Ashmore

Beyond ‘conventional unconventional’ policies

By Jan Dehn

Emerging Markets (EM) economies can be thought of as a flotilla of sturdy ships sailing on a sea of developed market risk. Policy makers in developed economies are now whipping up another storm and EM investors must beware of the potential consequences.

Having exhausted both conventional and ‘conventional unconventional’ easing options and with the short-term impulse from asset purchases fading, developed economies are now slowing again and a central question is what they can do when the next economic downturn takes hold. Their options are limited to increasingly distortionary, economically costly and ultimately ineffective policies unless they start to deal with their underlying debt and productivity issues.

Sadly, the rise of populism across most developed economies bodes poorly for reforms. Of all the developed economies, the US is probably least badly placed if only because it has a chance of inflating and devaluing its way out of debt. For investors, this will be costly and there is still time to escape the crash zone.

Introduction

As growth falters in developed economies policy-makers face an important choice –grab the bull by the horns and finally begin to deal with the enormous underlying debt and productivity issues, or double down on short-term stimulus and populism.

All indications point to more short-term stimulus and populism. In the US, the Fed continues to be very dovish despite near full employment. Congress has no appetite for reform and the leading presidential candidates are overtly protectionist. In Japan, there is no sign whatsoever of a ‘third arrow’, while nationalism and xenophobia are splitting the European Union apart precisely at a time when the region ought to be investing in building better institutions.

With no efforts to deal with the underlying growth impediments additional policy support will likely be required sooner rather than later. Unfortunately, conventional easing tools were exhausted a long time ago and policy-makers are now running out of ‘conventional unconventional’ policy tools. The next rounds of policy measures are likely to be distinctly third rate, even heterodox. Not only will such policies not encourage economic self-healing; if anything they will achieve the opposite.

EM investors also need to beware. Bad policies in developed economies can induce volatility in EM asset prices. Investors should look beyond such volatility; EM is one of the few genuine hedges against the slow steady decline in developed economies.

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Recap: The QE portfolio shift

How did we end up here? The answer is that policy-makers have paid far more attention to fixing the markets than to fixing the economy. Stock prices and the Dollar have benefitted from QE in the US, while bonds have gained from QE in Europe. Central bank sponsored asset purchases provided the initial impetus and institutional investors have since amplified the price action by jumping on the band wagon. Meanwhile, however, per capita incomes have evolved very modestly in both the US and Europe and inflation rates have been low and stable. In short, QE has placed a great wedge between the two.

In EM, the effect of QE was to create a negative wedge, i.e. lead to overselling of EM assets. Not a single EM asset price or currency is stronger today compared to developed markets than before QE. Indeed, EM bond yields started the year at higher absolute yields than when the Fed had rates at 5.375% at the end of 2006. Despite outflows from the assets class, however, sovereign defaults have been few and idiosyncratic, while HY corporate default rates are actually lower in EM than, say, among US HY corporates. EM growth has averaged roughly the same since 2011 than in the pre-crisis era (1990-2007), also with tame inflation.

The huge divergences of asset prices and currencies from fundamentals in both EM and developed economies represent an enormous portfolio shift. Capital has been moved, quite deliberately, into the QE markets, funded in large part by outflows from the non-QE markets, including EM (where no central banks embarked on QE).

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QE only provides temporary relief

A financial crisis occurs when financing that was previously available in abundance suddenly becomes scarce. When a financial crisis happens the only game in town becomes grabbing as much finance as possible, because there is not enough to go round. The policy response adopted by developed economies in the immediate aftermath of the Developed Market Crisis (DMC) of 2008/2009 was designed deliberately to attract capital back to developed economies so that they could avoid a depression. The policies resulted in a portfolio shift on a global scale that saw capital flow from the non-QE world to the QE world.[1]

The magnitude of the swing of capital from non-QE to QE markets in recent years and the recovery in asset prices are testament to the early success of this financing strategy. Unfortunately, the abundant flow of capital to the crisis economies has also had important negative side effects. Increasingly, it has become obvious to a wider audience that financing alone may be a necessary condition for recovery, but it is not a sufficient condition for recovery. At best, finance provides temporary relief, but if the underlying economic issues, which gave rise to the crisis in the first place are not addressed, then growth eventually stagnates.

The adoption of unconventional monetary policies after the DMC is partly to blame for the failure to reform. QE has had a dulling effect on the political willingness to address any underlying causes of the crisis

Negative side effect number one – neglect of reforms

Growth has stagnated for two reasons. One is that developed economies have uniformly failed to use the good times to implement the necessary reforms. Trend growth rates in developed economies are nearly 40% lower than in the decade and a half prior to the DMC.

The adoption of unconventional monetary policies after the DMC is partly to blame for the failure to reform. QE has had a dulling effect on the political willingness to address any underlying causes of the crisis. By pushing down interest rates and pushing up stock prices, QE policies have eliminated incentives to deleverage and undertake tough reforms to address the deeper productivity issues. The last few years have, in other words, been a massive opportunity lost.

Reasons to be (less) gloomy, part 2

QE has also caused a severe misallocation of global capital since the onset of QE. Specifically, EM countries, once the growth engine of the world, have been starved of capital as QE has sucked funding out of the region and into the already over-borrowed developed economies. In EM, these outflows fostered spread widening, currency weakness and tighter financial conditions, which in turn caused a cyclical slowdown.

Fortunately, EM countries did not suffer widespread defaults despite the financial stresses nor did they allow inflation get out of control despite meaningfully weaker currencies. There are now signs that EM growth will re-accelerate due to significant improvements in EM's external accounts.

Third rate policies coming up

Returns in developed markets have been waning as the marginal effectiveness of bubble policies decline. At the same time, the deeper economic problems that were exposed by the DMC are manifesting themselves again. This is clearly worrisome. It poses the difficult question of what policy options are available if the QE economies should enter a new economic downturn.

It is an inescapable fact that all economies, even overleveraged, unproductive QE ones, experience business cycles. The problem is that the conventional easing options were used up a long time ago and the 'unconventional conventional' ones are now rapidly nearing exhaustion too. What should policy makers do when the next recession hits?

The good news is that there are additional policy options available. The bad news is that they are third rate – far less effective and far more costly than the policies that have been implemented so far. The following section discusses some of the possible options available to policy-makers in developed economies.

Negative interest rates

The US is the only QE economy that has positive policy rates, though the room to cut is extremely small (25bps). Beyond a 25bps cut, the Fed would be pushing into negative rate territory. Negative rates have already been adopted in Europe and Japan. Rates could in principle be taken lower, but negative rates adversely impact banks by causing funding – deposits – to be withdrawn.

The fear of deposit withdrawal in response to negative rates has already stimulated a public debate about electronic money and the elimination of cash. This link is clear: curtailing cash effectively eliminates citizens' abilities to withdraw money from the banking system, thus closing off the main avenue for escaping the tax of negative rates.

Depositors can of course escape negative rates by moving money across borders from one banking system to another. To prevent this, it may be necessary to place restrictions on offshoring of funds too. The publishing of the 'Panama Papers' has given fresh impetus to this school of thought.

More QE

Central banks could engage in yet more purchases in secondary markets, the policy known as QE. However, the Fed indicated in no uncertain terms when it embarked upon 'Tapering' in May 2013 that it sees diminishing returns to QE.

One problem is that central banks are running out of fixed income securities to buy, particularly at the short end of yield curves and in Europe and Japan. But expanding the set of eligible securities to non-interest bearing securities presents non-trivial problems. Central banks face awkward funding issues when they stray from fixed income.[2] They also run into tricky political issues if, say, they bought stocks of specific companies.

[1] In addition to engaging in QE, the currencies of the US, UK, Europe and Japan account for 97% of global FX reserves, so these countries were able to create their own liquidity – and did so in abundance. Only reserve currency issuers can do this; this is why QE has only been pursued in the US, UK, Japan and Europe.

[2] What portfolio of stocks would, for example, provide reliable income to match the interest paid on reserves if interest rates go up?

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Then there is the thorny issue of bubbles. Some 50% of European government bonds already trade at negative nominal yields and yield curves out to several years in all developed economies currently trade at negative real yields. It is easy to get accustomed to such valuations, but they are clearly wrong. Bonds issued by governments in economies with major debt burdens and severe growth challenges should not trade at negative yields.

The bubble problem is not confined to bonds, however. Stock market valuations are also substantially higher today than before the crisis despite the evidently weaker economic landscape. Besides, despite having pushed financial asset prices much higher than before the DMC QE has so far proven entirely ineffective in encouraging banks to lend and households to borrow.

Central banks that engage in Helicopter Money create liabilities that have no corresponding assets. Hence, as soon as rates go up and the central bank has to pay interest on reserves it will start to lose money due to the absence of offsetting revenue on the asset side of its balance sheet

Helicopter Money

The policy of Helicopter Money is designed to address the problem of insufficient household spending. The central bank issues cheques to households or other economic entities. Households get cash directly in hand rather than cheap credit as under QE, so it is hoped that they will be more prone to spend, though this is not a given.

Unfortunately, central banks that engage in Helicopter Money create liabilities that have no corresponding assets. Hence, as soon as rates go up and the central bank has to pay interest on reserves it will start to lose money due to the absence of offsetting revenue on the asset side of its balance sheet.

The only ways for central banks to cover for the missing interest income are inflation tax or raising reserve requirements on banks; neither is attractive. Killing banks hardly helps the economy, while the experience with inflation taxes, particularly in Eastern Europe in the aftermath of the fall of the Berlin Wall, is that it quickly loses its effectiveness as the money demand starts to shift in response to changing inflation expectations.

Of course, if a country genuinely wants to inflate and devalue its way out of its debt problem then Helicopter Money would be a quick and effective way to do so. Just make sure you don't own the currency.

Central bank financing of the government

Direct monetary financing of governments by central banks is probably the most likely policy to be implemented in the event of a significant downturn in developed economies today.

Unlike QE where central banks buy securities in the secondary market this policy sees the central bank buy government bonds in the primary market. The central bank prints to buy the bonds and the government passes the money to households through, say, tax cuts or increased spending.

Unlike pure Helicopter Money, the central bank's liabilities are matched by an increase in assets – government bonds. The problem is that government debt rises. Most developed governments are already heavily indebted, having run fiscal deficits in non-crisis periods for years on end. Indeed, many developed economies today have debt levels bordering on or outright exceeding sustainable levels.

This means that if markets lose faith in the ability or willingness of the government to repay its debt in full the central bank holding the bonds can suffer capital losses and/or loss of principal.

Of course, regardless of whether central banks finance households directly or via the government there is still no guarantee whatsoever that private banks will lend or that households will spend.

Ricardian Equivalence – the notion that households take into account future tax burdens arising from rising debt levels into account when deciding how much to spend today – is clearly also a problem under this type of policy.

Bond financing

Pure bond financing does not involve the central bank. The government simply spends more or cuts taxes and finances the resulting deficit by issuing more bonds into the bond market.

The problems with this policy are numerous and rise exponentially in the volume of issuance.

- Governments are already very indebted, so there is limited room to use this policy.
- The additional supply of bonds will crowd out private sector financing and therefore hurt growth (empirically a strong positive relationship exists between indebtedness and weak growth).
- Markets may increasingly refuse to buy the bonds, in which case the policy will only work if accompanied by additional financial repression, such as policies to force pension funds and insurance companies to buy ever more debt.
- There are good reasons to fear Ricardian Equivalence under this policy, i.e. households may increase savings rates rather than reduce them.

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Directed lending

Policies that force banks to make specific loans to specific sectors at specific prices – directed lending – have been used extensively in the most heterodox economies of the world, such as Argentina and Venezuela. Banks are typically given defined lending destinations, often accompanied by ceilings on the interest rates they are allowed to charge. In turn, this reduces interest rates that banks pay to savers and thus financial intermediation and growth suffers. Money ends up under the mattress.

No one has explicitly touted such policies in developed economies in recent years, but we only have to go back to the immediate aftermath of the DMC when some sections of the establishment in Britain proposed to use newly nationalised banks for direct lending. Such ideas could easily come back in the event of a recession, in our view. The policy has strong emotional appeal, because it directly addresses the difficulties encountered in getting banks to lend. Experience from other parts of the world, however, clearly shows that this particular cure can be significantly worse than the disease.

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Currency manipulation and trade protectionism

When short-term stimuli lose their effectiveness and productivity deficiencies undermine competitiveness the temptation to manipulate currencies and/or intervene in free trade grows stronger.

Governments are always vulnerable to the targeted lobbying efforts of focused interest groups. Once the decision has been taken to protect one group the incentive for others to rent-seek rises sharply. Eventually, more and more economic resources go into securing and defending existing privileges ('rents') at the expense of risk-taking and long-term productive investments.

Protectionism renders the economy less efficient as resources are allocated by means other than the price mechanism. Capital controls of various kinds often accompany such policies in order to prevent flight capital. Once controls are in place, parallel exchange rates emerge and corruption and other bad practices follow soon after.

Why worry?

This list of bad policies is not exhaustive. Such policies tend to be implemented despite their low quality because they buy time and give the impression of action, while avoiding the tough issues. But the repeated reliance on band aid policies while neglecting the underlying problems tend to worsen the underlying problems. This is exactly where the policy discussion in developed economies is heading these days.

EM can teach policy-makers a great deal about bad policies. Many EM countries pursued such policies between the1950s and the 1980s and the lessons are unambiguous – heterodox policies do not work. They produce ever more marginal benefits at ever greater costs to the economy. They become more difficult to unwind with time. They reduce economic flexibility, induce rent seeking, distort incentives, and weaken growth. They worsen debt dynamics and can be seriously inflationary and even encourage capital flight. They encourage corruption. In the final equation, they lead to outright crises.

Focus on debt

Policy-makers in developed economies face three main problems:

- Low productivity
- Too much debt
- Overvalued currencies and asset prices

Clearly, correcting all three at the same time would be extremely difficult. Governments would have to pass difficult fiscal reforms and invest in infrastructure and human capital to raise productivity. Deleveraging would trigger recessions and correcting asset prices would require monetary tightening and therefore recession. This is why they are not being done. There is simply no appetite for 'the full Monty'.

Given these constraints, developed economies ought to focus on the debt problem. The options for bringing down debt are: Repay, default, or inflate and devalue the debt away.

Most countries will try their best to avoid default in the conventional sense and have the means to do so, say, by leaning more on financial repression. With reforms and other productivity enhancing measures unlikely due to political populism inflation and devaluation are the main realistic means of exiting the debt overhang.

Inflation and devaluation

Of all the Western economies, the US economy is best placed to avoid the most grievous third-rate policies listed above. But this is only because the US is in the better position to inflate and devalue its debt burden away. The US recapitalised its banks early in the DMC, while massive purchases of mortgages from banks by the Fed helped households to deleverage. House prices are appreciating too, so if the US manages to avoid recession then inflation should be forthcoming within the next year or so. Unfortunately, the Fed will find it difficult to tighten policy meaningfully due to a number of factors, including an already over-valued Dollar, sky-high equity and bond market valuations, record low productivity and therefore trend growth and the ongoing recessions in manufacturing and the energy sector. Inflation will therefore put the Fed face to face with a tough dilemma: to protect low tepid growth rates in exchange for living with higher inflation, or to fight inflation at a major cost to the economy. Faced with this choice, we think the Fed opts to protect growth over price stability.

Inflation and associated Dollar weakness are not first-best, but nevertheless economically and politically feasible means to get the debt burden down. They would rob future generations and foreign investors with assets denominated in Dollars of their wealth. While this is sad for them, it works quite well politically within the US, because present generations of voters would be spared the pain of adjustment and reform. Those who end up paying – future generations and foreigners – do not vote in current US elections.

Since capital flows tend to follow currencies, a weaker US dollar would help to move capital back into EM countries, where each Dollar can produce a much larger bang for the buck in terms of growth than in developed economies

A weak Dollar is good for the world – and for the US

The main challenge in implementing an inflation-led deleveraging policy is to ensure that the Dollar declines in an orderly fashion (and of course to ensure that inflation does not get completely out of control). The best way to do this is to reach a global currency accord, whereby the Dollar can decline in an orderly way, carefully managed by coordinated global central bank action.

A weaker US dollar would be positive for global growth. The last few years of exorbitant Dollar strength has clearly been counter-productive, initially to the rest of the world, now to the US as well. A lower Dollar would support commodity prices and help the beleaguered shale and manufacturing sectors. The American economy would be able to lean more on net exports as a driver of growth while the domestic economy reforms and deleverages.

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The downside for EM is that currency appreciation could eventually pose a challenge to some EM exporters. But the starting point is one of very weak EM currencies and the investment accompanying inflows would provide offsetting increases in productivity, particularly if the funds are channelled into infrastructure (as China has shown over the past several decades).

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Conclusion

Forewarned is forearmed – understanding what could be on the way should help investors to appreciate the potential looming dangers.

Many of the new policy ideas bandied about in developed economies belong in the realm of the truly heterodox. Experience shows that such policies are ineffective at best.

One potential fall-out from more heterodox policies in developed economies is volatility in EM asset prices, though real risks – as in large permanent losses – are much smaller. More often than not the volatility that arises from wonky policy decisions in developed economies turns out, in retrospect, to be excellent entry points for investors looking to add to EM positions. Last year's exaggerated fears over Fed hikes are a case in point; EM bonds have outperformed developed market bonds significantly this year.

EM investors should take comfort that they are in the right asset class, particularly if policies go really haywire in rich countries. As for those investors who are still invested in developed markets regard this as a warning; there is still time to escape the crash zone, but the clock is ticking ever louder.

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