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2016

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Around THE Curve

And I Thought I Knew about Monetary Policy

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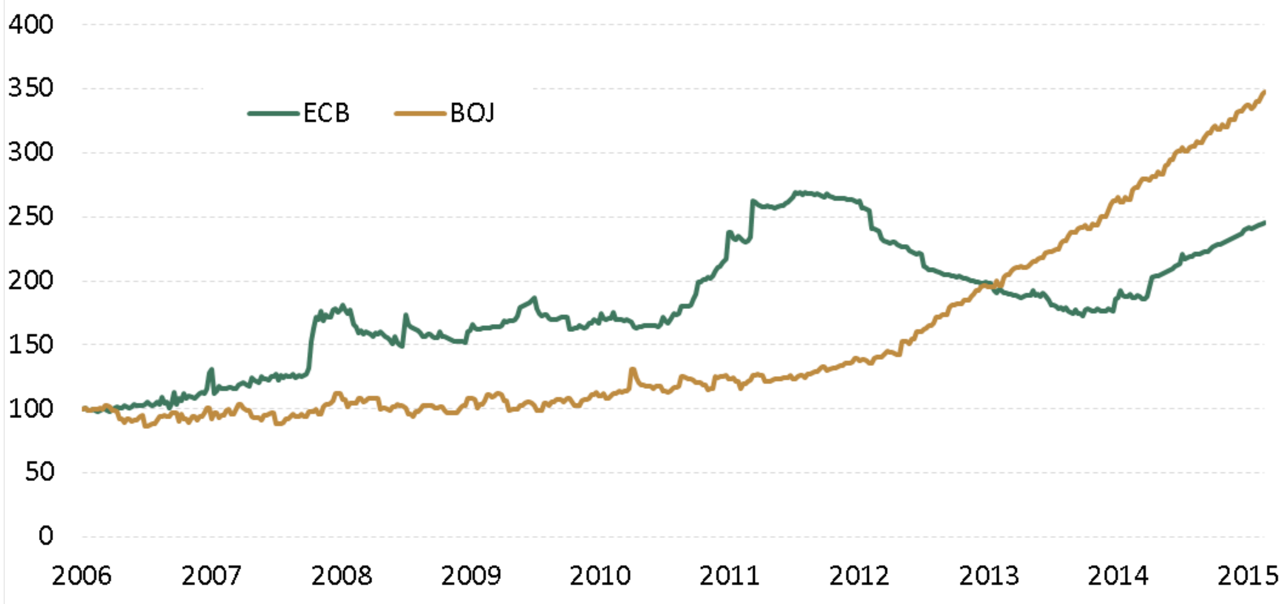
The post-Global Financial Crisis (GFC) world has been characterized by expansionary monetary policy among developed countries, along with the introduction of unconventional policy tools. Central banks have taken their policy rates to zero—or in some cases, into negative territory—and have injected massive reserves into the financial system through quantitative easing (QE). The U.S. QE program has ended, but the European Central Bank (ECB) and the Bank of Japan (BOJ) continue their programs. Most recently, the BOJ reduced its policy rate to -0.1%, joining four other central banks with negative policy rates. That gang of five, with Japan, includes Denmark, the eurozone, Sweden, and Switzerland. What these central bankers hope is that negative interest rates will chase banks' excess reserves from the central bank. Instead, banks will lend these reserves, spurring economic activity and helping the central banks move closer to their inflation targets. Recalling Say's Law—French economist Jean-Baptiste Say's law of markets—does supply really create its own demand? Surveying the monetary landscape, current economic developments are challenging several long-held beliefs, as recent central bank moves are not playing out as planned. Increased money supply has not necessarily led to increased demand:

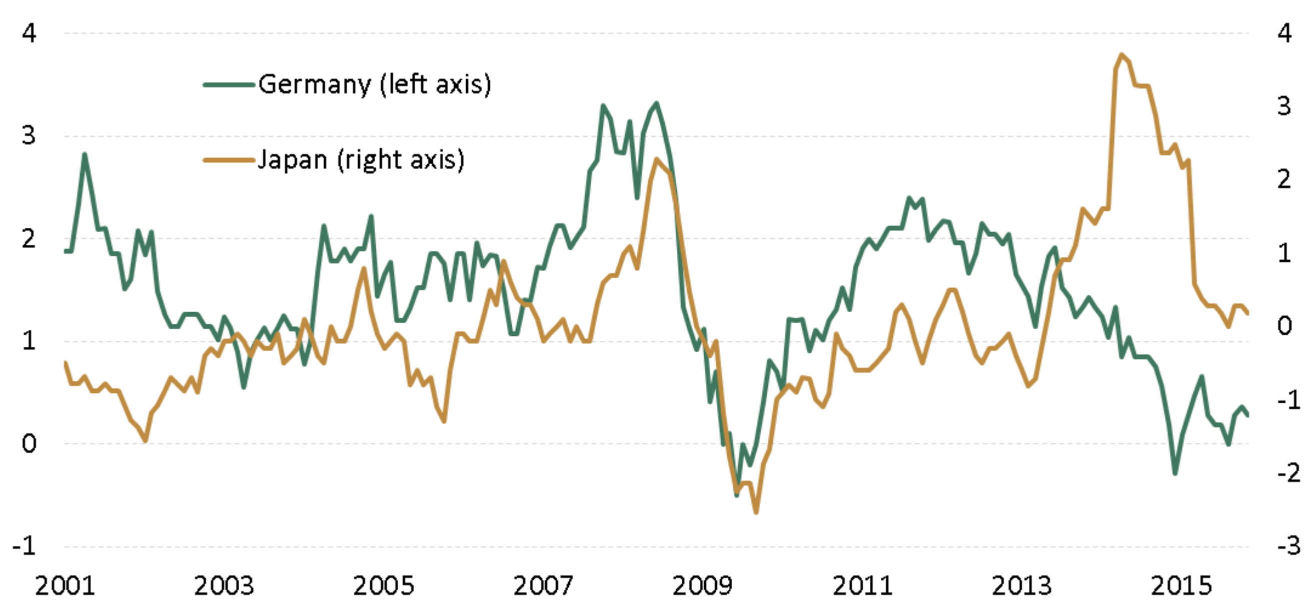
- Inflation targeting drives most central banks' policies, since aiming for a stable inflation rate can anchor inflation expectations. In turn, stable inflation supports a country's economy over the longer term. Post-GFC, some central banks instituted QE programs in an effort to spur lending to help stimulate their economies and hit their targeted inflation rates. The chart below (see Chart 1) shows the aggressive balance sheet expansion programs undertaken by the ECB and BOJ. The second chart (see Chart 2) illustrates what happened to inflation in the eurozone and Japan. Despite the massive injections of monetary easing, inflation remains far below the stated 2% targets. Germany is the exception, with its inflation rate moving higher, but most other eurozone countries currently exhibit deflation. Market measures of inflation expectations remain far below the target, suggesting that monetary policy has not successfully anchored inflation expectations as intended.

Chart 1: Central Bank Balance Sheet* *Index; As of 2/10/2016*



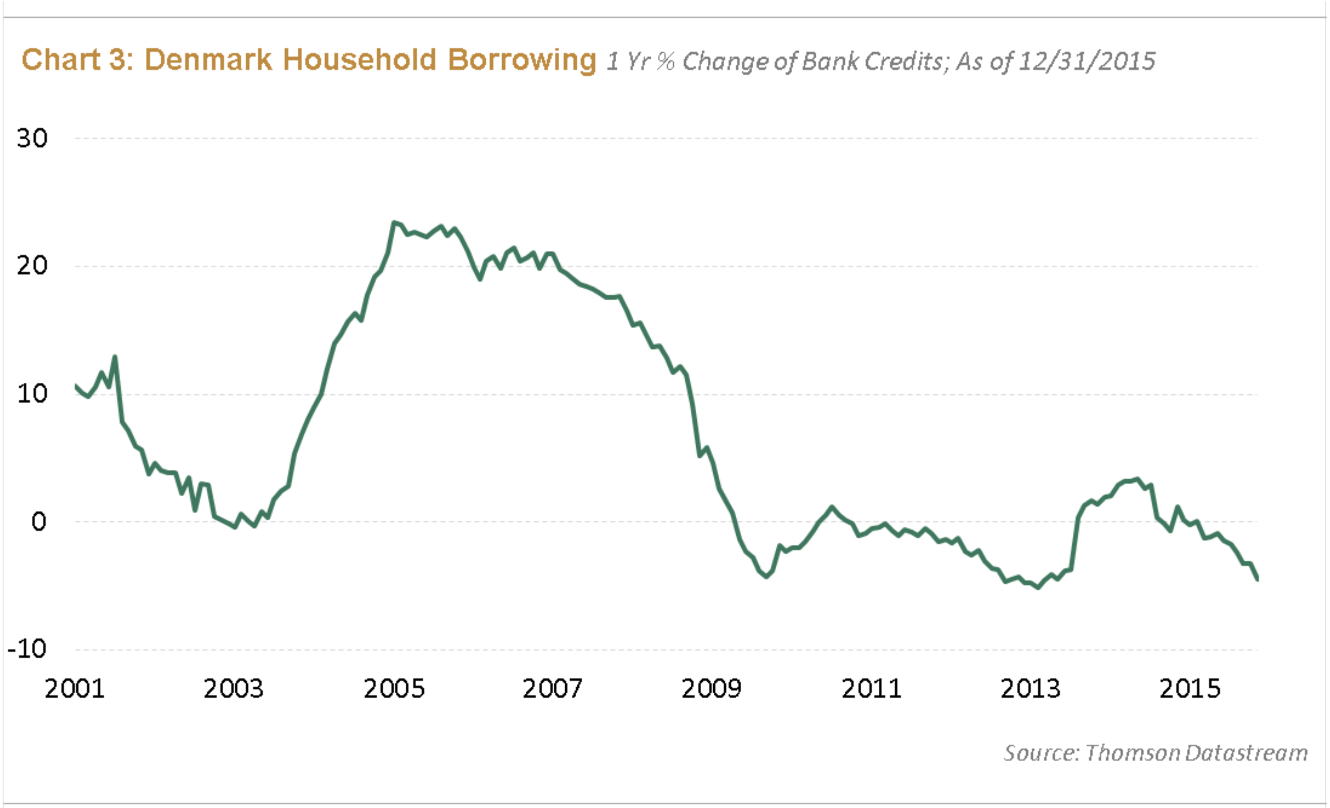
**Rebased as Jan 2007 = 100.*
Source: Thomson Datastream

Chart 2: Germany and Japan Inflation *% YoY; As of 12/15/2015*



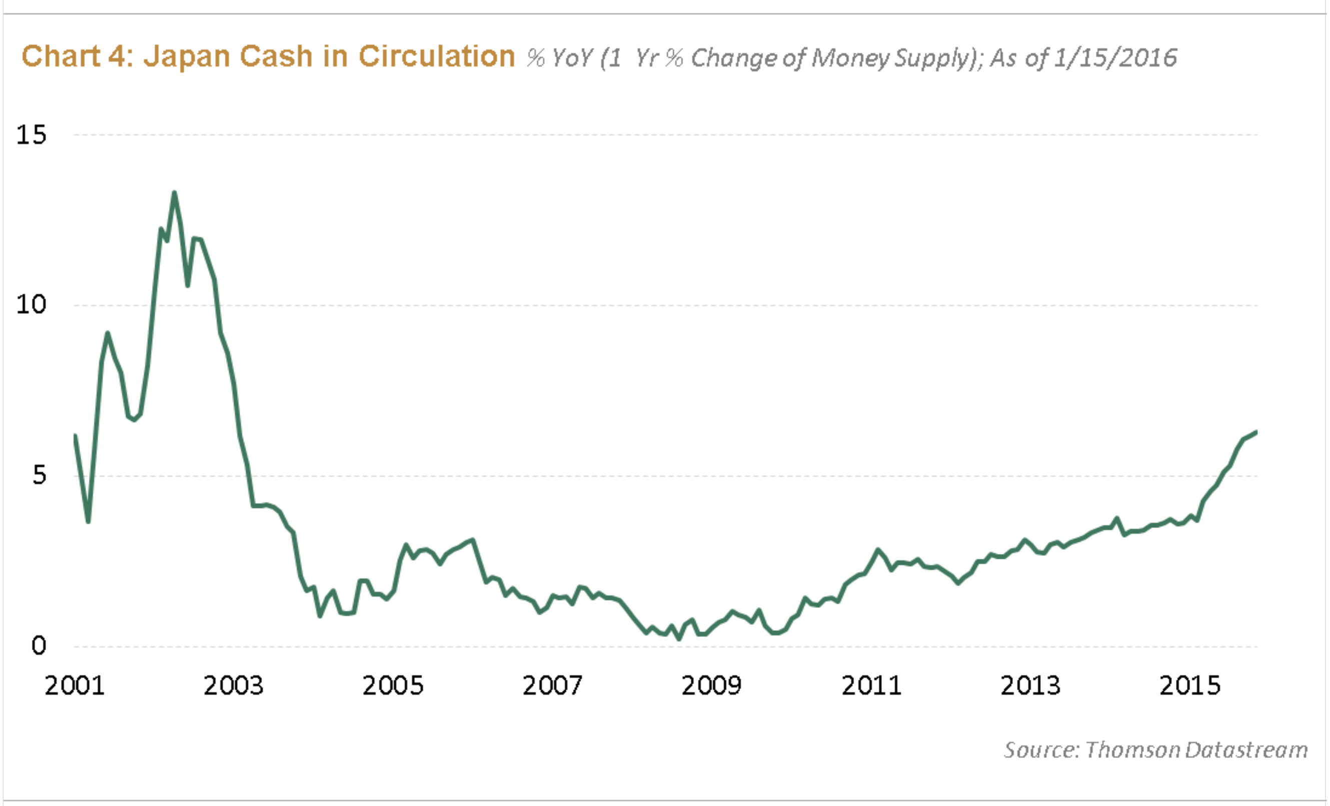
Source: Thomson Datastream

- Low borrowing rates should increase loan growth, providing economic stimulus in countries with easy monetary policies. If this belief holds true, one would expect to see solid loan demand in those countries with expansionary policies. However, take Danish consumer borrowing (see Chart 3) as an example. Loan growth has been declining nearly 5% year over year. In Sweden, a country with both a QE program and a negative interest rate, loan growth to nonfinancial companies is positive, but the growth rate is slowing. Similarly in Spain, business loans are growing by just over 2.5%, but the growth rate has slowed sharply, even as the ECB augmented negative policy rates with additional QE.



- The main transmission of monetary policy appears to be through the exchange rate. In the case of Denmark, Sweden, and Switzerland, their focus on a competitive currency is a stated goal of monetary policy. Denmark wants to maintain its currency peg versus the euro. In Sweden, the Riksbank's First Deputy Governor, Kerstin af Jochnick, recently discussed both the need to anchor inflation expectations and the potentially negative (i.e., deflationary) impact of ECB QE on Swedish import prices. In February 2015, the Riksbank pushed the policy rate down to -.10%. More recently, it lowered the rate further to -.50%. In late January 2016, Japan moved to negative interest rates, which initially pushed the yen sharply lower. In recent weeks, the yen has done a complete about-face, posting a gain of over 7%. The euro, too, is up for the year, but has underperformed the yen. The Danish krone and Swiss franc are stronger against the dollar. Only the Swedish krona has depreciated this year, but by less than 1%. Markets appear to be questioning the resolve and ability of central banks to be successful.

- Some central bankers have expressed concerns that monetary policy, specifically negative interest rates, could have negative, unexpected consequences. Since banks cannot pass along negative deposit rates to consumers, bank profit margins could come under further pressure. Risk-averse banks could become less willing to lend or keep interest rates higher. Subsequently, banks and consumers may opt to hoard cash in response to negative interest rates. Demand for cash is already on the rise. In the case of Japan (see Chart 4), which has been zero-interest-rate bound for a long time, cash-in-circulation growth is accelerating. According to news reports, demand for safes (to securely keep cash) is significantly higher. Cash in circulation is rising in both Denmark and Switzerland, although Sweden's cash demand is declining sharply. These are early signs of adverse behavior.



Conclusion

The success of monetary policy in those developed countries that instituted negative interest rates seems lackluster. Sweden stands in contrast with expected growth of over 3% in 2015, the small country dividend. The eurozone should grow less than 2%. Switzerland is expected to post growth below 1%. Across these areas, the inflation goal is even more elusive. These disappointing economic results have led to conclusions that monetary policy has lost its effectiveness and that negative interest rates are simply desperate moves on the part of central banks. Monetary policy, in its current implementation, appears better suited to addressing a credit-supply problem rather than an insufficient demand problem. The current account surpluses among the aforementioned gang of five suggest excess saving, a factor that would mute the effectiveness of monetary policy. Some experts, like Harvard economist and former U.S. Secretary of the Treasury, Lawrence Summers, call for fiscal stimulus to address the current, stagnant environment. However, monetary policy is not yet out of ammunition either, as higher inflation targets and the possibility of "helicopter money"—the idea that the government can expand the monetary base by putting money directly in the hands of consumers, as a helicopter might drop cash from the sky—have entered into the discussion of possible policy prescriptions. But whether it is fiscal policy, additional quantitative easing, unconventional monetary policy, or a combination of tactics, one thing is certain—bold action may be required. New policy action may need to shock the system out of its lethargy, similar to Franklin Roosevelt's daring decision to take the U.S. off the gold standard in 1933, which helped the country recover from the Great Depression.

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