G4 central banking – the times they are a changin’

August 2014

As the great and the good in the world of global monetary policy come gather round to meet and prophesies in Jackson Hole at the end of August, they have good reason to reflect on Bob Dylan’s famous song because the times are indeed a-changin’. Indeed a recurring theme in monetary policy over the past few years has been changed: change in the intellectual understanding, change in the operational procedure and change in the underlying forces that ultimately drive it. Underlying this change is an implication that there is no longer such a thing as a ‘normal’ policy.

Since the start of the financial crisis, the four major central banks – the Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ) - have been united in a common direction of travel and faced a common set of challenges. Having slashed interest rates to rock bottom to try to stimulate their respective economies, all four banks had to find ways to provide further stimulus once rates hit the zero bound. When interest rates have hit zero it is very hard to cut them much further as it is almost impossible to sustain deeply negative rates for a large period of time, so central banks looked to various unconventional policies instead, learning from the experiences of the others. And together they face the perhaps even more difficult challenge of navigating a safe path out of the distorted and unconventional policy environment where the traditional operational tools of central banking are obsolete, and there may be a conflict between macroprudential objectives and normal monetary policy concerns of price stability and unemployment has arisen. By definition, when you enter uncharted territory navigating your way back will be precarious too.

Within that big picture, there is now another story of divergence: between the BoE and the Fed on the one hand, and ECB and BoJ on the other. In the case of the former two, both are looking to very slowly start raising over next year as their respective economies improve, while in the case of the latter we are likely to see some further easing as the European Central Bank (ECB) and Bank of Japan battle with deflation. The G-4 central banks are effectively pulling in two different directions.

The BoJ in Japan and the ECB in the eurozone continue to struggle to stave off deflation and the question is largely around if and how the banks will provide further stimulus.

Japan have become accustomed to this battle, having faced deflation for at least a decade. Prime Minister Shinzo Abe’s recent success has provided an uplifting and welcome relief – hopefully a sustainable one too. Lots of question marks remain, however. For example, does the Bank of Japan need to see further progress on the structural reform “third arrow” side before further easing? The sales tax hike has made it is very difficult to get a sense of the underlying strength of the economy, but it does seem to have weakened somewhat. How long does the Central Bank wait before adding further stimulus in order to reach their 2% target?

Meanwhile in the eurozone, the situation is far more politically charged and complicated. The challenge is how best to achieve inflation expectations of around 2% with a large output gap, high unemployment and extremely low inflation. While perennial risks around the stability of the eurozone as a currency union have largely abated thanks to Draghi’s “whatever it takes” speech, the risk of another flare up should not be discounted. A test of the political glue will be the ongoing stability of the European banking system and the European Central Bank’s (ECB) overarching chief regulatory role – the stress tests underway at the moment being an interesting test bed, with onlookers eagerly asking how credible they will be and whether the sovereign/bank doom loop really been broken?

At the risk of posing more questions than answers, the ECB has the unenviable task of trying to stimulate the aggregate eurozone economy if inflation continues to underwhelm. The very thought of quantitative easing is contentious, and it’s potential form and make up is anything but clear.
Meanwhile, although the BoE and the Fed are in the more enviable position of considering how to slowly draw-back stimulus, they are not short of their own challenges. Even as the UK and US economies improve both central banks will struggle to judge the true employment picture as simply reading off the headline numbers is not sufficient. In the US a fall in the participation rate and highly elevated long term unemployment suggest the labour market is weaker than implied by the headline figure, while in the UK the strength of the headline unemployment rate is the mirror image of the troubling collapse in productivity. Given the lack of transparency here, monetary policy makers will tend to err on the side of caution, leave policy looser and thus potentially accept higher levels of inflation. In the scheme of things, this could well be a very reasonable compromise.

Despite a slightly obsessive view from investors to the contrary, the timing of the first interest rate rise in UK and US is actually a relatively minor issue. The expected and future path of rates to their eventual, lower natural level is what matters. There are very good reasons to believe that both central banks will struggle to hike rates to the roughly 4% level that we thought of before the crisis as normal. This is due to a number of factors including lower potential growth, a large debt overhang, the distribution of income and wealth, the relative cost of capital goods and demographic change. The BoE and Carney in particular have been quite explicit in communicating this message, while the Fed has been somewhat more hesitant to embrace this idea although there are signs they are slowly moving in this direction. The big concern is that if the neutral policy rate is lower, this means the Fed and BoE will have less scope to cut rates before hitting the zero bound when the next recession strikes, and once again they are forced to turn to potentially ineffective unconventional policy.

What is clear is that there was nothing privileged about the particular monetary arrangements that existed before and during the financial crisis; they were the contingent product of the prevailing environment at the time. As this environment changes we should expect the appropriate monetary framework to also change. There is no such thing as 'normal' policy and different domestic environments require different approaches.

Times of flux and change are inevitable after massive economic dislocations and shocks such as the ones we have endured over recent years. While it may be a stretch to call the current transition in central banking a revolution, it is encouraging, and reassuring, that intellectual thinking is adapting and adjusting.

Luke Bartholomew, Investment Manager, Global Macro

For more information
Client Services Team
Aberdeen International Fund Managers Limited

Room 2603-06, 26/F., Alexandra House
18 Chater Road
Central. Hong Kong

Tel: +852 2103 4700
Fax: +852 2103 4788
www.aberdeen-asset.com.hk

Important information

The above is strictly for information purposes only and should not be construed as advice or an offer or solicitation, to deal in any investment product. Any research or analysis used in the preparation of the above information, procured by Aberdeen International Fund Managers Limited (“AIFML”) for its own use and purpose, is based upon sources believed to be reliable as of the date thereof, but no representation or warranty is given as to the accuracy or completeness of data sourced from third parties. Any projections or other forward-looking statements regarding future events or performance of countries, markets or companies are not necessarily indicative of, and may differ from, actual events or results. Opinions, estimates or forecasts may be changed at any time without prior warning.

Investment involves risk. Past performance is not a guide to future performance. Investors may not get back the amount they have invested. No liability whatsoever is accepted for any loss arising from any person acting on any information contained in this document.

Investors should not make an investment into the investment product based solely on this document and should read the relevant offering documents for more details to ensure that they fully understand the associated risks before investing.

Investors are responsible for their investment decisions and should ensure that the intermediary has advised on the investment product’s suitability and consistency with their investment objective and risk tolerance level. If in doubt, please seek independent financial and professional advice.

This document is issued by AIFML and has not been reviewed by the Securities and Futures Commission.