Central Banks And The Limits Of QE. Fiscal Policy In The Wings. Leaning Left.

Beware negative interest rates. The intention of central banks imposing negative rates upon an economy is to stimulate growth. But if 10 years of falling rates have done little to stimulate demand, 7 of those at close to zero interest rates, why would negative rates encourage more demand? Taken in the extreme, negative interest rates will encourage owners of money to change the relationship with their depository institutions from one of debtor to custodian. The result would be a withdrawal of money from the money market into a custodian network. There will of course be custody expenses but these are limited and such expenses are, at least for now, beyond the influence of central banks. Negative interest rates could therefore trigger a contraction of the money supply which would maintain the zero bound in market rates of interest while liquidity would overflow out of the money markets. The provision of liquidity to the system will have become waterboarding.

The FOMC meets March 16, the ECB March 10, the BoJ March 15. Confidence in central banks is waning resulting in more volatility surrounding signals they send whether hawkish or dovish. It certainly appears that central banks have reached the limits of policy and that efforts to boost growth will have to be even more innovative, if in fact growth needs boosting. Given the dogmatic pursuit of growth apparently beyond the natural metabolic rate of the global economy, it would not be surprising if fiscal policy were engaged.

In some ways, fiscal policy will be more effective than monetary policy. For all the magnitude of QE, it only supplies credit to the economy, it does not directly increase demand. QE policies assume that there is always demand for credit, but this is clearly not the case. If governments insist on pushing the economy towards a higher target growth rate, in the absence of private demand, it may have to spend. It cannot finance this spending out of taxes as that would sterilize the fiscal expansion. Instead, government would need to run a deficit and monetize it. When economists speak about ‘helicopter cash’, this is what they mean.

There is another way, which is to tax and spend, but to do it in a tax neutral and redistributive way. Imagine a wealth tax of 100% for all wealth over 100m USD. Put aside the practicalities and politics of such a tax for a moment and see what can be done with this. By one estimate (by Boston Consulting Group), this wealth totals 10 trillion USD, basically equal to the current nominal annual output of China. The marginal propensity to consume of these ultra-high net worth people is presumably quite low. Imagine if this, expropriation, to put it candidly, were 'spent' by distributing it to the bottom tenth of the global population, a group of households who could not save their income because they might be living below the poverty line, the boost to global output would be substantial. This is an absurd limiting case of course, but it illustrates the cost of inequality.

Economic orthodoxy will not easily relax the need for fiscal rectitude and austerity. Monetary policy has clearly hit a wall. Fiscal policy will eventually need to be engaged, and again, I qualify that this is if we target growth at a level beyond the natural metabolic rate of the real economy. Then countries will begin to tax and spend. Around the world, the people have already signaled their political choices, and it leans that way. Perhaps the masses know something the economists don't.