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Cheap credit cannot restore broken illusions

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Hans Christian Andersen's fairy tale about the "The Emperor's New Clothes" is a good explanation for the spectacular expansion and implosion of the bubble economy in the 2000s.

For a time, a collective suspension of disbelief allowed markets and investors to ignore risks produced by cheap credit, subprime mortgages, securitisation and the shadow banking system.

The system worked until someone impolitely shouted out the risk had not gone away, it was just hidden in plain sight, and many institutions were insolvent.

But how many people remember how the fairy tale ends?

"'But he has nothing on at all,' said a little child at last. 'Good heavens! Listen to the voice of an innocent child,' said the father, and one whispered to the other what the child had said. 'But he has nothing on at all,' cried at last the whole people.

"That made a deep impression upon the emperor, for it seemed to him that they were right; but he thought to himself 'Now I must bear up to the end.' And the chamberlains walked with still greater dignity, as if they carried the train which did not exist."

The emperor decided it was too embarrassing to admit he had been fooled. But that is where monetary policy and the fairy tale part company.

The emperor could try to sustain the illusion (the fairy tale does not record whether he succeeded or not). Central banks have been less successful in their effort to recreate the confidence and beliefs that supported asset prices and could lead to a resumption of normal lending behaviour and growth.

PARADIGM SHATTERED

Expectations about income, asset prices, interest rates and risk are central to pricing of all real and financial assets, as well as the spending decisions made by households and firms. Whether termed animal spirits, sentiment or optimism, expectations determine asset prices and growth.

Central bankers, policymakers and the financial services industry have spent the past two years trying to rebuild the essentials of the pre-2007 credit and commercial system — minus the more egregious components. Get credit growing. Restart securitisation (minus the liar loans). Incentivise new borrowing and investment (minus reckless projects).

But that system rested on a set of beliefs about risk and returns that has been comprehensively shattered after it was proved false by the worst financial trauma in three generations. It cannot easily be recreated until the passage of time encourages a gradual forgetting. For now, caution about the outlook dominates cheap money and liquidity, rendering monetary policy temporarily impotent.

By cutting interest rates to zero and supplying unlimited liquidity to the banking system and other parts of the financial markets, central banks have limited explicit defaults and socialised the maturity risk in banks' loan books. Unconventional policies have averted Armageddon in the banking system and a worldwide depression.

But monetary policy cannot do more to restart growth. It cannot stimulate credit to the real economy. And it cannot put back the securitisation structures that fed much of the credit demand over the last two decades.

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In a Federal Reserve working paper on "Money, Reserves and the Transmission of Monetary Policy: Does the Money Multiplier Exist?" economists Seth Carpenter and Selva Demiralp observe that:

Since 2008, the Federal Reserve has supplied an enormous quantity of reserve balances relative to historical levels as a result of a set of non-traditional policy actions. These actions were taken to stabilise short-term funding markets and to provide additional monetary policy stimulus at a time when the federal funds rate was at its effective lower bound.

The question arises whether or not this unprecedented rise in reserve balances ought to lead to a sharp rise in money and lending. The results in this paper suggest that the quantity of reserve balances itself is not likely to trigger a rapid increase in lending.

"To be sure, the low level of interest rates could stimulate demand for loans and lead to increased lending, but the narrow textbook money multiplier (linking bank reserves to lending) does not appear to be a useful means of assessing the implications of monetary policy for future money growth or bank lending."

With rates now at zero, monetary policy can do no more. Adding more reserves does not stimulate lending.

The paper's findings chime with the Bank of England's struggle to explain how its vaunted quantitative easing (QE) programme works. The Bank is still unable to say how the effects of QE are transmitted to the real economy. It has struggled to identify any concrete benefits at all — beyond a rather nebulous improvement in asset prices.

STRUCTURAL PROBLEMS

Manipulating the yield curve through low rates and QE can shuffle money around within the financial system, redistributing income and wealth from creditors to debtors, and help banks and hedge funds make money by playing maturity transformation (whether in fixed income markets, currencies or commodities). What it cannot do is rebuild the expectations (about creditworthiness, risk and return) on which interactions between the financial sector and the rest of the economy depend.

Listening to the debate in recent weeks among policymakers and banks about the merits of more QE has sometimes seemed like listening to the band on the Titanic arguing about what tune to play.

There has been no discernible real-economy impact from QE programmes so far. There is no reason to expect expanding central-bank balance sheets another few hundred billion dollars would be more successful stimulating growth. Key financial institutions have been calling for an expansion of QE. But that is hardly surprising. So far they have been the only ones to show any benefit.

The bubble's collapse has laid bare a set of deep-seated problems (including oversupply of residential and commercial real estate, obsolete industrial capacity, imbalances between the public and private sectors, and mismatch between the unemployed and available jobs). Monetary policy can anaesthetise the adjustment, but because the problems are structural rather than cyclical, it cannot solve them.

Only when poor investments and excess capacity have been written down, expectations about employment have been tempered by realism, and the bottom has been plumbed, will the economy resume a more robust growth trend.

In theory, monetary policy could produce real effects if it could transform pessimistic expectations about the future.

But with so much support already failing to lift the caution, it is hard to see what more could be done on sufficient scale to provide a real and substantial transformation of beliefs. Even the Fed's legendary printing press would not work. Inflation has never been shown to produce real growth.

If the recovery is not as fast as some commentators (and anxious politicians) hope, there is nothing unusual in that, and more importantly there is nothing that monetary policy can do about it.

Perhaps one of the most misguided books on the economy in recent years was "Maestro", a hero-worshipping account which implied we could all sleep easy because Fed Chairman Alan Greenspan was deftly and single-handedly directing the economy.

Apparently, it fulfilled a deep-seated need, because the same hero worship and expectation of salvation has been transferred to Fed Chairman Ben Bernanke and his colleagues on the Federal Open Market Committee and at other central banks around the world.

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It is time to recognise the limitations of monetary policy. It can only do so much, and has already done all it can this time. The faltering recovery in financial and commodity markets in recent months suggests investors are beginning to realise there is no magic monetary solution, only a tough slog ahead.

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