Beyond interest rates
By Eric Lonergan
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The US Federal Reserve should start considering policy alternatives to cutting interest rates. The current global recovery is almost entirely dependent on US demand - specifically, US consumer spending. Interest rate cuts are facilitating this process by encouraging house price inflation and credit growth.

Alan Greenspan, Fed chairman, is explicit about this process. In his recent testimony to Congress, he argued: "Mortgage rates remain at historically low levels and thus should continue to fuel reasonably strong housing demand and, through equity extraction, to support consumer spending as well."

Is it really optimal to prop up the global economy through an explicit weakening of the US household balance sheet? The most palatable alternatives require European and Japanese initiative and are not within the Fed's control. Moreover, there are considerable institutional barriers to progress in both Europe and Japan. Fiscal stimulus in Europe is hamstrung by the stability pact. Monetary stimulus is similarly hindered. Despite near-stagnant growth in domestic demand within the eurozone and six months of currency strength, the European Central Bank has been reluctant to cut rates. Japan's problems are deeper because it has exhausted orthodox forms of demand management.

It is impractical and imprudent for America to wait for European or Japanese action. It is also imprudent for the Fed to encourage increased leverage, house price inflation and home equity withdrawal. So what are the alternatives? A starting-point is to look at Japan, where monetary policy alternatives to interest rates are openly debated.

The most frequently discussed options include the purchase of longer-dated government bonds, or private sector securities such as equities. These are options the Fed is likely to have looked at and rightly dismissed. The Bank of Japan's aggressive programme of government bond purchasing by means of monetary-base expansion has increased liquidity in the financial system with negligible impact on the real economy. Purchasing equities amounts to renewed distortion of asset market pricing, which policy should seek to avoid.

A consensus is starting to emerge that the most direct monetary solution to Japan's problems would be for the BoJ to finance private sector debt repayment. If the BoJ repaid 30 per cent of all household and corporate debts outstanding, financed by monetary base expansion, there would be a recovery in domestic demand. Equivalently, and perhaps more equitably, the BoJ could simply post a cheque for the Yen equivalent of, say, $10,000 to every household. If this has little impact, they could send another one. Milton Friedman, the economist, called this a helicopter drop of money.

Are these plausible options for the Fed? A helicopter drop of money has many advantages over current policy. It is difficult to believe that cash transfers to the household sector would not stimulate demand. Furthermore, a cash transfer or debt repayment stimulates private sector demand by strengthening, not weakening, the household balance sheet.

When monetary policy takes this route the line between monetary and fiscal policy is blurred. What is the difference between a tax rebate and a cheque from the Fed? There are two crucial differences. One involves an expansion of the monetary base - printing money; the other involves issuing government debt. More important, monetary-base expansion is controlled by the central bank, not politicians: the essential tenet of an independent monetary authority is that only central banks should be free to write cheques at will.

How far-fetched are these proposals? Federal Reserve Board economists recently argued that when inflation approaches zero, interest-rate cuts and fiscal policy should be more aggressive than baseline forecasts would typically suggest because the downside risks of policy failure are so great. This logic explains current fiscal and monetary policy thinking in the US and is consistent with further and aggressive interest-rate cuts, which many economists are now predicting.

This is likely to remain the favoured approach. But post-interest-rate monetary policy is already at the heart of the current debate in Japan. The Federal Open Market Committee itself discussed at its January meeting the monetary options should interest rate cuts fail. What about the ECB?

Central bankers often pride themselves on unpopularity. And so it should be during booms or rising inflation. But in deflation, this principle should be turned on its head: they should print money and be popular.

We are not yet facing global deflation. Conventional monetary and fiscal policies in the US are having their desired effect. But the mechanism used to stimulate US demand is neither desirable nor sustainable. The Fed and central banks globally should rethink.

The writer is head of global macro research at Cazenove & Co