U.S. central bankers eye public spending to plug $1-trillion investment gap

By Howard Schneider
August 26, 2016 – *The Globe and Mail / Reuters*

While markets wait for Janet Yellen's latest message about the direction of monetary policy, the Federal Reserve chief and her colleagues already have one for politicians: the U.S. economy needs more public spending to shift into higher gear.

In the past few weeks, Yellen and three of the Fed's other four Washington-based governors have called in speeches and Congressional hearings for government infrastructure spending and other efforts to counter weak growth, sagging productivity improvements, and lagging business investment.

The fifth member has supported the idea in the past.

The Fed has no direct influence over fiscal policy and its officials traditionally refrain from discussing it in detail. Having its top officials – from Yellen to former investment banker and Bush administration official Jerome Powell – speak in one voice sends a strong signal to the next president and Congress about the limits they face in setting monetary policy and what is needed to improve the economy's prospects.

The Fed's annual conference in Jackson Hole, Wyoming, where Yellen speaks on Friday, is due to focus on how to improve central banks' "toolkit," but the unanimous message from the Fed's top policy makers is that those tools are not enough.

"Monetary policy is not well equipped to address long-term issues like the slowdown in productivity growth," Fed vice chair Stanley Fischer said on Sunday. He said it was up to the administration to invest more in infrastructure and education.

Trillion Dollar Hole

Behind Fischer's statement lies a troubling feature of the recovery – business investment has fallen below levels in prior years and companies seem to have stopped responding to low borrowing costs.

As a share of gross domestic product, U.S. annual business investment since 2008 has averaged nearly a full percentage point below the previous decade's average, government data shows. Reuters calculations indicate the investment shortfall has blown a hole in annual GDP that has grown to as much as one trillion dollars a year compared with what it would have been if the previous trend continued.

Little suggests a rebound any time soon. Fixed business investment has fallen in three successive quarters as a share of GDP. Researchers and analysts blame the slide on everything from doubts about future economic growth to distortions caused by Fed policy itself in helping boost the value of financial assets.

Companies have run up share buybacks to record levels of around half a trillion dollars a year, and held onto record amounts of cash, despite cheap financing that should in theory spur long-term investment. Research by Fed board economists Steven A. Sharpe and Gustavo Suarez suggest a reason: executives are putting little stock in interest rates when making investment decisions, and are not adjusting expected rates of return to fit the emerging low-growth world.

Based on data collected from chief financial officers, their study found the internal rate of return needed to justify capital projects has "hovered near 15 per cent for decades," and barely budged even as global interest rates have fallen. Such targets made sense during spells of strong growth, but may be inconsistent with the current low-growth, low-interest rate environment, and hold back corporate spending, the Fed economists argue.

That challenges the core monetary policy notion that low short-term rates spur investment by making long-term returns more attractive.

“I have started to wonder, and many wonder, as rates stay at zero, whether that may not be true anymore,” former Fed Governor Jeremy Stein told Reuters.

The situation has perplexed analysts, with some suggesting executives may be out of synch with a low-growth world.

“I am not sure that people’s notion of an adequate return on equity has come down as much as the riskless rate,” said Thomas Mercein, global head of debt capital markets for Credit Suisse.

The Jackson Hole conference will likely take stock of several unconventional solutions proposed as a way of breaking out of the cycle of subdued demand, weak investment and low growth that has followed the 2007-2009 recession.

U.S. and global central bankers have brought into the mainstream such ideas as GDP targeting or “helicopter” cash injections to generate demand and inflation, and have been testing negative interest rates in Europe and Japan.

Fiscal policy is not on this year’s agenda, which is dedicated to the details of monetary policy operations. But the idea that governments need to pick up the slack with infrastructure spending or other initiatives has been gaining traction among central bankers.

Well-targeted public investment, the argument goes, could in effect pay for itself through higher productivity and growth, and in doing so make any additional public debt comparatively less onerous.

Japan, which has been running sizable fiscal deficits since 2009, has already announced another spending package to complement negative rates, while Britain’s new finance minister has said he would look at whether new fiscal measures are needed in the wake of the country’s vote to leave the European Union.

Rare Agreement

In the United States, the need for investing in the nation’s aging infrastructure is a rare point where both presidential candidates seem to agree. Democrat Hillary Clinton is proposing a $275-billion package; Republican Donald Trump is calling for about twice that.

Not everyone agrees though, that more public spending is the best cure, or that an infrastructure program would pinpoint projects with a positive return.

“Economic policy should bolster private investment. Yet, it is striking that most academics and policy makers are pushing another big government spending stimulus package,” said former Fed governor and Hoover Institution fellow Kevin Warsh.

However, there is broad agreement that, for now, private investment may remain in the doldrums – unless it is clear the economy is picking up.

Bill Lutz, chief financial officer of Illinois-based industrial services provider Advanced Technology Services, said the still low factory utilization and doubts about growth and demand have set a high bar for any private investment that was not necessary to maintain output or offered compelling savings.

“You’ll find a way to finance if it is real and strategic,” Lutz said. “Whether the interest rate is a per cent higher or lower is secondary.”