

DRAFT FOR PKF O'Connor Davies, LLP

China, Negative Interest Rates, and Economic Policy in a Turbulent World

June 2, 2016

D. Sykes Wilford

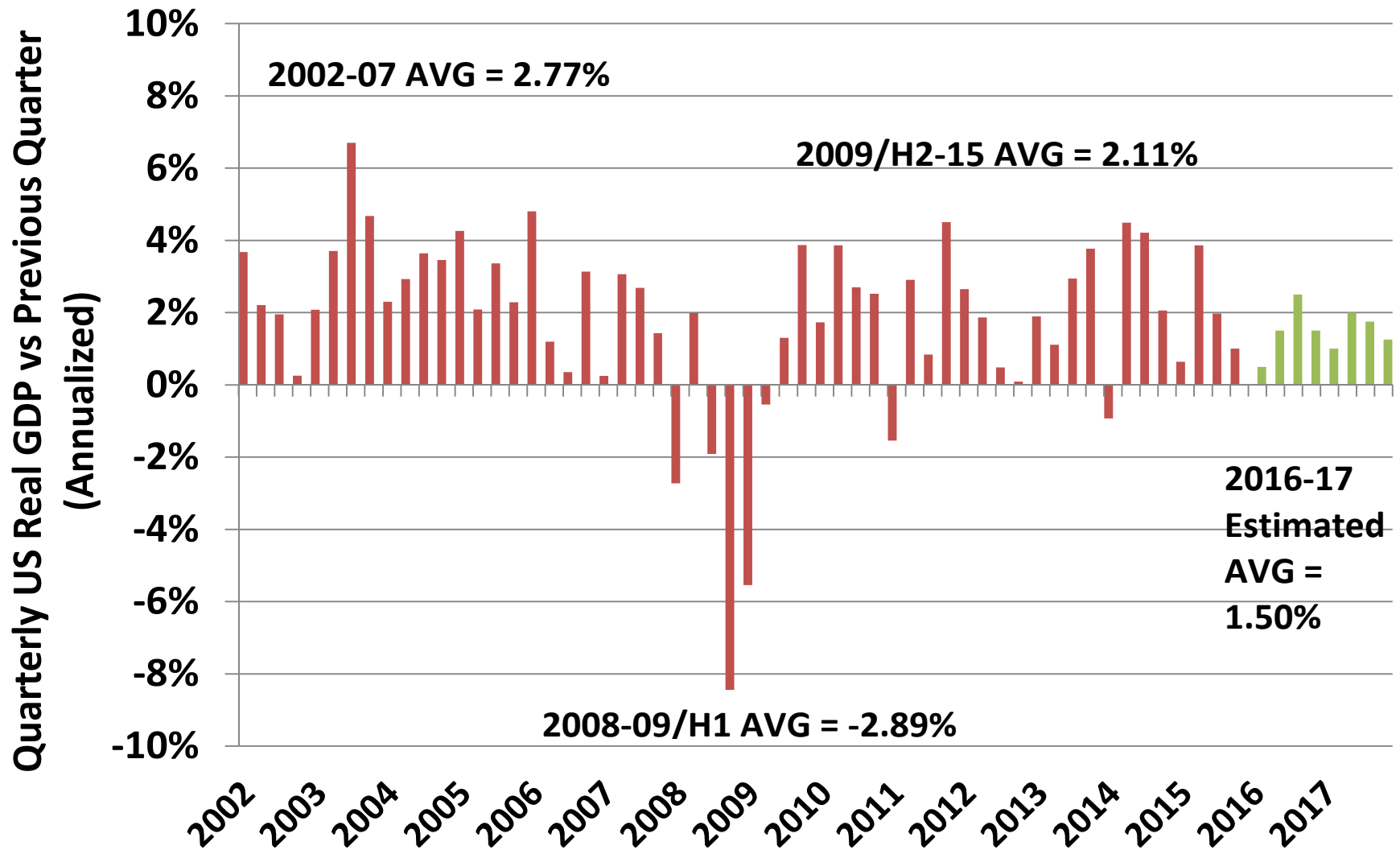
The Citadel

Setting the Stage

- The U S Growth Picture
 - 1.5% Norm?
 - Do we have to live with this?
- The Inflation Picture
 - 1.5% Norm? ?
- The People Picture
 - Demographics are ugly
- And China is not a help!

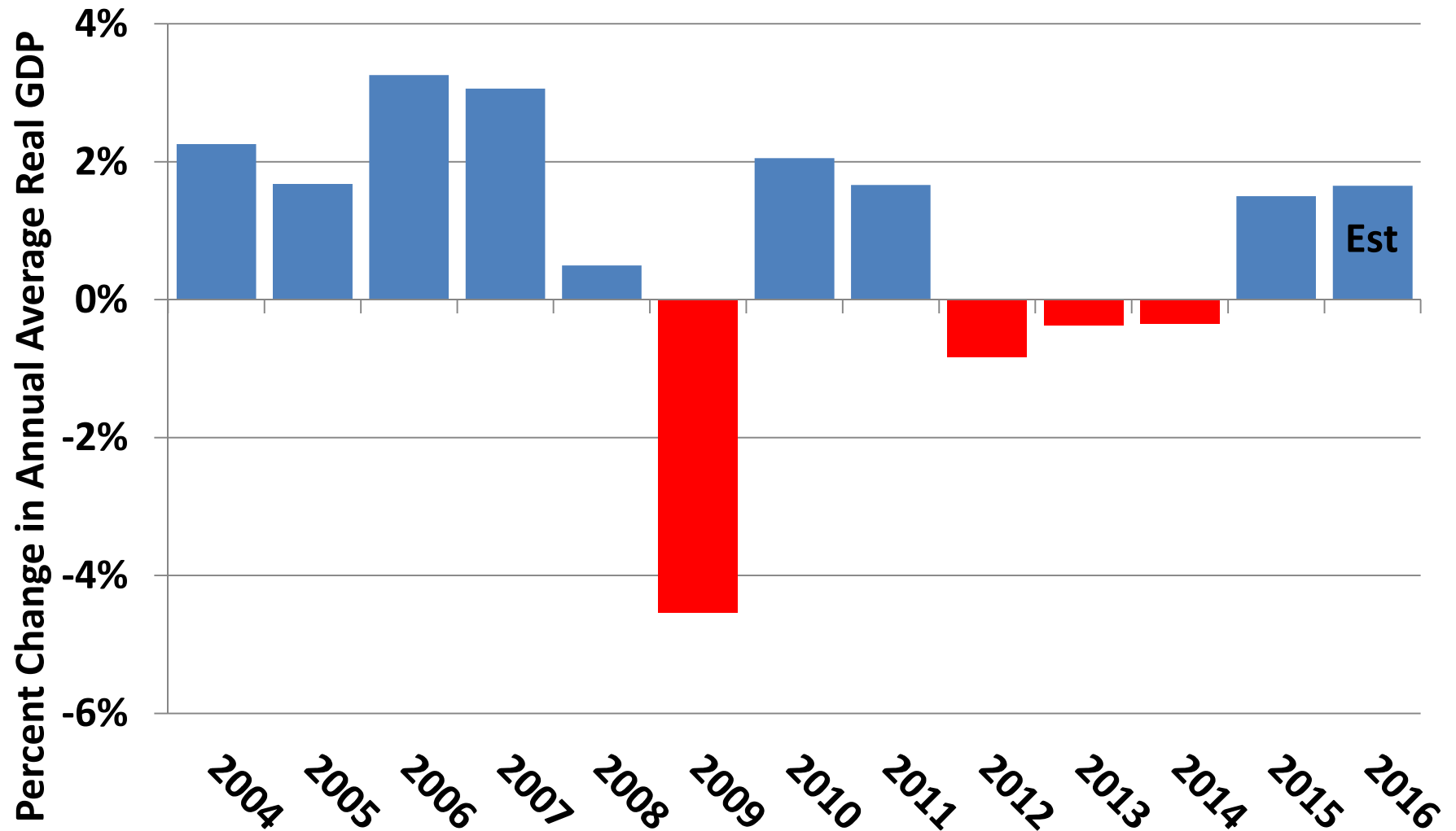
The Western Economy: No Inflation,
No Growth, No.....: Hope?

US Real GDP



Source: St. Louis Federal Reserve Bank FRED Database (GDPC1).

Euro-Zone Economic Growth



Source: Historical data from the World Bank via Bloomberg Professional (WRGDEURO). 2014 and 2015 estimates by CME Economics

Quantitative Easing (QE) did not create Inflation or growth

- **US Federal Reserve -- \$3.6 trillion of QE since September 2008 – Virtually no inflation.**
- **European Central Bank -- € 1.3 trillion of QE since 2008 – Virtually no inflation.**
- **Bank of Japan -- ¥ 250 trillion of QE since December 2012 – Virtually no inflation.**

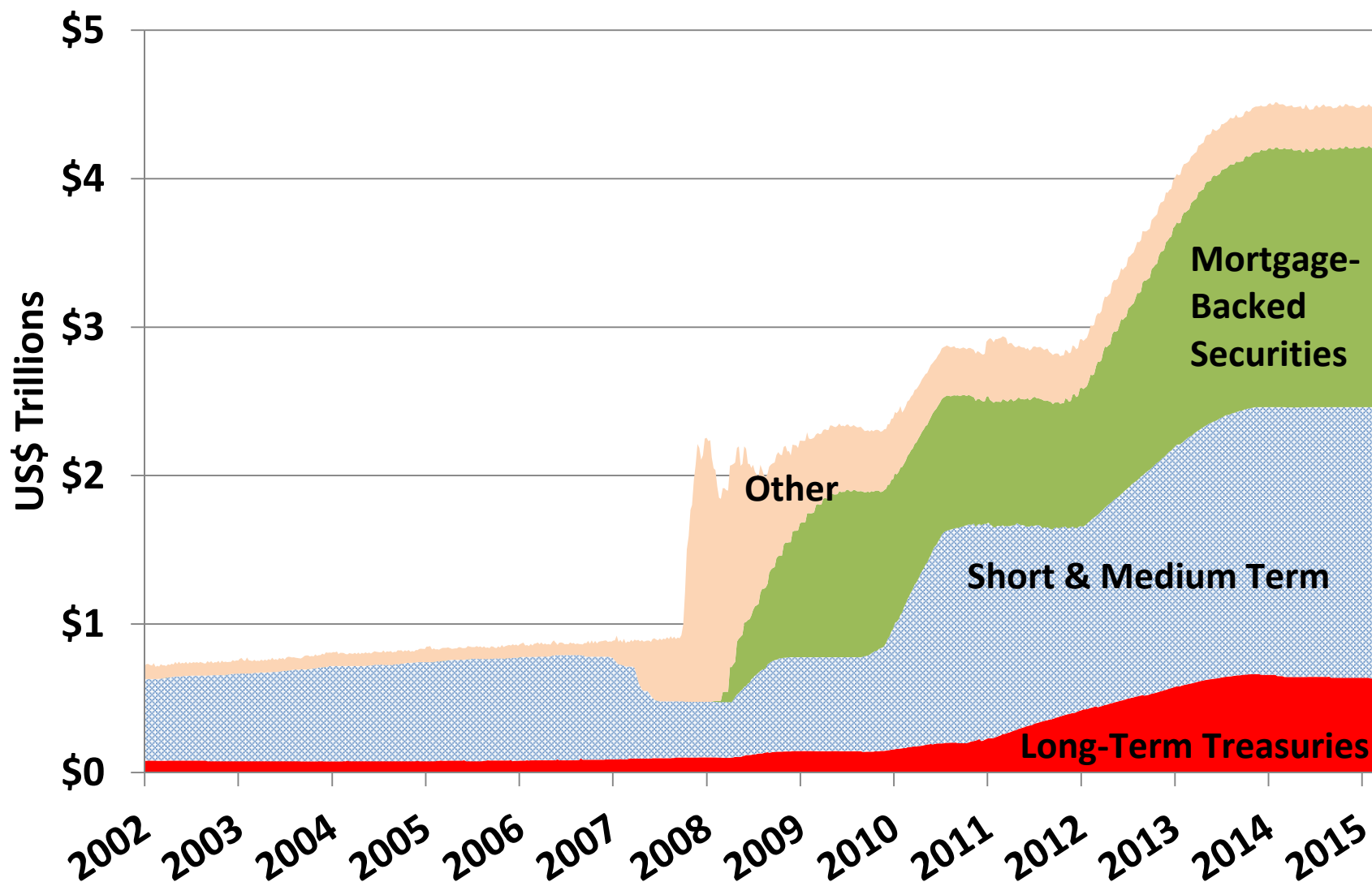
Can the Fed Create Excess Demand and Inflation?

- From Friedman and Schwartz Monetary Economists know Excess Money causes Inflation

$$\bullet MV = PT$$

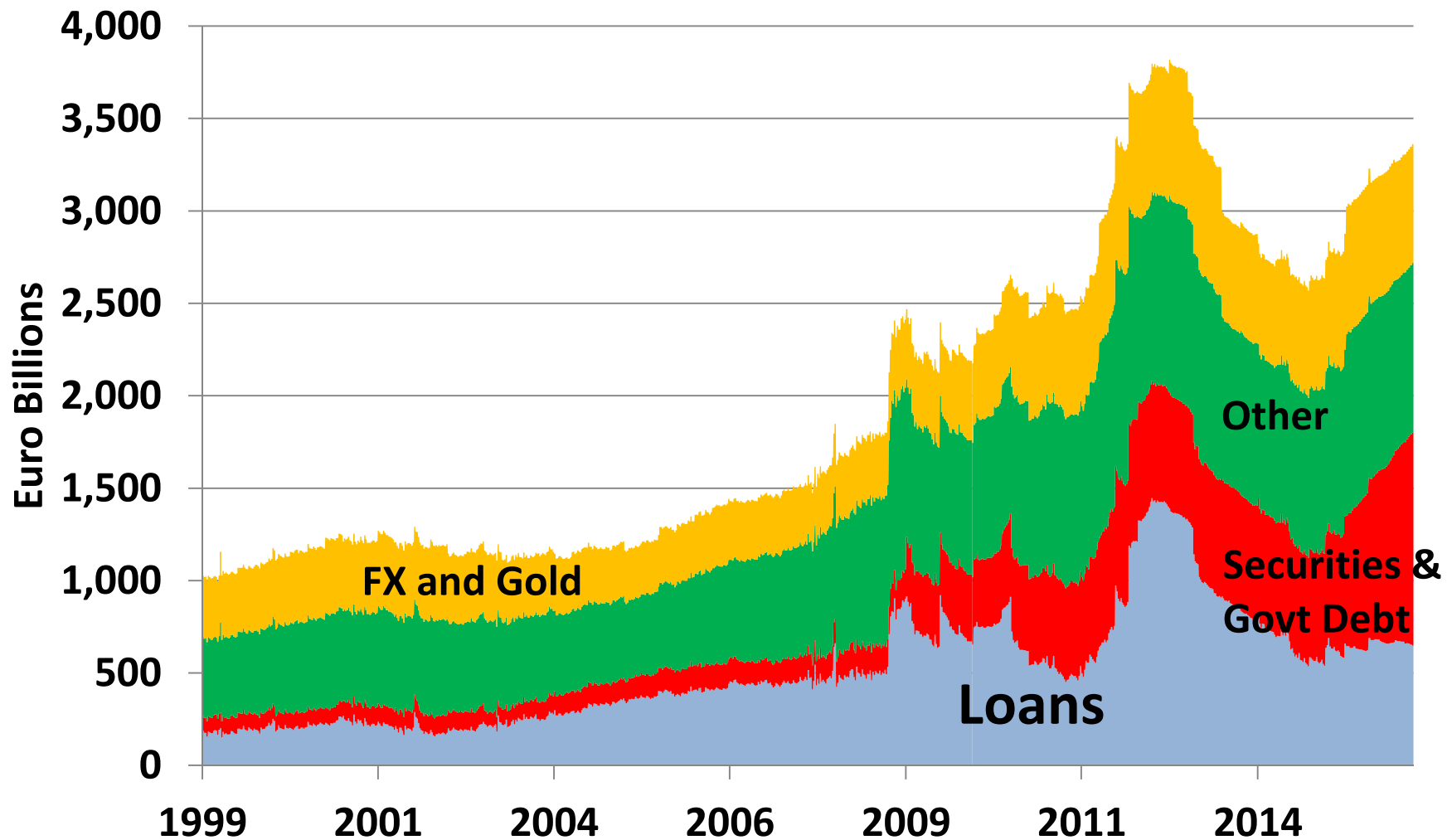
- And,
- $M = H$ (High Powered Money) X a (Money Multiplier)
- So lets get H going and

Composition of Federal Reserve Assets



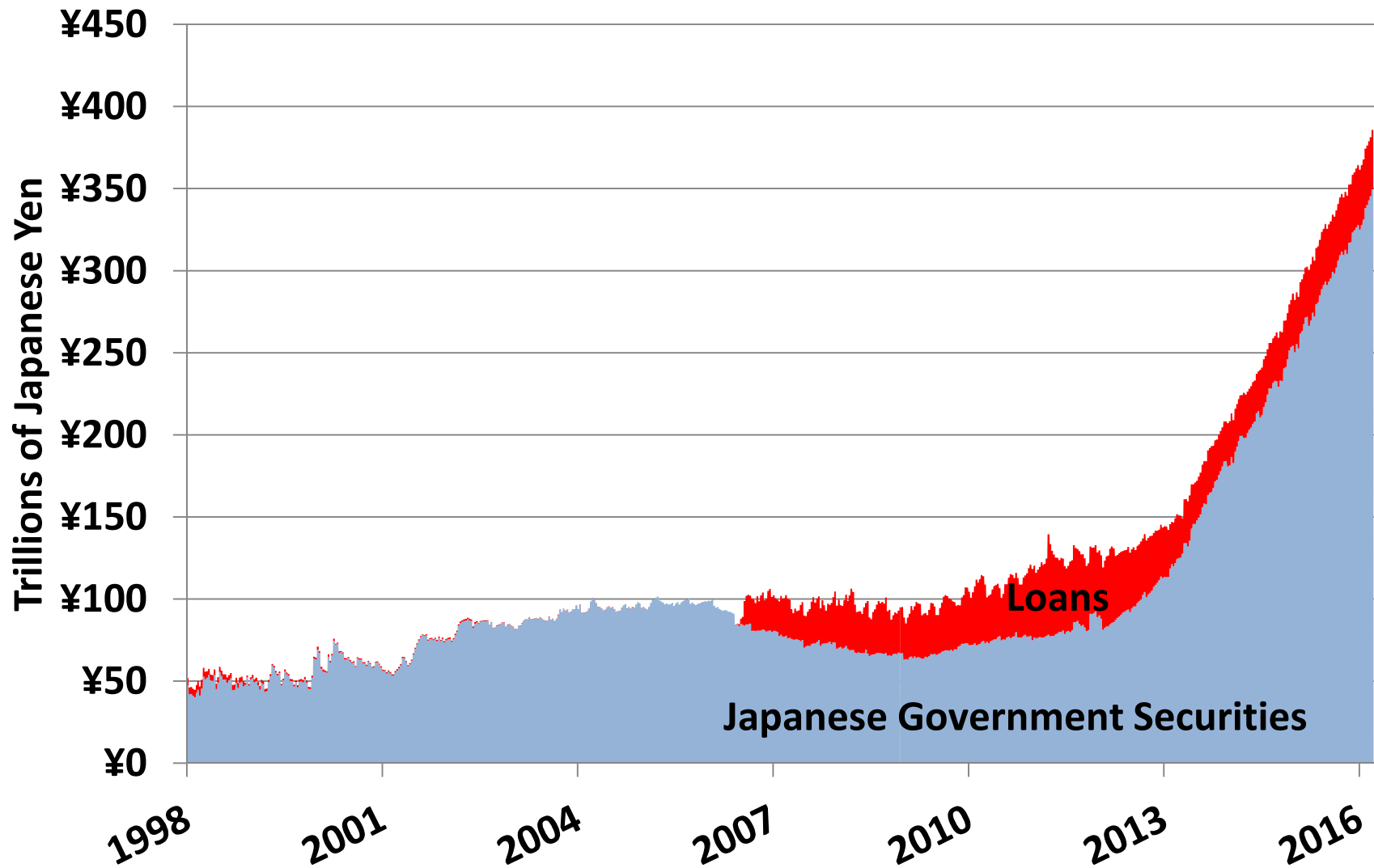
Source: Federal Reserve Bank of St. Louis FRED Database

European Central Bank Assets



Source: European Central Bank Monthly Bulletins, obtained through the Bloomberg Professional.

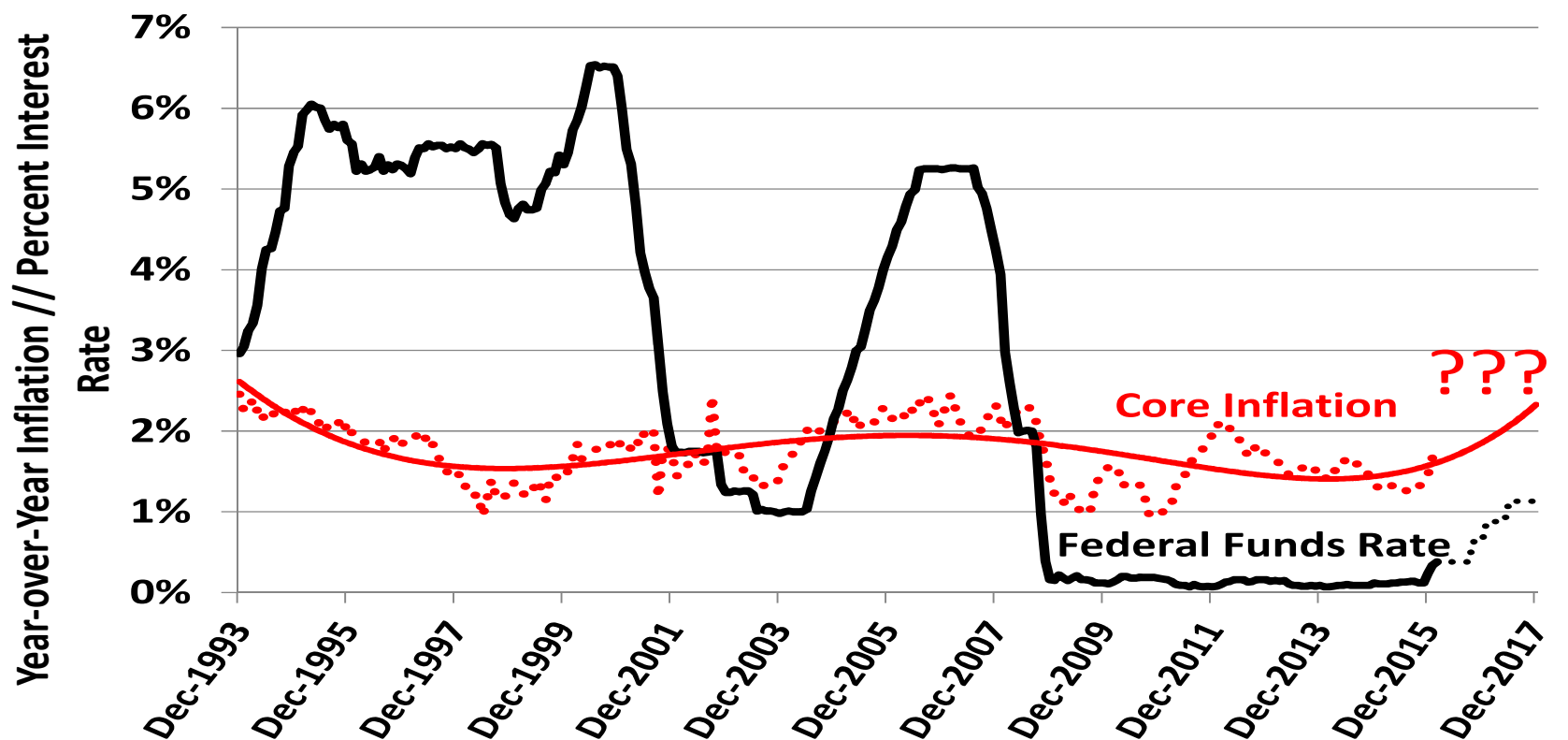
Bank of Japan Assets



Source: Bank of Japan (www.boj.or.jp)

No Excess Demand and No Inflation

US Core Inflation and Federal Funds Rate

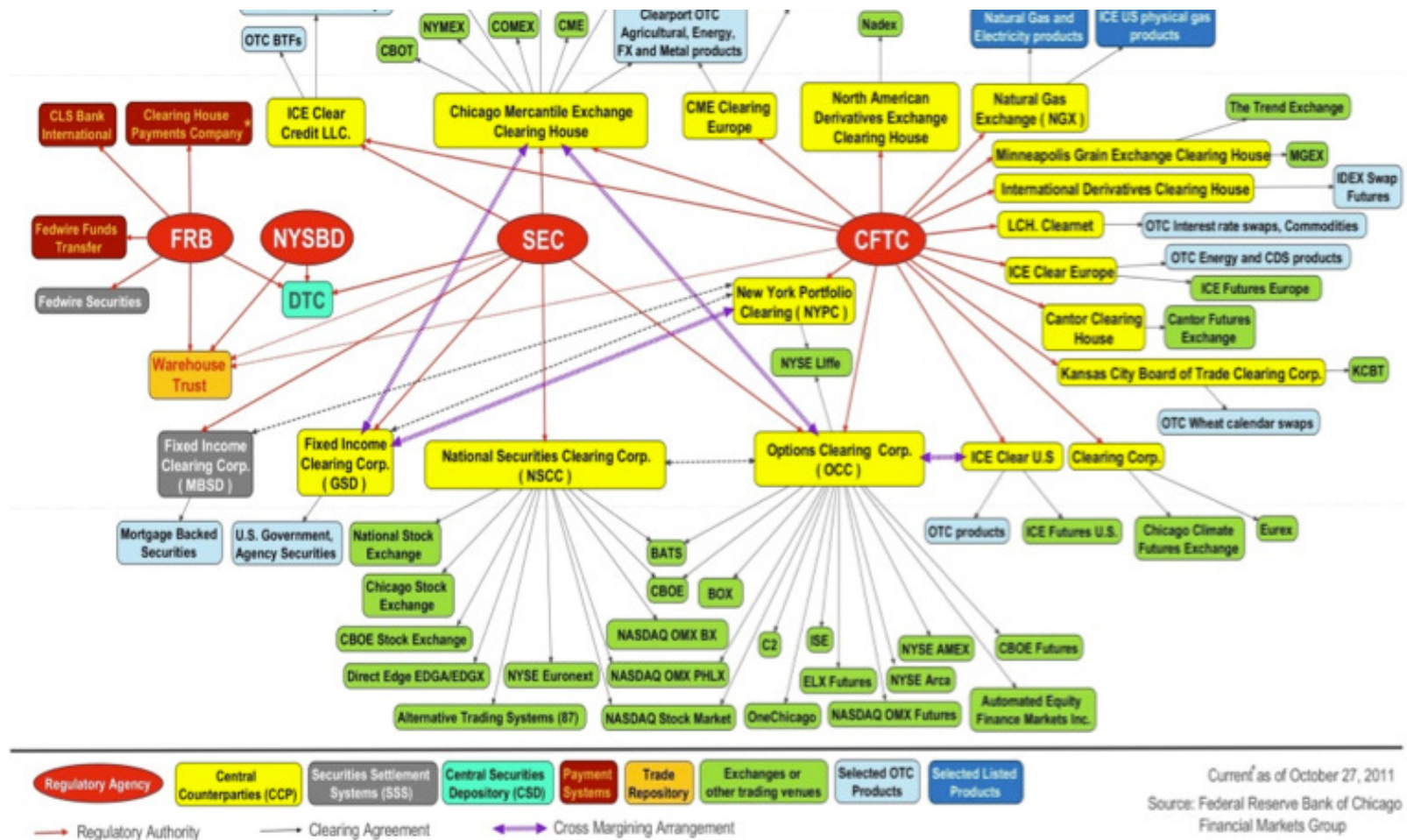


Source: Federal Reserve Bank of St. Louis FRED Database (PCEPILFE, FEDFUNDS)

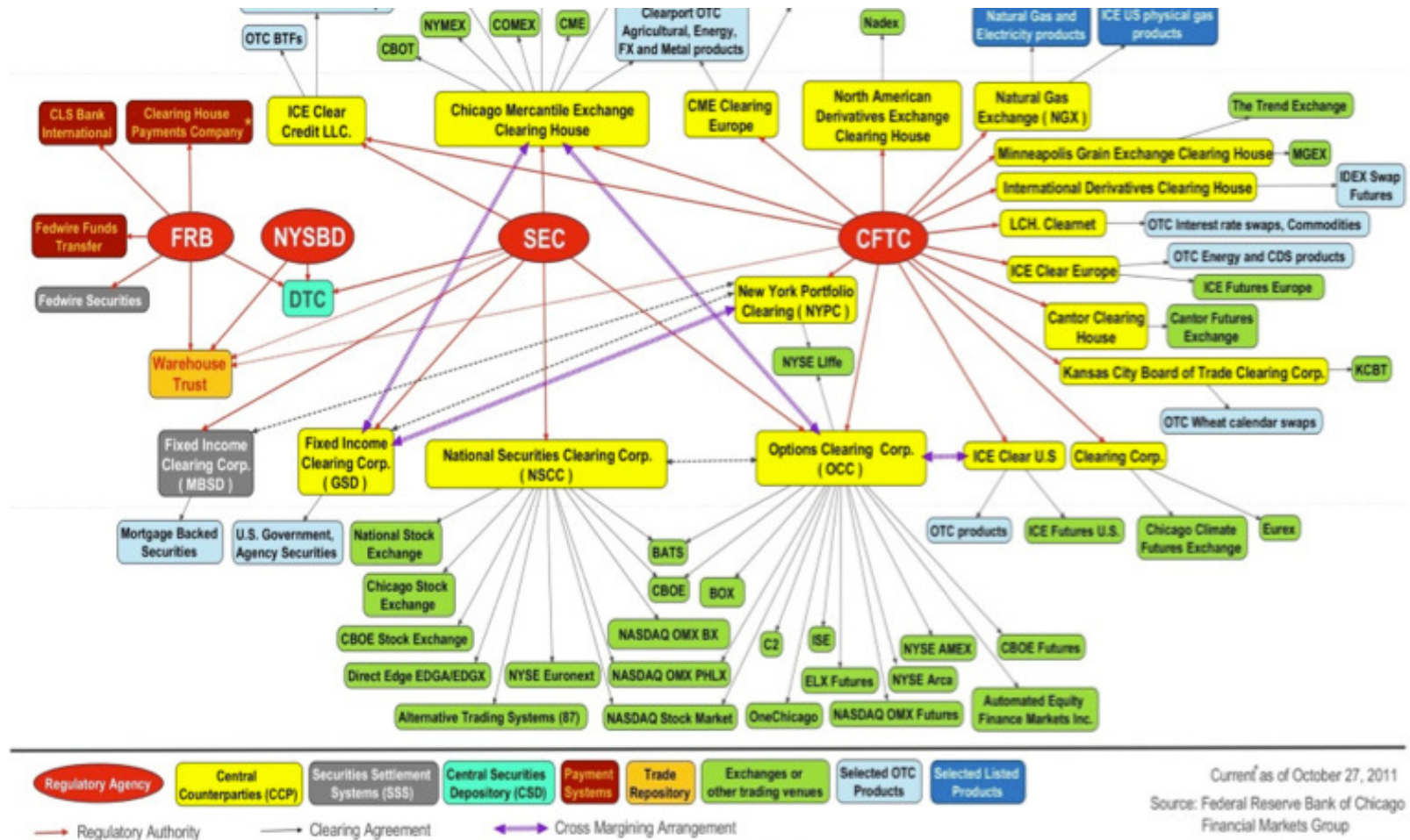
Add it UP: The monetary authorities have lost their **Swagger!**

- ✓ Central Banks can slow an economy
- ✓ Central Banks can cause non-market allocation of capital – MULTIPLE EXPANSION
- ✓ They can cause a recession and or a depression if they really want to do so
- ✓ They maybe can provide liquidity to avoid a depression after a banking failure
- ✓ **Create Excess Demand: Not Easily – they need banks to function --**
- ✓ **Or as Hayek said, Busts are just Broken Banks**

Why are the Banks Broken?



Oh, this is not even the Banks!



Global Banking System is Broken
and we cannot engineer an old
fashioned Boom or Inflation!

Destroying the System does not
appear to be a good alternative!

Let's try Negative Interest Rates

Ok, We want growth!
Give us Negative Interest Rates

Negative Rates = Stimulus: Yes or No?

Simple Logic: $MV=PT$

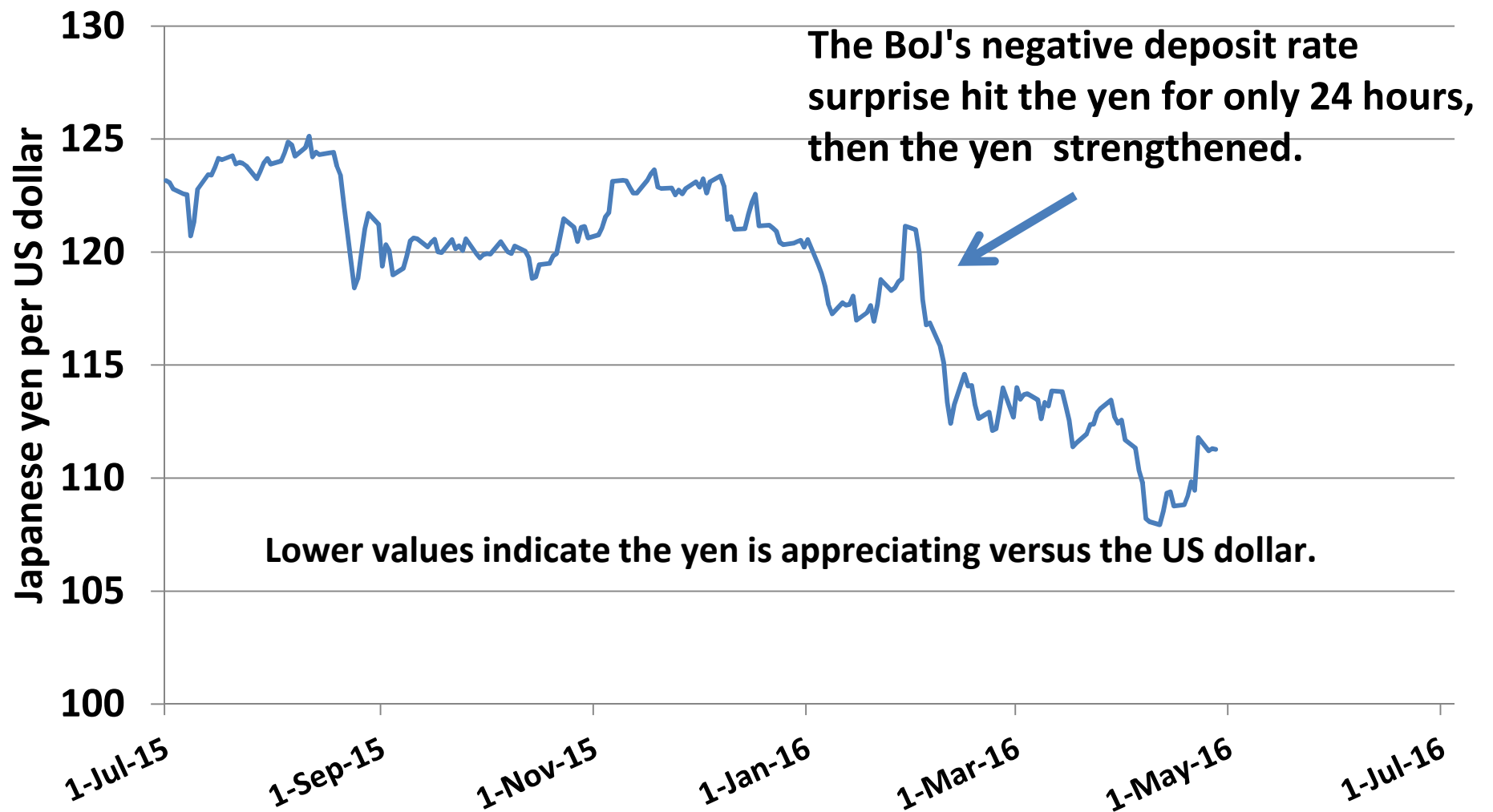
$M_s = a \times H \uparrow$, Did not work!

$M_d = f(-\text{rates})$, so get rates **Negative**

Rates \downarrow = Stimulus

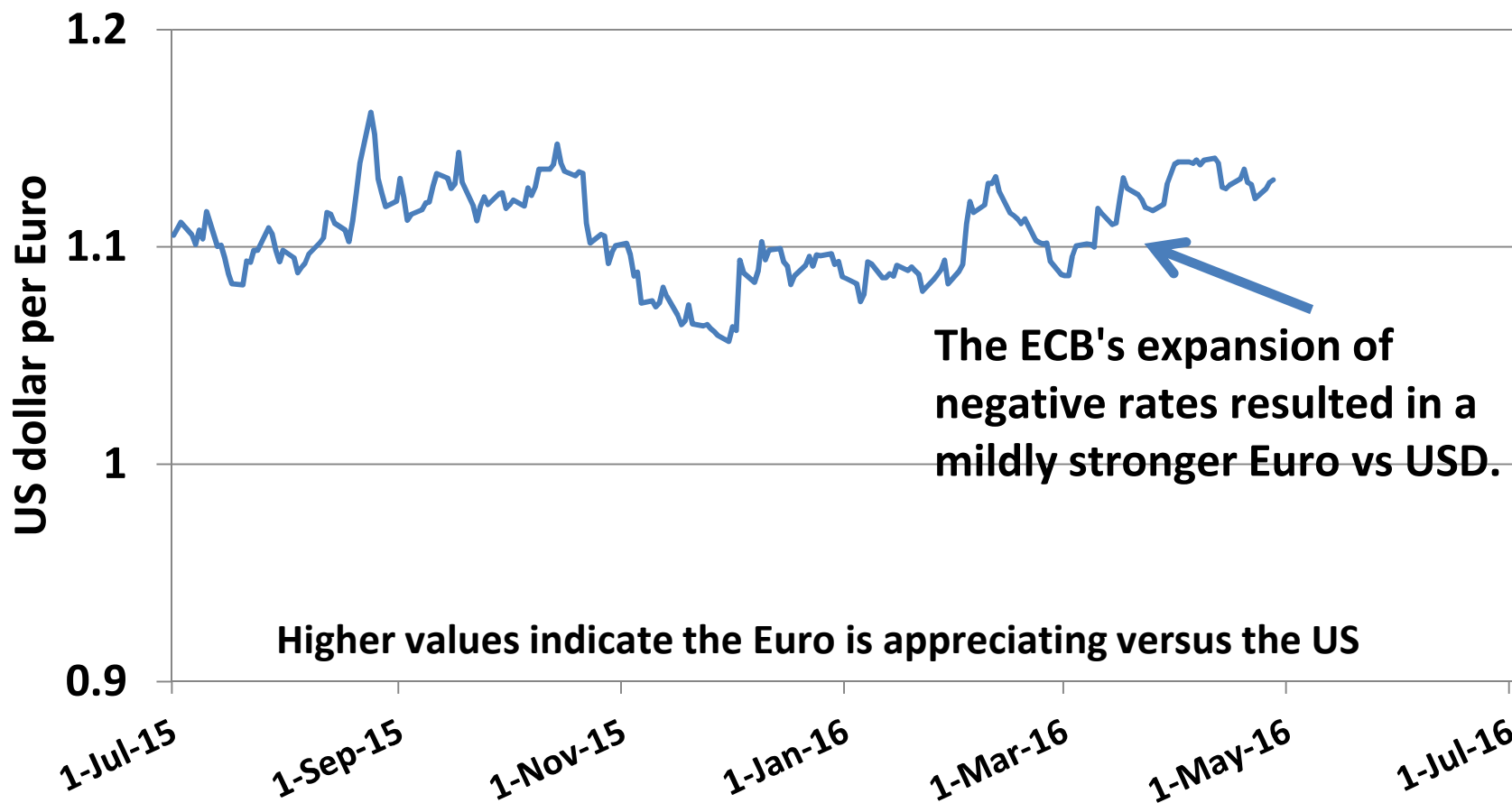
Weaker Currency, More Demand,

Japanese Yen (vs USD) and the Bank of Japan's Negative Interest Rate Policy



Source: Reuters (Japanese yen per USD spot FX).

Euro and the European Central Bank's Negative Interest Rate Policy



Source: Reuters (USD per Euro Spot FX).

Negative Rates Are A TAX on Banks

- Banks work on a Fractional Reserve System
- Negative rates imply **Less**, not more **Capital!**
 - **Because**

Banks cannot pass along the negative rates to depositors!

Capital ↓ Restricts Liquidity →→→
Tighter Policy

Can Government Stimulate Economic Growth from a recession?

- Keynesian Approach
 - (Demand Driven)
- Increase Spending
 - USA
 - Europe
 - China
 - Japan
- Decrease Taxes
 - USA
 - Europe
 - Japan
- Monetary System does not matter

- What we did!

Not really

- Total Spending slowed as % GDP
- Remember the Germans
- Yes
- Tried to build bridges to nowhere

NOPE

- Raised Marginal Tax Rates
- Raised Taxes
- Raised Taxes again

Can Government Stimulate Economic Growth from a recession?

- Austrian Supply Side Approach

- (Less Government)

- Decrease Regulation

- USA
- Europe
- China
- Japan

- Decrease Taxes

- USA
- Europe
- Japan

- Monetary System needs Freedom to allocate Capital efficiently

- What we did!

Not really

- Silly Question
- Some yes (banking NO< NO< NO)
- Yes to some extent (less now)
- Fix the Banks and Crony Capitalism: Impossible!

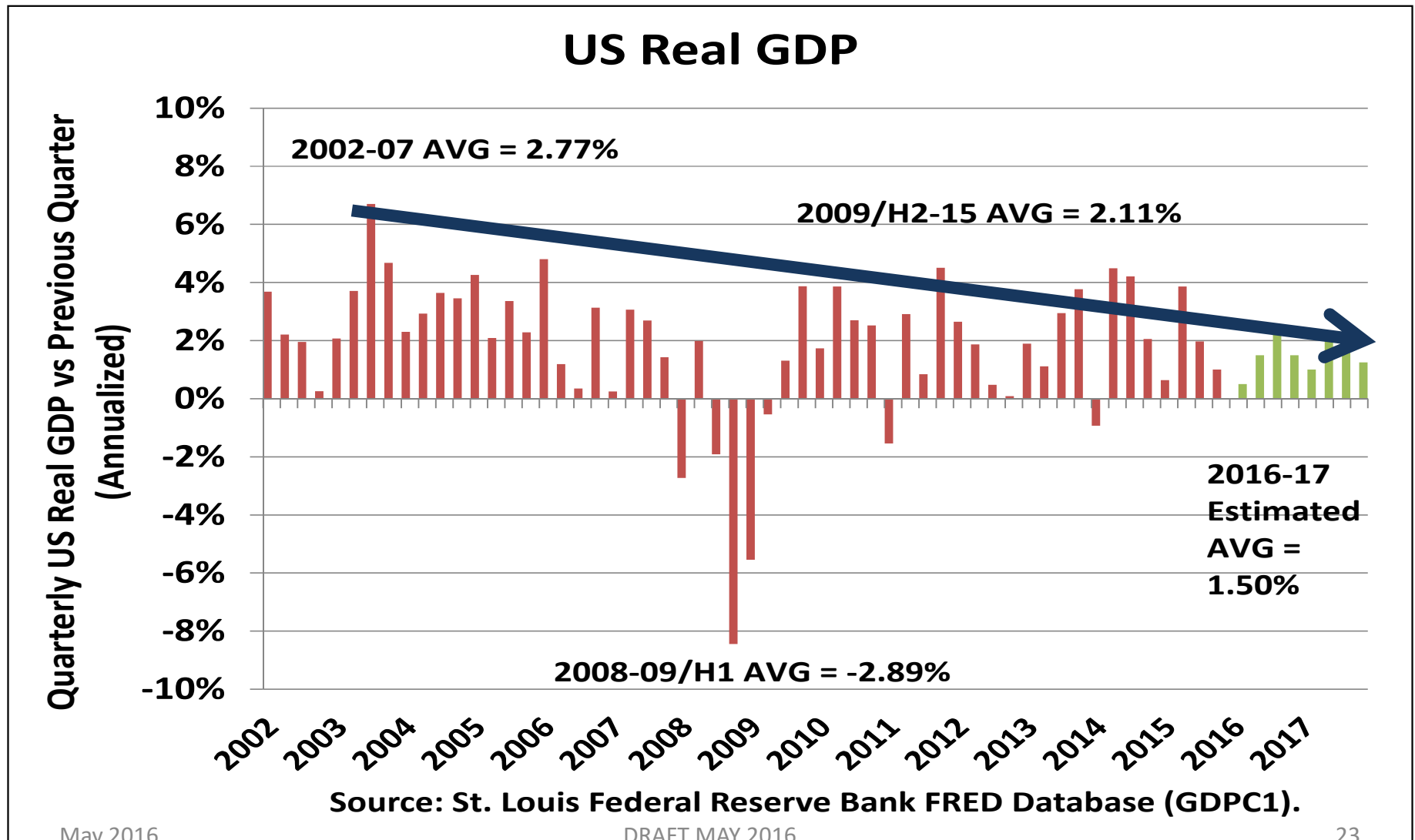
NOPE

- Raised Marginal Tax Rates
- Raised Taxes across
- Raised Taxes again

Basel III

ARE U FINISHED LAUGHING?

Slowing Growth is No Laughing Matter!



Growth: External Factors

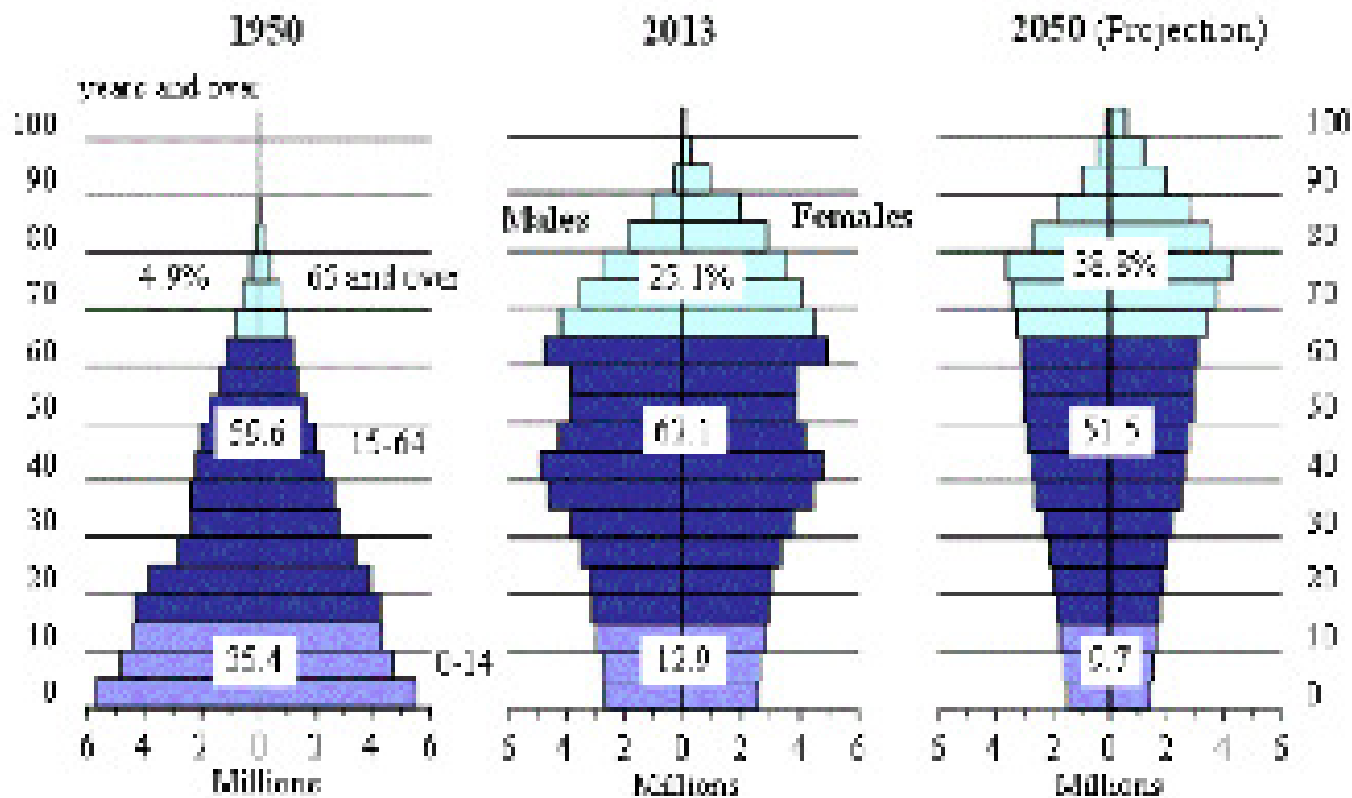
- Demographics imply decreased real long term demand!
 - Implies slower demand in wealthy Countries
 - Long Run is NOW: EUROPE, JAPAN AND MUCH OF ASIA
 - Stagnating demand
- **China**: The Engine of Growth!
 - That was the old China –
- What about the **New China**?

Demographics Have Defined China and Will do so

Let's Look At History First:
Japan

Japan {OLD}

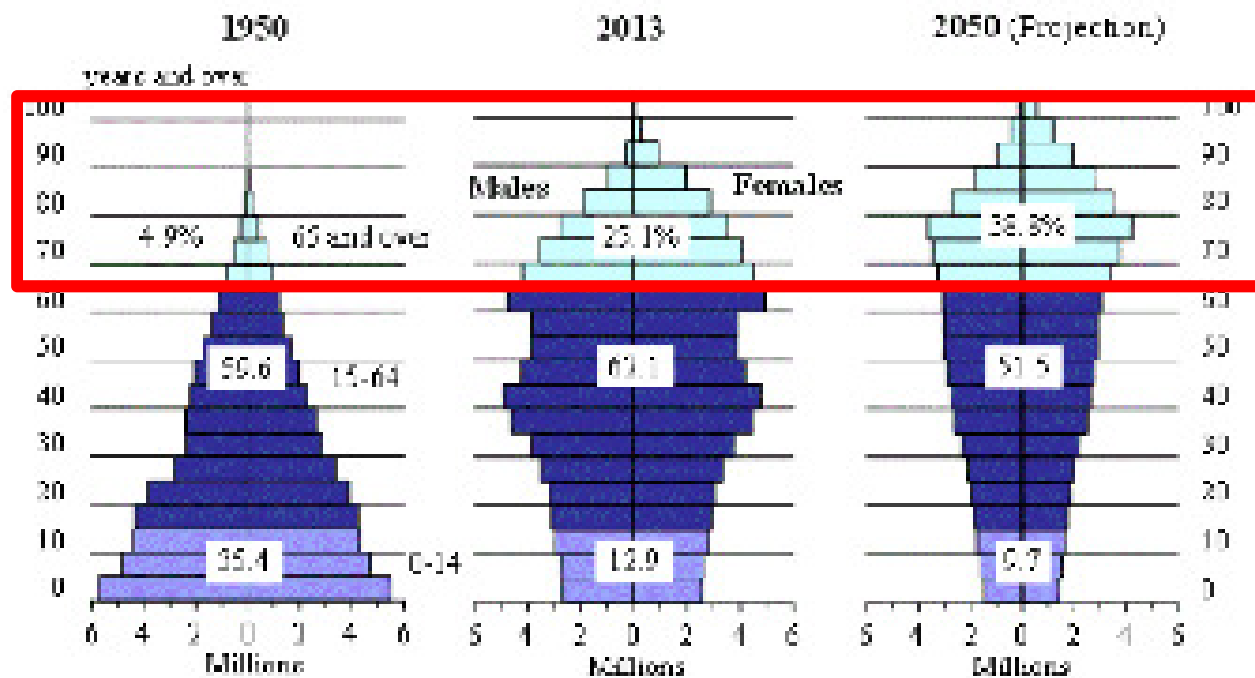
Figure 2.4
Changes in the Population Pyramid



Source: Statistics Bureau, MHO, Ministry of Health, Labour and Welfare

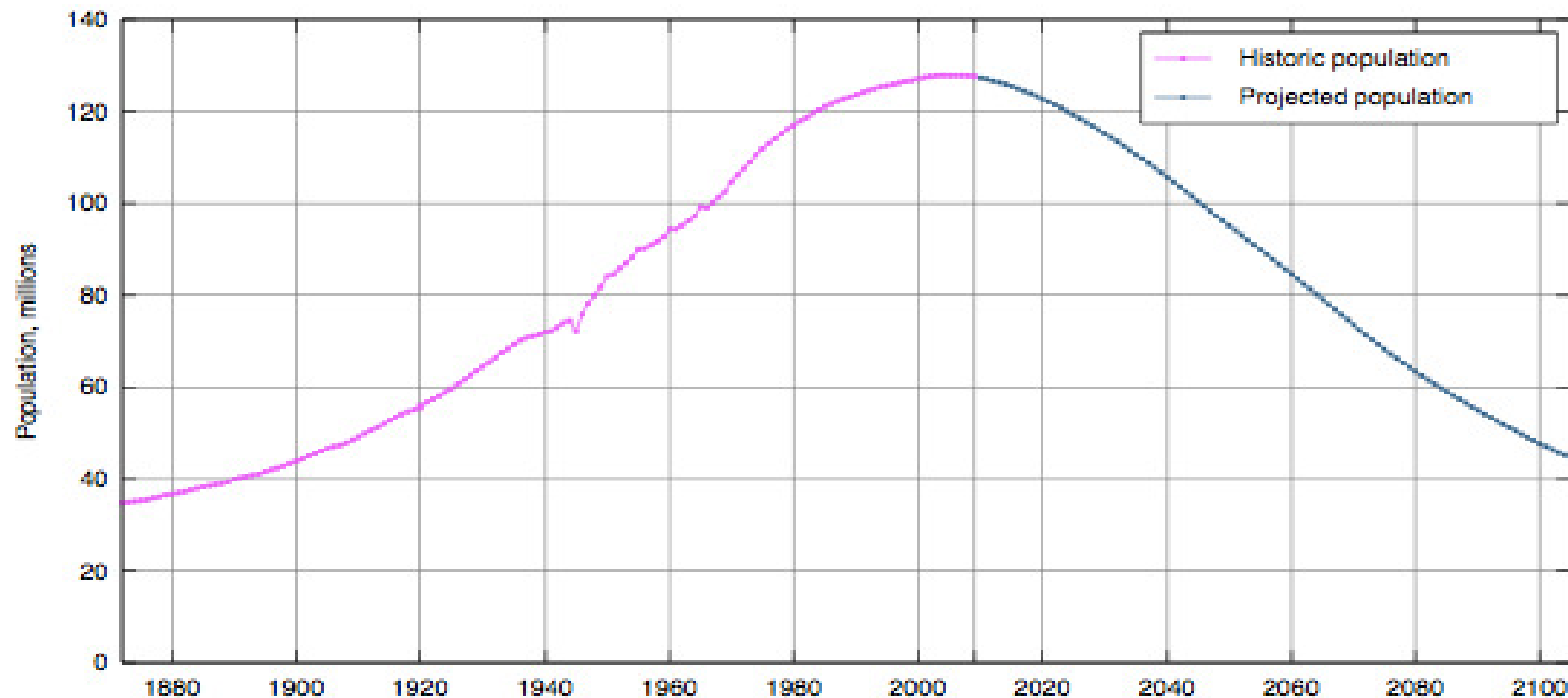
Let's Project Japan: Dying Demand

Figure 2.4
Changes in the Population Pyramid



Source: Statistics Bureau, MTC, Ministry of Health, Labour and Welfare

Japan's Projected Population



These folks still alive are really old

Ok, Japan is Extremely Old but what China in 2010?

Age Structure of Population by Country

Country	2010			2050 (projection)		
	0-14 years	15-64	65 and over	0-14 years	15-64	65 and over
Japan	13.2	63.8	23.0	9.7	51.5	38.8
Korea, Rep. of	16.2	72.7	11.1	12.0	53.1	34.9
Italy	14.0	65.7	20.3	13.9	53.1	33.0
Germany	13.4	65.8	20.8	12.6	54.7	32.7
France	18.4	64.8	16.8	17.0	57.6	25.5
U.K.	17.6	65.9	16.6	16.6	58.7	24.7
Canada	16.5	69.4	14.2	16.5	58.8	24.7
China	18.1	73.5	8.4	14.7	61.3	23.9
Sweden	16.5	65.3	18.2	18.0	59.2	22.8
Brazil	25.5	67.6	6.9	15.3	62.2	22.5
U.S.A.	19.8	67.1	13.1	18.2	60.4	21.4
Russia	14.9	72.0	13.1	17.1	62.4	20.5
India	30.2	64.8	5.1	19.5	67.8	12.7

Source: Statistics Bureau, MIC; Ministry of Health, Labour and Welfare; United Nations.

Percent of Japanese over 65 = **23%** in 2010, but in China **only 8.1%** -- Young?

Ok, Japan is Extremely Old now but so are other Countries in 2050?

Age Structure of Population by Country

Country	2010			2050 (projection)			(%)
	0-14 years	15-64	65 and over	0-14 years	15-64	65 and over	
Japan	13.2	63.8	23.0	9.7	51.5	38.8	
Korea, Rep. of	16.2	72.7	11.1	12.0	53.1	34.9	
Italy	14.0	65.7	20.3	13.9	53.1	33.0	
Germany	13.4	65.8	20.8	12.6	54.7	32.7	
France	18.4	64.8	16.8	17.0	57.6	25.5	
U.K.	17.6	65.9	16.6	16.6	58.7	24.7	
Canada	16.5	69.4	14.2	16.5	58.8	24.7	
China	18.1	73.5	8.4	14.7	61.3	23.9	
Sweden	16.5	65.3	18.2	18.0	59.2	22.8	
Brazil	25.5	67.6	6.9	15.3	62.2	22.5	
U.S.A.	19.8	67.1	13.1	18.2	60.4	21.4	
Russia	14.9	72.0	13.1	17.1	62.4	20.5	
India	30.2	64.8	5.1	19.5	67.8	12.7	

Source: Statistics Bureau, MIC; Ministry of Health, Labour and Welfare; United Nations.

China 2050: It's Japan 2010

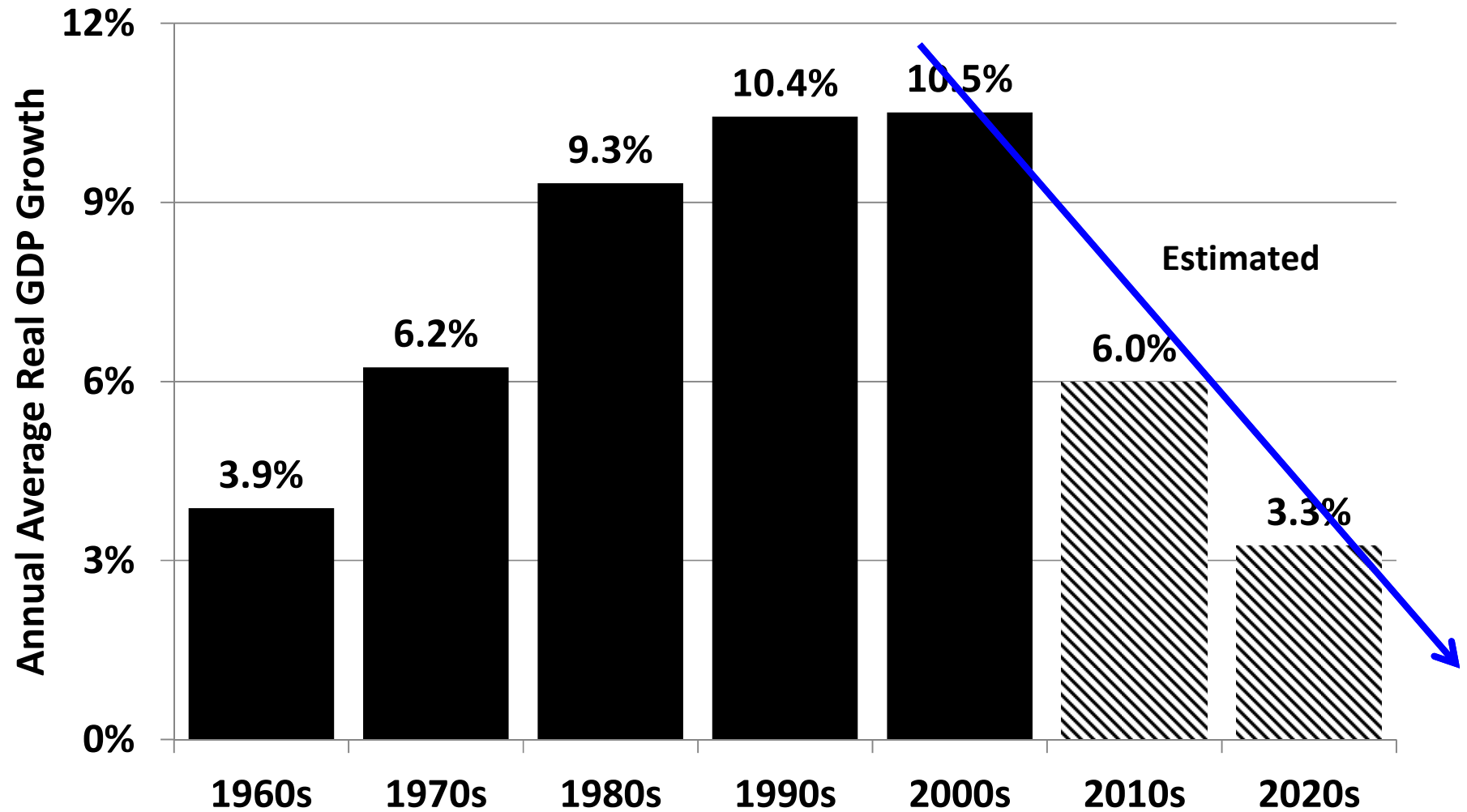
And

Japan has had near zero growth for

25 years

China: Slowdown or Collapse?

China: Real GDP Growth Rates by Decade



Source: World Bank Real GDP Index from the Bloomberg Professional (WRGDCHIN). Estimates by CME Economics Research.

So how do we get Growth?

- Not from Population Expansion
 - You can't simply create people
- Not by creating a climate that slows growth
 - Higher taxes and more regulation destroy growth
 - Global Regulations spreads weakness, not protection
 - Basel I and II and the Great Recession
 - No Euroland country's debt left behind : Can we say Greece?
- And, Monetary Policy does not seem to work

So how do we get Growth?

- *Private Sector Capital Formation*
 - Predictable Rule of Law – Property Rights in the widest sense of the words – Peruvian Example
 - Freedom to keep one's earnings from *taking risks* – taxes
 - And the freedom to lose ones investment as well – **No cronyism**
 - (Fear of) Bankruptcy **is the life blood of capitalism!**
- **Trade: NOT FAIR TRADE but FREE TRADE**
 - Trade has ALWAYS been a vehicle for growth and wealth creation
 - Trade for the US, either among the States or Globally has been a key to our success
 - Trade Barriers simply lead to Reallocation to the Protected few

So how do we get Growth?

- **Innovation and Technological Change**
 - I will not expand upon this but to say the *climate* for innovation MUST be supported
 - Let the market work.
- There is good news!
- **Actually we may be growing!** – In Spite of Government Policy – we just may not be measuring properly
 - Old measures and paradigm shifts
 - The knowledge economy
 - The sharing economy
 - The bleeding of efficiencies
 - Replacing Rules with information
 - Uber, Air B&B
- **PS:** Don't Tell Washington or Brussels -- they may find a way to stop it!