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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The background of a possible concerted policy shift by leading central banks, etc.

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1. Overview Macroeconomic and Financial Risks (Trends & Topics)

 # The background of a possible concerted policy shift by leading central banks (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy (CRMS) at Deloitte Touche Tohmatsu LLC/Deloitte Asia Pacific Risk and Capital Management Leader)

The global macroeconomic and market condition in the past months had been seen as somewhat weird as the strong macroeconomic indicators and stock market movements [or a recently emerging hawkish stance of the Federal Reserve Bank (FRB)], and a bullish bond market (or a continued or even declining low interest rates) coexisted. In the current markets, the views are still divided between the idea of bond market dominated by secular stagnation and the idea of stock market that the current strength in the economy will continue and lead to stronger price increase as depicted by the FRB. Quite interestingly, the FRB is not the only one which had recently emphasized a little hawkish stance but other major central banks including the European Central Bank (ECB), Bank of England (BOE) and Canada Central Bank (CCB) are also currently following the FRB by showing a positive attitude towards normalization of ultra-loose monetary policies, and thereby placing an upward pressure on long-term interest rates. A big question in this regard is whether this central banks' movement indicates a final victory of the idea of bond market against the idea of stock market or not.

In last month's issue, I emphasized three possible reasons behind FRB's hawkish stance; (1) securing "buffer" for future easing of monetary policies, (2) normalizing the abnormal scale of the balance sheet to secure independence of the FRB, (3) cool down stock- and real estate markets to avoid potential financial instability. However, the fact that other central banks in developed economies are also following the FRB for normalizing monetary policies in a somewhat concerted way might indicate another more profound reason, a view which I am now being inclined. This may be “a concerted renunciation” of the idea of buoying up the economy than potential and accept the idea of secular stagnation as the one not to be addressed by monetary policy.

Of course, all central bankers would answer “No” to the question of whether they are trying to improve the potential growth rates through monetary policy. Still, it is hard to justify their keeping extraordinary monetary policy such as negative interest rates and huge central banks’ balance sheet (or the legacy of quantitative easing) when financial crisis management mode has ended and further deflationary concerns are fading. One excuse would be that prices are not increasing, and another would be that growth rates have not yet reached the expected level as seen before the crisis. However, in the case of United States and Japan, labor markets are already at full employment. Also, the prices of risky assets such as stocks and real estate have already come to a point beyond pre-financial crisis levels. With the exception of the fact that price increases do not accelerate, all other indicators imply the current growth rates being significantly higher than potential ones, leading to the overheating of both labor and asset markets. In this case, without any reaction from the central banks, correcting these imbalances will eventually come only at a cost of collapsing asset bubbles and consequent financial instability.

Normalization of monetary policy in the absence of increasing prices demands courage in politics. Justifying it only as easing asset bubbles and thereby keeping financial stability does not necessarily fall within the general understanding of politicians as well as “main street” people. However, as the BIS (Bank of International Settlements Bank) and Bundesbank have long argued that the central bank of leading countries should accept the reality of declining potential growth rates and thus move towards monetary normalization even without the expectation of price increase to secure the stability of the financial system, these central banks might begin to raise awareness to their own conduct risk by ignoring this warning. In this case, the likelihood that the idea of the bond market will finally win against the idea of stock market could prevail.

Furthermore, seeing the Bank of Japan as the only major central bank that could not join this concerted action, how it will place itself in the global arena should be carefully monitored as this could significantly impact the value of the Yen and its interest rate.