Central Banks Likely to Stay Easy in 2015 as Normalcy Is Elusive

By Simon Kennedy - Dec 1, 2014

The world’s central bankers could be forgiven for thinking that things are never going to get back to normal. More than six years after the financial crisis plunged the world into recession, monetary policy looks nothing like it did before those events.

Even as economists predict that the U.S. Federal Reserve and Bank of England will finally begin to raise benchmark rates in 2015, the central banks are unlikely to push borrowing costs anywhere near pre-crisis, inflation-fighting levels. And even though the Fed in October ended the bond-buying campaign it undertook when the U.S. economy was weaker, it isn’t shedding the assets it bought. The European Central Bank and Bank of Japan, for their part, are stepping up purchases.

Central bankers know that global growth is shaky, that debt is rising and that they’re getting little help from government fiscal policies, Bloomberg Markets magazine will report in its January issue. Economic progress will again depend on the monetary spigot in the coming year -- as will stock prices, bond yields, commodities demand and currency rates.

“Given the slow and unsteady nature of the recovery, supportive policy remains necessary,” Fed Chair Janet Yellen said on Nov. 7 at a conference of central bankers in Paris. Monetary officials should keep trying extraordinary measures, Yellen argued, especially because fiscal policy today remains “somewhat contractionary.”

Fiscal Constraints

In the U.S., more government spending to stimulate growth isn’t in the cards, especially after Republicans won full control of Congress in November’s election. In the euro zone, governments can back away from austerity only slightly before they run up against European Union rules and German opposition. In Japan, Prime Minister Shinzo Abe’s fiscal stimulus plan has been blunted by a consumption tax increase that went into effect in April.

The International Monetary Fund in October forecast that the global economy will expand 3.8 percent in 2015, up from an estimated 3.3 percent for 2014 but below the boom years of 2004 to 2007, when growth was 4.9 percent or higher.
While the U.S. economy is accelerating, the euro zone is slowing, with growth there vanishing in the third quarter. China has slowed. Japan has slipped into recession again, contracting two quarters in a row, which has prompted Abe to postpone a second scheduled tax increase and call snap elections. Monetary policy makers are scrambling to provide support to a still-fragile global economy.

‘Impossible Task’

“To be a central banker is an impossible task,” says Thomas Mayer, the former chief economist at Deutsche Bank AG who now runs a think tank for German wealth manager Flossbach von Storch AG in Cologne. He compares the actions of central bankers since 2008 to that of U.S. generals in the Iraq War: They started with shock and awe and won the initial battles, but they ran into trouble when it came time to withdraw.

The difficulty of getting out after six years of mostly coordinated global monetary stimulus was evident in stock markets recently. The MSCI World Index lost about 9 percent in September and the first half of October before gaining almost all of it back over the next six weeks. No single reason can explain such a swing, but investors attributed the sell-off to concern that global growth is slowing, that deflation is a threat -- and that, this time, monetary policy responses are exhausted.

The Fed has been trying to gradually wean investors and the economy off of quantitative easing, tapering its asset purchases from $85 billion a month in 2013 to $15 billion in October 2014.

Bond Buyers

At a meeting on Oct. 29, Yellen ended the bond-buying program. By then, stocks were rebounding. The Fed’s move didn’t interrupt the momentum, and right away, stocks got new support from central bankers elsewhere.

Bank of Japan Governor Haruhiko Kuroda and his policy board said on Oct. 31 that they would boost asset purchases to an annual pace of about 80 trillion yen ($675 billion).

ECB President Mario Draghi announced on Nov. 6 that his institution stood ready to make more purchases and expand its balance sheet. He followed that up with a Nov. 21 speech in which he said that the ECB must return inflation to target levels “without delay.”

The divergence in monetary policy, with more stimulus for Japan and the euro area and less for the U.S. and U.K., is likely to push the dollar and sterling higher.

Foreign-exchange strategists surveyed by Bloomberg predict the euro will weaken to $1.20 in the second half of 2015 from about $1.25 recently. The yen has fallen 7.7 percent to about 118 to the dollar since the announcement of more BOJ bond buying. The median forecast is for a drop to 122 yen by the end of 2015, while the most bearish prediction has the currency plunging to 135 yen to
Currency War

A currency war of sorts may be brewing, in which officials in Europe and Japan try to weaken the euro and yen to help them avoid deflation.

“Though there is no explicit agreement by representatives of the Group of Seven to drive the dollar higher, much of the world now agrees the U.S. currency should appreciate,” says Stephen Jen, co-founder of London-based hedge-fund firm SLJ Macro Partners LLP.

With weak growth in major economies, central banks, including the Fed and the BOE, are likely to remain relatively dovish in the near future, says Gustavo Reis, a global economist at Bank of America Corp. “They’re going to be very sensitive to what’s happening to the economy and act conditionally on the data,” he says. This will certainly be true when they finally start raising interest rates, which have been near record lows for years. “When they do hike, they’re going to do so slowly and carefully.”

Rate Increases

Bank economists surveyed by Bloomberg expect 2015 will be the year in which the Fed raises its benchmark federal funds rate after six years near zero, with the first increase coming in the second half. They predict that Bank of England Governor Mark Carney and his colleagues will start raising rates sometime after a general election in May. But these moves are likely to be modest -- and may yet be delayed.

The thinking of monetary authorities today is colored by the mistakes of the past, says Lars Svensson, a former board member of Sweden’s Riksbank. The Fed, for example, boosted rates in 1937, choking off a recovery in the U.S. and prolonging the Great Depression. In a more recent misstep, the ECB hiked rates half a percentage point in 2011, even as the euro-zone sovereign-debt crisis undermined growth and employment.

Svensson quit the Riksbank policy board in 2013 after objecting to its overly tight monetary stance. The Swedish central bankers raised rates in 2010 and 2011, concerned about rising household debt and home prices, and then were forced to reverse themselves. They’ve cut rates seven times in the past three years, and the bank’s benchmark reached zero in October.

“The lessons are quite obvious to other central banks,” Svensson says.

Dovish Bent

A major reason for interest rates to stay low next year is the likelihood that inflation will remain tame worldwide, even if prices don’t fall enough to spark deflation. Economists at Morgan Stanley say price increases are running below central bank targets in virtually all developed markets. They
predict the Fed won’t raise its benchmark in 2015 and that the Bank of England will wait for the final quarter to do so.

“Lowflation is the new enemy as it harms debtors, reduces the scope for negative real interest rates and damages central bank credibility,” Joachim Fels, Morgan Stanley’s chief international economist, said in a report to clients this week.

A dovish bent in global monetary policy, however necessary, means savers who want their money in low-risk investments such as bonds or bank deposits will continue to get paltry payouts -- as they have in the entire post-crisis era.

**Punishing Savers**

Central bank efforts to keep borrowing costs low punish those who need to build retirement nest eggs, according to Larry Fink, chief executive officer of BlackRock Inc., the world’s largest money manager, who spoke at the same Paris conference as Yellen. And when savers are hurting, Fink said, that does its own harm to economic growth.

A survey of financial professionals, meanwhile, shows concern about the potential for rising rates to send fixed-income investments into a dive. In the Bloomberg Global Poll, run Nov. 11 and 12, traders, investors and bankers identified government debt and high-yield corporate bonds as the asset classes they would most likely sell short, preferring them over real estate, stocks and even gold as a place to bet on a rout.

**Heavy Debt**

There’s another reason for central bankers to go slow on rate hikes: The world is swimming in debt.

The level of debt in the global economy, excluding financial companies, is up by more than a third since 2008, according to a September report by the International Center for Monetary and Banking Studies in Geneva. The report concludes that the potential global growth rate has dropped to less than 3 percent from about 4.5 percent prior to 2008.

The more debt there is, the greater the cost to governments, businesses and consumers of higher rates -- and that translates into a worse drag on growth.

Central bank balance sheets aren’t going back to normal any more than rates are. After three rounds of quantitative easing in the U.S., the Fed held a record $4.5 trillion of assets on its balance sheet at the end of October, up from less than $1 trillion in 2007.

The U.S. central bank and the BOE have said they won’t start selling the securities they have acquired until after they begin raising rates. The BOJ and ECB, of course, are still adding assets.

**Interventionist Era**
Multitrillion-dollar balance sheets show that central banks have entered a new, more interventionist era, says Ben Friedman, a Harvard University economics professor. In the past, he says, these institutions left more of the power to set prices in the hands of markets, but the change makes sense.

“As a permanent matter, they should keep a balance sheet that’s much higher than they had going into the crisis,” Friedman says. “They should be prepared to use the asset side of the balance sheet symmetrically, so sometimes it will be appropriate to buy assets and other times it will be appropriate to sell assets.”

In the euro zone, where inflation is running less than a quarter of the ECB target of just below 2 percent, it’s time to buy more assets. The central bank’s balance sheet peaked at 3.1 trillion euros ($3.9 trillion) in 2012 and then shrank as banks paid back emergency loans, dipping below 2 trillion euros in September.

**ECB Buying**

The Nov. 6 announcement signaled that the ECB is headed back toward 3 trillion euros in assets and might soon buy sovereign debt in addition to the private securities it has purchased so far. Buying government bonds won’t be as simple for the ECB as it was for the Fed. Moving to make such purchases risks a fight with German officials, who argue that they may violate the ECB’s founding treaties and object that they will reduce pressure on governments to overhaul their economies.

Central banks are giving direct support to bond prices worldwide -- and especially in Europe -- and are indirectly boosting equities because safer fixed-income assets pay so little.

**Reliant Markets**

Stock markets have become reliant on monetary support, says Matt King, global head of credit strategy at Citigroup Inc. He estimates that central banks need to pump about $200 billion into the global economy every quarter to keep stocks from falling -- and that no net monetary stimulus would cause a 10 percent quarterly drop.

The sudden sell-off in October was a reaction to the withdrawal of central bank support, which was as high as $1 trillion per quarter in 2012, King says, and the rebound was spurred by expectations that the BOJ and ECB would do more -- which they did.

As central bankers search for the right levers to promote growth, it’s all for naught unless they prevent the credit excesses and overhyped markets that threw the financial system into turmoil in 2007 and 2008.

The Fed has created a panel, led by Vice Chairman Stanley Fischer, to monitor markets and catch...
early signs of asset bubbles. Yellen told Congress in July that valuations appeared stretched in some financial markets, citing lower-rated corporate debt as one area to watch.

The Fed is also scrutinizing leveraged loans, a type of high-risk debt that banks resell to investors.

**Macropurudential**

The BOE has been at the forefront of this approach, which falls under the banner of macroprudential regulation. Carney chairs a Financial Policy Committee to assess hazards to the financial system. He's currently trying to cool U.K. property values, using measures that limit riskier mortgages, and prevent an unsustainable buildup of consumer debt.

“Central banks will now and forever be putting weight on financial stability issues or risks when making their decisions,” Bank of Canada Governor Stephen Poloz says. “Central banks were first invented for what we’d now call financial stability reasons,” he says. “We’ve come full circle. We’re back to our roots.”

The alternative, if the macroprudential approach fails, is higher interest rates to maintain market calm.

**Bubble Risk**

A common criticism of Alan Greenspan, Fed chairman from August 1987 to January 2006, is that he left monetary policy too loose, fueling first a technology mania and then the property bubble that burst just after he left office. Greenspan’s Fed also did little to promote macroprudential regulation.

Cognizant of the hazards of raising rates, Yellen, Carney and other monetary leaders are betting that vigilance against bubbles will allow them more scope to stimulate the fragile, debt-laden economy.

Jeremy Stein, a former Fed governor who’s now at Harvard, cautions that sometimes the needed medicine is to drain some liquidity out of the markets. Raising interest rates, as a remedy, “gets in all the cracks,” he says.

Spotting bubbles, soothing markets, keeping a fragile global economy growing -- there’s nothing normal about what central bankers are being asked to do. Stephen King, chief economist at HSBC Holdings Plc, frets that they’re being asked too much.

“With conflicting objectives, they’re always going to fail in one, and that will only put them under greater political scrutiny,” King says.

To contact the reporter on this story: Simon Kennedy in London at skennedy4@bloomberg.net
Central Banks Likely to Stay Easy in 2015 as Normalcy Is Elusive - Bloomberg

To contact the editors responsible for this story: Fergal O'Brien at fobrien@bloomberg.net Robert Dieterich

©2014 BLOOMBERG L.P. ALL RIGHTS RESERVED.