

WORLD ECONOMICS

VOLUME 13 | NUMBER 3 | JULY–SEPTEMBER 2012

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Is current monetary policy doing more harm than good in the US and the UK?

John C. Michaelson and Sébastien E.J. Walker¹

In 2010, John Michaelson wrote an Op-Ed for the *Wall Street Journal* (featured on 11 August), arguing that the Federal Reserve's low interest rates were inhibiting economic recovery and job creation, not assisting them. This piece was among the first critiques of the policy which the Federal Reserve announced it would continue for several more years. A similar critique applies to the policies of the Bank of England. Since the Op-Ed, this view has gained traction, albeit not at the Federal Reserve or the Bank.

The prevailing view among economists and policymakers at the Federal Reserve, at the Bank, and elsewhere – and the conventional economic wisdom broadly – remains that ultra-low nominal interest rates is the right medicine for the current low-growth and jobless-recovery economic malaise. Put simply, the lower the interest rate, the greater the economic stimulus. In particular, policymakers believe that recapitalising the banking sector through ultra-low interest rates leads banks to lend more to companies, and notably to the job-creating small and medium-sized enterprises (SMEs) that rely more on bank credit than do larger companies, resulting in higher growth and employment rates. Proponents of ultra-low rates also believe that they lead to higher stock prices, and that

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these translate into increased consumption and investment, also fostering job creation. However, actual lending and investment, and therefore job creation, have been well below what was hoped for.

It is generally accepted that very loose monetary policy has potential costs, in the form of high inflation and asset price bubbles. Monetary-policy makers are well aware of these risks, and consider them to be the lesser

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of two evils, given the current economic predicament. This position would be defensible were ultra-low interest rates providing the economic stimulus they are intended

to; but what if, rather than being part of the solution, ultra-low interest rates were in fact part of the problem? The anaemic economic recovery in the US and UK suggests, at the very least, a close re-evaluation of current monetary policy.

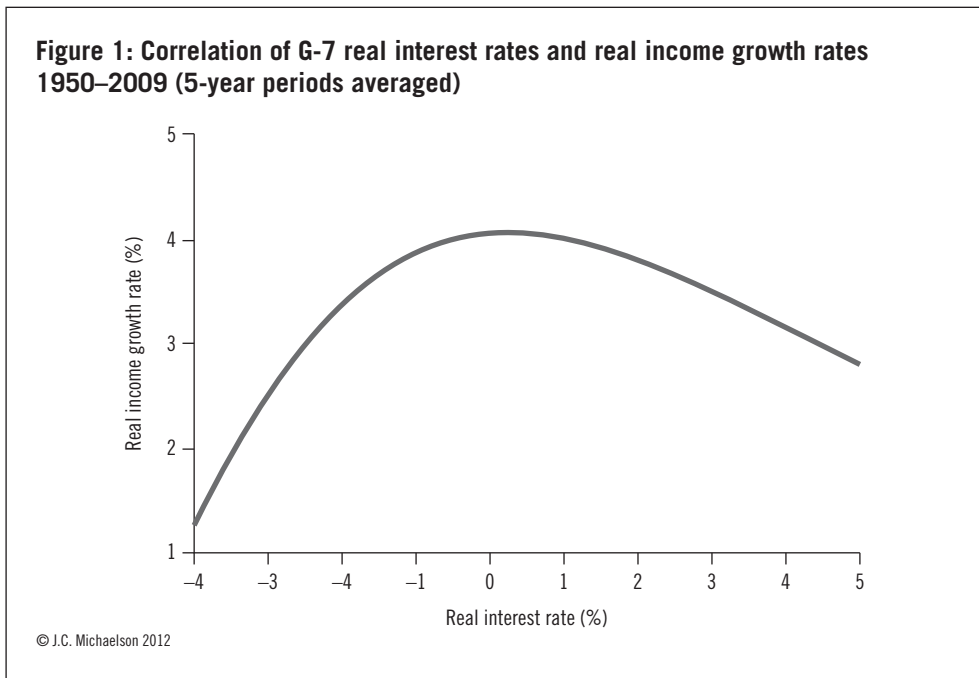
Naturally, interest rates do not operate in isolation from fiscal policy, demand for exports, and tax and regulatory policy. However, it is generally accepted that monetary policy exerts a material influence on the level of economic activity, and hence on the rate of economic growth. The textbook story is as follows. Real output growth is monotonically decreasing in the level of the real interest rate; in other words, the lower is the real interest rate, the higher is growth, and vice versa (other things being equal, and provided that inflation remains at moderate levels). A lower interest rate leads to higher growth through a number of channels. First, when interest rates fall, households can borrow more cheaply, pay less interest on existing debts, and receive lesser rewards from saving, so they spend more. The same logic applies to investment by companies. In addition, lower interest rates tend to raise asset prices, increasing household wealth and hence their spending. Finally, lower interest rates decrease the returns on domestic assets relative to foreign assets, leading investors to sell the former in order to buy the latter, lowering the value of the domestic currency in the process, which tends to increase net exports.

We believe the textbook story, but only up to a point. Our hypothesis is that, as interest rates decrease, there is a turning point beyond which they may hinder, rather than stimulate, economic activity. According to this hypothesis, the relationship between real interest rates and growth is best

described not by a downward-sloping curve, but by a non-linear hump-shaped curve, which we dub the Michaelson Curve. Figure 1 shows the relationship between real income growth and the real interest rates for G7 countries from 1950 to 2009.²

Figure 1 shows a clear hump-shaped relationship between growth and real interest rates; moreover, our simple regression analysis suggests that this relationship is statistically significant, i.e. it describes the data sufficiently well that it is highly unlikely that it does so merely by chance. These observations lead to the conjecture of the Michaelson Curve.

However, the apparent relationship between contemporaneous growth and real interest rates is not sufficient to establish that either causes the other. For example, it could be that low real interest rates cause lower growth, as per our hypothesis; yet, it could also be that low growth ‘causes’ low real interest rates, insofar as monetary-policy makers cut interest rates as growth slows or in response to adverse economic shocks (the



² Annual data. Source: World Bank. The curve shown is given by a quadratic equation fitted to the data points, without conditioning on any other variables. Generating a curve using a third-degree polynomial, or removing observations for 2008 and 2009, does not give a fundamentally different picture.

‘Greenspan put’ argument). Both of these hypotheses are compatible with the pattern observed.

In this simple analysis, for the data to provide evidence to suggest that low real interest rates *cause* low growth, it would be necessary (although not sufficient) for them to indicate that low real interest rates precede low growth in some systematic manner; this is based on the premise that a cause must occur before the effect it supposedly causes. Our analysis³ did not yield any such evidence, whether using annual World Bank data that was used to generate Figure 1, or using quarterly data series from the IMF; in G7 countries pooled together or considered individually; and for a number of different assumptions about the time it takes for interest rates to affect the real economy.

This lack of evidence from the data is not entirely surprising, given the fairly simple nature of the analysis we conducted. However, we believe that there is a reasonable argument to be made to support the hypothesis that low (indeed, negative) real interest rates are impeding economic growth at present, at least in the US and in the UK (euro-area countries currently face problems of a rather different nature). We also believe that further research could generalise this argument and support the Michaelson Curve as a useful conceptual tool. The remainder of this paper is devoted to the aforementioned reasonable argument.

The ultra-low interest rate policies of the Federal Reserve and the Bank began with their slashing policy interest rates to near zero, leading to extremely low short-term market interest rates; they were extended with quantitative easing, which has reduced yields on long-term domestic government bonds, pushing down long-term market interest rates. The upshot is that savers are struggling to make real returns much above zero on interest-bearing investments; households are earning negative real interest on their short-term savings, and ‘conservative’ institutional investors cannot generate adequate income from the investment-grade long-term government and corporate bonds upon which they rely.

³ We regressed growth on lags of the real interest rate and its square, and did so with and without using the ‘Autometrics’ model-selection algorithm. Real interest rates were calculated by deflating the nominal lending rate (on loans by banks to prime borrowers) by the realised inflation rate based on one-quarter forward inflation of the GDP deflator, used as a proxy for expected inflation (this approach can be motivated by appealing to the assumption of rational expectations).

These negligible returns on savings put stress on all of the following: households and the beneficiaries of trusts, who have less income to spend; retirement accounts, which need replenishing to compensate for lower investment income; pension plans, which have to seek additional funding from their sponsors or from tax payers; endowments, which have fewer resources available to support their missions; foundations, which have less funds to give; and companies with cash. These stresses also undermine the restoration of confidence, which is a key ingredient for recovery. Moreover, high earners in the financial sector, which benefits from an implicit subsidy (in the form of virtually interest-free loans), have a lower propensity to consume, as a proportion of their income, than less well-off households that have forgone income; this transfer is a drag on the economy, while increasing socially divisive wealth disparities.

The process whereby agents (households, in this case) change their spending plans because their purchasing power varies is what economists call the ‘income effect’ of a fall in interest rates. In contrast, the process through which agents spend more because spending becomes more attractive relative to saving is the ‘substitution effect’: agents substitute *from* saving *towards* spending when the interest rate falls, because borrowing is cheaper and saving is less rewarding. The income effect of a fall in interest rates depends on whether the agent is a net saver or a net borrower: provided that interest rates on savings and on debts change in commensurate amounts, agents who save more than they borrow tend to be worse off when interest rates fall, while agents who borrow more than they save will tend to be better off under lower interest rates. In comparison, the substitution effect of a fall in interest rates is always to encourage current spending, regardless of whether an agent is a net borrower or a net saver. Thus, when interest rates fall, the income and substitution effects may work in different directions, so the question of whether overall current spending increases or falls is an empirical one.

However, evidence has been accumulating to suggest that, in aggregate, a negative income effect of ultra-low interest rates has been dominating the positive substitution effect, resulting in depressed spending. On the one hand, real interest rates below, or barely above, zero are taking their toll on agents who depend on low-risk interest-bearing investments for part or all of their income. On the other hand, uncertainty about jobs and incomes is pushing households to save even if they are earning little or no

real interest to reward them for doing so; uncertainty about the economy is also making companies hoard cash rather than invest and hire. In addition, numerous households and companies that do want to borrow are being shut out by banks that refuse to lend at all, or lend at interest rates that have fallen by less than those that savers earn.

To be sure, large, creditworthy and too-big-to-fail companies are able to borrow at very low rates, but this is not leading to materially increased investment. Almost every large company chief financial officer will tell you that slightly cheaper credit has little impact on most investment decisions; demand and growth prospects are far more important. Moreover, large companies do not contribute materially to employment growth: it is well established that SMEs are the primary source of new jobs. In contrast to previous recoveries, SMEs have not been actively hiring, hence the weak upswing in employment. SMEs are dependent on credit to invest, hire and grow; at present, the supply of credit to SMEs continues to be well below what it had been in mid-2008.

Part of the motivation for current monetary policy, as previously mentioned, is to provide a back-door means of recapitalising the financial system, thereby increasing lending and spurring job-producing investments. There is no question that the banking sector is thriving. However, the fact that banks are withholding credit, notably from the SMEs that create jobs, is linked to ultra-low interest rate policies. The conventional wisdom is that the lower the interest rate, the more credit is available; but we believe that this is only true for SMEs when short-term interest rates are comfortably above zero.

While long-term interest rates for investment-grade borrowers are low, the fact that short-term rates are near zero means that banks and investors can make a profit by exploiting the spread – they can borrow short term for almost nothing, and lend long term almost risk-free by buying government or government-guaranteed debts, such as those of Fannie Mae and Freddie Mac. Such a strategy is a mainstay of the profitability of large US banks today, as it generates comfortable profits without effort, expense or risk. These banks could potentially make larger profits by buying higher-interest but riskier debt, financing growth in the process; however, career concerns mean that bankers are reluctant to make riskier investments that could cost them their jobs, rather than coast to virtually guaranteed profits. This also results in a misallocation of resources, with funds going to

low-risk low-reward investments, rather than to productive ventures that would deliver sustained growth in the longer run.

Large US banks were supposed to increase their lending to SMEs in exchange for the funds that rescued them in 2008, and for the guarantee of large spreads between borrowing and lending rates that has led to record profits, but this has not happened. These banks lost interest in SME lending long ago, as they found other sectors such as credit card lending, originating mortgages, providing lines of credit to large companies, and proprietary trading to present fewer problems, be more profitable, and be considerably easier to scale up. The large banks today have limited capability and expertise to make SME loans, even if they had the inclination to do so, which they do not.

Over the past 20 years, large US banks willingly ceded SME lending to local and regional banks and to the parallel (or ‘shadow’) banking system, comprising commercial credit companies and private commercial loan funds. The expertise and inclination to make SME loans resides in these institutions rather than in the large banks. As well as being a major direct lender to SMEs prior to the crisis, the parallel banking system also provided the critical secondary market for SME loans originated by banks, thereby freeing up capital for new SME loans and allowing banks to balance their liquidity needs.

The local and regional US banks rely on the inter-bank market for liquidity. When the prevailing inter-bank lending rate fell close to zero (and remained there), large banks with surplus reserves became unwilling to assume the credit risk of lending to small banks for a derisory yield. Inter-bank loans outstanding in March 2011 were at only a third of their level in May 2008, just before the crisis began. Without access to this liquidity cushion, smaller banks need to hold far greater cash reserves and reduce SME lending accordingly. Moreover, the duration of most SME loans is such that today’s liquidity-focused local and regional banks are not comfortable holding these loans on their balance sheets until maturity. Without the access to the secondary market for SME loans that was provided by the parallel banking system, these banks are reluctant to originate new SME loans.

Since 2008, it is not clear that the Federal Reserve has fully appreciated the role of the local and regional banks, and particularly of the parallel banking sector, in SME lending; the parallel banking sector has come under severe strain during the financial crisis because, in contrast to traditional

financial intermediaries, it lacks access to the Federal Reserve's discount window and to federal deposit insurance. SME lending will not recover without a restoration to strength of local and regional banks as the primary lenders to SMEs, and of the parallel banking system both as a direct lender to SMEs and as the primary buyer for such loans originated by banks.

In the UK, SMEs rely largely on the main high-street banks for credit. These banks were also supposed to increase their lending to SMEs in exchange for the rescue in 2008, and for the large spreads between borrowing and lending rates that has led to record profits. The UK banks have not fulfilled their side of the agreement either. This is partly due to the fact that, despite the low level of the Bank of England's policy rate, UK banks have faced high borrowing costs because of continuing worries about their balance sheets, hindering the transmission of low policy rates to low lending rates; similar difficulties have affected regional US banks, while the large US banks have enjoyed access to cheap credit.

There is a stark example already on offer of the failure of ultra-low interest rates to stimulate the economy, namely, Japan. Following the bursting of the credit bubble in 1990, the Bank of Japan eventually brought its main policy interest rate down to a then-unprecedented 0.25%; yet the nation came to suffer a 'lost decade' of economic stagnation that never really ended. It is accepted wisdom that this happened *despite* the stimulative effect of ultra-low interest rates, and that the Bank of Japan's mistake was not to have cut them fast enough. According to our interpretation, Japan got caught in a cycle in which ultra-low interest rates led to anaemic private consumption and investment. The Japanese government then made up for this private-sector shortfall by borrowing and spending; this borrowing was facilitated by the same ultra-low rates that contributed to the private-sector shortfall. National debt ballooned, eventually making it perilous to raise rates, thus trapping Japan in a vicious cycle of depressed consumption and investment, prompting more spending and borrowing to keep the economy afloat. Japanese government debt now amounts to more than twice annual GDP, and raising interest rates would be catastrophic for the Japanese government budget. In addition, cheaply borrowed funds have fuelled 'carry trade' offshore investments,⁴ which bring no benefit to the local economy.

Our reading of the Japanese story is as follows.

⁴ Where funds are borrowed in a low-yielding currency to be invested in a higher-yielding currency – for example, borrowing in Japanese yen to lend in Australian dollars.

- The economy does not respond to ultra-low rates.
- Policymakers view the problem as inadequate demand (as households, companies and public-sector bodies tighten their belts).
- In response, the central government borrows more at ultra-low rates, with the aim of stimulating the economy.
- Borrowed funds go towards politically directed activities with little economic benefit, and funds withdrawn from the economy in both taxes and borrowing further destroy demand.
- This leads to even more government borrowing to fund ‘stimulus’ spending.
- The government cannot afford to pay a higher rate of interest on the debt it has accumulated, leaving the central bank reluctant to raise rates for fear of bankrupting the government.

Naturally, there are considerable differences between Japan, and the US and Britain. The latter two countries have more flexible and vibrant economies, and Japan faces many other issues. Nonetheless, the potential impact in terms of higher unemployment and slower growth, relative to what would otherwise prevail, is similar. Our concern is that the UK and the US could suffer similar problems as Japan if interest rates remain at historical lows.

Monetary-policy makers remain committed to ultra-low interest rates on the assumption that this will assist the recovery, but this commitment is in fact undermining the very recovery they seek to create. Contrary to conventional wisdom, we believe that raising interest rates from current levels would increase consumption, productive lending and job-creating investment, and thereby help to restore confidence and get the long-awaited recovery under way. Increasing banks’ borrowing costs will force them to look for lending opportunities beyond government-type credits and other low-risk investments. Investors, companies and banks will also become less tolerant of underperforming assets and seek to move those assets more swiftly to superior owners and operators, creating additional efficiencies and job-creating growth.

Monetary-policy makers should increase their policy rates to bring short-term interest rates back up, and discontinue quantitative easing to help long-term interest rates go back to levels that adequately remunerate the assets of retirement accounts, pension funds, endowments, and so on. However, we believe that there are effective ways in which the

Federal Reserve and the Bank can ‘print money’ to support growth and job creation. For example, Adam Posen (an external member of the Bank’s Monetary Policy Committee) has called for a state-owned bank funded by the central bank to lend to small businesses; this is an option worth considering, although it would need to be underwritten by national treasuries.

We are clearly facing a situation of market failure, since markets are failing to achieve an efficient allocation of resources: banks and other investors are channelling funds to unproductive assets, rather than to the SMEs that would make good use of them by creating jobs and fostering growth. Any undergraduate economics student is taught that, where ‘free’ markets do not achieve efficient outcomes, there is an unambiguous case for governments to intervene, unless there is a significant risk of making things worse; we do not see any such risk in this case.

Adam Posen’s proposal is one possible solution. An alternative would be to lend banks money that would be specifically earmarked for lending to SMEs; the banks would then be charged a concessional rate of interest if they lend it as agreed, and a severe penalty rate otherwise. This would have the advantage of compelling the banks to lend to promising companies, provided the incentives are correctly designed, while avoiding government micromanaging of credit decisions. Part of the funds currently devoted to quantitative easing could be used for such a programme, in order to avoid additional inflationary pressures. It is crucial that governments and central banks take decisive action, in one way or another, instead of persisting with policies which, in our opinion, are doing more harm than good. Both Adam Posen’s and our proposals for increasing lending to SMEs involve exposing taxpayers to credit risk (as does quantitative easing, albeit to a lesser degree); however, this is surely preferable to the near-certain economic and social costs of high unemployment and anaemic growth.

As for the US in particular, it will take the restoration of the parallel banking system and the capacity provided by the secondary market for loans to revive SME credit. There is much that government can do. It can support the purchase of good quality SME credits at fair prices from banks and other credit providers, thereby unfreezing the credit market and allowing capacity for new loans. It can also work towards restoring regional banking and refocusing the large banks on productive lending.

We urge policymakers to seize the opportunity to act.

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