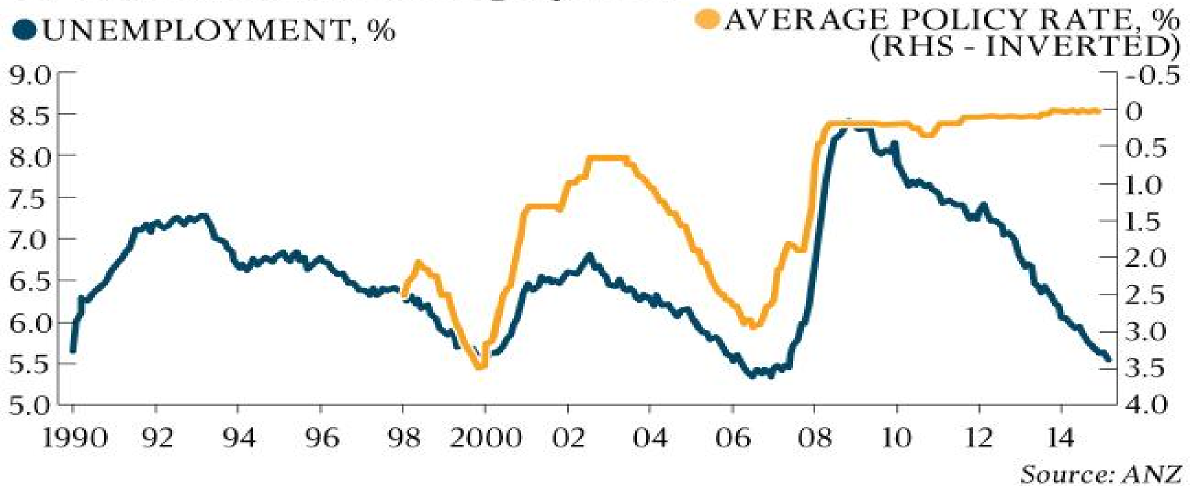
Trust me, monetary policy hasn't lost its mojo

- THE AUSTRALIAN
- MARCH 29, 2016 12:00AM
- DON STAMMER



The dominant view of investors, strategists and commentators is that monetary policy has lost its effectiveness, because banks are reluctant to lend and banks and businesses aren't keen to borrow. Investors need to understand — and assess — this line of market thinking, which is largely factored into the pricing of bonds, term deposits and shares.

In my view, the problems constraining effective monetary policy are nowhere as dire as the prevailing view in investment markets currently suggests. I expect somewhat stronger economic growth, an earlier return of mild inflation, and higher bond yields.

Seven years on from the global financial crisis — and despite major central banks buying huge volumes of bonds from the public, as well as Europe and Japan cutting cash rates below zero — monetary policy is seen as losing its impact.

Mehreen Khan, a British financial journalist, sums up global sentiment this way: "Having hoovered up $US12.3 trillion in financial assets and carried out 637 interest rate cuts since 2008, central banks have been stunned back into action … But the new wave of policy accommodation has ushered in fresh panic that monetary policy is suddenly subject to dwindling returns."

A more extreme view is taken by those who argue that the world is experiencing secular stagnation.

Lawrence Summers, former head of the US Treasury, points to "an imbalance resulting from an increasing propensity to save and a decreasing propensity to invest … Excessive saving

acts as drag on demand, reducing growth and inflation, and the imbalance between savings and investment pulls down real interest rates”.

The only solution, they say, is aggressive and sustained easing in fiscal policy.

Certainly, easy monetary policy hasn’t delivered a rapid rebound in global economic growth or lifted inflation rates from near-zero levels. But, as my chart illustrates, average unemployment in developed economies has fallen sharply — in part because monetary policies have been highly accommodative.

Where is evidence in the chart of impotent monetary policy or secular stagnation? In fact, claims of monetary policy losing its mojo are old hat. Every time monetary policy is employed to counter an economic slump, central banks are said to be “pushing on a piece of string”, and when economies overheat, we hear “monetary policy can’t contain cost-push inflation”.

Yes, this time around Europe and Japan aren’t dancing well to the tune of easy monetary policy — in large part because they’ve been slow to recapitalise their banks. In my view, market sentiment has not yet recognised the shortcomings of the subzero cash rates now in place in Europe and Japan.

If negative rates are sustained, some depositors will switch from bank deposits to holding high denomination banknotes; banks will hoard high-yielding assets rather than lend; and bank profits and the ability of banks to raise capital will be squeezed.

When European Central Bank president Mario Draghi announced the monetary package in March, including a cut to minus 0.4 per cent in the cash rate of the eurozone, he hinted we should not expect any further cuts. For a time, that comment led to a big sell-off in European bonds and the euro.

Subsequently, investors have come to focus on the ECB’s beefed-up program to purchase bonds (extended it to include corporate bonds) and the revamp of its targeted longer-term financing operations to spur on bank lending to European companies. Europe is now better-placed to get back to reasonable growth — provided European banks strengthen their capital bases and make good use of the generous incentives to extend their lending.

My guess is that market thinking on the effectiveness of monetary policy will change significantly in coming months. In the US and Europe, concerns that monetary policy is ineffective in boosting growth and raising inflation are likely to dissipate.

Instead, the attention of market participants is likely to shift to a focus on what’s an appropriate pace of monetary tightening in the US to limit the cyclical increase in inflation. Expect to hear occasional worries from investors, strategists and commentators that the Fed’s monetary actions risk being too potent.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.