Engineering a New Crisis*

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News that the United States economy grew at 3 per cent during the hurricane-blighted third quarter of 2017, close to the 3.1 per cent recorded in the previous quarter, has once more revived claims that the world economy has left the Great Recession behind. There is one reason to discount this claim. Back to back 3 per cent annualised rates of growth in consecutive quarters has been observed more than once since the 2008 crisis. In fact, as recently as the second and third quarters of 2014, rates of gross domestic product (GDP) growth in the U.S. stood at 4.6 and 5.2 per cent respectively.

So, besides indications that Europe has seen the worst of the recession and is possibly experiencing a mild recovery, the principal cause for celebration, if any, is the falling unemployment rate in the developed economies. According to the International Monetary Fund's (IMF) latest World Economic Outlook, the unemployment rate in the advanced economies is estimated to have fallen from its 8.3 per cent high in 2010 to 6.2 per cent in 2016 and a projected 5.7 per cent in 2017. In the U.S., the unemployment rate touched a 16-year low of 4.3 per cent. Some of this decline is because of the discouraged worker effect, or the tendency of those who have been looking for employment for long to, on not finding it, report themselves as not seeking work anymore. That leads to a fall in the number of unemployed actively seeking work but not finding it, captured in the unemployment rate. But with the labour force participation rates rising recently, there is reason to believe that unemployment is indeed falling.

So, what we have is evidence of moderate growth in the world economy combined with a falling "headline" unemployment rate as indicated by the official statistics. While this is mild cause for satisfaction for policymakers, inasmuch as the worst of the recession seems over even in Europe (where real per capita output is expected to grow 2 per cent in 2017), it is also a cause for concern since the increasing "tightness" in the labour market has not been accompanied by an acceleration of wage growth. According to the IMF, wage growth was just 1.8 per cent in 2016 and is likely to rise 2.3 per cent in 2017, which compares with an average of 3.4 per cent during 1999 to 2008. An important reason, buried by the IMF in multiple and often trivial explanations of why wage growth does not keep pace with employment growth, is the poor quality of additions to employment, involving part-time, precarious jobs that pay poorly. That is, not only is the recovery of output growth volatile and moderate, but the jobs that recovery delivers are not just limited but also qualitatively poor. The popularity of policies aimed at making the labour market flexible and reducing wage "rigidities" has only contributed to this accumulation of low-paying part-time employment or self-employment. That is something that has implications for wage growth, which the headline unemployment rate does not capture.

With wage growth sluggish, inflation too has remained low, despite low productivity growth, with the inflation rate for 2016 placed at 1.5, 1.8 and 1 per cent in the U.S., Euro area and Japan, and projected at 2.2, 2.1 and 1.5 per cent respectively for 2017. The new wisdom is that the "Phillips curve", that was seen as pointing to an inverse relationship between the unemployment rate and inflation, has "flattened out" so that there is little by way of a relation between trends in unemployment and prices.

This has created a peculiar situation for policymakers in the advanced economies, where for a long time proactive monetary policies have been privileged and fiscal conservatism and "consolidation" seen as non-negotiable. Since central bankers wielding the monetary lever were supposed to be concerned with inflation and growth, in that order, when inflation was running low monetary policy was loose and interest rates kept low to favour growth.

Conversely, when inflation was high, the pursuit of an inflation target led to the adoption of tight money policies and measures to raise interest rates, so as to dampen demand in order to rein in inflation at the expense of growth. Central bankers adopting, consciously or otherwise, simple rules of thumb when designing monetary policies (such as the much-cited Taylor's rule for setting interest rates) were seen as all-powerful. But these rules were based on the premise that when growth accelerated and unemployment fell, inflation would rise, and vice versa. When the 2007 financial crisis broke, this perspective came in handy. Growth slumped and unemployment spiked, and, as expected, inflation was low. So, once self-imposed fiscal stimulus limits had been reached, the focus was on monetary policy, involving the infusion of liquidity into the system and the maintenance of low, near-zero or even negative policy interest rates, to stimulate the recovery. One important means to liquidity infusion was bond purchases by the central bank at relatively high prices.

According to Financial Times (August 16, 2017), the six central banks that adopted policies of "quantitative easing"—the U.S. Federal Reserve, the European Central Bank (ECB), the Bank of Japan, the Bank of England, and the Swiss and Swedish central banks—now hold more than $15 trillion of assets, or more than four times the pre-crisis level. Of this, more than $9 trillion is in government bonds, amounting to one-fifth of the $46 trillion total outstanding debt owed by their governments. The rest consists of other bonds and securities. Overall the U.S. Fed's balance sheet rose from a little less than $1 trillion before the crisis to $4.5 trillion currently, while the ECB's total balance sheet stands at $4.9 trillion of assets, including nearly $2 trillion in eurozone government bonds, and the Bank of Japan's balance sheet reflects $4.53 trillion of holdings, of which 85 per cent are Japanese government securities. The balance sheet size of the different central banks relative to that of their economies was by June 2017, 39 per cent of GDP in the case of the ECB, 23 per cent in the case of both the Federal Reserve and the Bank of England and 94 per cent in the case of the Bank of Japan.

Soon, however, it emerged that there were three problems associated with the pursuit of such a monetary strategy. The first was that it was not too successful in triggering a recovery, which has been 10 years coming and is still, as noted, moderate in intensity and volatile in nature. The second was that it triggered forms of the speculative carry trade in which low cost money is borrowed to invest in assets varying from government bonds, equity and emerging markets paper of different kinds to real estate and alternative assets, leading to a self-reinforcing rise in asset prices globally. The third is that, in the pursuit of this policy, while growth has moderately revived and unemployment fallen, inflation has remained stubbornly low, providing no conventional arguments for central bankers to unwind their balance sheets, reverse the spike in liquidity and raise interest rates. But failing to do that keeps asset price inflation high, increasing the possibility that the bubble could burst, precipitating another financial crisis. Quickly unwinding central bank balance sheets by selling accumulated assets could, however, set off a collapse in asset prices and deliver another kind of financial crisis. This strengthens the case of those who argue that, since inflation is low, there is no reason to change the prevalent monetary policy stance.

This has troubled global policy institutions, which fear that having got drunk on easy money, the financial sectors in advanced economies may implode once again. In June, Claudio Borio, the head of the Bank of International Settlements' monetary and economics department underlined the fact when he said: "The most fundamental question for central banks in the next few years is going to be what to do if the economy is chugging along well, but inflation is not going up." In his view, "Central banks may have to tolerate longer periods when inflation is below target, and tighten monetary policy if demand is strong—even if inflation is weak—so as not to fall behind the curve with respect to the financial cycle." (Financial Times, June 25, 2017)

In sum, central bankers need to reverse much of what they did over the last decade, even if they do not have high headline inflation, but only asset price inflation as a justification. Faced with this situation, central banks are deciding to scale back their policy of "quantitative easing" in the form of liquidity infusion through asset purchases. The Federal Reserve has already implemented that, while the European Central Bank announced end-October that it would halve its bond-buying programme from €60 billion to €30 billion a month starting from January 2018. But none is willing to commit to a quick unwinding of balance sheets for fear of precipitating a different kind of crisis as markets react to a radical change in the easy money environment they have gotten used to. Even if bond sales by central banks is resorted to, the measure will go only a part of the way. Asset holding by central banks will remain well above their pre-crisis levels for quite some time.

Whether this gradual approach will prevent a financial crisis stemming from a collapse of inflated asset prices, which some fear an end to the era of easy money could precipitate, only time will tell.

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