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QE likely to impair living standards for generations

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INSIGHT

New monetary orthodoxy is likely to permanently impair living standards for generations to come, while creating a false perception of reviving prosperity.

As economic growth returns again to Europe and Japan, the prospect of a synchronous global expansion is taking hold. Or, then again, maybe not. Bank of America Merrill Lynch has projected that world economic growth, as measured in nominal US dollars, will decline in 2015 for the first time since 2009.

In fact, the prospect of improvement in economic growth is largely a monetary illusion. No one needs to explain how policy makers have made painfully little progress on the structural reforms necessary to increase global productive capacity and stimulate employment and demand. Lacking the political will necessary to address the issues, central bankers have been left to paper over the global malaise with reams of fiat currency.

With politicians lacking the willingness or ability to implement labour and tax reforms, monetary policy has perversely morphed into a new orthodoxy where even central bankers admittedly view it as their job to use their balance sheets as a tool to implement fiscal policy.

One argument is that if central banks were not created to execute fiscal policy, then why require them to maintain any capital at all? Capital is that which is held in reserve to absorb losses. If losses are to be anticipated, a reasonable inference is that a certain expectation of risk must exist. Therefore central banks must be expected to take on some risk for policy purposes, which implies a function beyond the creation of a monetary base to maintain price stability.

What kinds of risk are appropriate for a central bank? Well, the maintenance of a nation's banking system would plainly be in scope, given the central bank's role as lender of last resort. The defence of the currency as a store of value and medium of exchange is another appropriate risk. This was the apparent motivation of Mario Draghi, European Central Bank president, for his famous promise to defend the euro at all costs made in the summer of 2012. The central bank balance sheet has proved a flexible tool limited in use only by the creativity of central bankers themselves.

In response to those who argue against the metamorphosis of monetary policy into fiscal policy, one need only point toward the impact of quantitative easing on interest rates. The depressed returns available on fixed income securities, largely as a result of QE, are a tax on investors, including savers, pension funds and insurance companies.

Essentially, monetary authorities worldwide are levying a tax on investors and providing a subsidy to borrowers. Taxation and subsidies, as well as other wealth transfer payment schemes, have historically fallen within the realm of fiscal policy under the control of the electorate. Under the new monetary orthodoxy, the responsibility for critical aspects of fiscal policy has been surrendered into the hands of appointed officials who have been left to salvage their economies, often under the guise of pursuing monetary order.

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The consequences of the new monetary orthodoxy are yet to be fully understood. For the time being, the latest rounds of QE should support continued US dollar strength and limit increases in interest rates. Additionally, risk assets such as high-yield debt and global equities should continue to perform strongly.

But in the long run, classical economics would tell us that the pricing distortions created by QE will lead to a suboptimal allocation of capital and investment, which will result in lower output and standards of living over time. In fact, although US equity prices are setting record highs, real median household incomes are 9 per cent lower than 1999 highs. The Bank of America Merrill Lynch research plainly supports the conclusion that QE and associated currency depreciation is not leading to higher output.

The cost of QE is greater than the income lost to savers and investors. The long-term consequence of the new monetary orthodoxy is likely to permanently impair living standards for generations to come while creating a false illusion of reviving prosperity.

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Fiat currency is a form of currency that a government has declared to be legal tender, but is not backed by a physical commodity.