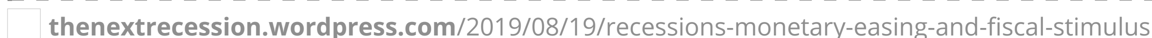
# Recessions, monetary easing and fiscal stimulus



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Michael Roberts, August 19, 2019

As the stock markets of the world gyrate up and down like a yo-yo, all talk in the financial media is on whether a new global recession is coming and when. The financial pundits search for economic or financial indicators that might guide them to tell. The favourite one is the 'inverted bond yield curve'. This is the difference in the annual interest rate that you get if you buy a government bond that has a ten-year life (the maturity before you get your money repaid) and the interest rate for buying either a three-month or two-year bond.

The curve of interest rates for differently maturing bonds is usually upwards, meaning that if you lend the government your cash (ie buy a government bond) for ten years you would normally expect to get a higher interest rate (yield) than if you lent the government your money for just three months. But sometimes, in the market for buying and selling government bonds (the 'secondary market'), the yield on the ten-year bond falls below that of the two-year or even three-month bond. Then you have an inverted yield curve.

Why does this happen? What it suggests is that investors in financial assets (who are banks, pension funds, companies and investment funds) are so worried about the economy that they no longer want to hold the stocks or bonds of companies (ie invest in or lend them cash). It's too risky and so instead investors prefer to hold very safe assets like government bonds – as the governments of Germany, Japan, the US or the UK are not going to go bust like a company or bank.

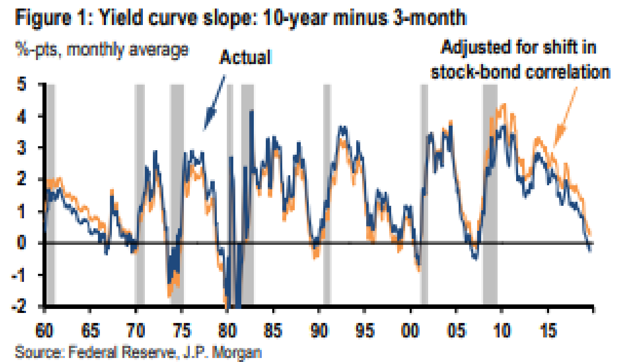
If investors buy more government bonds, they drive the price of those bonds up in the market. The government pays an annual fixed interest on that bond until it matures, so if the price of the bond keeps rising, then the yield on that bond (ie. interest rate/bond price) keeps falling. And then the bond yield curve can invert. Empirical evidence shows that every time that happens for a sufficient period (some months), within a year or so, an economic recession follows.

How reliable is this indicator of a recession coming? Two Bloomberg authors have questioned the validity of inverted yield for causation; it may be that an inverted curve correlates with recessions, but that is no confirmation that another recession is on its way because all it shows is that investors are fearful of recession and they could well be wrong. Indeed, when you look at corporate bonds, there is no inverted curve. Longer-term corporate bonds have a much higher yield than short-term bonds.

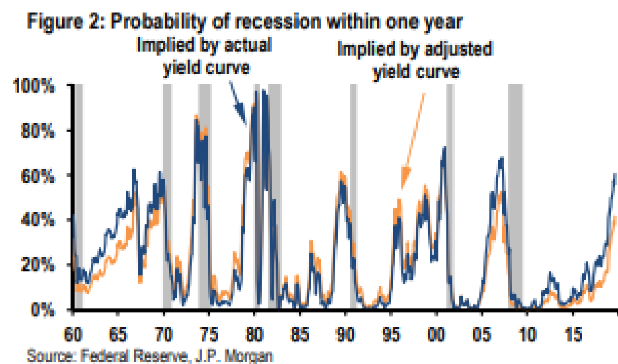
On the other hand, JP Morgan economists recently did some regressions on the inverted yield curve and reckoned that the very low inflation that most major economies have experienced in the post Great Recession period may have altered the reliability of the

indicator to some extent because the yield curve could go flat but not really express investor fear and loathing of stocks. Even so, JP Morgan still reckoned it was a valuable indicator. Currently, the US bond yield curves (10yr-3m) and (10yr-2yr) have inverted. And as you can see from the JPM graph below, that every time that has happened before, a recession has followed (the grey areas) within a year.

JP Morgan reckons on this basis the current probability of a slump in the US economy within a year is about 40-60%.



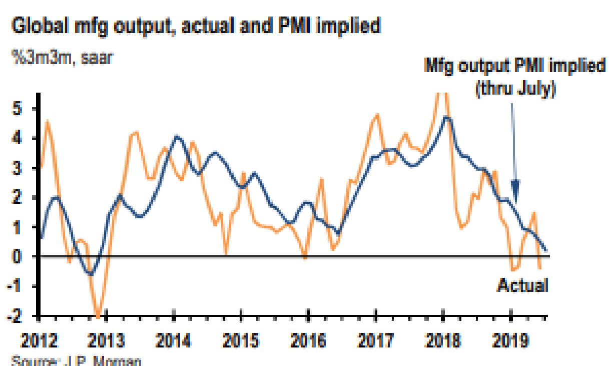

And this is the US, the capitalist economy with still the best economic performance of the G7, with real GDP growth at about 2.3%. Everywhere else in the G7, in Europe, in Asia, and also in many large so-called emerging economies, economic growth is falling fast towards zero and below. Look at this list:




Canada: 1.3%; France 1.3%; Japan 1.2%; UK 1.2%; Russia 0.9%; Brazil 0.5%; Germany 0.4%; Italy 0.0; Mexico -0.7%; Turkey -2.6%; Argentina -5.8%. Only China, India and Indonesia can record decent growth rates and even here, there is a rapid slowdown.

I have reported before on the manufacturing and industry activity indexes that show the world is already in a manufacturing sector recession and only 'service sectors' like health, education, tourism etc are keeping the world economy moving. But those sectors are ultimately dependent on the health of the productive sectors of a capitalist economy for their sales and profits.

In some of the major economies, there is so-called full employment, at least on the official stats, even if it is temporary, part-time, self-employed and on basic wage



levels. This employment income helps to keep spending going, but in many countries it is not enough, so that household savings are being run down. For example, in the UK, the household savings rate is at a 50-year low. So people cannot keep borrowing indefinitely, even though interest rates are very low.

And are they low! We are now in the fantasy world of negative interest rates, where borrowers get paid to borrow and lenders pay to lend. In Denmark, one mortgage lender is offering loans at -0.1%, in other words it is paying you to take out a mortgage! Over 20% of all government and even some corporate bonds have negative interest rates. The entire spectrum of German government bonds from two-years to 30 years have negative interest rates if you buy them. So sellers of bonds (borrowers) can expect you, the lender, to pay interest to them to buy their bonds!

So why are bond investors prepared to do this? As I said, it's because they fear a global recession that will cause a collapse in stock markets and other 'risky' financial assets, so the safest place to put your money is with governments (which don't go bust) like the US, the UK, Japan, Germany and Switzerland.

If a recession is coming, what can be done to avoid it? Mainstream and Keynesian economics has basically two policy solutions. The first is to inject more money into the financial system in the hope that piles of dollars, euros and yen will find their way into the coffers of corporate borrowers, which will then keep investing in jobs and machines; or into households who will keep spending

The 'çonventional' way to so this was for the central banks of the major economies to cut their 'policy' interest rate, which would lead to falling interest rates across the board and thus reduce the cost of borrowing. But the experience of the last ten years of what I call the Long Depression reveals that this does not work. Investment has remained low as a share of GDP, wages have stagnated and economic growth has been feeble.

So governments and central banks have resorted to 'unconventional monetary policy' where the central banks buy billions of government and corporate bonds (even company stocks) from commercial banks. This is called quantitative easing (QE). This led to a huge boost in bank reserves. The banks were supposed to lend that cash on to companies to invest. But it did not work. Companies did not borrow to invest. They were either so cash rich like Amazon or Microsoft that they did not need to borrow or so weak that the banks would not lend to them. So all this cash ended up being invested in stocks and bonds (what Marx called fictitious capital, ie just claims on future profits or interest, not actual profits or interest). The financial markets rocketed up, but the 'real' economy stagnated.

Monetary policy has failed, whether conventional or unconventional. Central banks have been 'pushing on a string'. That was something that Keynes found too during the Great Depression of the 1930s. His policy proposal for getting full employment and ending the

depression in the early 1930s was first conventional interest-rate cuts and then unconventional QE. By 1936, when he wrote his great work, The General Theory, he announced the failure of monetary policy.

Ánd so it has been this time. Mainstream economists including Keynesians like Paul Krugman at first advocated massive monetary injections to boost economies. Japan's government even invited Krugman and others to Tokyo to advise them on QE. The government and the Bank of Japan adopted QE with a vengeance, so much so that the BoJ has bought virtually all the available government bonds in the market – but to no avail. Growth remains weak, inflation is near zero and wages stagnate.

The central banks have run out of ideas. And investors know it. That is why bond yields are negative and in the US the yield curve has inverted. But there is nothing else that the central banks can do except cut interest rates where they are not yet zero and bring back yet more QE where they are.

Some radical economists have not given up on monetary policy. Some are advocating 'helicopter money'(named after right-wing monetarist economist Milton Friedman who advocated by-passing the banking system and printing cash and giving it directly to households to spend ie send helicopters over the country dropping dollars – not napalm as in Vietnam). This 'people's money' is the last resort of the monetary policy solution.

The more perceptive of mainstream economists now recognise that monetary easing will not work. The Financial Times and even the Wall Street Journal have been trashing this policy. And Keynesians who advocated it before now recognise its failure. Take this example by Edward Harrison, a macro economic financial advisor.

*"I think monetary policy is ineffective. We don't even know how it works. Sure, rate policy can help at critical junctures in the business cycle by lowering interest payments when debtors are under stress. But, we've hit the limits of what central banks can do. As a result, we've resorted to quantitative easing, negative interest rates, and yield curve control. And for what? It's crazy. The solution is staring us in the face: help put money in the pockets of the people who are facing the most severe financial stress in our economies. Those are the people who need the money the most and are most likely to spend that money too. Until we do that, the stress on our economic and financial system will continue to grow… and political unrest will continue to grow with it.*"

Harrison cites empirical work from his own college that shows monetary policy does not work – as Keynes discovered in the 1930s. "*For example, economic researchers at my alma mater Dartmouth wrote this in 2013 as the abstract for an economic study:*

*"We study the factors that drive aggregate corporate investment from 1952–2010.* ***Quarterly investment*** *responds strongly to prior profits and stock returns but, contrary to standard predictions,* ***is largely unrelated to changes in interest rates****, market volatility, or the default spread on corporate bonds. At the same time, high investment is associated with low profit growth going forward and low quarterly stock returns when investment data are*

*publicly released, suggesting that high investment signals aggregate over investment. Our analysis also shows that the investment decline following the financial crisis of 2008 represents a fairly typical response to changes in profits and GDP at the end of 2008 rather than an unusual reaction to problems in the credit markets."*

And he cites work by the US Federal Reserve that concluded that: *"A fundamental tenet of investment theory and the traditional theory of monetary policy transmission is that investment expenditures by businesses are negatively affected by interest rates. Yet,* ***a large body of empirical research offer mixed evidence, at best, for a substantial interest-rate effect on investment****. In this paper, we examine the sensitivity of investment plans to interest rates using a set of special questions asked of CFOs in the Global Business Outlook Survey conducted in the third quarter of 2012. Among the more than 500 responses to the special questions,* ***we find that most firms claim to be quite insensitive to decreases in interest rates, and only mildly more responsive to interest rate increases***."

I have cited this paper that Harrison refers on many occasions in this blog before he brought it up. But Harrison emboldens the text from the paper about how interest rates have little effect on business investment. But he ignores the other key conclusion in the paper cited. I quote again *with my emphasis now*: "***Quarterly investment responds strongly to prior profits and stock returns*** *but, contrary to standard predictions…..* ***Our analysis also shows that the investment decline following the financial crisis of 2008 represents a fairly typical response to changes in profits and GDP*** *at the end of 2008 rather than an unusual reaction to problems in the credit markets."*

In other words, what drives capitalist economies and capital accumulation are changes in profits and profitability – indeed that is what the paper cited shows. And there is a pile of other empirical evidence that confirms this relation, which I have covered in several papers. The profit investment nexus. Economic growth in a capitalist economy is driven not by consumption but by business investment. That is the swing factor causing booms and slumps in capitalist economies. And business investment is driven mainly by one thing: profits or profitability – not interest rates, not confidence and not consumer demand. It is this simple, obvious and empirically confirmed explanation of regular and recurring booms and slumps that is ignored or denied by the mainstream (including Keynesian) and heterodox post-Keynesian economics.

Take this alternative explanation of recessions recently offered by an ex-Bank of England economist Dan Davies. Davies tells us that *"financial meltdowns aren't the usual way in which recessions happen, and emergency credit lines and taxpayer bailouts aren't the usual way that they're prevented or managed. What normally happens is that there's a shock of some sort to business confidence – say, political uncertainty or trade restrictions, as we're seeing at the moment – and companies react to this by cutting back investment plans."* According to Davies this *"orthodox Keynesian recession of this sort, unaccompanied by a financial market crisis, is the normal kind – and one of the best understood problems in economic policy*." Really, best understood?

So this Keynesian explanation is that there is a sudden loss of business confidence caused by some external factor like a trade war or a government falling or a war. There is nothing endogenously wrong with the capitalist process of production and investment for profit. The idea of 'shocks' to an inherently equilibrium system is the mainstream macro view, in essence. It has bred a whole industry of empirical work based on Dynamic Stochastic General Equilibrium (DSGE) models, which is a smart word for seeing what happens to an economy when an external 'shock" like a sudden loss of çonfidence' or trade tariffs is applied. Larry Summers, a leading Keynesian guru critiqued DSGE models: *"In four years of reflection and rather intense involvement with this financial crisis, not a single aspect of dynamic stochastic general equilibrium has seemed worth even a passing thought."* He moaned: *"Is macro about–as it was thought before Keynes, and came to be thought of again–cyclical fluctuations about a trend determined somewhere else, … inserting another friction in a DSGE model isn't going to get us there. "*

This órthodox Keynesian' explanation of recessions explains nothing. Why is there a sudden loss of business confidence as we are seeing now? How does a sudden loss explain <u>regular and recurring</u> slumps and booms, not one-off shocks? Davies argues that the Great Recession was exceptional in that the huge slump was caused by an extreme financial crash that won't be repeated, as 'normal' slumps are just contingent 'shocks'.

And yet the theory and the evidence is there that capitalist accumulation and production moves forward in a succession of booms and slumps or varying magnitude and length according to movement of the profitability of capital culminating on a regular basis in a collapse of profits, taking down investment, employment, incomes and consumption in that order.

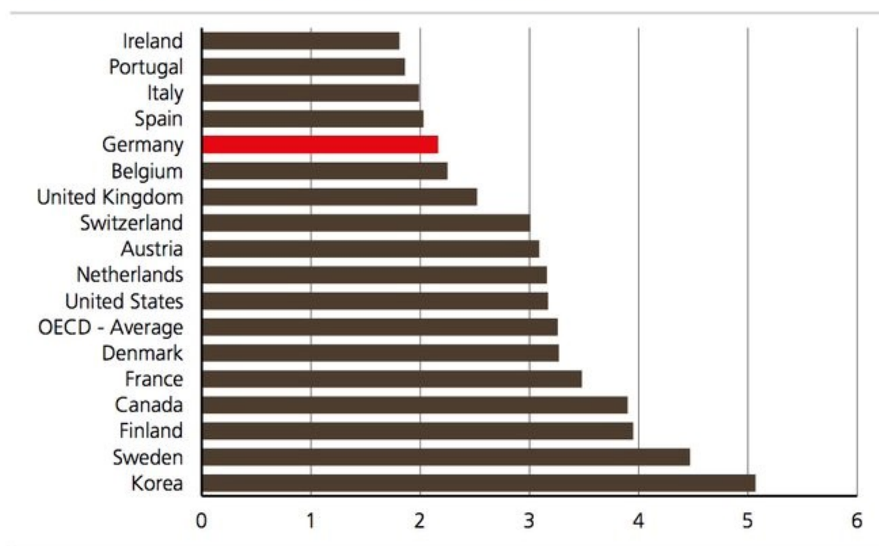
In the 1930s when Keynes realised that monetary easing was not working to end the depression, he opted for government spending (investment) through running budget deficits to stimulate 'effective demand' and get investment and consumption on a rising trend. This policy has become known as the Keynesian one, also adopted by more radical post-Keynesians and in their latest version, Modern Monetary Theory (MMT). The Keynesians reckon capitalist economies can be brought out of recessions by governments borrowing more than they get in tax revenues (running budget deficits). Governments borrows by getting financial institutions to buy their bonds.

The more radical post-Keynesians and MMTers reckon that it not even necessary to issue bonds for that purpose. Governments can just print the money and then spend it on useful projects. But all agree that 'fiscal easing' is the answer to restoring growth, investment, employment and incomes in a capitalist economy. The government borrows or prints money and the capitalists and workers spend it. Once growth is restored and full employment and rising incomes are achieved any debt servicing can be funded and you can turn off the government money tap and moderate any possible ensuing inflation if the economy is 'overheating'.

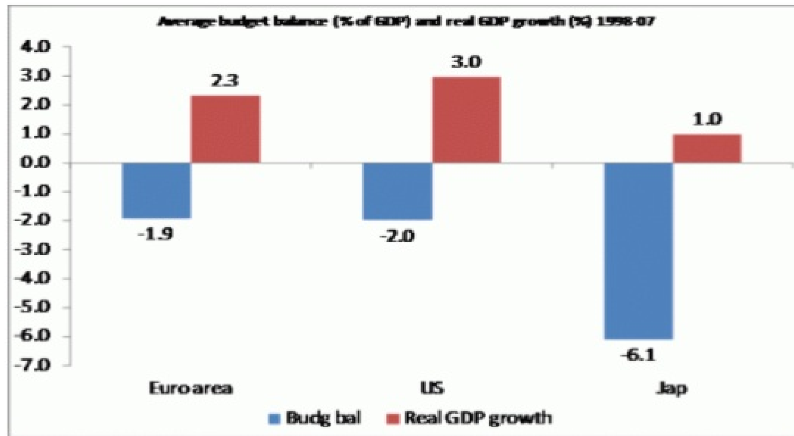
The trouble with this policy option is that we live in a capitalist economy where the investment decisions that drive any economy are made by capitalist companies. Unless government makes those investment decisions itself and rides roughshod over the capitalist sector or replaces it with state operations in a plan (as in China, for example), then investment and growth will depend on the decisions of capitalist companies.  And they only invest if they are confident of getting good profits ie the profitability of investment is high and rising.

The history of the Great Depression of the 1930s shows; and the collapse of Keynesian demand management policies in the 1970s shows; and the history of the Long Depression since 2009 shows, that if corporate profitability is low, and especially if its falling, then no amount of fiscal stimulus will deliver more investment and faster growth.

I and others have delivered a pile of empirical evidence to show that government spending has little or no impact on boosting economic growth or overall investment – the amount is either too small to have an impact (government investment averages just 2-3% of GDP in most capitalist economies compared to 15-20% of GDP for capitalist sector investment).  Or most government spending in capitalist economies are really handouts to capitalist companies or to boost welfare with little productive result.



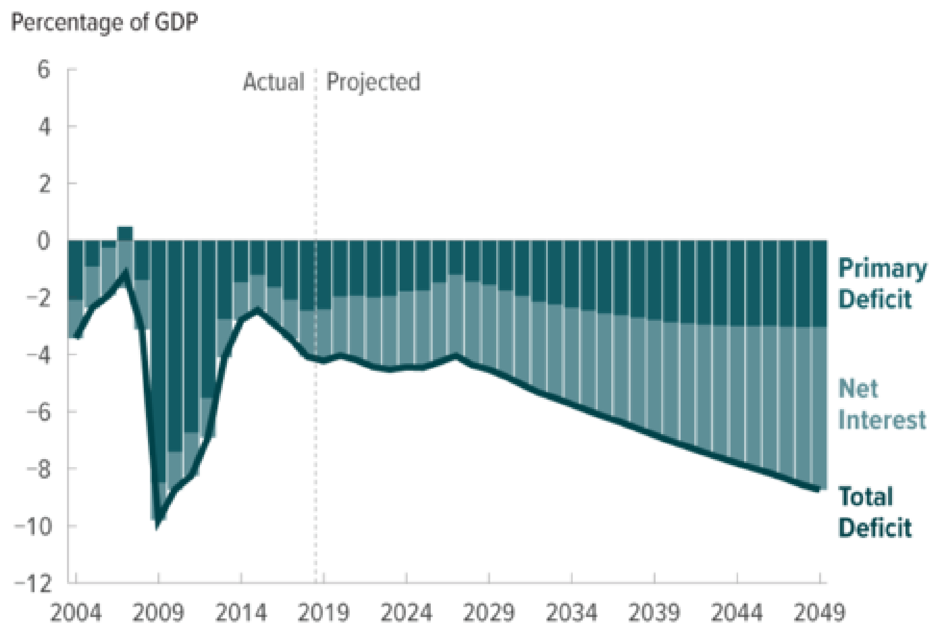

Don’t believe me – then look at the evidence here.  Take Japan – it has run budget deficits of between 3-10% of GDP for nearly 20 years and yet its growth rate has been even lower than the US or Europe.



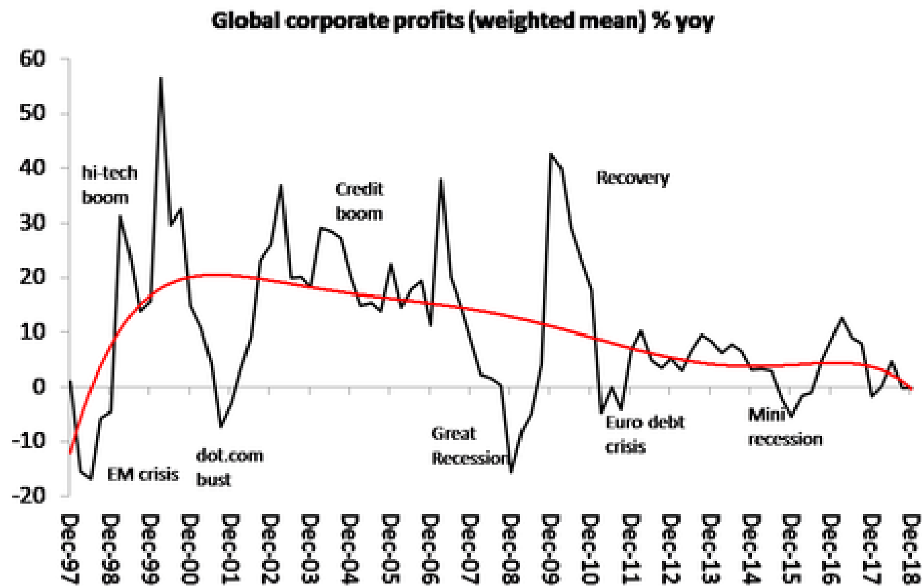

*Source: OECD, author's calculations*

The Trump tax cuts have raised the US budget deficit in the last two years and going forward – Trump is following Keynesian policies in that sense – and yet the US is now slowing down fast. The US is projected to run a primary budget deficit (that excludes the interest cost on the debt) for the foreseeable future. Do Keynesians really expect the US economy to grow faster as a result?

<u>US budget projections</u>




Although the inverted yield curve can be checked daily, it may not be a useful indicator of a coming recession but falling profits are (unfortunately, profits data are mostly quarterly). Empirical studies by the one mentioned by Harrison above and many others confirm this. And global corporate profits are now stagnating;




while US non-financial corporate profits are falling.

Monetary and fiscal solutions to recessions that still preserve the profit-making capitalist system won't work.  Monetary easing has failed, as it has done before.  Fiscal easing, where adopted, has also failed.  Indeed, capitalism can only get out of a recession by the recession itself.  A recession would wipe out weaker capitalist companies and lay off unproductive workers.  The cost of production then falls and those companies left after the slump have higher profitability as the incentive to invest.  That is the 'normal' recession.  In a depression, however, that process requires several slumps (as in the late 19th century depression) before normal service is resumed.  Another recession is on its way and neither monetary nor fiscal measures can stop it.