The Problems with Success

Failures are humbling and costly, but ultimately it is success that is more challenging.

The strains which broke the back of the economic and financial system emanated from its successes. Years of economic growth produced surpluses in Asia after the 1997-1998 financial crisis, and emerging markets more generally, that could not absorbed. These surpluses were exported.

The financial deregulation can be traced to the late 1970s and accelerated in 1980s and 1990s. This widened the financial pipes, broadening capacity and multiplying the number of financial instruments, while weakening the walls of those very pipes.

Europe's financial system could not absorb its own surpluses; instead European banks feasted on US securitization of debt instruments before turning to its own peripheral sovereign bond markets.

In an environment characterized by de-leveraging, fiscal austerity and weak wage growth, the ability to sustain aggregate demand is critical for social, political as well as economic stability. A parallel issue exists in the financial system. Ultimately, it needs to be able to absorb and distribute greater amounts of savings and investment and at a lower societal price.

Using Central Banks' Balance Sheet: Permanent?

The recent string of US data has helped relieve fears that the pattern of the past couple of years was going to repeat, by which respectable Q4 growth is followed by a disappointing Q1. While a broad number of economic indicators continue to suggest the US economy is on the mend, the financial system remains in disrepair.

Central banks have moved to fill the breach. The Federal Reserve and the European Central Bank reject that they are engaged in what the market calls "quantitative easing". Yet the fact of the matter is that their balance sheets, like those of the Bank of England, the Bank of Japan and the Swiss National Bank, have all expanded markedly since onset of the crisis.

Out of the Great Depression grew a nearly universal recognition among policy makers of the value of counter-cyclical government spending. But more: the size of government (expenditures as a percentage of GDP) has grown markedly since then and on a seemingly permanent basis. In fact, it is not uncommon for some European countries, and not just the weak periphery but even France and some very successful and competitive Northern European countries, for government expenditures to account for a little more than half of GDP.

In a parallel fashion, it is possible that out of what has become dubbed as the Great Recession that officials have acquired another policy lever that can be brought to bear—its balance sheet. Thus, it is tempting to think that it is only possible to do so in the unusual circumstance of near-zero interest rates.

While this does seem to apply to the US, Japan and Switzerland, it does not apply so much to the ECB and BOE. In fact, recall that the ECB was buying sovereign bonds in the secondary market as it purchased sovereign bonds last year.

Operation Twist in the US also illustrates that it is not just the size of the balance sheet that be used, but also its portfolio allocation can be used to achieve policy goals. The experience of the BOJ and the ECB suggests another way the balance sheet can be used.

The Federal Reserve and the Bank of England for the most part have bought what are regarded as low risk assets. The BOE has bought mostly government bonds. The Federal Reserve has bought mostly Treasures and mortgage backed securities (the risk of which seems to have been nationalized now that US government through Fannie Mae and Freddie Mac own the majority of mortgages).

In contrast, the Bank of Japan and the European Central Bank bought higher risk assets. The BOJ is buying assets like ETFs and corporate bonds, for example. It argues that buying riskier assets allows its purchases to have greater impact. It suggests that when adjusted for volatility, its purchases are "larger" than the notional value implies.

The ECB is buying sovereign bonds, but the sovereign bonds that are higher risk and many in the market do not want to buy or hold on to. Its purchases are not transparent, but it is understood to have bought Greek, Irish, Portuguese, Spanish and Italian bonds, not German, French, Dutch or Austrian bonds.

The ECB has also lent money to numerous banks, some of whom would not survive without such access. It has also reduced the credit threshold of the collateral it is willing to accept, including sovereign bonds that have lost their investment grade ratings.

Corporate Surplus

Since the crisis, and fearful of another credit crunch, businesses have boosted their cash holdings. At the end of last year, non-financial US corporations had $1.7 trillion of cash or cash equivalents on their balance sheets.

This means that cash accounts for almost 6% of all corporate assets and the highest in sixty years. It represents a 50% increase from pre-crisis levels. Anecdotal reports suggest European corporate have also boosted cash holdings.

This increase is a result of a number of factors. Record profits give businesses the wherewithal. Corporate profits as a share of GDP have not been this high since 1950. America is producing more goods and services than ever before with about three million less workers.

Next, with economic growth sub-par, excess capacity may also limit new profitable opportunities. Corporations have been so successful that profits have grown faster than opportunities for new investment. US corporations are also paying out a smaller proportion of their earnings as dividends than since at least 1900.

There are economic and financial consequences of such large and growing cash holdings. First, consider what does not happen. Corporations are not rewarded for the cash holdings. Work by Birinyi Associates found that the top 25 corporations in the S&P 500 with the largest cash holdings saw their shares rise a little less than 3% last year. This compares with an almost 12% rise in the shares of the 25 S&P 500 corporations with the least amount of cash.

Second, the cash is held in such instruments as money market funds, commercial paper and bank deposits. It adds to the pool of short-term capital looking for a home. It is part of the fuel of asset market bubbles and busts. Recall what happened when US money markets shunned parts of the US commercial paper or when they dramatically reduced exposure to European banks.

Third, often for tax purposes the cash is kept overseas. Apple illustrates the point. Of its nearly $98 bln in cash on its balance sheet, about $64 bln or 2/3 is overseas. This creates a powerful constituency lobbying of tax breaks for repatriation. Studies of the last such tax holiday show that corporations did not use those funds for investment or employment purposes.

This in turn distorts the US current account by depressing the investment income balance. The US current account deficit appears to be a source of angst of policy makers and fuels almost a chronic threat of protectionism.

Separately, note past experience, surveys and anecdotal evidence suggests the bulk of the retained earnings overseas are kept in dollar denominated instruments. This means that the dollar implications of the overseas cash holdings may not be very significant.

In summary this essay sketches out how central banks and businesses, especially American corporations, have responded to the crisis. Regardless of the labels, the major central banks have deployed their balance sheets. This may be a more permanent addition to the policy tools that central banks may draw upon.

Corporations have boosted their preference for cash. Part of this increase in cash holdings is a form of self-insurance against another credit crunch. It is securing its supply (capital) lines. Part of it appears to be involuntary--a function of fewer new suitable investment opportunities relative to current profits.

To the extent that these retained earnings add to the pool of hot money sloshing around the global capital markets, it contributes to the financial instability, especially when the financial dis-intermediaries are unable or incapable to safely manage the funds.

Corporations with large cash stockpiles have not been rewarded by investors. Surveys suggest investors have little confidence in the ability of businesses to deploy the cash wisely either in fairly priced acquisitions or share buy backs. Rating agencies and government officials often express concern when managing cash becomes an increasingly important part of the corporate treasurers' function.

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