It may be weaker than before but monetary policy still works

- THE AUSTRALIAN
- MAY 24, 2016 12:00AM
- DON STAMMER

Most sharemarkets are a good deal stronger than they were after the global financial crisis. Bond prices, which move inversely with interest rates, are close to all-time highs. In many countries, parts of the property market have increased in price.

However, these buoyant prices in asset markets are not the result of investors feeling optimistic on the global economic outlook. Indeed, the dominant sentiment of investors has been — and continues to be — somewhere between caution and gloom.

Instead, the upswing in asset markets mainly reflects the easy settings in monetary policy. Globally, monetary policy is more accommodative than at any other time in history.

Why is monetary policy so stimulatory? Why is it affecting asset markets more than the real economy? And what are the medium-term consequences?

When the global financial crisis hit, most central banks acted — aggressively and for the most part successfully — to prop up their financial systems and to contain the risks of economic depressions. Global growth resumed in 2009, but has been running at a slower-than-usual rate.

The sovereign debt crises in the eurozone and, more recently, global risks of low inflation morphing into deflation, have caused central banks to maintain, or even intensify, their highly accommodative settings in monetary policy.

How effective is monetary policy?

Many investors and commentators believe monetary policy, these days, is largely ineffective in giving a boost to the economy. I think that argument is overstated: in my view, without the easy setting in monetary policy, the US would not have achieved its (moderate) growth in GDP or its (strong) growth in jobs; and Australia would not have chalked up 3 per cent growth in GDP last year or kept unemployment as low as it's been during the collapse in mining investment.

But monetary policy is a weaker instrument than it has been in the past.

The global financial crisis has left many households and businesses reluctant to borrow to finance additional spending. In Europe and Japan, the impact from monetary policy has been further eroded because some banks are undercapitalised

Even with the accommodative monetary policy, inflation has remained generally low since the global financial crisis. Recently, with wages hardly increasing and commodity prices trending down, inflation rates have been negligible — and concerns of deflation have developed. It's in the US that concerns of rising inflation are likely to first reappear.

Low interest rates have encouraged a “hunt for yield” that’s helped raise average share prices. The combination of stretched valuations in sharemarkets and of sluggish growth in company earnings has at times added to the volatility in sharemarkets.

Early investors in medium-dated and long-dated maturities have also achieved good returns as interest rates moved down. But bonds, and other interest-paying assets such as term deposits, now carry yields that are uncomfortably skinny.

Where to next?

The US Federal Reserve — the only central bank thinking about taking its foot off the monetary stimulator — says it will “normalise” short-term interest rates “cautiously” and “gradually”. The Chinese central bank is moving back from easy policy to a neutral setting.

I can detect three different views on the medium-term consequences for investors of the sustained easing in monetary policy. The most pessimistic assessment is that the ultra-low interest rates are creating a new financial bubble and bust. Those who take this line worry particularly about the borrowings used to purchase existing assets (including, in the US, share buybacks and, in China, overpriced property assets).

In my view, it’s too early to bunker down for the next boom-bust phase of the cycle in finance. In most Western countries, overall credit is increasing at single-digit rates. As well, the new forms of bank regulation coming into force will constrain credit growth for some time. In China, bank lending has quickened recently, but the monetary authorities are flagging actions to check the excesses. A different — and dominant — view in investment markets is for the continuation over the medium term of sluggish growth, disinflation, a choppy (and generally soft) sharemarket, and sustained low interest rates.

The weakness of this view, to my thinking, is that the easy setting in global monetary policy could have useful — though lagged — effects on household spending. A moderate lift in global consumption would underpin a mild cyclical uptick in global growth; were that to happen, the widespread fears of secular stagnation and sustained deflation would probably abate.

As the Reserve Bank noted recently: “Conditions in the major advanced economies generally remain supportive of consumption: employment growth has been strong; accommodative monetary policies are keeping borrowing rates low; household net wealth has been recovering, with house prices approaching, or even exceeding, pre-crisis levels; and low fuel prices have been boosting real incomes.”

In my view, the accommodative monetary policies of the major central banks have a reasonable prospect of producing a stronger-than-expected cyclical rebound in global growth in the next year or two — followed by the beginning of the next cyclical upswing in inflation. Investors often expect the future will be a continuation of the recent past; but at all times, we need to be on the lookout for turning points in the investment cycle.

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.