The right tool for the right job

BY PAOLO SAVONA

Playing with interest rates is certainly one way of nudging an economy in a desired direction. But recent experience has made clear that the economic context is more important than previously suspected.

The most recent US monetary policy debate, both academically and politically, has focused on "returning to normal" with respect to the Federal Reserve's use of its tools. This means a return to a policy that – through the Federal Reserve Rate (FFR) and no longer through the monetary base – is positively influencing growth, inflation and financial stability.

A survey conducted by the Federal Reserve System indicates that 3% is the level that the FFR has to reach in order to achieve this return to normal. The Fed Board, chaired by Janet Yellen, has already raised the FFR twice to 1% and announced two possible increases during the remainder of the current year, provided that the positive trend in the GDP growth rate continues, that inflation remains under 2% and unemployment rates stabilize between 4% and 5%, which is considered a level of full employment in a developed society such as the United States.

Many economists agree that the FFR should grow by 3% within 2018 but are skeptical of the possibility that this single instrument can affect financial stability through its effects on real growth, inflation, and employment. The reasons for this skepticism are varied. Firstly, financial asset and liability stocks and flows vary too widely for their stability to be controlled by a sight deposit interest rate, such as the FFR; it would be a mountain sustained by a mouse. Recent experience indicates that the Fed cannot abandon the task of directly intervening to keep stable the pyramid of accounting records (or computer bits) that it helped grow. The second reason is that the Trump administration's fiscal policy could have uncertain results, being centered on the relaunch of public infrastructure and the reduction in fiscal pressure leading to a greater public deficit and an increase in federal indebtedness. It could also push inflation downward as a result of the growth in aggregate demand that it entails. The third reason is that stock prices in the US, evaluated on the basis of the price-earnings ratio (P/E), are considered to be the result of a speculative bubble that sooner or later deflates, re-introducing financial stability issues. The P/E ratio is currently in the order of 30, more than consistent with the riskless alternative financial investments (the 10-year Treasury Bonds). Obviously, considering the risk of real investment, this comparison does not hold.

Even before the recent decision to raise the official interest rates, our monetary seismograph reported that US pension funds continued to consider a return on investment of about 7%, which implies the existence of a speculative bubble and, therefore, the possibility of a financial crisis that, at the same level of profit, would reduce the price of stock market shares. It is true that the 7% yield is not linked to macroeconomic considerations, but to commitments to secured customers, vindicating the Nobel-Prize winning economist Ronald Coase who had warned of irreconcilable discrepancies between objectives pursued by economic policy makers and private businesses. If Trump's tax cuts were primarily on profit, stock market prices would receive a lot of oxygen, but it would not be sufficient to bridge the gap between actual P/E and effective P/E, as outlined above. To ensure financial stability, the Fed could not pursue a return to normality and should also continue to maneuver the quantities.

Well before the Great Recession, the debate among economists about the effectiveness of monetary policy in pursuit of real growth had been resolved in the negative direction. It was considered not to be an effective tool for development, but only for monetary stabilization. More recently, another debate focused on the ability of the financial market to be able to self-govern without a crisis, provided it behaved rationally. The experience of "irrational exuberance," coined and experienced by Alan Greenspan, former chairman of the Fed, gave lie to this possibility and today we find ourselves supporting the same arguments – the real and financial effectiveness of mon-

US Federal Reserve Chair Janet Yellen is pictured during a G7 summit of finance ministers in Bari, May 12, 2017.

etary policy – as if nothing or very little had happened, in an attempt to return to normality. If there is any room in this direction, it can be found in a policy of monetary base quantities (called "balance policy," referring to the Fed's balance sheets) as a permanent instrument to be used according to the trends of the real and financial economy; therefore, an interest rate policy remains a tool for "normal" times, or at least for a period when the GDP is moving toward its potential level and inflation and unemployment are within the indicated limits. In short, two instruments for two goals, according to the most classic economic policy approach.

For the European Central Bank, a debate like the one in the United States is without any practical foundation, even though there is a logic behind its policy. The dilemma to change or not would arise if growth and stability, both monetary and financial, were at the desired levels. Notwithstanding the fact that ECB President Mario Draghi has indicated that his monetary policy will continue through 2017, much will depend on what Italy does after the French and German elections as it looks forward to its round of voting. However, in order to change economic policy, it is necessary to change the "European rules of the game" in the light of those prevailing in the US.

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