Article for the Bretton Woods Committee

Robert Bergqvist, Chief Economist, SEB Group

The world economy is in a difficult uphill struggle, despite many years of uniquely expansionary and unproven monetary policy. Central banks are continuing along the same well-worn path, but doubts are growing – even at the IMF and BIS – about the effectiveness and impact of this policy on the real economy. Meanwhile global indebtedness is record-high, according to BIS statistics. Threats of sustained lethargic growth – secular stagnation – increase the risk of a new balance sheet recession like the one that occurred in 2008-2009. Central banks are under pressure to continue supporting asset prices, while investors add further portfolio risk to achieve the promised returns. Credit quality is falling and credit risks are rising. Central banks and investors are caught in a downward spiral that might eventually have major consequences in the real economy.

The risks of monetary policy are obvious. Zero or negative interest rate policy and quantitative easing are creating efficiency losses and new problems in the real and financial economy. Economic inequalities are rising. Allocation of financial resources is worsening. Large asset purchases represent ever-larger interventions in the functioning of the market economy. Central banks are aware of – and seemingly accept – these risks in the absence of smart fiscal policy and the presence of asymmetric risks.

Sweden has had negative interest rates since February 2015; today's key rate is -0.50 per cent. The effects of Riksbank policy exemplify these policy issues. Households have not experienced negative deposit rates, affecting profitability in the banking system and ultimately the monetary transmission mechanism. Swedish businesses have not become more willing to invest, since manufacturers and others are struggling with global overcapacity and weak pricing power. Some Swedish households are concerned that current policy is signalling problems, despite about 3.5 per cent GDP growth. This uncertainty is contributing to a historically high 15 per cent savings ratio.

High global savings propensity and low investment appetite are squeezing short-term real interest rates. Their level is very important in assessing the degree of expansiveness, but also the pace at which monetary normalisation can be implemented. Creating further uncertainty among central banks are analyses that send mixed messages on whether the current squeeze on real interest rates is *permanent/sustainable* or *temporary/cyclical*. There are many indications that it is sustainable. This past year, more and more central banks have adapted their models to a new world of real interest rates. For example, the Fed has made major downward adjustments to its normal real and nominal short-term rates. Other central banks have, or are expected to, follow the Fed's real interest rate conclusions.

Lower central bank key rates are thus partly a reflection of, and adaptation to, these “gravitational forces" related to saving and investments, but it cannot be ruled out that unconventional policy also adds new uncertainty about the future, thereby contributing to the downward spiral. This problem is global. The solution is increased international monetary and currency coordination within the G20 and greater focus on fiscal and restructuring policies that help reduce uncertainty and promote optimism.