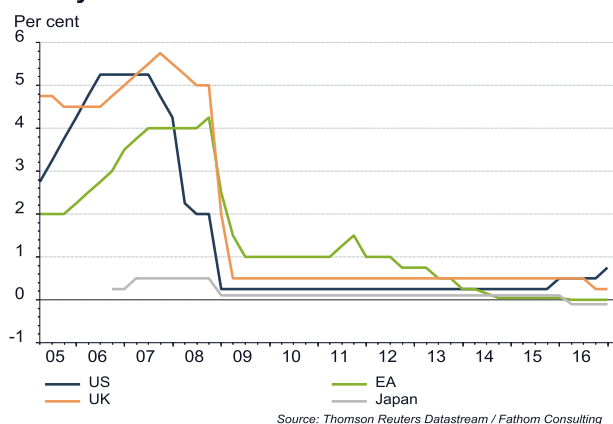


Productivity puzzle: the drugs don't work

- Since the financial crisis, monetary policy has stimulated demand but developed economies have failed to reach 'escape velocity'.
- In our view, ultra-low interest rates are the problem – not the solution – progressively undermining the supply side.
- Demand stimulus cannot improve long-run supply fundamentals, but it can make them worse.
- The solution is for yields to rise, with a fiscal stimulus to soften the blow in the short term: a policy mix that may be coming in the US right now.

Low interest rates in the US and elsewhere are no longer part of the solution. They are part of the problem.

Policy rates

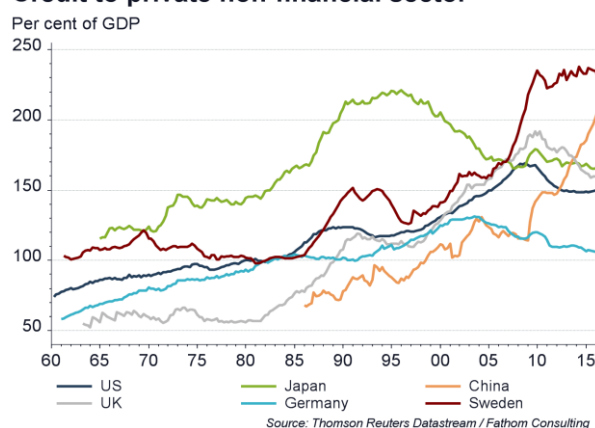


The decline in interest rates has deep roots. It started with China and other developing nations exporting both savings and disinflation to the developed world, leading policymakers here into error. By freeing up the banking sector, we believed we had permanently reduced risk and the price of credit. By cementing central bank independence, we believed we had achieved unprecedented levels of monetary credibility and stable inflation.

We were wrong. Like an episode of House, the first diagnosis is always wrong.

Misdiagnosis led to incorrect policy – too loose for too long – and to a colossal build-up of credit and asset prices ahead of the financial crisis. The recession saw asset prices fall but the accumulated credit, largely, remained in place.

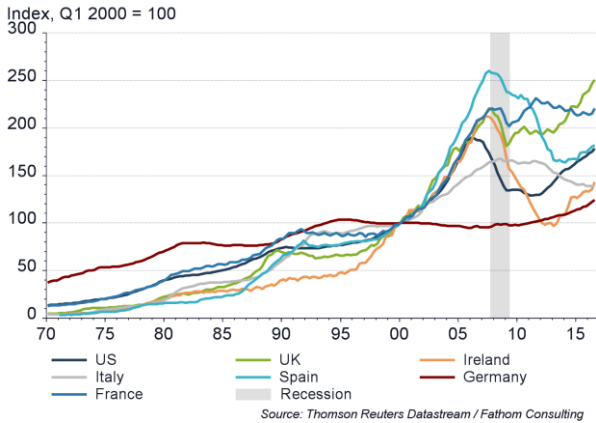
Credit to private non-financial sector



High credit and low asset prices meant that the banking system faced insolvency. The policy response was a mix of: injections of central bank liquidity to prevent an implosion; fiscal injections into the banking system to increase their capital; and massive monetary loosening to stimulate demand and cause asset prices to

recover. Emergency measures that have remained in place for eight years.

House prices



Since the recession, monetary policy (conventional and unconventional) has kept the banking sector afloat, by keeping banks liquid and asset prices high; and has stimulated demand, through wealth effects and by encouraging borrowing. But, as the years have gone by, developed economies have failed to reach 'escape velocity' in the words of Mark Carney.

Current thinking in central banks goes: zero interest rates plus quantitative easing are not working, so the natural interest rate must have fallen. Policy needs to be much looser than it is. Monetary stimulus has maxed out. So now is the time for fiscal stimulus to boost demand.

Wrong again. The second diagnosis is also always wrong.

Enter Gregory House MD, with the third diagnosis: the correct one.

What if the problem is not a lack of demand, but a lack of supply? And what if the current prescription – loose monetary policy – is making that problem worse?

Low interest rates affect the supply side in many ways. They lead to low corporate death rates — if companies can borrow cheaply, they can stay alive for longer. They support excessive asset prices, including house prices, which drive up inequality, reward unproductive activities like buy-to-let investing, and cause labour market mismatch. They lead to low foreclosure rates, so resources remain tied up in activities that yield the prevailing interest rate – zero. They encourage labour hoarding, as firms can borrow to hang on to staff on the expectation of better times in future. And they bid down the required return on new investment towards the prevailing (low) real cost of capital.

US company failures and policy rate



US company failures and productivity growth



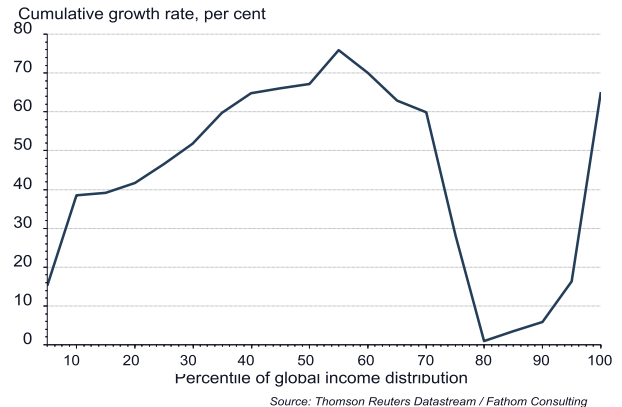
In short, low interest rates lead to zombification, progressively undermining productivity growth across the whole economy. Low rates stimulate demand, but they progressively undermine supply. Fiscal stimulus has the same effect through different channels.

If the problem were insufficient demand then policy stimulus, monetary or fiscal, would be appropriate. But if it is insufficient supply – the third diagnosis, correct in our view – then it is not just wrong but potentially damaging.

What would insufficient supply look like? Unemployment at equilibrium rates: check. Low growth in productivity: check. Large current account deficits: check. Low saving rates: check. High ratios of asset prices to GDP: check. High ratios of credit to GDP: check. High inflation – that box goes unchecked. That is the dog that did not bark.

Inflation is low across the developed world, at least for now. But we are still importing disinflation from China and from the rest of the developing world. That pesky dog has led us into error before; let it not do so again. Disinflationary pressure comes not only through imports of cheap goods and services, but through downwards pressure on wages in developed countries thanks to globalisation – illustrated in the famous Milanovic 'elephant chart'.

Global growth incidence curve 1988-2008



The solution? If the problem is too much debt, the solution cannot be more debt (whether government, corporate or household debt). We need to move from a high-debt/low yield equilibrium to a normal debt/normal yield equilibrium. There are three ways to achieve that: more growth, but not fuelled by credit; debt deleveraging; or debt default through haircuts and/or inflation.

The first is very difficult, otherwise policymakers would always choose that option. The second was the route chosen in the 1930s, and look where that led. The third is politically unpalatable, as it involves greatly reducing the wealth of those who hold assets, probably through substantially higher inflation, probably achieved through a big but temporary fiscal splurge and accommodative monetary policy. Who would vote for that? Eh, Mr President?

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