Time for the big reset of monetary and fiscal policy

Column
Wim Boonstra, Allard Bruinshoofd and Elwin de Groot

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- **Financial markets are in complete disarray, though there is hardly any notable news on the real economy that justifies the timing of this panic**
- **Setting the timing issue aside, a loss of faith in policy makers worldwide appears to be the underlying cause of the market turbulence**
- **The discussion of the day is about how far down future interest may go, although it is completely unclear how this would help the real economy**
- **What we need is a big reset, meaning a coordinated normalization of the monetary situation, combined with a sizeable net fiscal stimulus**

Financial markets are in complete disarray. The frightening aspect is that there is hardly any notable news on the real economy that justifies the timing of this panic. The US economy is growing slowly but steadily. The Chinese economy is decelerating, but seems to have been bottoming out since the summer of last year. Several major emerging markets, such as Brazil and Russia are in deep recessions, but have been for quite some time now. Japan is caught in a severe liquidity trap, but that's hardly news for our generation of economists. The Eurozone is on average recovering slowly, although this average hides widely diverging trends between its member states and unsolved issues with some European banks. Yet, most, if not all of this, is really dated information. So where's the trigger that pushed markets in disarray?

Setting the timing issue aside for now, a loss of faith in policy makers worldwide appears to be the underlying cause of the market turbulence. The policy of quantitative easing, as pursued by central banks, has proven hardly effective, whatever the central banks' presidents say about this. Whilst ECB policy has been crucial in covering the fault lines within the eurozone government bond markets, a continued economic policy that only rests on a perpetual expansion of the monetary base, weakening currencies and pulling interest rates below zero, is ultimately unsustainable. The problem is that policy makers are already in uncharted territory. They don't know where they are and they have no idea what the exit looks like, let alone where to find it. It has been a leap of faith that is now feeling the return of the gravitational pull.

Lack of policy coordination

The challenges are common to most central banks, yet their solutions are pursued in isolation. That is where the real problem lies: the lack of international cooperation, both amongst central banks and between fiscal and monetary authorities. In the past, central banks were willing and able to cooperate in order to restore confidence in the economy. The famous Plaza and Louvre Agreements from the 1980s are good examples. Not only was there agreement back then among the global central banks on the policy to be pursued, they also immediately intervened in the markets in a coordinated way, putting their money where their mouths were. It worked. Today, cooperation between monetary policy makers appears to be all but absent.

The discussion of the day is about how far down future interest may go. It is completely unclear how this would help the real economy. Low (nominal) interest rates undermine the earning model of banks, destabilizing the banking industry, whatever bank supervisors try to do to prevent this. They are also harmful to insurance companies and pension funds. The impact via lower expected pension entitlement may actually stimulate additional household savings, dragging down consumer expenditure and thus weighing on the economic outlook. A further decline of interest rates could seriously worsen the situation. It seems markets have returned from their Christmas breaks and woken up to this fact and, to the surprise of many analysts and policy makers, they now react conversely to recent policy measures such as the Bank of Japan's step into negative policy rate territory or the ECB's announcement of further policy easing to come. The central banks, in short, are out of effective ammo.

Time for the big reset

How to get out of this mess? First, the expectations of an ever increasing monetary base and further decline of interest rates should be firmly eradicated. Second, positive inflation expectations should return. Third, the major central banks should show their ability and willingness to cooperate to repair the situation. This needs strong policy statements and immediate actions. What we need is a big reset, meaning a normalization of the monetary situation. What would happen if the central banks collectively would completely surprise financial markets with a sudden increase of worldwide policy rates of, let's say, 1%? Accompanied by a message that further bond buying is off the agenda? Once markets have got the message, a very gradual selling of parts of their portfolio of bonds could help in restoring a situation of a positive sloping yield curve. The ECB, of course, should operate very carefully in this, in order to prevent an explosion of yield spreads in the Eurozone. However, it might prevent this by - whilst selling bonds on a net basis - selectively buying governments bond of countries in the periphery of the Eurozone if spreads are rising too high. Of course, it would be even much better if Europe decided to mutualize public debt in the Eurozone by issuing conditional Eurobonds.

Initially, these actions would certainly shock markets, especially as inflation is still extremely low. Here fiscal authorities should play a positive role. A net stimulus consisting of an increase in VAT-rates and levies on energy, to finance part of a substantial decrease in taxes in wages, could help to restore both positive inflation expectations and increase consumer spending. The IMF may have to be provided with a special 'war chest' to alleviate the fallout that this may cause among emerging markets. Once markets realize that we have ended the liquidity trap, that central banks and fiscal authorities have regained their coordination of policies and that we have escaped a completely unsustainable policy and have in fact reset the system, confidence may return quickly.

To summarize, we feel that the problem is not that of a lack of money or restrictively high interest rates. On the contrary. We feel that we have become addicted to too much money and restrictively low interest rates. The best way to fight a serious addiction is a shock therapy. It is high time for the Big Reset.

Author(s)

Wim Boonstra

Chief Economist

+31 30 21 66617

Wim.Boonstra@rabobank.nl

Allard Bruinshoofd

International Research (IR)

+31 30 21 63272

Allard.Bruinshoofd@rabobank.nl

Elwin de Groot

+31 30 21 69012

elwin.de.groot@rabobank.com