VIEWPOINT:

THE PITFALLS OF POST-CRISIS POLICYMAKING

By **PETER HENSMAN,** Global strategist

WORKING LIKE CLOCKWORK?

Authorities in the major regions appear confident about the economic outlook. In this article, our strategist **Peter Hensman** questions this confidence. He explores the distortions caused by policymaking in the wake of the global financial crisis, and the prospect that they might actually accelerate disinflationary trends, which would exacerbate, in turn, the challenges faced by debt-burdened economies.

Authorities appear to believe that the 'portfolio balance' effect (of rising asset prices and ensuing confidence among households and businesses) is finally channelling success from Wall Street to 'Main Street'. In this context, we have regularly referred to the diagram in exhibit 1, which represents the official view of how monetary policies are supposed to create a virtuous economic cycle.

According to this view, success in firing up the economic machine leaves policymakers needing only to look out for diminishing spare capacity, and other precursors of consumer-price inflation, before they consider any significant change in policy.

Could anything undermine policymakers' faith that, barring rising nominal interest rates, economic momentum will be sustained?

EXHIBIT 1: LARGE-SCALE ASSET PURCHASES

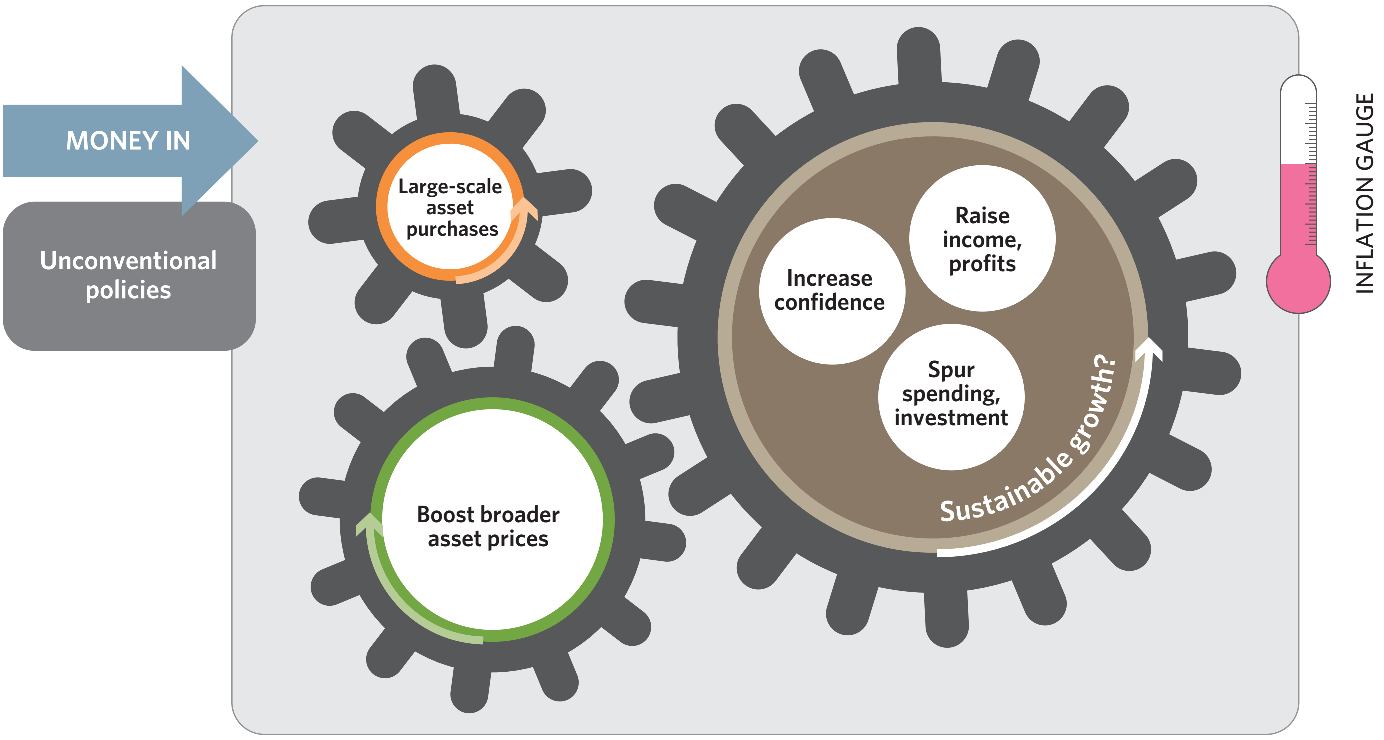

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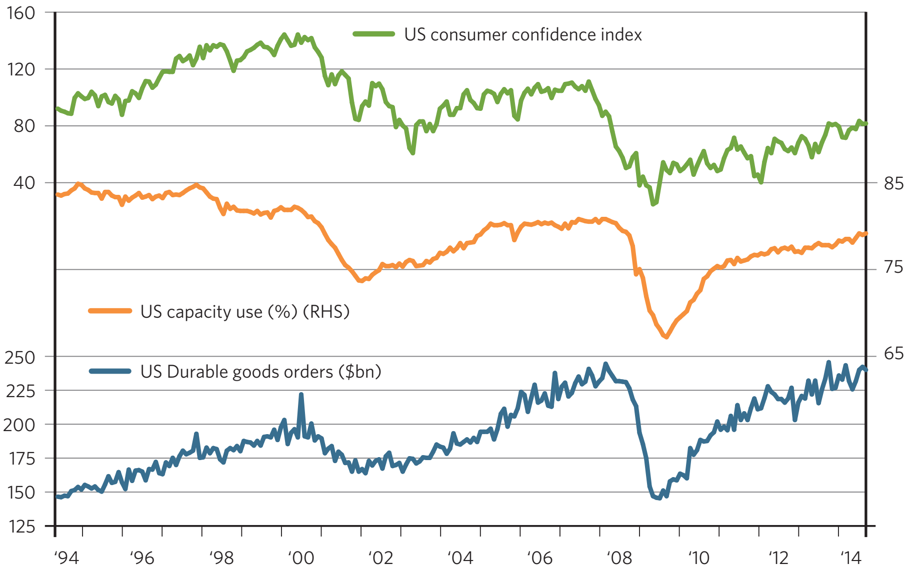
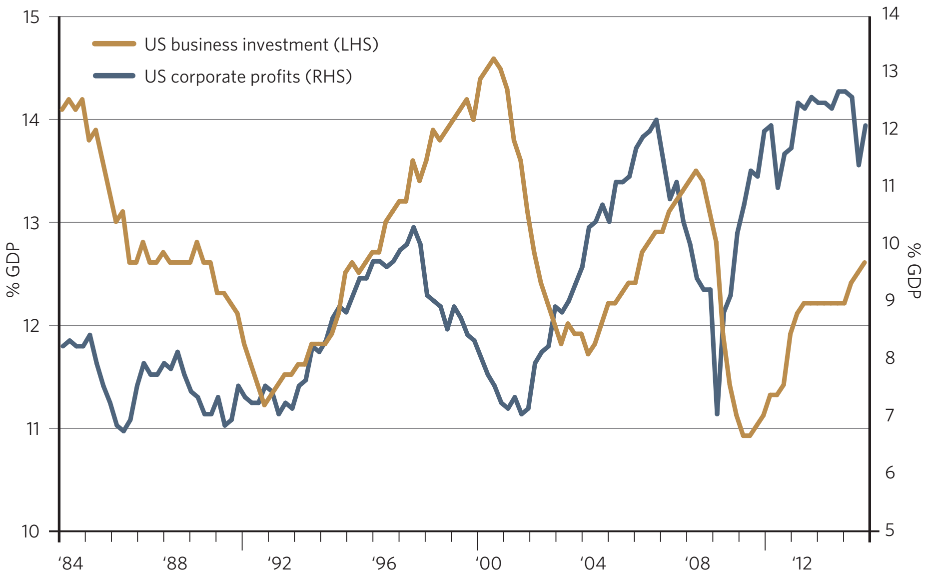
EXHIBIT 2: US CONSUMER CONFIDENCE, CAPACITY USE AND DURABLE GOODS ORDERS



Source: Thomson Reuters Datastream, September 2014. Rising confidence and capacity use matter for rising investment. A high level in either series is insufficient, by itself, to lift capital expenditure. (Note also, neither is there any 'normal' level at which confidence or capacity use tends to peak. Levels in 2007 were below those of the late 1990s.)

EXHIBIT 3: US BUSINESS INVESTMENT AND PROFITS AS PERCENTAGE OF GDP



Source: Thomson Reuters Datastream, September 2014.

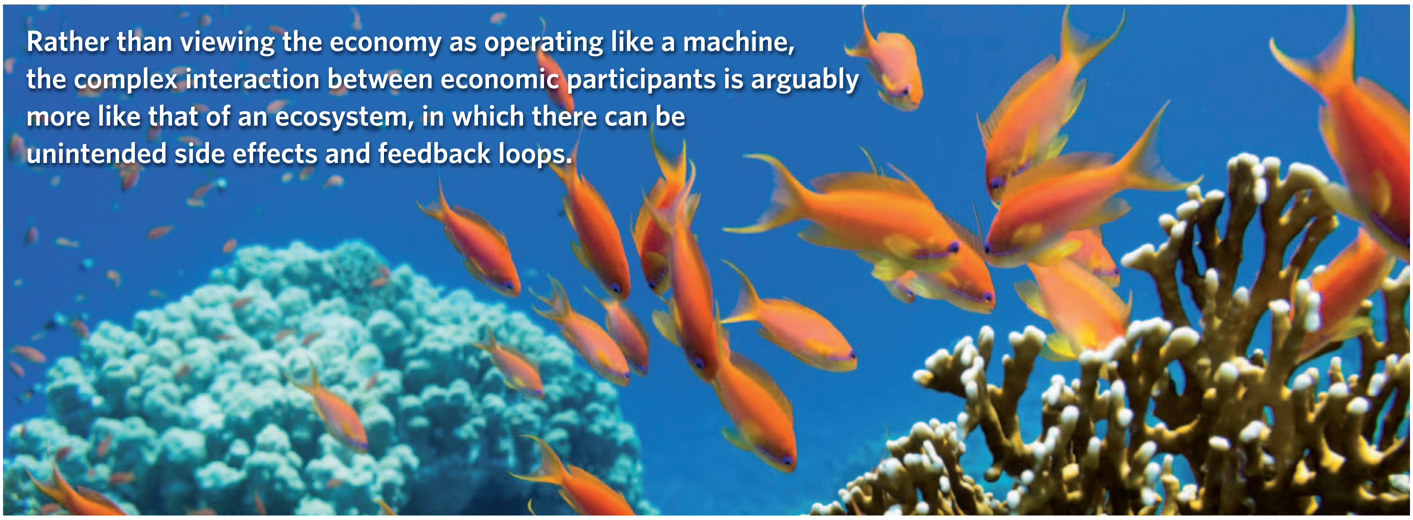
Is a high rate of capacity utilisation sufficient for continued business investment?

Official forecasts assume that capital expenditure by businesses will be a key driver of GDP growth in the years ahead. Across the globe, projections of rising activity rely on high levels of business confidence, combined with low spare capacity, to justify expectations of increased capital spending. But has there ever been an economic cycle during which confidence was not high as the cycle was reaching its peak? As exhibit 2, which plots US durable goods orders (a lead indicator of business investment) against industrial capacity utilisation and consumer confidence, shows, it is *rising* confidence and *increasing* capacity usage that are essential precursors to the enlargement of business capital expenditure.

Clearly, the fact that capacity use is high is not a sufficient condition on its own to signal a further increase in business investment spending. The reason that investment starts to rise when capacity use is still near the recession trough, and when confidence is low, is because the main driver behind the decision to expand productive capacity is the opportunity for profit.

As exhibit 3 highlights, it is the lowest point in the profit margin cycle that is the precursor to rising investment spending. As such, given current (record-high) profit margins, profitability, and therefore investment, may be at a cyclical peak.

Instead of a self-feeding cycle of rising confidence and activity, it appears that over-expansion threatens to undermine pricing and profitability, as over-confidence encourages more aggressive capacity expansion.



Does quantitative easing exacerbate deflationary trends?

The poor job done by authorities' pre-financial-crisis economic models in predicting both the downturn in economies which followed the crisis and the sluggishness of the recovery has not altered official reliance upon their outputs. As the only way in which an economic cycle has come to an end in recent memory has been via the mechanism of central banks raising interest rates in the face of tightening spare capacity, it is assumed that this will be the way in which the current cycle ends.

The factor upon which most central banks are focused is the unemployment rate. Without an unacceptable acceleration in wage pressures, mounting 'animal spirits' are forecast to continue to underpin growth. To many investors, this means that the only possible cause of financial-market weakness is the return of central-bank policy to 'normal' settings.

However, the unusual nature and extent of monetary intervention could, we believe, contribute to a different kind of cycle from this 'norm'. Ultra-cheap credit for corporations may, we think, lead to aggressive price competition which undermines nominal GDP growth and corporate profitability.

Instead of a self-feeding cycle of rising confidence and activity, it appears that over-expansion threatens to undermine pricing and profitability, as over-confidence encourages more aggressive capacity expansion. A number of airline operators, for example, have followed Lufthansa in warning that profitability will be negatively affected by the expansion of capacity across a range of routes. Worse still, the pace of technological change is forcing companies to invest, or risk being left behind, as increasing numbers of shoppers access retail sites via their mobile phones.

It is not just 'old economy' companies that have been affected. The serial acquisitions by technology companies increasingly reflect the battle to remain relevant. Growing competition is reflected across the new economy landscape. Examples include Twitter's purchase of MoPub in 2013, via which it is seeking to build its mobile advertising presence as a means of growing revenues, and Yahoo's multiple acquisitions this year. Meanwhile, Facebook has bought WhatsApp and Oculus VR – the maker of virtual-reality headsets – as part of its mission to challenge the positions of Apple and Google as the dominant platforms of the future.

Despite the intention, monetary policy which targets asset-price appreciation seemingly accelerates this pace of change. In the absence of significant economic traction, ultra-loose policy boosts asset valuations, as well as the appeal of 'story' stocks that promise future growth.

As valuations rise, the ability of new companies to expand increases – not just in terms of their greater access to finance, but also via their use of (highly valued) paper as a currency for acquisition. Both routes serve further to disrupt existing business structures. While the abundant availability of cheap credit means incumbent corporations are able to sustain dividend payments and employment in the near term, the increase in indebtedness that this encourages heightens the fragility of these organisations in the longer run. As fixed costs increase, any revenue shortfall is likely to be even more catastrophic. Outstanding US non-financial corporate debt has grown by more than 30% in dollar terms from its 2007 level and, as exhibit 4 below shows, it is now 10% *above* the level, relative to GDP, that contributed to the *corporate* credit crunch at the beginning of the millennium.

With low interest rates encouraging a hunt for yield, a further phenomenon has been the ability of firms to 'term-out' their debts (i.e. switch short-term borrowing to long-term debt). For each individual business, this reduces the near-term threat to operations from the need to refinance. In aggregate, the result is that competition can remain more intense for longer because the point at which weak businesses fail is postponed. With heavily indebted firms setting prices to sustain near-term cash flows, rather than targeting profit maximisation, the downward pressure on prices could well be exacerbated, contrary to the intention of policymakers seeking to erode the real value of debts via higher inflation.

Even the 'success' of generating wage inflation need not create the virtuous cycle of demand to which policymakers aspire if higher wages lead businesses to cancel or reduce their growth plans. The decline in profitability associated with higher input costs gives a strong signal to firms to slow or stop expansion. The ultimate consequence is likely to be slower wage and employment growth as firms seek to reduce their reliance on higher-cost labour.

Conclusion

Instead of supporting a virtuous cycle of rising demand and pricing power, which can only play out in the same way as the economic cycles of the last 40 years, the distortions wrought by the post-crisis policy response could result in very different outcomes. Rather than viewing the economy as operating like a machine, the complex interaction between economic participants is arguably more like that of an ecosystem, in which there can be unintended side effects and feedback loops.

With policy having enhanced the availability of cheap debt and equity finance for companies, capacity growth has been boosted and technological disruption of incumbent businesses has been accelerated. The outcome of this has been an intensification of competitive pressures.

EXHIBIT 4: US NON-FINANCIAL CORPORATE DEBT AS % OF GDP

Thomson Reuters Datastream, September 2014.

Policymakers, who wish to see a strong correlation between rising employment and GDP, as well as further improvement in financial prospects, could find their projections derailed.

The lesson of focusing on real economic variables, learned during the inflation-prone era of the 1970s, may be less relevant in the debt-burdened world of today.

The increasing squeeze on corporate profit margins is likely to contribute to greater price reductions as businesses seek to support sales volumes and cash flow by undercutting competitors. As a consequence, price pressures can be expected to diminish. The hoped-for cycle of rising confidence and business investment is equally likely to be short-circuited by stubborn fixed costs that further squeeze profits. As concerns about profitability mount, continued disappointment at the pace of nominal GDP growth is likely to undermine sentiment towards credit and equity markets too.

In short, as loose monetary policy boosts financial asset prices and capital expenditure, disinflationary price trends could be accelerated and the challenges for an indebted world exacerbated. The lesson of focusing on real economic variables, learned during the inflation-prone era of the 1970s, may be less relevant in the debt-burdened world of today.

FURTHER INFORMATION

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