The Fed and ECB Monetary Reviews: Let's not let bygones be bygones?

February 2020

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SUMMARY

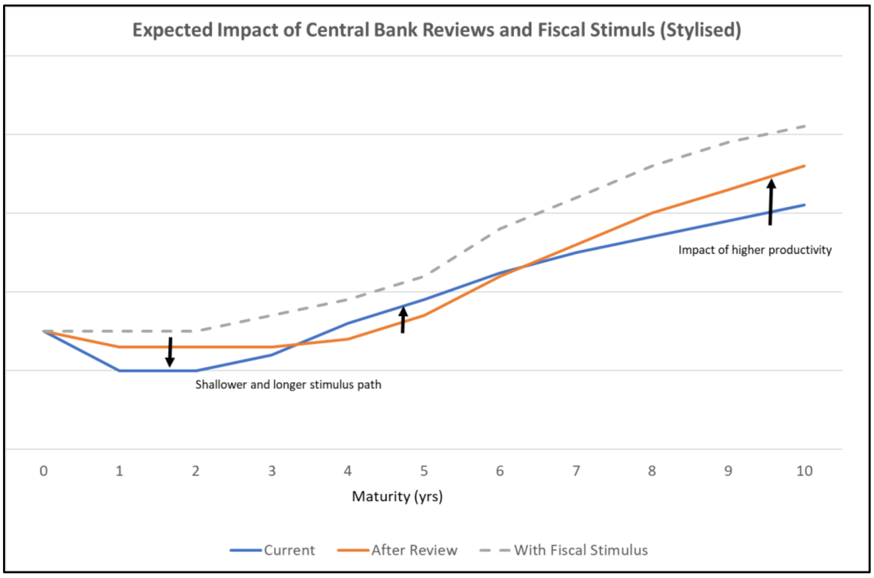
The US Federal Reserve and European Central Bank are currently undertaking reviews of their monetary policy settings. These will be wide ranging, but an ongoing commitment to price stability is assured.

Our observations of financial markets reveal that a heightened degree of sensitivity of credit spreads to cash rates has emerged since the Fed commenced its mid-cycle adjustment in July 2019. This is consistent with the aims of monetary policy but the escalation in the degree of this relationship may also be yet another indication that the effects of ultra-loose policies are becoming caustic;

Central banks have regularly adjusted their approaches to emerging weaknesses in their doctrines. We expect the extent of commitment to return inflation to target levels in the medium term will be revisited;

An evolution *towards* a policy objective that resembles price targeting may emerge. Such arrangements commit the central banks to delivering inflation outcomes which consider what has occurred. If the economy encounters a period of low inflation, under a price targeting regime, the central banks would commit to allowing an overshoot until price levels meet their longer term targets once again. It would not let low outcomes be bygones. Such a commitment is consistent with a longer term price stability objective.

The impact on yield curves would be along the following lines:



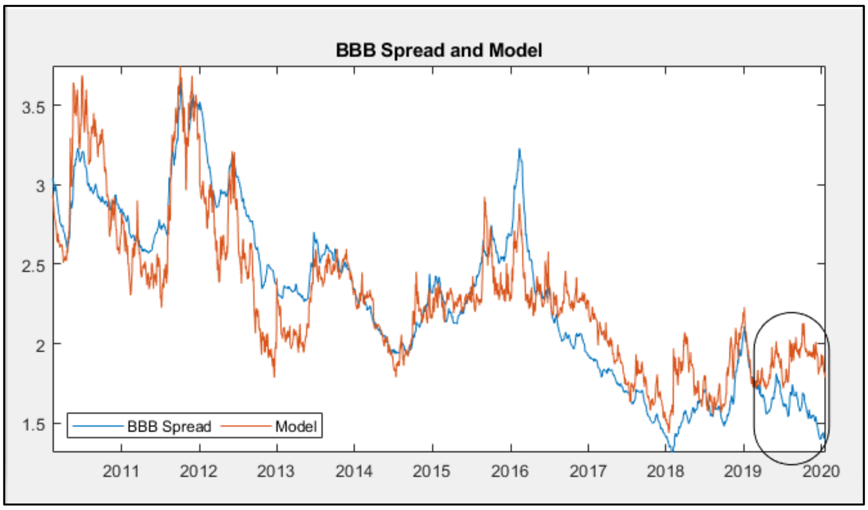
This is one way to balance the inflation objectives with rising concerns for financial stability, economic inefficiency and social equity. It also recognises that some secular matters which are hampering inflation, like demographics, increasingly disparate wealth distribution and low productivity are not well managed by monetary tools.

More substantive revisions to the system via debt monetisation amongst the western central banks is a longer-term possibility.

Although the geopolitical influences on bond markets will continue to have a strong effect, on balance, the role of interest rate duration within credit-oriented portfolios has diminished somewhat. Portfolios need to be adjusted for these developments.

OVERVIEW

Our models for the pricing of credit risk have been showing a disturbing development. The likelihood of default on bond payments is related to the likelihood that a borrower will become less able to service their interest payments and also the degree of leverage on their balance sheet. These features are combined in a well-accepted framework, the Merton model, whose origins date back to at least 1974[1]. We utilise this basis to create a behavioural model which has explained the movement in corporate spreads[2] in a satisfactory way…until the Fed's 'mid-cycle adjustment' commenced in July 2019, where its Target Rate was lowered again:



Source: Author, FactSet

Since the GFC, central banks have utilised QE approaches to directly influence the prices of high-quality bonds and, in some cases, the price of other market instruments as well. The influence on credit spreads largely operated through providing expectations for a more stable economic outcome than would otherwise have occurred[3]. However, the extent to which lower interest rates are now impacting the price of risk assets has significantly shifted. Cash rates appear to be influencing spreads in a manner which extends well beyond management of economic volatility.

This emerging behaviour of markets has the potential to increase the weighting which the central banks place on financial stability concerns. It may also be an indication that further cuts to the cash rate have become counter-productive. On the other hand, central banks may also see this as an indication that unconventional policies need to be escalated further, particularly if fiscal support is not forthcoming. A pressure point is clearly emerging which suggests more clearly that pursuit of the current policy regime could be an exhausted strategy for central banks.

Additionally, there is now materially less diversification potential between bonds and credit. Portfolios which are meaningfully exposed to both may need to reconsider their positions and, on balance, would likely fare better by reducing their exposure to nominal duration.

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[1] Merton RC; 1974; *"On the pricing of corporate debt: the risk structure of interest rates"*; Journal of Finance 29; 449-70

[2] US Moody's BBB Spreads

[3] The yield curve of central banks operating with active balance sheet was managed in a way which had the effect of reducing the level of the VIX which acts as a proxy for the level investment uncertainty

ON FINANCIAL STABILITY

The value of financial stability was highlighted in the GFC when its absence was strongly felt. The smooth functioning of financial markets, including the ability to settle transactions, provide adequate liquidity, as well as secure credit on fair terms is fundamental to a modern economy[4].

As economies sought to recover from the GFC, major central banks moved their objectives from the restoration of the flow of credit to include modifying the price at which credit would be provided in order to stimulate the extent that it would be drawn upon to aid in economic recovery. This is a delicate operation which involves impacting the balance sheets of banks in a helpful way and attempting to alter the price at which financial transactions take place. All of this occurs whilst balancing the impact on the currency markets and a host of other matters. Quite an undertaking.

The ideal outcome is one where the flow of credit is at an appropriate level and composition to foster the development of a balanced and highly productive economy. The central banks can gradually extract themselves if this can be successfully achieved.

If, in trying to restore the flow of capital in the real economy, asset prices become particularly detached from reality, it exposes the economy to increased risks of a shock to wealth and smooth function of financial markets. Efforts to restore confidence can have the opposite effect. The increased concerns relating to the levered loan markets[5], 'cliff-risks' for investment grade credit[6] and much lower labour productivity growth provide direct evidence of these concerns.

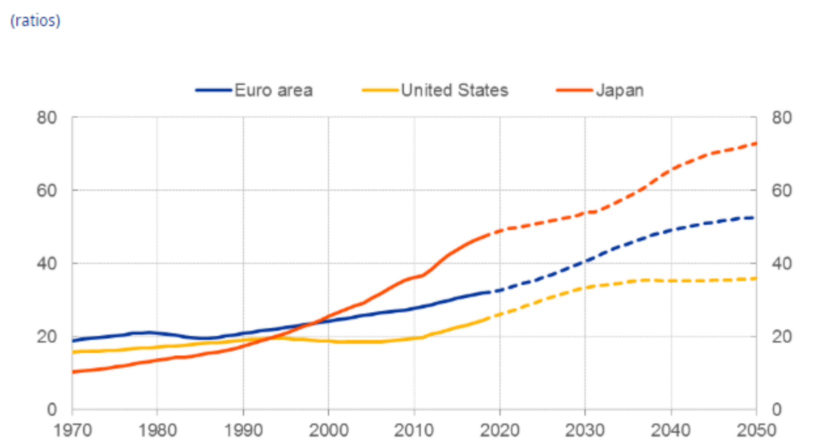
It can also impair the function of pension funds and insurers because of difficulties associated with managing their balance sheet risks, and adversely impact the ability of banks to operate profitably.

Finally, it also shows itself through when the price of risk assets begins to move particularly closely with the cash rate. That occurs when precautionary saving rises while the desire to borrow by corporates and financials is limited. Rather than being helpful, rate cuts make the household sector even more concerned, so they save even more than they did rather than spend because interest costs have been lowered.

[4] *"If we don't do this, we may not have an economy on Monday"* Ben Bernanke as quoted by Sorkin et al; 2008; "As Credit Crisis Spiralled, Alarm Led to Action"; New York Times
[5] IMF; 2019; *"Global Financial Stability Report"*; Oct 2019
[6] Powell JH; 2019; *"Business Debt and Our Dynamic Financial System"*; Fed Speech

Consider that the average European expects to spend 20 years in retirement[7]. As old-age age dependency ratios rise, a greater proportion of wealth is being saved for retirement. As interest rates fall, and the expected return from investments declines, the need to increase savings required for a comfortable retirement rises. This effect goes some way to offset the fact that households with debt may be able to spend more as their interest payments have declined:

Old-age dependency ratios: historical data and projections



Sources: World Bank, Eurostat, OECD and ECB staff calculations.
Notes: Dashed lines denote projected values. For the euro area, historical data are from the World Bank and projections are from Eurostat. All other historical data and projections are from the OECD.
Latest observation: 2018 for historical data and 2050 for projections.

However, as corporations remain restrained on their capital expenditure plans[8], savers bid up the prices for existing assets (including housing) and hence create financial risks.

MORE OF THE SAME IS NOT HELPING AS MUCH. NOW WHAT?

The central banks have successfully restored the flow of credit and brought unemployment levels back to historical lows. Although we have had very some close calls and China’s credit system is perpetually a source of concern, no major financial disruption has occurred since. Although gold, “whatever it takes”, the Trump discount and Brexit made headlines amongst other things, no disorderly break-out in price inflation or loss in confidence with a major currency took place. The Fed and US Treasury even made profits on the assets they acquired to keep the system afloat.

Nonetheless, if they continue to pursue inflation targets with the same fervour, it may not improve the underlying economy and could make it more fragile and inefficient.

New leadership has been installed at the ECB and increasing levels of political influence are being applied to the Fed. Both are undertaking a strategic review of their frameworks at present[9].

[7] Lane PR; 2019; *“Determinants of the real interest rate”*; ECB Speech
[8] Williams G; 2019; *“Global Corporate Capex Survey: Curbed Enthusiasm”*; S&P Research Report
[9] The Fed review is scheduled for delivery in H1 2020. The ECB review was launched in January 2020 and is expected to take a year to complete.

Markets appear to be pricing a future path of rates on the basis that the current levels of commitment to inflation will be retained and additional fiscal support will not be forthcoming. This may well be the outcome. However, the risks of a change in policy stance are more significant now than for many years.

At one extreme, the time frame over which central banks aim to meet their inflation targets might be lengthened from the current practice of between 2 and 3 years[10] [11] [12] [13] or altered to take into account the historical path of inflation[14] [15]. On the other, we may see some banks, potentially in concert with their governments, pursuing arrangements which are closer to those Japan has undertaken since December 2012[16] which involves a reasonable degree of coordination between fiscal and monetary stimulus.

WHEN IT COMES TO MONETARY POLICY, WHAT EXACTLY IS CONVENTIONAL?

The extensive use of central bank balance sheets has been represented as 'unconventional'[17] which implies that a conventional form of monetary policy implementation exists. If it does, this may be taken as the implementation of policy objectives via the management of short-term interest rates. The policy objectives usually combine elements of inflation and employment with some consideration to financial stability as well.

However, the extent to which monetary policy frameworks have been revised in the last 150 years is very significant. We have seen primacy given to stability of the currency with specie (various forms of 'gold standard'); the abandonment of gold in exchange for a preparedness to accept currency fluctuations to prioritise the stability of macro-economic outcomes instead; belief in the ability to manage the economy via quantitative monetary volumes; primacy given to employment outcomes; managed currency exchange rates; floating currency exchange rates; outright monetisation of debt; dual mandates involving inflation and employment; the idea that rates would not go below zero replaced by the realisation that significant swathes of the bond market could trade at negative yields; the increased focus on financial stability and various hybrids of them all.

What is conventional? Far from exhibiting far-sighted and accurate prognostications, policy frameworks have lurched between objectives, sometimes between extremes as the weaknesses of any prevailing regime are revealed and eventually become untenable. Central banking is a process of learning by doing.

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[10] Engemann K; 2019; *"The Fed's Inflation Target: Why 2%?";* St Louis Reserve Bank Open Vault Blog
[11] ECB resource: https://www.ecb.europa.eu/mopo/strategy/princ/html/orientation.en.html
[12] "in the medium term" from Debelle G; 2018; *"Twenty-five Years of Inflation Targeting in Australia";* RBA Speech
[13] Jahan S; *"Inflation Targeting: Holding the Line"*; IMF
[14] Bernanke BS; 2017; *"Temporary price-level targeting: An alternative framework for monetary policy"*; Brookings Institute
[15] *"The Rationale for Inflation Targeting"*; FRBNY Economic Policy Review; August 1997
[16] Launch of 'Abenomics' which ushered in ultra-loose policies based on the 'three arrows' of monetary and fiscal stimulus in addition to structural reforms. Government of Japan; 2017; "Abenomics";
[17] Lowe P; 2019; "Unconventional Monetary Policy: Some Lessons From Overseas"; RBA Speech

Even between epochal shifts, large changes in settings can occur as conditions are re-assessed. For example, the Fed's recent 'mid-cycle adjustment'[18] was regarded as "one of the biggest U-turns in recent monetary policy history"[19].

A constant re-assessment of the appropriateness of policy objectives and a pattern of ongoing variation in methods to achieve them are the only things which could be regarded as conventional practice.

ADJUSTMENTS ARE REGULARLY DEBATED

Even within the current frameworks, despite a convergence of inflation targeting as a key objective, there are variations in the wording of objectives, a process of evolution in their interpretation and constant developments in the tools used to achieve the objectives.

For example, Australia's inflation objective is to "achieve an inflation target of 2-3%, on average, over time"[20]. Some commentators interpret that statement to mean that the RBA gives some weight to realised inflation when determining the desired path of monetary policy[21]. However, the time frame was adjusted to 'over the cycle' and more recently to 'in the medium term' and clarified as 'forward-looking' rather than a concept which gives weight to historical price movements[22]. The articulation of the financial stability objective has also evolved.

The use of forward guidance to communicate the future path of rates has some similarities to QE in terms of attempting to manage yield curves beyond the cash rate. By emphasising that the inflation objectives are 'symmetric' and that rates will remain stimulatory until inflation expectations are restored[23] to desired levels, the Fed is seeking to convey that rates may remain low even if the inflation outcomes meet their targets. This helps reduce the chance of exhausting policy space by managing the yield curve through guidance. Communications have become an important way in which central banks attempt to influence economic outcomes.

The implementation of central bank mandates is constantly evolving and active discussions take place around alternative approaches which might produce superior outcomes.

EXCESSIVE ASSET PRICE SPECULATION

Our credit spread model indicates the sensitivity of asset prices to the actions of monetary policy, has moved from levels which can be explained by affecting probability of default to directly impacting asset prices. As mentioned, this is one indication that asset price speculation has become even more excessive and reliant on monetary policy, making it harder to successfully remove monetary accommodation.

[18] FOMC Minutes for July 30-31, 2019

[19] El-Erian M; 2020; *"How central banks are fuelling the phony asset boom"*; AFR 17 Jan 2020

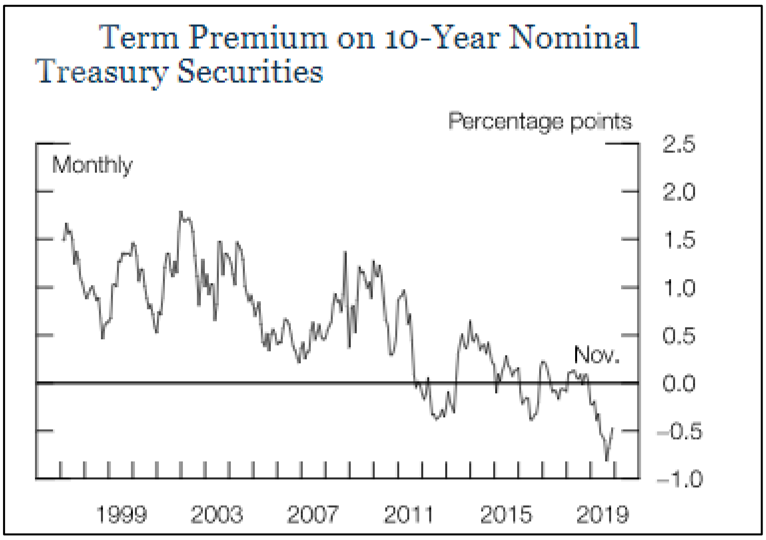
[20] Debelle (2018) ibid

[21] Wessell D; 2019; *"What is 'average inflation targeting'?"*; Brookings Institute

[22] An example is price level targeting, see Bernanke (2017) ibid

[23] Transcript of Chair Powell's Press Conference ; 30 Oct 2019

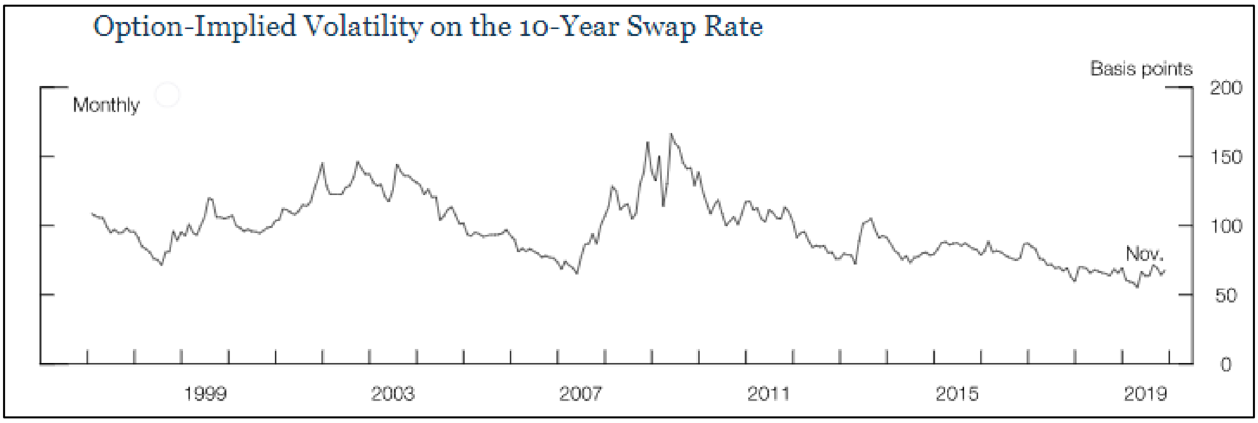
Elevated asset prices are a source of risk to financial stability and segments of the markets already showing signs of excessive pricing[24] or, at best, reasonable only because of exceptionally stimulatory financial settings[25]:



Source: US Fed, Financial Stability Report Nov 2019

To aid economic recovery, central banks seek to create an environment where the economic outlook can be more reliably estimated. This improves the confidence with which the private sector can deploy capital and reduces the extent of contingent funds they keep aside. The uncertainty created by the trade dispute between China and the US throughout 2019 highlights what happens if this is challenged. Manufacturing activity around the world experienced a synchronised slowdown and sentiment was adversely affected.

The extent to which uncertainty has been compressed is visible from the following chart which shows that markets believe that long bond yields for the US market are expected to remain within a tight band:



Source: US Fed, Financial Stability Report Nov 2019

[24] Levered loans are frequently mentioned as an area of particular focus. For example, see BIS Quarterly Review September 2019, Box B
[25] US Federal Reserve Financial Stability Report Nov 2019

Over the last 25 years, these impressions of stability in the outlook have been associated with significant risk events. The very low levels of uncertainty about the economic outlook are an indication that the market may be under-estimating risk and creating instability in some way by doing so:

Year at which Implied Volatility was low	Subsequent Event
1998	Asian Financial Crisis/LTCM
2007	Global Financial Crisis
2013	Taper Tantrum

Having relied on altering the pricing signals from financial markets to stimulate the real economy, central banks have become beholden to the conditions they have created.

One indication of how difficult it is for central banks to extract their economies from reliance on monetary policy comes from the Riksbank, the Swedish Central Bank. Their expectations are for the economy to achieve target outcomes for growth and inflation. However, their QE program will continue for another year at least and the repo rate is expected to remain at zero for another year after that, before rising to a mere 0.1%. The level of indebtedness of households and structural problems in the housing market have made their economy very fragile and this has the effect of constraining their ability to react[26].

Even the hint that policy support might be lowered brings significant risk of a disorderly outcome which can create financial market risks. The Taper Tantrum in 2013, when Fed Chair Bernanke indicated that balance sheet activities would be reduced[27], roiled markets around the world. Those with longer memories may recall the Great Bond Massacre of 1994 where bond yields sharply as the Fed tightened rates for the first time in six years.

The longer that central banks rely on manipulating prices to discourage excess saving (another way of saying encourage speculation), the harder it will be to extract themselves from long-held policy settings, and not just via the immediate impact on asset prices[28].

[26] Riksbank; Dec 2019; "Repo rate raised to zero per cent"; Press Release
[27] Bernanke said "..take a step down in our pace of purchases", during a Congressional Appearance on 22 May 2013
[28] See, for example, the impact on life insurers if interest rates rise Foedoria M & Forstemann T; 2015; *"Lethal Lapses - how positive interest rate shock might stress German life insurers"*; Deutsche Bundesbank Discussion Paper

OTHER SIGNS OF POLICY EXHAUSTION AND POTENTIAL OVER-REACH

Attempting to stimulate the economy with further monetary stimulus is becoming less effective at low interest rates[29]. Also, some of the reasons why monetary policy may not be effective in restoring inflation to its target levels are structural in nature: ageing demographics and lower productivity[30] . These matters fall more neatly into economic policy which is usually regarded as a matter for government.

It is no wonder then that the monetary authorities have been calling for fiscal support for some time, where it is available[31] [32] [33] [34], with the US being a notable exception at this time[35] and the Chinese government demonstrating a preparedness to use fiscal levers to offset the impact of trade uncertainty[36].

Whilst central banks are concerned for entrenchment of expectations for low inflation[37] and concern for the moral hazard associated with bank bail-outs exercised the minds of policy-makers[38], moral hazard has clearly developed amongst some fiscal authorities which have come to over-rely on central banks to produce favourable economic outcomes. This led former head of the NY Fed, William Dudley to call the US Fed to act in a way which decreased the reliance that President Trump might expect when formulating his disruptive trade policy. In his judgment, by allowing the economy to experience the effect of President Trump's decisions more fully[39] the Fed may reduce moral hazards at the level of government and contribute to long term economic and financial instability[40].

Central banks are even being called to consider the prospect of nationalising energy assets in the event of a disorderly adjustment to a low carbon economy[41].

[29] RBA Statement of Monetary Policy, November 2019
[30] ECB; 2020; *"ECB launches review of its monetary policy strategy"*; Press release
[31] Lagarde C; 2019; "The future of the euro area economy"; ECB Speech
[32] IMF; 2020; "World Economic Outlook, January 2020"; WEO Report
[33] Draghi M; 2019; "Stabilisation policies in a monetary union"; ECB Speech
[34] Lowe P; 2019; "Remarks at Darwin Community Dinner"; RBA Speech
[35] Follows the tax cuts for individuals and corporates introduced in 2018
[36] Chen Y et al; 2019; "China says will step up fiscal spending this year to support economy"; Reuters
[37] Moore A; 2016; "Measures of Inflation Expectations in Australia"; RBA Bulletin December Quarter 2016
[38] SIGTARP; Quarterly Report to Congress; 21 October 2009
[39] Baum C; 2019; "Why tit-for-tat monetary policy is a bad idea"; Marketwatch
[40] See also comments regarding excessive reliance on USD as a reserve asset by Carney M; 2019; "Addressing the Growing Challenges in the International Monetary and Financial System"; BOE Speech
[41] Bolton P et al; 2020; "The green swan: central banking and financial stability in the age of climate change"; BIS

It is thought that monetary stimulus has also contributed to a significant increase in inequality by increasing the borrowing capacity of the wealthy who already had strong borrowing capacity[42]. Although the wealthy may also suffer by earning less income from interest bearing assets[43] they also benefited most from the asset inflation which has accompanied low rates. Risks to social cohesion are live considerations, even if the longer-term benefits may ultimately justify this[44]. The concept of "late capitalism"[45] has also been coined to depict stresses which may lead to a revision of the capitalist system.

The ability to utilise cash rates or the management of government yield curves is also showing the strain. For example, the ECB has had to tier its rates for excess reserves[46] and the Bank of Japan has limited its intervention in the longer end of the yield curve to support a positive sloping term structure that helps protect bank profitability[47]. The ECB is also reaching self-imposed limits relating to the proportion of outstanding government bonds that it can acquire[48] [49]. Whilst the RBA believes it still "a fair way from" such levels having a material influence on its current approach[50], limitations are being encountered amongst highly influential central banks.

ON INFLATION TARGETING

Central bankers and monetary theorists believe that they can contribute effectively to economic prosperity by keeping inflation positive and within a narrow band[51]. By doing so, economic planning can occur with greater confidence, which will help maintain a balanced and efficient economy. The targeted figure tends to be around 2% per annum which is consistent with an observation that high rates of inflation tend to be associated with more volatile inflation outcomes.

By seeking to keep inflation slightly positive, at a level where there is some buffer against going negative, some protection is afforded to prevent price deflation. Depending on the particulars of how this occurred, it can lead to a reduction in expenditures as consumers wait for lower prices, resulting in a cycle of reactions that can lead to an economic contraction.

Further, wages tend not to fall, even during a severe economic downturn as encountered in the GFC[52]. If workers become overpaid for whatever reason, the economy has difficulty adjusting via the reduction of wages. By keeping inflation slightly positive, eventually, the real value of the wage can erode to a fair level.

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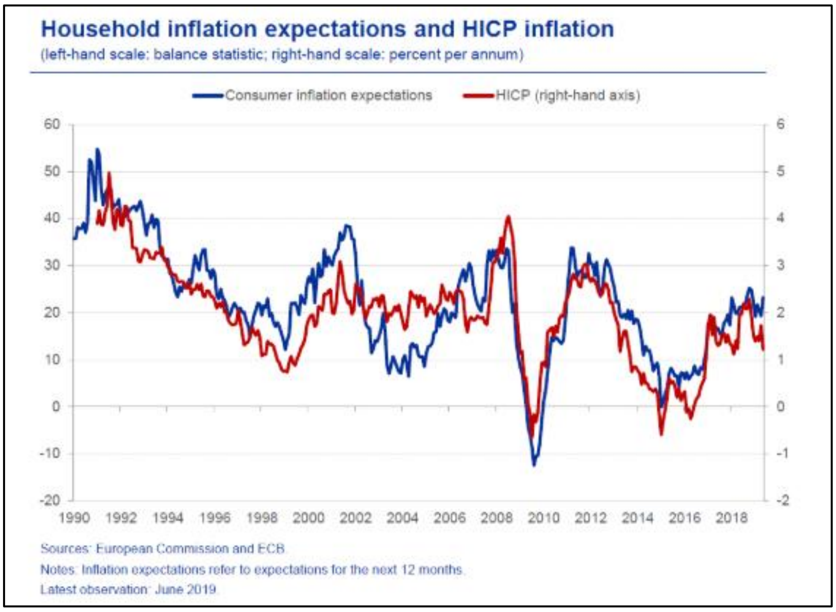
[42] Bullock M; 2018; "The Evolution of Household Sector Risks"; RBA Speech
[43] Bernanke B; 2015; *"Monetary policy and inequality"*; Brookings Institute
[44] Weidmann J; 2019; "No evidence that non-standard monetary policy measures have increased distributional inequality"; Deutsche Bundesbank Speech
[45] Milanovic B; 2020; *"The Clash of Capitalisms: The Real Fight for the Global Economy's Future"*; Foreign Affairs
[46] Draghi M; 2019; *"Policymaking, responsibility and uncertainty"*; BIS Speech
[47] Bank of Japan; "New Framework for Strengthening Monetary Easing: 'Quantitative and Qualitative Easing with Yield Curve Control'"; 21 September 2016; Policy Announcement
[48] This was 25% in March 2015 but was revised to 33% on a case by case basis in September that year. The proportion of bonds issued by supranational issuers was adjusted to 50% in April 2016
[49] Stubbington T; 2019; *"Investors start to ponder 'QE infinity' from the ECB"*; Financial Times
[50] Lowe P (2019) ibid
[51] *"Part 1. The Rational for Inflation Targeting"*; FRBNY Economic Policy Review, August 1997
[52] Fallick BD, Lettau M & Wascher W; 2016; *"Downward Nominal Wage Rigidity in the United States during and after the Great Recession"*; Federal Reserve Bank of Cleveland Working Paper

Finally, by keeping inflation rates slightly positive, there is scope for interest rates to be set below those levels and stimulate the economy more strongly via negative real rates.

The current practice of seeking to achieve these targets sees central banks undertaking policy actions which aim to bring outcomes to their targeted levels within a 2-3 year period[53]. There are few suggestions that some commitment to an inflation target of sorts will not be maintained[54]. The regime of inflation targeting has generally been regarded as successful in the context of the modern history of central banking, albeit operating within the moderating influences in the form of mandates that consider employment and financial stability in some way[55].

ARE LOW INFLATION EXPECTATIONS REALLY A PROBLEM NOW?

Considerable effort is made by central banks to manage inflation expectations on the belief that outcomes are highly influenced by expectations[56]. However, the targeted rate of inflation for consumer goods and the perceptions of this rate by actual consumers (ECB data is shown) are an order of magnitude apart which does put into question the value of an obsessive pursuit of a narrow outcome[57]:



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[53] Jahan S; ibid

[54] Some exceptions exist. For example, see McKibbin WJ; 2015; "Central banks must target growth not inflation"; Brookings Institute for discussion about a nominal GDP target

[55] Variations exist. For example, the ECB mandate is primarily focused on price stability, with economic growth and employment ranking below this. The RBA operates with a mandate which is to contribute to the stability of the currency, full employment and economic prosperity and welfare of the Australian people. It implements this via a focus on price ('currency') stability, taking into account economic activity and employment level. Yet the Fed operates with a dual mandate which seeks to maximise employment and stabilise prices (although maintaining moderating long-term interest rates is also part of the Federal Reserve Act).

[56] Powell JH; 2018; *"Monetary Policy and Risk Management at a Time of Low Inflation and Low Unemployment"*; US Fed Speech

[57] Lowe P; 2019; *"Remarks at Jackson Hole Symposium"*; RBA Speech

In Australia, consumer expectations for inflation over the coming 12 months are 4% per annum[58], well above the upper band of the RBA's inflation objectives of 2-3% per annum. For the US, consumers expect inflation for 2020 to be 2.53%[59] (target 2%per annum). In the UK, the corresponding figure is 3.1%[60] (target 2% per annum).

Given the significant role the central banks give to expectations, surveys of consumers themselves suggest that there is no obvious issue with overly low expectations becoming entrenched amongst them in the largest western economies.

HOW STIMULATORY ARE CENTRAL BANKS RIGHT NOW?

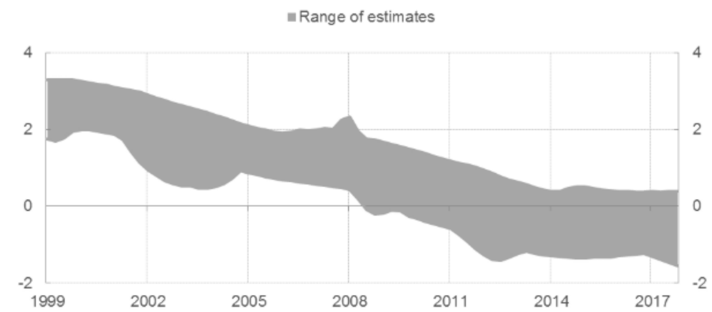
At present, the Fed expects the level of inflation in the US to return to its target of 2.0% per annum in 2020[61] and employment conditions are very favourable. The current Fed target range of 1.5-1.75% is not expected to change for 2020. This produces a negative expected real yield in the order of -0.25 to -0.5% for 2020 and this is judged to be very stimulatory against estimates of the real short-term rate required if the economy is at full strength and inflation is stable[62] ('r-star' or neutral rate of interest) of 1%.

In contrast, the estimated real rate of interest for the Eurozone in the next 12 months is close to its r-star of approximately -1%. However, the ECB finds it more difficult than the US to lower its short-term rate further from these levels[63] and the economic outlook is weaker than desired.

The r-star for the Euro Area is shown in the following chart[64]:

Range of point estimates of the natural rate of interest in the euro area obtained from econometric models

(percentages)



Notes: The grey-shaded area reports ranges of point estimates of *r** for the euro area, as estimated in Brand, C. and Mazelis, F. (2019), "Taylor-rule consistent estimates of the natural rate of interest", *Working Paper Series*, No 2257, ECB. Corresponding individual point estimates are reported in Brand, C. et al. (2019), op. cit.

Source: ECB

[58] Source: RBA for data as at 31 Dec 2019
[59] Source: FRBNY
[60] Source: BoE
[61] Central tendency of 1.9-2.0% for core PCE for 2020 (2.0-2.1 for 2021) from FOMC Projections as at 11 Dec 2019
[62] As at the time of writing, the Laubach-Williams estimate for r-star is close to 1% (source: NY Fed)
[63] For example, the ECB had to introduce tiering of the interest rate applicable to bank reserves in order to limit the impact of the pass-through of negative rates
[64] Lane PR; 2019; *"Determinants of the real interest rate"*; ECB Speech; 28 Nov 2019

Based on their own internal analysis[65], the RBA's interest rate settings are also lower than the r-star. Japan's inflation outlook remains bleak, suggesting that, even with its considerable stimulus program, it is finding it difficult to bring its economy into the desired balance.

Overall, it appears that the Fed is strongly stimulating the economy at present, whilst the ECB and Japan are having trouble providing adequate support via monetary channels. The RBA presently sits between these extremes.

INFLATION TARGETING AND THE TRADE-OFF WITH ECONOMIC QUALITY

Ultra-loose monetary policies can produce undesirable effects. When implemented, they were intended to smooth a recovery that had not been expected to take as long to arrive as it has[66]. In the search to smooth economic output, the quality and efficiency of output was compromised.

Given the extent of dislocations which were experienced, it was more important that jobs were created than to be particularly selective about the productivity or quality of those jobs. This appears to have created structural problems for the productivity of the workforce[67] which does have ongoing consequences.

For example, Japan's labour productivity growth rate has still not recovered from the excesses of the 1980s and has become even more impaired in the post GFC period with the most extensive stimulus program amongst major nations.

In the long term, quality of life and economic prosperity rests heavily with the rate at which economies become more productive. It appears that ultra-loose monetary policy may have contributed to lowering unemployment rates to pre-GFC levels, but potentially at the cost of inefficiency.

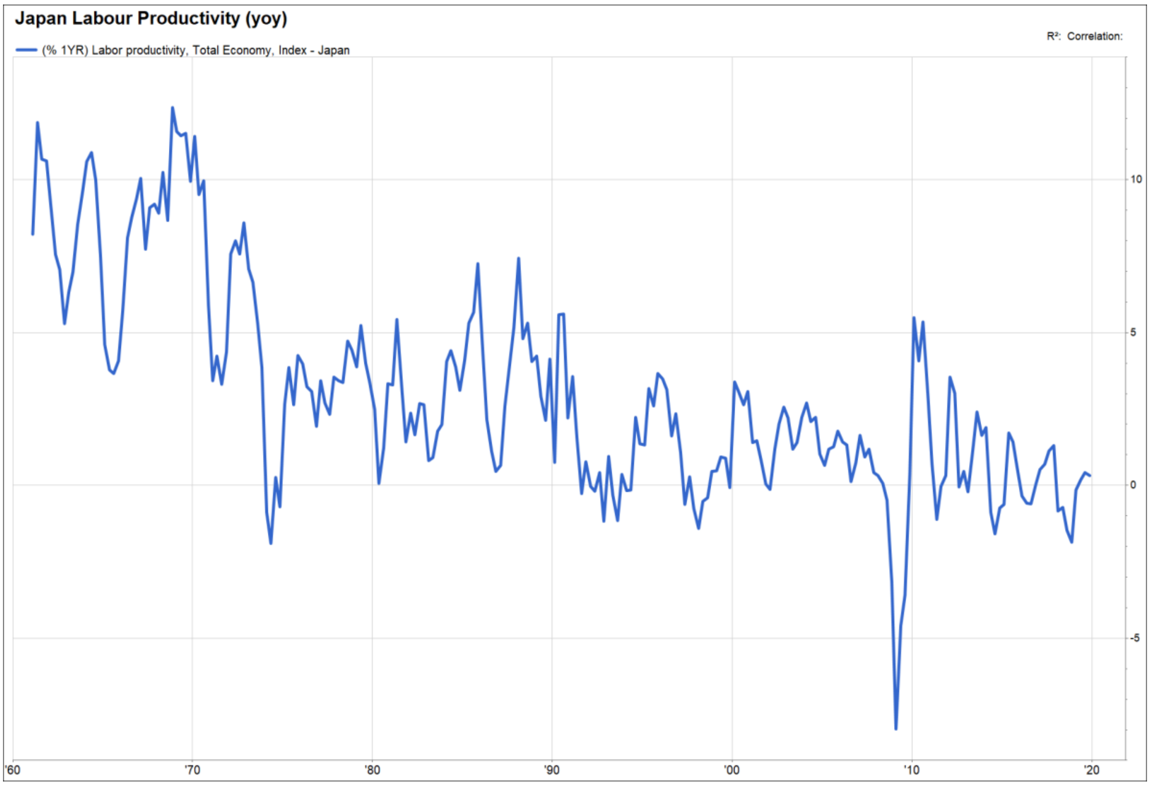
Now that unemployment levels, if not labour utilisation, in major nations have recovered from the GFC, there is an economic cost to pursuing inflation targets with the same priority. The reviews of monetary policy under way at present will undoubtedly give weight to these concerns.

[65] McCririck R & Rees D; 2017; "The Neutral Interest Rate"; RBA Bulletin Sept Qtr 2017

[66] Fed rate futures pricing has consistently anticipated reversion towards historical norms, over a period of 2-3 years from each observation point, in the post GFC period

[67] Labor productivity growth for the US and Europe for the 5 years to 2018 (from Lane (2019) ibid) is approximately half that for the five years ended 2000. A similar statement can be made for Australia (ABS "Estimates of Industry Multi-factor Productivity 2018-19")

The following chart shows the deterioration in Japanese labour productivity since the debt bubble of the 1980s and even weaker outcomes since the launch of Abenomics in 2012:



Source: FactSet

DEBT MONETISATION?

There have been significant calls for fiscal intervention to assist with the achievement of economic objectives. Christine Lagarde colourfully stated "I'm not a fairy" when calling for more fiscal involvement[68]. Even Kristalina Georgieva, the new IMF Managing Director who replaced her saw fit to softly joke that the IMF stood for "It's Mostly Fiscal" in her first official speech[69].

However, in an environment of stretched fiscal resources, some financial alchemy may be required. For example, the US fiscal deficit passed the $1tr mark in 2019[70] and its fiscal trajectory would pose "substantial risks" and "significant challenged" in the coming decades[71].

[68] Rettman A; 2019; *"Rich EU states should spend more, Lagarde says"*; Euobserver
[69] Georgieva K; 2019; *"Decelerating Growth Calls for Accelerating Action"*; IMF Speech
[70] US Treasury
[71] Congressional Budget Office; 2019; *"The 2019 Long-Term Budget Outlook"*

One potential evolution of monetary policy may take a leaf from the Japanese practices. This involve a coordinated whole-of-country effort towards economic goals which coordinate the actions of the Bank of Japan with its Treasury. Japan's monetary arrangements have less independence from its government than other western arrangements[72]. It maintains a relatively high fiscal deficit, approximately 6% of GDP, which is significant given the context of its demographics and low productivity and yet the Bank of Japan purchases more bonds than are issued. Some may consider this to be debt monetisation and this has been something modern western central banks have avoided doing.

China also pursues its own version of a whole of government approach[73] to economic management.

As President Trump continues to erode the independence of the US Federal Reserve, some form debt monetisation may be possible even for the US. Although Modern Monetary Theory has its detractors amongst thoughtful experts[74], some form of monetisation may be possible at a future time for even the most prominent western central bank[75].

SCOPE OF REVIEWS

The US Fed initiated its latest review with a commitment to its inflation objective of 2%, *over the longer run*, taken as a given[76]. Focus would be given to instruments and communications along with its current monetary policy strategy. The ECB's review within its price stability Treaty[77] is more wide ranging in that even the inflation target is available for review.

[72] Balls E; Howat J and Stansbury A; 2016; *"Central Bank Independence Revisited: After the financial crisis, what should a model central bank look like"*; Harvard Kennedy School Working Paper
[73] US Treasury; 2019; *"Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States"*
[74] Mankiw NG; 2019; *"A Skeptic's Guide to Modern Monetary Theory"*; Harvard; Paper for AEA Meeting
[75] Holland B; 2020; *"Dalio says something like MMT is coming, whether we like it or not"*; Bloomberg
[76] US Federal Reserve; 2019; "Review of Monetary Policy Strategy, Tools, and Communications"
[77] Treaty of the Functioning of the European Union

OUTLOOK

We believe the reviews are unlikely to leave the current arrangements unchanged. Any change would likely take into account the increasing harm which ultra-loose monetary policy is creating given the primacy attached to achieving inflation targets over a 2-3 year period. Additionally, recognition will be given to the lower effectiveness which monetary pools have for matters like demographics and low productivity growth.

We expect that the commitment to price stability will be maintained with the following changes:

> The timeframe over which inflation targets will be achieved will implicitly be lengthened and *more emphasis* will be given to forward guidance via a price targeting approach of some kind. This approach inherently takes into account periods where inflation has been below target and commits the bank to a period of higher inflation going forward so as to target a pre-determined price target for a basket of goods. Most, if not all, current policy tools will be retained with some technical tweaks;
>
> More explicit consideration will be given to traditional financial stability concerns as a factor in determining monetary settings including consideration of specific risks associated with climate risks including that of climate transition; and
>
> It is possible that the ECB would raise its inflation target from “below 2%” to a figure of “2%” or possibly towards a more explicit range as per Australia’s 2-3% commitment.

IMPLICATIONS FOR PORTFOLIO SETTINGS

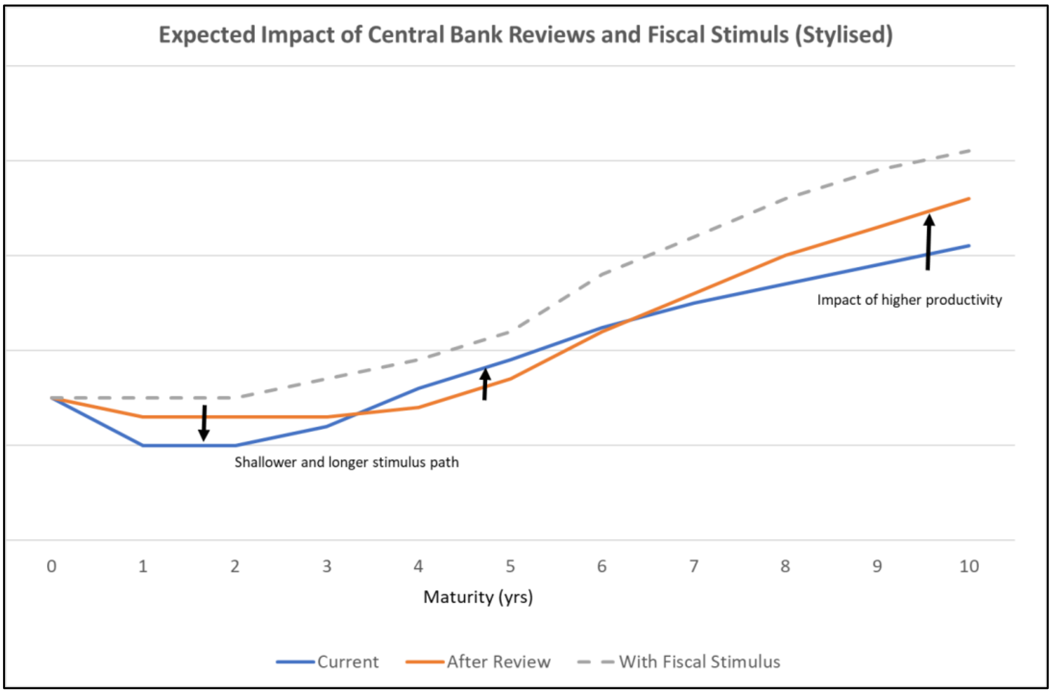
The extent of co-movement between policy rates and credit spreads has increased significantly. We believe that the diversification benefit of interest rate duration for a credit-oriented portfolio has deteriorated. For credit-oriented portfolios, a reduced role for interest rate duration is appropriate. Alternatively, it might be said that an increased level of confidence in a rally for bonds is required to support existing interest rate duration positions.

We expect that the monetary policy strategy reviews will result in relatively modest changes. The greater use of rules-oriented forward guidance will have the effect of producing are shallower rate path over the short to medium term but also steepening the yield curve to the long end as a commitment to restoring inflation over the longer term becomes more credible and also on expectations of more favourable productivity outcomes.

As the recent events with the China/US trade dispute, the Iran/US skirmish following the execution of General Soleimani, and the outbreak of the coronavirus demonstrate, there are also many other unexpected developments which will come to affect the yield curve as well.

A significant uncertainty is the extent to which fiscal support may be forthcoming. If the pattern of public spending assists with economic growth but not to the extent of affecting the credit worthiness of the relevant government, this would also result in a steepening of the yield curve, but cash rates would not be expected to rise in the immediate term.

Our expectations for the impact of the reviews is depicted below:



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