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Featured G

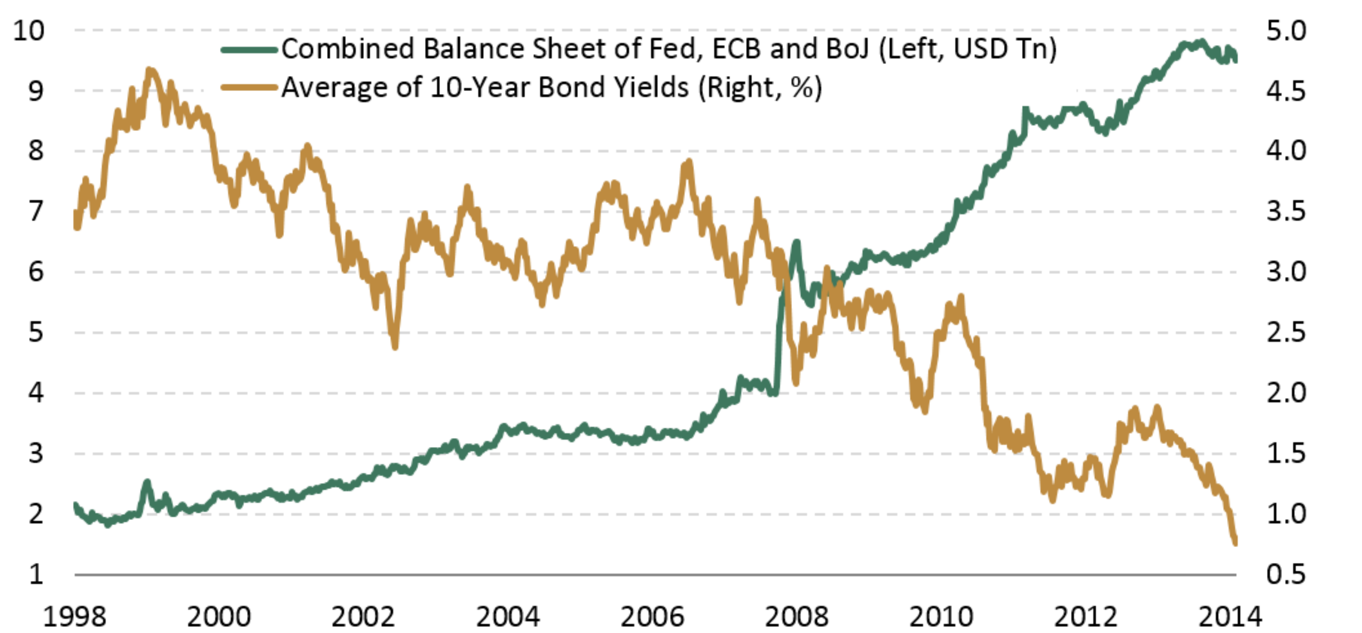
A Bridge Too Far

More central banks have joined the global monetary easing race, the latest two being the Reserve Bank of Australia and the People's Bank of China. Their actions suggest that deflationary pressures continue to accumulate in the global economy, but also reflect their intensifying battle to confront downward pressure on growth and prices.

While stock prices have celebrated central banks' relentless efforts to quantitatively ease monetary policy, the global inflation rate has continued to fall ever lower, and output growth remains subdued among most G7 nations since 2009. Even for developing countries, gross domestic product (GDP) growth has fallen far below trend in recent years, with two key BRIC countries, Brazil and Russia, on the verge of recession. China's inflation rate is a mere 1.5%.

In hindsight, all of these developments represent some kind of conundrum. Quantitative easing is supposed to shore up nominal growth, bring about stronger real output expansion, and/or create inflation—all of which should lead to a steady rise in nominal bond yields—or at least in countries where central banks have been actively expanding their balance sheets. In reality, this does not seem to be the case, as evidenced in Chart 1.

Chart 1: G3 Central Bank Balance Sheet & Bond Yields *As of 1/28/2015*



Source: Thompson

Although the combined balance sheets of the three central banks (the Fed, European Central Bank, and Bank of Japan) have exploded upward since 2010 and will soon reach more than $12 trillion, the average nominal bond yield in the U.S., Japan, and Germany has melted ever lower. Nominal GDP growth for the three economies has also fallen precipitously.

Some blame low bond yields on the explosion of the central banks' balance sheets, causing increased scarcity of high-quality government bonds. Others have attributed low and falling bond yields to the recent collapse in oil prices, which have dramatically lowered headline Consumer Price Index (CPI) and inflation expectations. These arguments may have captured some aspects of the recent decline in inflation and nominal bond yields, but they are not the root cause.

For example, although a central bank can mop up most new bond issuance, the inventory of outstanding debt in any country dwarfs new issuance, and bond yields reflect the average assessment that all bondholders have on the nominal outlook of an economy. Should the majority of bondholders decide to sell their holdings for whatever reason, bond yields will go back up. The oil collapse could cause the short-term inflation rate to fall, but it should not push down long-term inflation expectations so dramatically.

The key reason behind ultra-low bond yields in the developed world reflects the inability of central banks to overcome the problem of a global supply glut, excess savings, and the resulting deflationary pressures. The widespread deleveraging following the 2008 Great Recession drove up the private sector savings rate while depressing capital investment. This has been a common phenomenon in almost every industrialized nation. The huge gap between excessive savings and capital investment has consistently depressed economic activity and driven down inflation around the world, particularly in developed nations.

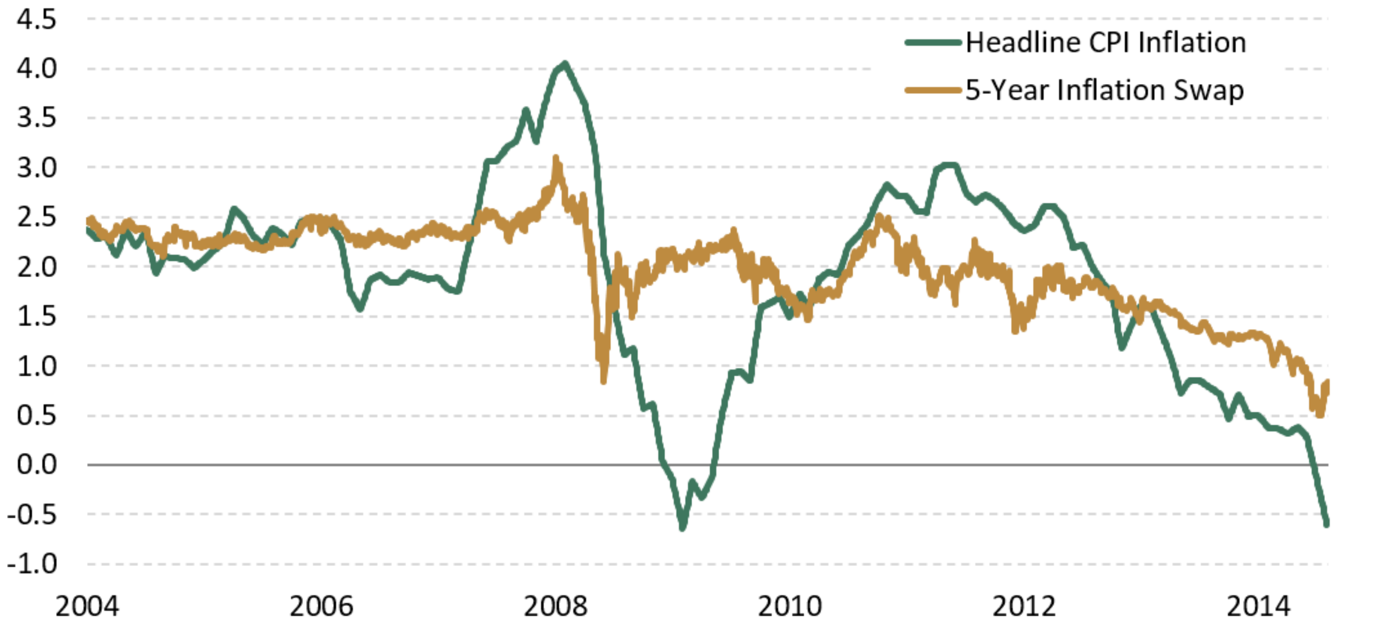
In the meantime, G7 nations have been caught in a "liquidity trap" where interest rates have already fallen to zero and central banks can no longer rely on lowering interest rates to stimulate aggregate demand. Alas, any alteration of money supply by central banks is rendered almost ineffective in terms of the impact on overall spending behavior within an economy.

Given these circumstances, only fiscal policy can make a difference by filling up the demand gap and driving up nominal expansion. This is simply because government sector dissaving directly creates final demand. The unfortunate reality is that public sector debt and deficits have been demonized and considered irresponsible government policy. It is politically unpopular for any politician or government to advocate for more budgetary deficit and/or additional borrowing, regardless of prevailing economic conditions.

Since 2010, most G7 nations have pursued fiscal austerity to varying degrees. This, in essence, has added more savings to a world that is already stashing way too much savings. The natural economic responses to this policy are weakening growth and increasing downward pressures on prices. To make the matter even worse, many developing countries have increased interest rates or tightened fiscal policy in the aftermath of the 2013 "taper tantrum." This policy move exacerbated weak growth and added more deflationary pressure to the global economic system.

What does all of this mean? Global inflation is low and has been falling for some time and this condition will not change at any time soon. With the euro zone already stepping into the deflation zone and bond yields in both Japan and Germany standing at mere 35 some basis points, it is difficult for global interest rates to rise significantly and quickly.

Chart 2: Eurozone Inflation Rates *As of 2/4/2015*



Source: Bloomberg (© 2015, Bloomberg Finance LP)

The Fed needs to tread carefully; any premature monetary tightening could tip the global economic balance quickly toward deflation.

Finally, it is also wrong to assume that we are doomed in our fight against deflation. The developing world may hold the key to the final outcome, because growth potential in the emerging market world is much higher, with no "liquidity trap" plaguing the underlying economies. Therefore, monetary policy still can make a major difference in bringing about much needed growth to the global economy. In this vein, the recent interest rate cuts in India and China are indeed good news.

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