

FUNDAMENTALS

Unconventional policy in the next downturn

A lack of policy space means that central banks may have to turn to more unconventional responses when the next recession occurs.



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Our long-term research of the past year has explored the demographic, technological and energy transformations that will shape our common future. However, these revolutions are shaped by and, in turn, help shape the political environment and the resultant policies. We will focus on this additional dimension through a fourth research theme: politics and policy.

Perhaps the most profound feedback of policy onto markets comes through the actions of central banks. In the short term, markets have an unhealthy obsession with parsing every word and phrase of central bankers for clues to their immediate policy intentions. However, from a long-term perspective, the most important questions relate to the scale and nature of the policy response to the next economic downturn.

The lessons of the last 50 years of policy responses are sobering. It is highly unlikely that anything like the amount of conventional policy space utilised will be available in the next downturn. We therefore need to consider the scope of what is possible and examine the largely unconventional potential policy choices, such as augmented quantitative easing and 'helicopter money'.

THE (LACK OF) CONVENTIONAL POLICY SPACE

The US economy, the world's largest, looks increasingly late in its economic cycle. This means it could be nearing the end of its 'expansionary' phase and may enter a recession relatively soon. We think now is the right time to ask how central bankers will respond to the next economic downturn. Put another way:

'If policy makers needed to reflate the global economy in 2019/20, what tools would they use?'

After 1945, monetary policymakers have largely used short-term interest rate cuts to stimulate demand when the economy was weak. This worked well until those rates hit rock bottom – with 'rock-bottom' re-defined a few times as rates continued to be reduced.

Recent experience has shown there to be no hard lower bound on nominal interest rates at zero. Across large parts of Europe, as well as in Japan, central bankers have experimented with negative interest rates though the jury is still out on whether the benefits of that policy have outweighed the costs.

However, as long as physical banknotes are available, keeping money under the metaphorical mattress becomes the most attractive choice after a certain level of negative interest rates. Taking recent events as a guide, interest rates could plausibly trough around 50 basis points below zero in a future aggressive easing cycle.

To gauge whether central banks will have enough space available to use policy rate cuts and nothing else, we assume that the average falls in interest rates during each of the last five rate cycles (Figure 1) as a 'normal' amount of easing and compare it to where markets are pricing interest rates will be three years from now (Figure 2 overleaf).

But this is a problem they've already confronted in the past; central bank orthodoxy has evolved and a normal monetary policy response now includes new tools – forward guidance (communicating in advance what policy will be), and purchasing assets (known as quantitative easing or QE). We believe that central bank policymakers have now come to the following thought process:

- Interest rates of different maturities affect saving and investment decisions in the economy
- Forward guidance and QE give policymakers greater ability to influence longer-term interest rates
- As long as there's room to push interest rates down at any maturity, they can stimulate the economy

Figure 1: The impact of interest rate easing (%) in post-war recessions*

Federal Reserve			
Recession start date	Recession end date	Change in 1y yields (%)	Change in 10y yields (%)
Aug-57	Apr-58	-2.50%	-1.00%
Apr-60	Feb-61	-2.50%	-1.00%
Dec-69	Nov-70	-4.50%	-1.75%
Nov-73	Mar-75	-3.25%	-0.75%
Jan-80	Jul-80	-5.00%	-1.25%
Jul-81	Nov-82	-7.25%	-3.75%
Jul-90	Mar-91	-4.50%	-1.75%
Mar-01	Nov-01	-5.50%	-2.50%
Dec-07	Jun-09	-4.75%	-2.50%
Average		-4.50%	-1.75%

Bank of England			
Recession start date	Recession end date	Change in 1Y yields (%)	Change in 10y yields (%)
Feb-79	Apr-82	-3.50%	-2.75%
Jan-84	Mar-84	-1.75%	-1.50%
Apr-88	Feb-92	-4.00%	-2.00%
Apr-08	Jun-09	-5.25%	-2.00%
Average		-3.75%	-2.00%

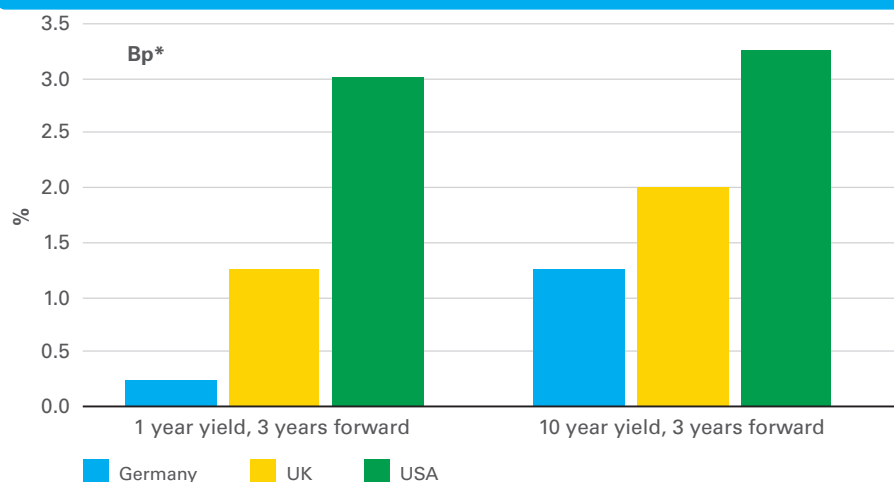
European Central Bank/ Bundesbank			
Recession start date	Recession end date	Change in 1Y yields (%)	Change in 10y yields (%)
Jul-74	Mar-75	-5.50%	-3.00%
Jan-80	Sep-82	-3.00%	-0.25%
Jan-92	Sep-92	-3.25%	-2.25%
Jan-08	Jun-09	-4.25%	-1.75%
Jul-11	Mar-13	-1.50%	-2.25%
Average		-3.50%	-2.00%

* Difference between the maximum yield in the twelve months leading up to the business cycle peak and the minimum yield during the downturn and subsequent twelve months. Cycle dates are taken from NBER (USA), CEPR (EMU) and NIESR (UK)

Source: Bank of England, Bundesbank, Federal Reserve, Shiller & McCulloch (1987), LGIM

But how much room is there? Comparing market pricing in Figure 2 to the average easing in Figure 1, we see that the US is arguably close to securing enough policy space, but the UK and the Eurozone are facing a serious shortfall.

It seems unlikely though that there will be enough room for monetary policy makers to rely on interest rate cuts, forward guidance and QE alone. Instead, central banks will have to turn to something new.

Figure 2: Flying too close to the ground (all in %)

*Rounded to the nearest 25bp, as of 30/04/18

Source: Bloomberg LP, LGIM

THE NEW MONETARY POLICY TOOLKIT

If policymakers are likely to find their conventional toolkit bare during the next downturn, we need to explore the less conventional tools central bank will have at their disposal, and the potential implications of their use. There are two operational examples which stand out. The first, augmented QE, represents only a slight departure from the norm whereas the second, helicopter money, is more of a step into the unknown.

1) Augmented QE

One of the key impacts of most QE programmes on investor psychology has been the credible promise of doing 'whatever it takes'. The limitless backstop provided has, over time, helped to improve liquidity, credit availability and confidence. Given that these three factors are all associated with rising asset prices, the promises

of market support sometimes obviates the need for the support itself. If investors genuinely believe policy will put a floor under prices then they start taking on more risk.

The problem with repeating this policy may be that of bond scarcity. The most immediate example is the European Central Bank (ECB) which has already almost exhausted the supply of German government debt. And at some point, all central banks will hit physical constraints as they clearly cannot own more than 100% of their own government's debt.

QE may therefore need to be broader and more innovative. If the focus stays on reducing interest rates at all maturities, central banks can use interest rate derivatives when they run out of government bonds, meaning that there would be no constraint on the potential scale of intervention¹.

Alternatively, central banks could increasingly venture beyond the pool of government securities. Over the last decade, global central banks have purchased around \$15 trillion of assets. That is a large fraction of the \$50 trillion² of government debt securities outstanding, but a small fraction of the \$336 trillion³ of global financial assets.

Steps in this direction have already been taken: the Federal Reserve bought mortgage-backed securities, the ECB and Bank of England have bought corporate bonds, and the Bank of Japan has purchased Japanese real estate investment trusts (J-REITs) and exchange traded funds (ETFs). The promise of such purchases on an even larger scale is likely to be part of the policy armoury in the next crisis.

Augmented QE is likely to have a lot of attractions for central bankers as the tool-of-choice during the next downturn. However, there are opposing arguments to the policy. One of the most convincing is that purchasing existing assets inevitably benefits the holders of those assets relative to other parts of society. The associated increase in wealth inequality may make policymakers look for more radical alternatives.

2) Helicopter money

In 1969, the economist Milton Friedman coined the phrase

1. There is a clear parallel with currency market intervention by emerging market central banks. In that case, buying/selling foreign-exchange forwards is a policy tool that sits alongside the buying/selling of foreign currency denominated bonds.

2. Source: https://www.bis.org/publ/qtrpdf/r_qt1803.htm

3. Source: <http://www.fsb.org/2018/03/global-shadow-banking-monitoring-report-2017/>

'helicopter money'. Friedman discussed showering a hypothetical yet fortunate community with \$1,000 dollar bills from the air. If a central bank wants to increase output and/or inflation, then the simplest solution is to give everyone in that economy more money.

Helicopter money can be structured in different ways: 'people's QE' (monetary-financed government spending) and money-financed tax cuts are the most popular prescriptions. Both hold a clear appeal for policymakers seeking a quick-acting inflationary boost.

The key to understanding both its effectiveness and its shortcomings is to determine how far this genuinely differs from conventional quantitative easing. If the monetary expansion is contingent on future economic conditions such as inflation, then central banks will finance the fiscal expansion today but take that financing away again in the future when they see fit. This is no different from previously deployed QE policy.

People's QE may create a different set of short-term winners (most likely labour and businesses directly

benefiting from state investment), but in the long run, without a permanent monetary expansion irrespective of future economic conditions, long-term inflation expectations would be unchanged. Helicopter money only substantially differs from conventional QE if the associated monetary expansion is permanent and irrevocable. There is therefore a corresponding risk that central banks could lose control of both inflation and the domestic currency.

In practice, however, the barriers to execution may be higher than they first appear. Pulling the fiscal and monetary levers together requires government and central banks acting explicitly in concert: a path that jeopardises the closely-guarded independent status of central banks.

A further concern for some is that once this hurdle is overcome, what is to prevent further rounds of helicopter drops? A government that really had finally created a 'magic money tree' might find the temptation to always give it one more shake too strong to pass up.

The biggest appeal of this policy for some is that it would likely

avoid many of the problems now associated with QE, which is seen as a 'bailout for the rich' and an enabler of social inequality. QE-financed infrastructure projects would potentially be more redistributive, create real publicly owned assets, provide skilled employment and even possibly raise long-term trend growth.

UNCONVENTIONAL TIMES

Politics in its simplest form is the business of who gets what, when and how. This has been particularly evident over the past decade, due to lower trend growth, ageing populations and creaking welfare systems; we expect the next decade to be no different.

By showing how much room, or how little as the case often is, central banks have to provide their societies with a conventional recovery from recession, unconventional policy ideas are likely to be championed with increasing urgency as we head towards the later stages of this economic cycle. The next downturn is likely to see at least some of these ideas made real as old tools are worn out. In our next article, we'll be examining how much these and other unconventional policies will be possible both legally and in the current political climate.

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