' spurring all kinds of bubbles. But QE has ended in the US and despite economic growth picking up a bit, rates have trended downwards, not upwards.

The few cases in which rates were increased (Sweden, the eurozone) post 2008 does nothing to inspire confidence that this is the way to go, these decisions were reversed pretty embarrassingly.

Conclusion

The unconventional monetary policies seem to suffer from greatly diminishing returns, unwanted side effects, and general exhaustion. The US, UK, and Swiss central banks have given up. The eurozone QE effort, looks dead on arrival, and the Japanese shot themselves in the foot with a tax hike.

There are a couple of choices left. Do nothing and risk the destruction of deflationary forces, or try to inject more direct means into the veins of the economy, there where necessary (basically Japan and the eurozone).

Original comments at seeking alpha