Absolute Return Partners

The Absolute Return Letter

October 2016
The New Normal, Mk. II

"Inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man."
Ronald Reagan

I spent much of August in Texas. An extraordinary bunch of people, those Texans. Exceptionally friendly and much less reserved than the sorts of people you typically run into in London or New York – and I have to give them some credit; they must be made of something quite special. How else do you work outside in 42 degree temperatures (107 Fahrenheit) as I saw quite a few do? Simply too much for a pale Northern European. No wonder Texans have a love affair with air conditioning.

I was also reminded of the fact that the Olympics are much more fun to watch when you don't have to set the alarm for 3 o'clock in the morning, but, most importantly, I learned that life can still be quite enjoyable, even if you miss an important statement from the Fed.

On the 15th August, John Williams, President of the San Francisco Federal Reserve Bank, rattled the world of Fed watchers when he stated that:

> *"Central banks and governments around the world must be able to adapt policy to changing economic circumstances. The time has come to critically reassess prevailing policy frameworks."*[1]

In the conservative world of central bankers, this was at least a seven on the Richter scale, and I could possibly only have missed it because I was intoxicated by the extraordinary success of the British and Danish athletes in Rio. Shame on me.

Ever since the brutal war against inflation, fought first and foremost by Paul Volker in the late 1970s and early 1980s when he was Chairman of the Federal Reserve Bank, central bankers have emphasised inflation targeting when conducting monetary policy, and 2% has become the widely accepted target – at least in most developed countries. John Williams is now questioning whether we have come to the end of the road as far as that policy is concerned.

[1] *"Monetary Policy in a Low R-star World", John Williams, FRBSF Economic Letter, 15th August, 2016.*

What did John Williams actually say?

In the opinion of John Williams, central banks should consider changing the practice of 2% inflation targeting, as the New Normal continues to change the economic landscape in front of us.

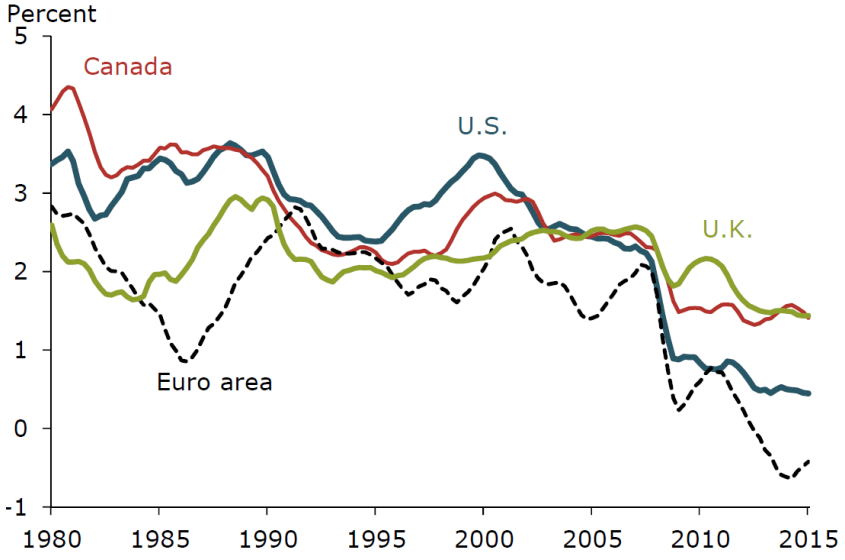
Central bankers work with something they call natural (aka neutral) interest rates. It is when prevailing interest rates are neither accommodative nor contractionary. In other words, the overall economy is in perfect balance. Let's call that level of interest rates r*.

The challenge facing central bankers today, according to John Williams, is that r* is extraordinarily low, and he argues that if we are ever to move on from the New Normal and the mess left behind by the Global Financial Crisis, we need to find ways to raise r*.

One implication of a low r* is that monetary policy loses much of its potency. In particular, when the economy is weak and needs a boost from lower policy rates, there is only so much central banks can do, because there is a limit to how low interest rates can go.

In his paper, John Williams actually provides estimates on r* for the US, Canada, the UK and the Eurozone (chart 1) and, as you can see, it has been declining steadily for the past 35 years, but the decline has gained momentum since 2000.

Chart 1: Estimated inflation-adjusted natural rates of interest



Source: John Williams, Federal Reserve Bank of San Francisco, August 2016.

Furthermore, he argues that it is a mistake to assume that central bank policy has always been the same, and that it *should* always be the same. When circumstances change, central bank policy should change accordingly, he says.

At this point, I should probably point out that his paper has not been universally endorsed by other central bankers. Bill Dudley and Stanley Fisher have both made less than enthusiastic comments, and Janet Yellen wasn't exactly complimentary either when commenting on John Williams' thoughts in Jackson Hole, so it is far from certain that his ideas will be implemented.

According to John Williams, the main culprits behind the low and falling r* are the usual suspects – adverse demographics, slowing productivity growth and the global savings glut. Hence it is no surprise that he suggests a much more active and counter-cyclical use of fiscal policy going forward, but his suggestion as to how monetary policy could be changed to raise r* is what caught my attention.

So what monetary policy changes did he suggest? In fact, he suggested two possible options:

1. Raise the inflation target to 4%, which would almost certainly drive interest rates up, making monetary policy more effective along the way; *or*
2. Drop inflation targeting altogether, and replace it with a nominal GDP target. The biggest advantage of such a change is probably the built-in protection against debt deflation.

Both would imply such a radical change to the modus operandi of the entire central banking system that they deserve more than just a passing comment.

Why John Williams could possibly be wrong

The New Normal, the secular stagnation, or whatever you prefer to call the post-crisis environment of low economic growth, low inflation and exceeding low - even negative – interest rates, is no longer a peripheral economic concept. After years of firing on only four or five of its eight cylinders, the global economy is in danger of falling into the trap of persistently low economic growth, which is increasingly recognised by investors.

One very simple way to measure the extraordinary level of pessimism, as far as economic growth is concerned, is to look at yield curves across the world. If investors weren't so downbeat, those yield curves would be a lot steeper than they are at present, so there is absolutely no question; investors are very glum when looking into the future.

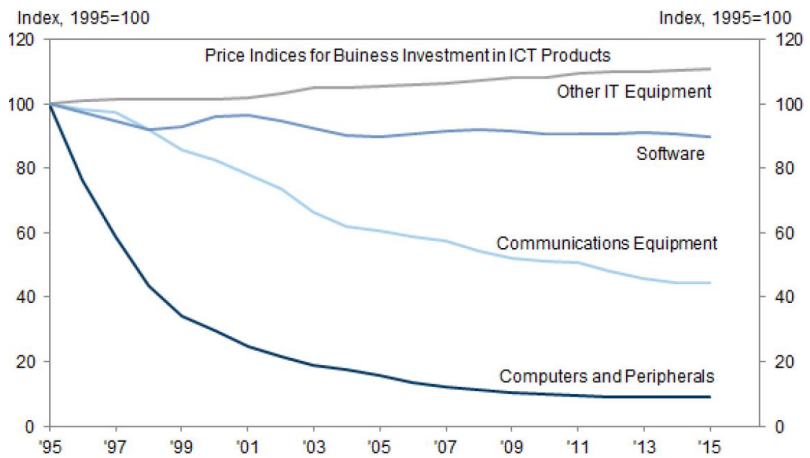
Is it possible that we are all wrong, though? Could GDP growth in fact be higher than we all think it is? In order to answer that question, I need to re-visit a very basic economic identity, which I have used many times before:

$$\text{I.} \quad \Delta GDP = \Delta Workforce + \Delta Productivity$$

ΔWorkforce is what it is. It is based on very identifiable statistics that one can't really argue with, so if there is anything wrong with how GDP growth is calculated, it must come down to how changes in productivity are measured.

Let's divide the economy into the Old Economy and the New Economy. The Old Economy is everything our parents used to do - in other words, how the economy used to work prior to the digital age. The New Economy is all the stuff made possible by the internet and digitalisation – e-commerce, digital currencies, smartphones, 3D printing, etc., and the argument put forward by a growing number of researchers is that the true growth rate of the economy is understated because much of the growth in the New Economy is not captured by the way we calculate GDP.

Chart 2: Official US price indices in communications & information technology



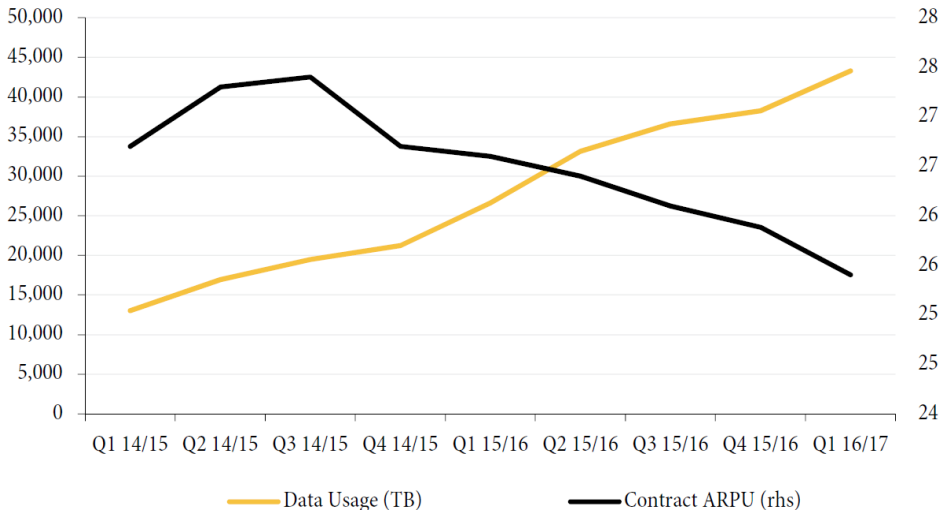
Source: Goldman Sachs Research, US Department of Commerce, September 2016.

The argument goes as follows: The guidelines provided by the OECD (which are used by most countries) re the price-deflators used when calculating GDP growth in industries where output needs to be quality-adjusted every year, are not far-reaching enough. Take the communications and information industry, where quality has certainly improved in recent years, whereas prices have fallen steeply (chart 2).

The statisticians in charge of calculating GDP will then apply a price-deflator, which is supposed to the make the necessary quality adjustment. So far, so good, but many online products (such as Google Maps and Facebook) are given away for free nowadays, the value of which is not at all included when calculating GDP.

All this has led to a rather fierce debate amongst researchers. Do we actually calculate GDP correctly? Let's look at a recent research paper from UK-based Redburn, which concludes precisely what I suspect, i.e. that actual GDP growth is underestimated. Redburn uses Vodafone – a global leader in the provision of mobile phone services – as an example. Not surprisingly, Vodafone's average revenues per user have fallen like a stone more recently. That said, data usage has done exactly the opposite, growing by approximately 35% year-on-year in recent quarters (chart 3).

Chart 3: Vodafone's average revenues per user and data usage



Source: Redburn, August 2016

Using a very traditional approach to calculating Vodafone's contribution to GDP growth, you would multiply revenues and volume (i.e. data usage), and you would find that falling prices have largely offset the increase in usage – and that is even after the Office for National Statistics have applied their OECD 'approved' price-deflator. In other words - Vodafone hasn't added much to economic growth in recent years, or so the numbers would suggest.

Now, I suggest you try to explain to your teenage daughter or your swanky brother-in-law that mobile phone services today do not offer much better value than they did a handful of years ago. Why else would millions of people walk around every day glued to their mobile phone?

GDP growth and inflation in the new vs. the Old Economy

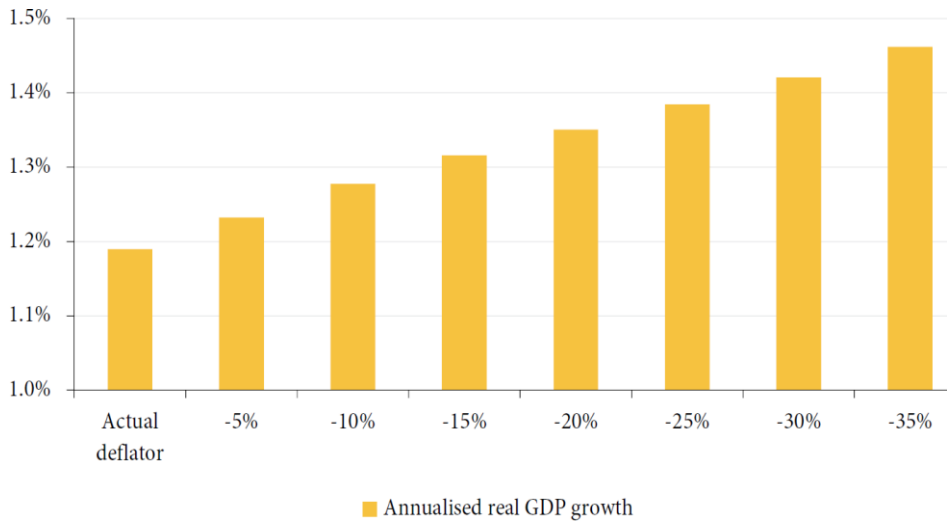
Let's look at the true value of free online content. Goldman Sachs Research have tried to apply a quality-adjusted expense principle to all free content – i.e. how much did it really cost Google to develop Google Maps? – following which they added those numbers back into GDP. Bottom line? GDP growth in the US is underestimated by approximately 0.4% per annum from free pricing alone.

This has left statisticians all over the world with a major headache. When calculating GDP, how do you incorporate the growing utility value of products produced by the New Economy? Everyone understands that, in the Old Economy, output (GDP) equals price × volume, but one could argue that, in the New Economy, a different approach is required.

Should one add a third dimension to the calculation? A component that measures the growing utility value of the product in question, effectively changing the calculation of output from *price × volume* to *price × volume × utility gain*, but this is where statisticians are getting stuck. They haven't yet figured out how to incorporate the increase in utility value on products created by the New Economy, and some statisticians argue (with some right) that this is in principal no different from the car industry, offering a few more gadgets for the same price every time a new car model is rolled out, and in the car industry there is no use of price-deflators.

If the pricing of products in the New Economy behaved in a conventional way (i.e. as in the Old Economy), this wouldn't be a problem, but that is not the case. Sometimes there isn't a price at all and, if there is one, the price paid by consumers fails to capture the rapid increase in the utility value of the product in question (such as Vodafone in the example above). Typically, it costs a small fortune to bring a product to market in the New Economy, but the marginal cost of production is more often than not close to zero.

Chart 4: Impact on real GDP growth in the UK from applying various deflators for household expenditure on communication (2005-15)



Source: Redburn, August2016

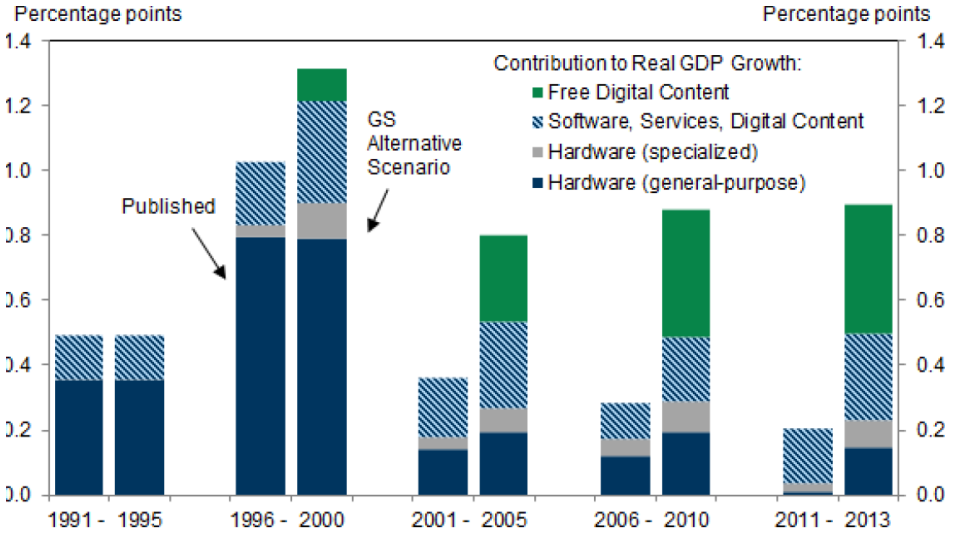
The net result of all of this is that the New Economy is deflationary and GDP growth probably understated. In the UK, if one were to replace the actual deflator on household expenditures on communication goods and services with a deflator resembling the growth rate in data usage (35%), Redburn have calculated that annual GDP growth over the past decade would not have been 1.18% as reported, but rather 1.46%[2] (chart 4). This may not sound that dramatic, but GDP growth over the last decade would be 3% higher than the reported number, and productivity growth almost twice as high as the stated number.

Goldman Sachs have reached a somewhat similar conclusion as far as US GDP is concerned. As you can see from chart 5 below, between using an understated

[2] *Source: "Secular Growth – Solving the Paradox", Redburn, August 2016.*

price-deflator and not including free content, Goldman Sachs conclude that the growth rate in the US is understated by approximately 0.7% a year.

Chart 5: US GDP growth contribution from information & communications technology



Source: Goldman Sachs Research, US Department of Commerce, September 2016.

Good vs. bad deflation

Years ago, I wrote an Absolute Return Letter about good vs. bad deflation. Bad deflation is when people stop spending, because they think everything will be cheaper tomorrow. Bad deflation kills economic growth and is what we experienced in the 1930s. Good deflation is when prices on some (but not all) consumer goods and services fall, leaving consumers with more money to spend on other goods and services. Falling oil prices in 2015 was an obvious case of good deflation, and so are falling prices caused by the New Economy.

The challenge facing central bankers is that the Old Economy is over-leveraged. If the overall economy only consisted of the New Economy, there would be absolute no need for any sort of central bank intervention, but central bankers all over are concerned about deflation in a world saddled with debt. Deflation combined with low (no) GDP growth is about the worst possible outcome when debt levels are high.

The problem is that the New Economy is only going to grow in magnitude, which means that the deflationary threat is very unlikely to go away anytime soon. Phrased another way – good deflation could potentially turn into bad deflation, because we have two economies operating in parallel, and one of the two will almost certainly struggle badly in a deflationary environment.

As far as the UK is concerned, the Old Economy is definitely not toying with deflation – at least not at the moment. All the deflationary pressure comes from the New Economy. I am not at all convinced that John Williams' proposal is actually going to be of any help to a country like the UK.

Increasing the inflation target to 4% or changing it to a GDP growth target won't address the core of the problem, which to me appears to be how we calculate GDP and inflation in a world that is increasingly dominated by the New Economy.

Final Comments

To put it bluntly, if I am on the right track, QE will *never* work the way it is intended to. The deflationary tendency currently prevailing all over the OECD, which looks as if it is a bi-product of the New Economy, should not be addressed by QE or, for that matter, by any other monetary policy tool, because it simply won't work.

What is required instead is an entirely different approach as to how the statisticians measure economic growth. There is no question that John Williams has a point. Demographics and other structural factors do indeed affect economic growth, and those factors will be with us for a long time to come.

That said, the points made by John Williams is only half the story. The New Normal is only to a degree a function of the factors referred to in his paper. The dynamics influencing the New vs. the Old Economy should be added to those factors, and they are not even mentioned in his paper.

Niels C. Jensen
1 October 2016

Important Notice

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Absolute Return Letter contributors:

Niels C. Jensen	nj@arpinvestments.com	Tel +44 20 8939 2901
Gerard Ifill-Williams	giw@arpinvestments.com	Tel +44 20 8939 2902
Nick Rees	nr@arpinvestments.com	Tel +44 20 8939 2903
Tricia Ward	tw@arpinvestments.com	Tel +44 20 8939 2906
Alison Major Lépine	aml@arpinvestments.com	Tel: +44 20 8939 2910