Back To The Future: Nominal GDP Targeting aka Financial Repression

"Roads? Where we're going we don't need roads."

Doc Brown in Back to The Future, 1985

There is a plan B. At least to listen to the growing endorsement for nominal GDP targeting, both inside and outside the Fed, it sounds like there is a plan B. That of course has to be a part recognition that plan A has somewhat failed. It is also a recognition of how plan A has failed and that is why investors need to pay attention.

Whisper it softly, but the Fed now realises that only financial repression can get them out of this particular pickle: the pickle in which inflation targeting creates a growth in debt well above any growth in money. Nominal GDP targeting is a commitment, unspoken but certain, to create ever more money. What that means for market-determined interest rates and their necessary extinction is the part of plan B that dare not speak its name - financial repression. It is also the subject of this newsletter.

The call for a move to nominal GDP targeting has been growing for some years and seems to be now emanating from within the Fed itself. Your analyst finds the timing somewhat peculiar as there are signs that the key solution to the too-much-debt and too-little-money conundrum may finally have been stumbled upon. The re-intermediation of existing credit assets has long seemed to your author a means by which money can be created without the direct creation of credit, though it does raise issues with the creation of replacement credit assets in due course. In the US recession of the early 1990s the US commercial banking system was able to keep its assets growing, thus its newly created liabilities (money) also grew, through massive purchases of US government debt. By the time that surge in Treasury holdings was over Treasuries accounted for more than 20% of all commercial bank assets. While money supply growth dipped dangerously during that particular recession, notably a recession with bank collapses occurring in New England, the money supply did not contract due to the scale of the Treasury buying bonanza by commercial banks.

Riding the yield curve back to solvency was not a new trick. A steep yield curve in the 1980s allowed US commercial banks to earn their way back to solvency after the credit crisis in lesser developed countries (LDCs), since re-branded as 'emerging markets', that had erupted in the summer of 1982. In that year your analyst, living near Belfast, home of the DeLorean Motor Company, was more concerned with the bankruptcy of the car producer than the bankruptcy of Mexico. However, it was the bankruptcy of Mexico and then a series of LDCs that destroyed the capital of key US banks. Time and a steep yield curve were the two ingredients that saved those banks. The earnings power of a geared corporation that borrows short and lends long is a wonder to behold - when there is a steep yield curve. The problem with global QE is that it massively reduced that profit opportunity and, with it, reduced the ability of banks to lend and in the process create money. It is the failure to create money, in a world of low long-term interest rates, that is the key to the failure by central banks to inflate away our debts. However, now perhaps that has changed, if only in the US.
US commercial banks have taken to pouring money into the Treasury market. In December the value of their holdings of US Treasuries grew by 18% and over the past three months of available data there is a double-digit annual growth in securities in bank credit. The Solid Ground has long warned of the consequences of the collapse in broad money growth in the US over the past 18 months. That may indeed have played a key role, along with the increased supply of Treasury securities, in the equity market collapse in 4Q 2018. Now, from a very low base, the growth in US M2 has just begun to accelerate, just as one would expect if bank balance sheets have started to grow again.

So it turns out that what you needed to create more money was not low interest rates but higher interest rates. Who knew? Well, who knew except anyone who has ever run or analysed a bank. So we will need to watch the data closely, but if this gap between deposits and short-term Treasury yields is sufficient to create ever more purchasing of Treasuries by commercial banks, then finally broad money growth may ‘normalise’ to the levels associated with nominal GDP growth that would see the US debt-to-GDP ratio begin to decline. Time will tell but The Solid Ground remains cautious on the outlook for US bank credit growth as the key customer of the bank, individuals and not corporates, is not likely to respond to higher interest rates by looking for more credit.

In particular the baby-boom generation, now aged 53-72 and a key customer of US commercial banks, is at the stage in life where their debt, their instant gratification fund, will need to be repaid by first freezing their desire in the form of savings. I guess Dr. Spock never considered just how his instantly gratified terrors could evolve into those who must sacrifice consumption for savings. Well, that time has come and, being late to it, they may have to pursue it with some gusto. Marty McFly arrived in the future, 2015, aged 17 when he should have been 47- the age in the US when debt burdens peak. The baby-boomers have a long way still to go on the road to de-leveraging.

So perhaps this minor spread between deposit rates and short-term Treasury yields can give us the US bank balance sheet expansion that drives broad money growth higher and delivers, without any change in Fed target, the scale of broad money growth necessary to generate the higher level of nominal GDP desired. If strong enough, it can more than offset the strong headwind on bank lending from the debt bulge, also known as the baby boomer balance sheet, reaching that degearing stage in life. While we watch and wait we do need to consider what happens if this does not happen and a switch in target is considered necessary. We need to consider that in relation to the US, but much more urgently we need to consider the consequences in Japan and the Eurozone.

If the rise in US yields has now permitted a bank balance sheet expansion and money creation in the US, there is no such relief for banks in the Eurozone or Japan. The ten-year yield in Japan is back to zero and the ten-year German bund yield is just above zero. This creates very limited opportunity for banks in these jurisdictions to seek profit through expanding their balance sheets. It is perhaps surprising that they are expanding at all, but at least in the Eurozone and Japan banks still have corporates for customers and their demand for debt is somewhat more robust that the US baby boomer.

However, unless somehow a profitable spread develops for commercial bankers in these jurisdictions, then broad money growth is likely to stay low and nominal GDP growth is likely to stay low. In these jurisdictions the fundamental problem for post-GFC monetary policy has not been solved as policy settings drive faster growth in credit, primarily non-bank credit, which does not increase the stock of money, but results in low growth in money being the liability created when commercial banks lend. So nominal GDP growth, at least currently, is likely to be something the central banks find themselves in need of in Europe and Japan, probably before they have need of it in the US. What intrigues your analyst and should worry investors is just how central banks are finally going to create much higher growth in broad money to hit their new nominal GDP targets. As ever, setting a monetary policy goal is the easy bit; it’s how you might achieve it that is at least...
as important for asset prices. Having failed to boost broad money growth and nominal GDP growth to high levels with QE, what fresh hell now awaits savers in Plan B?

Your analyst sees two ways in which central bankers could set the level of broad money growth and thus get close to their nominal GDP target. The first would be in the form of commercial bank/central bank/fiscal authority fusion now espoused by key leaders of the Democratic Party. The leader of the opposition in the UK has coined a nice name for it - ‘quantitative easing for the people.’ The other mechanism would be for the Fed to have much greater control over commercial bank balance sheets. If nominal GDP growth was flagging, a greater boost to broad money would be necessary and the key way to achieve that is by instigating an expansion in bank credit growth that generates the required level of broad money growth. Well, if the Fed thinks it can do that through existing mechanisms, one is entitled to ask why they have so far failed to do so?

Flushing the commercial banks with reserves has not led to the banks accelerating their loan growth and the higher level of money growth associated with higher nominal GDP growth. Indeed as the Fed switched to QT from QE, it seems so far to have made little difference to the pace of bank credit growth - indeed it has, just recently, started to accelerate as interest rates have risen.

So through what new mechanism could the Fed make sure that commercial bank balance sheets expand to create the requisite amount of money then needed to meet their nominal GDP target? Could the Fed achieve this through loosening the reins by which the monetary coachman controls his lethargic steeds - the commercial bankers? The reins are loose already. It is much more likely that the coachman turns jockey and, with spur and whip, drives his mount to go faster. It is difficult to tell in practice just what whip and spur will be used to create the necessary monetary impact. For this analyst, creating incentives for the re-intermediation of credit assets is probably the least bad distortion to the financial system that such interference in the allocation of credit creates. This is more a carrot than stick and the more the rider resorts to the stick, then the worse the allocation of credit becomes. This becomes a banking system with Chinese characteristics the more it’s the whip that is wielded. OK, too bearish. How do you think the central banker will boost broad money in pursuit of higher nominal GDP targets?

If the new mechanism to create money needs to be understood by investors, we also need to understand the consequences of the new target. In the US there are various levels bandied about for the level of nominal GDP growth that might be targeted. The chosen level is usually based upon pre-GFC growth levels, supposed to represent something that we can call normal. Of course that level of normal nominal GDP growth occurred as the US witnessed the fastest rise in its debt-to-GDP ratio in peacetime! Thus, in replicating the circa 7% level in nominal GDP enjoyed during that period, we don’t necessarily do anything to reduce the current near record debt-to-GDP level that hangs like the sword of Damocles over financial stability. Consider what might happen to interest rates as the Fed sets out to meet its new target.

The problem with nominal GDP targeting is that it would send market interest rates spiralling higher when implemented. The market, probably believing that the US is capable of 2%-2.5% real economic growth per annum, would not ponder long on what 7% nominal GDP growth might mean for inflation. The more interest rates rise, should they be allowed to do so, the more inflation the Fed would have to produce, assuming that real GDP growth had disappeared or indeed become negative. If the normal market consequence from such an aggressive push for higher inflation is higher interest rates, just what does this mean for real economic activity? Can nominal GDP targeting actually work at all in an economy with market determined interest rates? The Solid Ground believes that it cannot and thus a move to nominal GDP targeting inherently involves, though this will never be stated, the de facto abolition of market-determined interest rates. This will lead to more inflation and administratively controlled interest rates – the two key ingredients of financial repression. Any policy maker, whether elected or not, will always have the good grace to
give a failed policy a new name on its relaunch, so welcome to the world of nominal GDP targeting – very old wine in a very innocuous looking bottle.

Subscribers will be equipped for nominal GDP targeting/financial repression when it comes, having read Capital Management in an Age of Financial Repression (Solid Ground 3Q 2017). Many who have read it believe that it represents ‘the end of the world’. This, of course, is silly for financial repression represents no such thing. It merely represents the end of our world; the world where savers expect positive real returns on their capital. A move to nominal GDP targeting is simply a recognition that there are now more important goals than allowing such returns. It recognises the need to reduce global record high debt-to-GDP ratios. It recognises the need to redistribute wealth from savers to earners. It recognises the need to redistribute wealth from old to young. It recognises the need to redistribute wealth. Whether you agree with those ‘needs’ is not relevant, as a move to nominal GDP targeting means that these new goals are now the new normal.

Could central bankers take us back to the future in such a dramatic way? They could - in pursuit of what they believe to be their own independence. Faced with the prospect of a President Warren and the likely fiscal/monetary fusion, which would have even Arthur Burns turning in his grave, the Fed is capable of a great deal. The Solid Ground believes that in struggling for its own independence it embarks upon a path of ending the independence of the commercial banker. That might sound like a very un-American thing to do but it’s not a new thing to do. Through interest rate caps on deposits, the innocuously named Regulation Q, the central bank controlled commercial bank balance sheets for a generation. In the UK the Bank of England controlled, for a generation, the other side of the balance sheet through credit controls and briefly, under Richard Nixon, so did the US. The Reagan revolution ended all that but, of course, it was able to end it as debt-to-GDP ratios had been reduced to postwar lows by the time ‘the great communicator’ was elected. Today US debt-to-GDP and global debt-to-GDP are at record highs. There is now a clear and present danger of financial collapse and a need to inflate away that debt. We know exactly how that was done the last time, so should it come as any surprise that central bankers are adopting new targets and sharpening new tools to make it happen?

All of this, of course, can be done under the banner of macro prudential regulation, for what could be more prudent than reducing leverage levels in the global economy? It does, however, come at a price and not just for savers. The price is not instantly visible and for the majority of voters a successful move to inflate away debts, through high nominal GDP and wages, feels rather wonderful. The downside, though, is that it institutionalises the wrong cost of capital, something central bankers seemingly now think is their raison d’être, and thus over a long period leads to the very inefficient allocation of capital. It can take many years, sometimes decades, to experience the consequences of such misallocation of capital but it does come and ultimately the pain falls more widely than just upon savers. There are ways in which savings can produce positive real returns in a financial repression and the most obvious one is by investing in gold. Does any reader think the gold price will go down the day the Fed formally announces that its new target is nominal GDP growth of 7%?

In 1985 with the aid of a DeLorean and the Mr. Fusion Home Energy Reactor Marty and Doc left the road for the future. In 1986 the last remnant of Regulation Q was lifted and market determined interest rates returned to America. Landing in 2015 our heroes were perhaps too busy to read an interesting paper just published by The Richmond Federal Reserve: Nominal GDP: Target or Benchmark? The paper noted the ‘volatility’ that such a policy might induce without specifically stating that it would be a volatility of interest rates much as we experienced in the period when Paul Volcker targeted money supply growth from 1979-1982. In that period the pain of such interest rate volatility was high enough but how much higher would it be today with US debt-to-GDP near record highs? So this move back to the future must involve a return to administrative controls that can reduce that ‘volatility’ in interest rates as the Fed prints its way, co-opting the commercial banks, to glory in the form of higher nominal GDP growth. As the proponents on Modern Monetary Theory
(MMT) point out, there are no limits to how much a government can borrow in its own currency. However as they fail to continue to add, that is because all governments can ultimately inflate away their debts. The Fed, desperate to avoid the capture by the state which is a key part of MMT, is preparing to take us in a different direction but it’s a direction where the end goal is still the same - inflating away debts. Whether they are aware just how far such action will take them down the road of abolishing market determined interest rates, who knows? What is clear is that the more this new target gets closer to endorsement by the Fed, the more it’s back to the future for investors and in the words of Marty McFly ‘that’s about as funny as a screen door on a submarine’.
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