

Entrepreneurial risk and the most dangerous idea at a central bank: Monetary policy doesn't matter

"In the end, though, firms and individuals have to have the confidence to take advantage of the situation. They have to be willing to take a risk – on a new project, a new product, a new market, a new worker. Monetary policy can't force spending to occur."

Glenn Stevens, RBA Governor

One of the immutable truths of financial markets is the eternal (and often unjustified) optimism of sell-side analysts' earnings forecasts. But in recent years, economists' projections across the advanced economies have turned out to be far too optimistic as well.

Recently it was the turn of the US Federal Reserve to downgrade its growth projections for the US economy yet again. Their central projection is for real output to expand by 2.2% in 2014, well below the previous estimate of 2.9%. This amounts to a 70 basis point net loss in expected GDP over the next three years because the Fed has not re-allocated growth to the out-years. Thus, growth forecasts for 2015 and 2016 of 3.1% and 2.75% have remained unchanged.

The less optimistic outlook continues a long line of downgrades to the US economy. The Fed's first estimates for GDP growth in 2012, 2013 and 2014 were all above 3.5%, which have each been slashed to below 2.5% over the past four years.

Australia's growth in recent years has also fallen well shy of consensus expectations. The economy only now is starting to emerge from what has been a nominal recession for the past two years. Nominal GDP expanded at an annual rate of less than 4% in 2012 and 2013, the weakest two consecutive years since the recession of the early 1990s.

It is clear from recent RBA communications that its view is that dormant animal spirits and little appetite for entrepreneurial risk has hindered the post crisis recovery. For a while now, the Reserve Bank Governor has bemoaned the fact that the gales of creative destruction remain weak, acknowledging that there is not enough genuine entrepreneurial risk occurring in Australia and other advanced economies.

The data flow bears this out. New business investment in the Australian non-mining sector has declined to 4% of GDP, well below the 2009 peak of 7% and the historical average of 6%. Meanwhile in the US, private investment in non-residential fixed assets of around 11% of GDP remains well below the 2009 peak of 13.5%.

The post-crisis profile of capital spending in advanced economies has fallen well short of the history of post-recession recoveries. Most downturns following World War 2 were precipitated by monetary policy tightening to quell rising inflationary pressures. The pent up demand caused interest sensitive spending – including capital investment – to recovery strongly when interest rates were subsequently reduced. But since the financial crisis, private sector deleveraging and a slow recovery in nominal GDP have continued to dull the corporate sector's animal spirits and restrain capital spending.

At the micro level, the evidence shows that businesses have little appetite for hiring or taking on new projects. High cash levels on balance sheets and low corporate gearing point to a still strong precautionary savings motive, while companies continue to trim costs to boost profitability in an environment of anaemic top line growth.

Broadly speaking, there are two schools of thought for why animal spirits remain dormant. The first takes a long run view of entrepreneurial risk taking, emphasising the role played by supply side factors in influencing innovation, including shifts in technology, productivity and consumer preferences.

The second school embraces the view that there are inherently unpredictable and violent swings in the psychology of entrepreneurial risk taking which can cause the economic cycle to be unstable. This affords an important role to monetary policy to influence the corporate sector's psychology.

If capital spending in advanced economies remains weak because of lower expected growth in nominal GDP and greater uncertainty surrounding the outlook, monetary policy has an important role to play in promoting risk taking and reviving the corporate sector's animal spirits.

But by proclaiming that monetary policy cannot effectively encourage businesses to take risks nor force spending to occur, it is clear that the RBA Governor belongs to the supply side view of risk taking. But what is the role of monetary policy, if not to influence people's perception of risk and discount rates?

While monetary policy is limited in its ability to affect long-run dynamics of productivity growth, it is the role of a central bank to prevent a cyclical shortfall in aggregate demand or act to prevent any such shortfall from continuing. The experience of the Bank of Japan in recent decades provides an important lesson on this front.

Central bankers have been on a steep learning curve in the past five years. Concerns surrounding the liquidity trap associated with zero interest rate policies have given way to the growing realisation that monetary policy can still be effective and affect expectations, risk taking attitudes and asset prices through forward guidance and large scale asset purchases.

In the American Economic Review, Christina and David Romer from the University of California argue that the most dangerous idea in the Federal Reserve's history is that monetary policy does not matter. They attribute the prolonged downturn of the great depression and the great inflation of the 1970s to policy errors committed by the Federal Reserve, stemming from an *'unduly pessimistic view of what monetary policy can accomplish'*.

Glenn Stevens remains frustrated that monetary policy's role in promoting the recovery is not getting an assist from government policies that facilitate higher productivity. Moreover, he is clearly concerned that a prolonged period of low interest rates in Australia and globally will encourage excessive risk taking in financial markets, via the search for yield. But by being timid in its approach to monetary policy, the risk is that interest rates will have to remain lower for longer than is necessary.

The RBA's timidity and its tendency to underestimate the power of monetary policy to revive the corporate sector's animal spirits could well condemn Australia to a prolonged period of sub-trend growth in nominal GDP and company revenues. Against this backdrop, the new capital and cost discipline will remain a feature of corporate Australia's landscape for a while yet.

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All charts and references underpinning the analysis are available on request.



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