THE BIG QUESTION
behind IMF's gloomy outlook

Quantitative Easing: Saviour of the Economy and the Financial System, or Wrecker of Society?

Bart Le Blanc

- *The world economy is slowing down, due in part to an unholy alliance between a late stage economic cycle (overdue), the normalisation of interest rates (overdue), and trade wars and geo-political and social tensions.*
- *Growth in China, Europe and emerging economies is subdued; outlook for the US is not pretty.*
- *Expansionary, unconventional, monetary policy of Quantitative Easing was successful in fighting the financial crisis of 2008/2009 and saving the economy and the financial system, however the micro economic impact of QE, particularly its effect on income/wealth inequality, was generally ignored.*
- *Increased inequalities have fed unrest among broad groups, and lead to fierce social protests in different countries (e.g. recent "gilets jaunes" actions in France).*
- *Populist political movements in Europe and the US are thriving in this new world of social tensions.*
- *Governments need to re-assess their social economic policy approach and not rely too much on broad based macro/monetary policies.*
- *"Bolt" political action including re-building social cohesion are needed. Macron's national debate initiative demands support and should be copied. One might consider reviving of the old Dutch "Polder model".*

1. *"Slowing growth" and, "increased risks"* are key phrases in the IMF's latest economic outlook (*"A Weakening Global Expansion", IMF World Economic Outlook Update, January 2019).*
   In its analysis the IMF points to an unholy alliance between the late stage economic cycle (long overdue), the end of massive monetary stimulus, and a series of economic, political and financial upsets that darken the current economic outlook.

On the economic front: with the Chinese economy having risen to second place (globally), we note the increased impact of a slowdown in world growth. The necessary regulatory tightening of Chinese financial institutions has put a brake on the supply of credit, and thus on growth capacity, moreover the trade war with the US has had a negative impact on Chinese export growth.
We should not forget that China's GDP growth of just above 6% p.a. is still high by Western standards and the growth levels over the last 5 years have been between 6 and 7 %. The earlier 10%-plus growth levels are in a more distant past and belong to a different type of China (one with low household consumption base).

However, some European countries are vulnerable in their economic outlook; such as Germany (new car emission regulations affecting automotive industry), France ("gilet jaunes" protests) and Italy (populist/nationalist government policies).
The UK continues to suffer from Brexit uncertainties, which holds back investments on a broad scale.
Pressures on commodity prices, and their recent volatility, (particularly of oil) has depressed the economic outlook of emerging economies.

On the political front, Trump's government-by-Twitter dominates all international issues such as trade and security. The economic impact of trade wars with China and the government shut down in December/January cannot be neglected in their negative effects on future US growth.
Emerging nationalist tendencies in European countries such as Poland, Hungary and Italy (and far from dormant in France and Germany) are de-stabilising the European model and are frightening markets.
In financial markets we have seen increased volatility and repricing of risk as evidenced in both equity valuations and credit spreads.

The long anticipated normalisation of European monetary policy should normally lead to higher interest rates. However, these could be derailed by flights to safety in the stronger economies (see German and Swiss government bond rates).

The impact of all these factors on the economic growth forecast is very visible in the table below: slowing GDP growth outlook for China, Europe and the emerging economies. The US has only had a temporary respite and its outlook for the next years is also depressed.

	Year over Year								
					Difference from Oct 2018 WEO Projections 1/		Q4 over Q4 2/		
		Estimates	Projections				Estimates	Projections	
	2017	2018	2019	2020	2019	2020	2018	2019	2020
World Output	**3.8**	**3.7**	**3.5**	**3.6**	**–0.2**	**–0.1**	**3.5**	**3.6**	**3.6**
Advanced Economies	**2.4**	**2.3**	**2.0**	**1.7**	**–0.1**	**0.0**	**2.1**	**1.9**	**1.7**
United States	2.2	2.9	2.5	1.8	0.0	0.0	3.0	2.1	1.5
Euro Area	2.4	1.8	1.6	1.7	–0.3	0.0	1.2	1.9	1.5
Germany	2.5	1.5	1.3	1.6	–0.6	0.0	0.9	1.7	1.5
France	2.3	1.5	1.5	1.6	–0.1	0.0	1.0	1.6	1.5
Italy	1.6	1.0	0.6	0.9	–0.4	0.0	0.2	1.2	0.6
Spain	3.0	2.5	2.2	1.9	0.0	0.0	2.3	2.1	1.6
Japan	1.9	0.9	1.1	0.5	0.2	0.2	0.6	0.0	1.6
United Kingdom	1.8	1.4	1.5	1.6	0.0	0.1	1.3	1.5	1.6
Canada	3.0	2.1	1.9	1.9	–0.1	0.1	2.0	1.8	1.9
Other Advanced Economies 3/	2.8	2.8	2.5	2.5	0.0	0.0	2.8	2.3	2.9
Emerging Market and Developing Economies	**4.7**	**4.6**	**4.5**	**4.9**	**–0.2**	**0.0**	**4.7**	**5.0**	**5.0**
Commonwealth of Independent States	2.1	2.4	2.2	2.3	–0.2	–0.1	2.4	1.8	1.9
Russia	1.5	1.7	1.6	1.7	–0.2	–0.1	2.2	1.4	1.7
Excluding Russia	3.6	3.9	3.7	3.7	0.1	0.0	. . .	. . .	. . .
Emerging and Developing Asia	6.5	6.5	6.3	6.4	0.0	0.0	6.3	6.4	6.3
China	6.9	6.6	6.2	6.2	0.0	0.0	6.4	6.2	6.2
India 4/	6.7	7.3	7.5	7.7	0.1	0.0	7.1	7.6	7.7
ASEAN-5 5/	5.3	5.2	5.1	5.2	–0.1	0.0	5.1	5.1	4.7
Emerging and Developing Europe	6.0	3.8	0.7	2.4	–1.3	–0.4	1.3	2.1	1.6
Latin America and the Caribbean	1.3	1.1	2.0	2.5	–0.2	–0.2	0.3	3.0	1.9
Brazil	1.1	1.3	2.5	2.2	0.1	–0.1	1.9	2.4	2.2
Mexico	2.1	2.1	2.1	2.2	–0.4	–0.5	2.1	2.3	2.1
Middle East, North Africa, Afghanistan, and Pakistan	2.2	2.4	2.4	3.0	–0.3	0.0	. . .	. . .	. . .
Saudi Arabia	–0.9	2.3	1.8	2.1	–0.6	0.2	4.1	1.0	2.2
Sub-Saharan Africa	2.9	2.9	3.5	3.6	–0.3	–0.3	. . .	. . .	. . .
Nigeria	0.8	1.9	2.0	2.2	–0.3	–0.3	. . .	. . .	. . .
South Africa	1.3	0.8	1.4	1.7	0.0	0.0	0.5	0.9	2.2
Memorandum									
Low-Income Developing Countries	4.7	4.6	5.1	5.1	–0.1	–0.2	. . .	. . .	. . .
World Growth Based on Market Exchange Rates	3.2	3.1	3.0	2.9	–0.1	0.0	2.9	2.9	2.8
World Trade Volume (goods and services) 6/	**5.3**	**4.0**	**4.0**	**4.0**	**0.0**	**–0.1**	**. . .**	**. . .**	**. . .**
Advanced Economies	4.3	3.2	3.5	3.3	–0.1	–0.1	. . .	. . .	. . .
Emerging Market and Developing Economies	7.1	5.4	4.8	5.2	0.0	0.1	. . .	. . .	. . .
Commodity Prices (U.S. dollars)									
Oil 7/	23.3	29.9	–14.1	–0.4	–13.2	4.0	11.3	–9.7	–0.7
Nonfuel (average based on world commodity import weights) 8/	6.4	1.9	–2.7	1.2	–2.0	0.9	–0.9	0.1	1.4
Consumer Prices									
Advanced Economies	1.7	2.0	1.7	2.0	–0.2	0.0	2.0	1.8	1.9
Emerging Market and Developing Economies 9/	4.3	4.9	5.1	4.6	–0.1	0.0	4.5	4.1	3.7
London Interbank Offered Rate (percent)									
On U.S. Dollar Deposits (six month)	1.5	2.5	3.2	3.8	–0.2	–0.1	. . .	. . .	. . .
On Euro Deposits (three month)	–0.3	–0.3	–0.3	0.0	–0.1	–0.1	. . .	. . .	. . .
On Japanese Yen Deposits (six month)	0.0	0.0	0.0	0.1	–0.1	0.0	. . .	. . .	. . .

(Source: IMF World Economic Outlook January 2019)

The IMF illustrates that the world economy is suffering from an unfortunate convergence of many negative factors: a cyclical slow down (long over-due), the end of the massive monetary stimulus (also overdue), continuation of further structural reform particularly of labour markets, and unscripted political messaging by populist forces in the US and in several countries in Europe.

The picture the IMF describes does not make for happy reading but is a negative spiral avoidable?
Yes, but it requires courage - particularly on international political front - to avoid sleepwalking into the abyss.

2. One of the major issues behind all these macro-economic data points, and modelling in the last 10 years is the coordinated post crisis monetary policy of Quantitative Easing (QE) and its macro and micro economic consequences. The wrapping up of central banks QE policies and the resulting slow “normalisation” of interest rates will logically have a negative impact on the economic development of countries/sectors, and on some more than others as the IMF indicates.

   Moreover, large groups in society seem to have great doubts with regards to the general “success story” of QE. Feelings of resentment for “reverse Robin Hood” policies (“saving the banks but robbing the people”) have played a large part in popular movements starting with the “*Occupy Wall Street*” movement in the US in 2011 and continuing in the current “*gilets jaunes”* protests in France.

“Notre President…. il casse tout” **(***anecdotal evidence***)**

“He destroys everything” said my neighbour in northern France with some emotion. He is a recently retired policeman.
Two years ago he voted for Emmanuel Macron to become President of France, but the initial love-in disappeared very quickly.

Tax reform for companies and investors were part of the plan to make France attractive for corporate investments, and to create jobs. In a broad economic and financial reform package, a series of measures were introduced: including a lower corporate tax rate, labour market reforms, foreign direct investment stimulus, reduction of wealth tax, pension system reform and many others. As part of these reforms pensioners were no longer exempt from social contributions, as such my neighbour’s net pension came out lower, and the following “technical” revision of the pensions indexation methodology diminished the outlook for his future purchasing power.
The feeling of a reverse Robin Hood policy seemed to take root.
When in the Summer of 2018, a new “green tax” plan included extra levies on diesel-fuel, the lower and middle income groups particularly in rural areas, felt the exclusive victims of the government’s reform policies and that they were the ones that paid for tax reliefs for the big corporations and the rich.
One can easily see the fertile grounds for populist movements!

As a result my neighbour became a “gilets jaunes” sympathister (not an activist!).
The roundabout next to our village now has a gilets jaunes meeting point with a big banner : “MACRON VOLEUR: DÉGAGE TOI!!!” (MACRON THIEF: BUGGER OFF!!!).

It may well be that the result of the Brexit vote and the election of President Trump, can be traced back to resentments surrounding the impact of QE on people's lives. It also seems undisputable that nationalist movements in Poland, Hungary, France and Italy have also used the QE-success story to create an "Elite versus the People" narrative.

It is only relatively recently that economists and politicians have been focused on the impact of many of the macro-monetary policies following the financial crisis of 2008/2009: the consequences on a micro level have been grossly under-studied.

3. Let's start with a brief history of Quantitative Easing (QE).

After initial attempts by the FED of monetary policies to fight recessionary developments during the Great Depression in the United States in the 1930s, the first serious application of massive monetary expansion was by the Bank of Japan in the early 2000.

In a policy aimed at fighting falling consumer prices and stagnating economic growth in the early 2000s, the Japanese central bank started to buy Japanese government bonds in a large scale to push the economic activity upwards.
It is believed that Masaru Hayami, Governor of the Bank of Japan in early 2001, first coined this policy as "Quantitative Easing".

In the wake of the financial crisis of 2008/2009, Central Banks all over the world acted with major monetary expansion under the QE flag. The traditional policy response of interest rate cuts was quickly followed by massive programs of new money creation mainly through buying up of government bonds and other financial assets.
From late 2008 onwards the Federal Reserve in the US, the Bank of England, the Bank of Japan and the European Central Bank (Draghi's "whatever it takes" policy), and many other central banks have actively pursued QE policies
It was particularly after the collapse of Lehman Brothers in September 2008, that an Armageddon-sentiment of a pending collapse of the world's financial system triggered a coordinated massive intervention by all major central banks (see table from IMF study below).

Table 1. Unconventional Measures Undertaken by G-7 Central Banks

	Fed	BoJ	ECB	BoE	BoC
Commitment to keep policy rate low	**Yes**	**No**	**No**	**No**	**Yes**
Enhanced provision of liquidity to financial institutions	**Yes** TAF, PDCF, TSLF	**Yes** Broadened collateral; increased JGB purchases; introduced special funds-supplying operations	**Yes** Enhanced provision of long-term refi, broadened collateral	**Yes** Extended DW and OMO maturities; broadened collateral; introduced Special Liquidity Scheme	**Yes** Enhanced term PRA, introduced Term Loan Facility, broadened collateral
Provision of liquidity to credit markets	**Yes** CPFF, AMLF, MMIFF, MBS purchase program, TALF	**Yes** Outright purchases of commercial paper and corporate bonds (with remaining maturity under one year)	**Yes** Purchases of covered bonds	**Yes** Asset Purchase Facility (commercial paper and corporate bonds)	**Yes** Term PRA Facility for Private Sector Instruments
Purchase of long-term securities	**Yes** Treasuries and agency bonds	**Yes** Government bonds	**No**	**Yes** Gilts	**No**

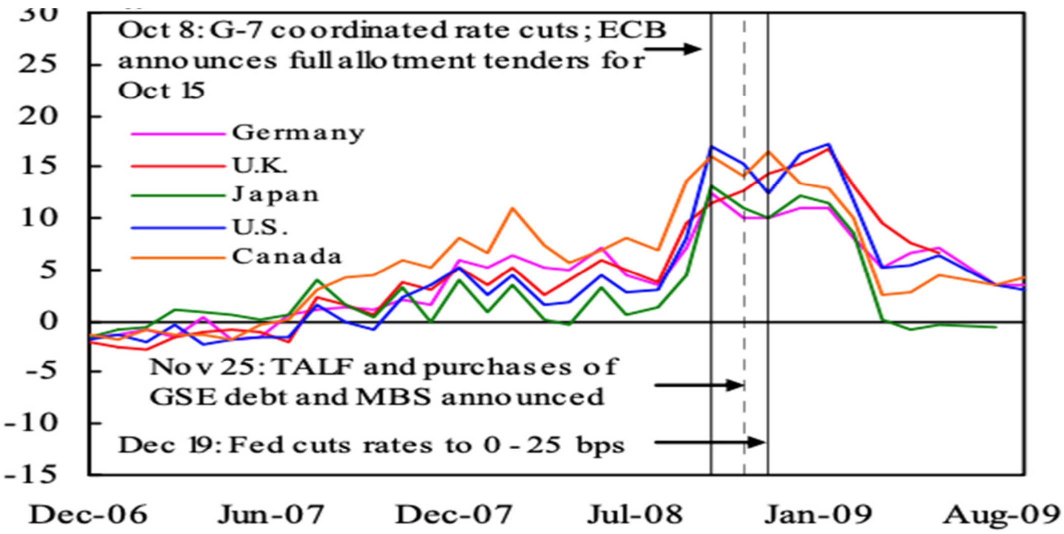
Source: “Unconventional Choices in Unconventional Times”,
IMF Staff Note, November 2009

In the years following the Lehman collapse, the QE monetary expansion reached dizzying heights with the Bank of Japan ballooning its balance sheet, with asset purchases up to almost 80% of Japan’s GDP at its peak. The FED in turn pumped $4.5 trillion into the system, close to 25% of US GDP, whilst the ECB bought financial assets equivalent to 30% of the European Unions’ GDP.

How do we now look back at these extraordinary policy responses 10 years after their launch? The IMF Research department has published a series of articles that address the effectiveness-question over the last years.
With its customary academic coolness, the IMF studies generally conclude that aggressive QE policies have helped to reduce the extreme financial stress following the 2008/2009 financial crisis, and that the policies have been broadly successful in stabilising financial conditions.

The graph below illustrates the immediate impact of the coordinated action in G7 countries in terms of reducing financial stress.

Financial Stress Indicators



Source: IMF Staff. FSIs consist of 7 financial market variables, including the beta of banking stocks, the TED spread, the slope of the yield curve, corporate bond spreads, stock market returns, stock market volatility, and exchange rate volatility.

Following on from the stabilisation effect of monetary easing, it is generally acknowledged that systemic tail risks were significantly reduced, and an economic cliff edge was avoided by stopping global deleveraging and the weakening of aggregate demand in the world's biggest economies.
In short: QE saved the financial system and the world economy after the financial crisis of 2008/2009.

And is the rest history?

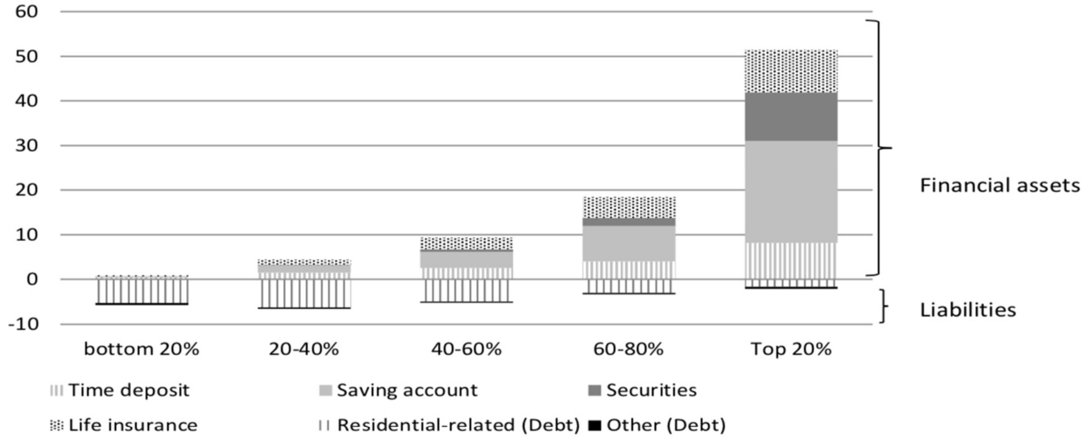
4. The general view of economists and policy makers is that QE brought many positive macro-economic results following the deepest economic and financial crisis of recent times. It saved the affected economies and brought the world's financial system back from the brink of collapse.
   Since the crisis a whole series of regulatory measures have been introduced to avoid repetition of financial systemic risks occurring (particularly in Basel IV).
   The impact of these measures is widespread and is felt in the banking community all over the world and demands further analysis.
   However below I would like to focus on the societal impact of QE particularly related to inequality as in my view this is linked to some of the broader political tensions, which dominate today's world.

QE quickly resulted in historically low interest rates; and in some cases negative nominal and real rates.
On a micro level, the effect is varied: they work differently for borrowers or for savers. People with personal loans or mortgages benefit from lower rates, as do leveraged companies. Savers, and particularly those depending on income from savings, as well as pension funds and life insurers are penalized by lower rates particularly through the ballooning valuation of their future liabilities (by means of a lower discount rate).
Lower interest rates also impact the valuation of other financial assets as many valuation models take interest rates to value future cash flows. Plus lower rates boost the value of other assets such as stocks and property.
Furthermore, inflation may be pushed by low rates, as aggregate demand for consumption and investment should push prices up.
Credit risk could also be less rewarded as a lack of return could push investors down the credit spectrum and undermine proper risk-rewards.

As a result it depends on where institutions and individual people sit on the asset and liability spectrum, and whether they benefit or not from lower rates. However, the impact of monetary policy on the distribution of income and wealth was until recently been largely ignored.

The Dutch Central Bank DNB published a paper in 2014 on the impact of QE on income distribution in the country with the longest QE-experience: Japan*. This is one of the first empirical studies on the distribution effects of monetary policies. The first object of study was analysing the general profile of groups of individuals on the income ladder and sketching out their personal ALM (see graph below).

Figure 4: Composition of Saving and Debt by Quintile



Data Source: Japan Household Survey (Saving and Liabilities Survey)

* How Does Unconventional Monetary Policy Affect Inequality? Evidence from Japan. Published by the Dutch Central Bank (DNB) in May 2014

The data shows: the bottom 20% of Japanese households have very little in terms of financial assets (some savings) and limited amount of borrowings (pre-dominantly for housing), whereas the top 20% has quite the reverse position: hardly any debt but significant levels of financial assets.
It is therefore not surprising that the study based on extensive stochastic analysis shows that "the rich" have generally benefitted significantly from QE through its important portfolio effect while lower income groups have suffered through higher inflation, and stagnating wages and reduced welfare benefits. As a result QE has contributed to increased income- and wealth-inequality in society.

The study concludes: "*Taken together, our results imply that, while the aggressive monetary policy finally seems to be bearing fruit, this strong medicine may come with an unwanted side effect: higher income inequality...... It is possible that the portfolio channel will be even larger in the US, UK, and many Euro-zone economies, where households hold a larger portion of their savings in equities and bonds."*

Other studies, particularly in the United States, seem to concur in general terms with these findings (*see also "Innocent bystanders? Monetary policy and inequality in the US", IMF's Jacques Polak Annual Research Conference November 8-9 2012 contribution by Olivier Coibion, Yuriy Gorodnichenko, Lorenz Kueng, John Silvia*).

5. To be fair: no central banker has ever claimed that monetary policy is or should be ***the*** dominant economic policy.

   Traditional micro economic policies such as income policy, industry policy, labour and welfare policies have for (too) long been seen as features of the past. Governments were generally reluctant to take a stance on these social-economic issues and did not want to be accused of introducing a “Nanny-State”.

   However there is a growing feeling that micro economic policy remains very much an essential complement t macro-monetary policies, dealing with the impact of these policies in micro-economic terms on people and society. Recent experience has revived the debate about the role of the state, particularly in the Western world.
   In France, the national debate initiative launched by President Macron, which looks to touch on a number of social-political topics in response to the “gilets jaunes” movement, is the first of a kind, and may be an experiment for broad based social change.

   Such new and inclusive government social economic policies, could fundamentally change the path of development in the western world in the coming years and reduce social tensions.
   These changes will take time, and a lot of political courage is required.
   In the meantime we will not see a lot of smooth sailing in front of us. Let me conclude with a few observations:

   - We will not escape the impact of economic cycles. Some slow-downs will happen, and will be aggravated by economic and political events, whilst the nature of the latter is likely to trigger market shocks and increased volatility.
     Some of these effects are probably already priced in the current valuations particularly following December 2018’s market rout. However, new surprises are always possible... The focus needs to remain on longer-term trends (health/longevity, energy transition, sustainability) and specific undervalued situations.

   - It is expected that government policies (particularly in the European Union) will be much less inspired by austerity, and more tuned towards income policies. This will require a more pro-active policy on public and social spending, combined with progressive tax policies. These may push inflation a bit from its current morose levels.

Over time higher long term interest rates will emerge, re-introducing fixed income as an investment category.

- In the coming years the political landscape will be re-jigged. The traditional political parties along the left-right divide may re-invent themselves as was shown in France in the Spring of 2017. The Brexit debate in the UK has recently lead to implosion effects within the established and entrenched political parties.
  There is a danger that populist nationalist groups may seek to benefit from this. We have seen that financial markets have become very volatile on the basis of populist political messaging which sometimes undermines the value investing approach.

  President Macron's initiative to launch a National Debate on public services, the environment, democracy and taxes is worthwhile following and may even be copying the Dutch "Polder model" which traditionally brought together government, employers federations, trade unions and other interest groups, and had a role to fulfil in all national debates in the Netherlands since the middle of the 20th century.
  Dusting of this now "ancient" model might also be worthwhile considering.

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