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Global Risk Watch Newsletter

Exit from extraordinary monetary easing: the US way and the European way, etc.

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

 # Exit from extraordinary monetary easing: the US way and the European way (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy (CRMS) at Deloitte Touche Tohmatsu LLC/Deloitte Asia Pacific Risk and Capital Management Leader)

In the US, the strong business environment and tightening labor market continue apace. While raises in wages and prices have calmed somewhat they are still roughly within the Fed's 2% target. Amid this, the FRB decided at the June FOMC to raise rates – something which was in-line with market expectations. The prospective number of rate hikes during this year (represented as the median number of FOMC members' expectation for the number of rate hikes) has also increased from three to four – attracting some attention in the market. Since the Fed has already raised rates twice, this means that many FOMC members now anticipate two further rate hikes. This indicates that the FRB is holding to a steady normalization of their monetary easing even though price and wage increases are not yet picking up.

Meanwhile, at the June ECB Governing Council meeting the members discussed ending the current quantitative easing measures at the end of September and then gradually rolling back bond purchases to zero by the end of the year. They also intimated that rate raises could happen sometime in the latter half of next year. What is a little surprising is that this decision was made when price rises (core HICP inflation) in Europe are only about half of the goal level. As well, current growth is showing to be decelerating somewhat and the uncertainty regarding the Italian political situation is conspicuous.

The Bank of Japan held their monetary policy meeting around the same time and decided to hold the current monetary policy as was expected. The background of this decision includes the continued stagnation in both price and wage increases despite an extremely tight labor market as well as the subsequent delay in the core core CPI inflation nearing its target level.

Under these conditions, the question of why wage and price increases have not yet shown any signs of acceleration despite ultra-tight labor markets once again draws the central bankers' attention. The orthodox arguments have actually not changed a lot for many years: that the labor force shift towards low-productivity areas is continuing; that the expectations for future growth and inflation are low; that the structural downward pressure on prices due to e-commerce remains strong; and that there is an underlying bias in how prices are calculated. Also, another basic assumption remains unchanged: should this kind of upward pressure continue, at some point the labor market will reach a boiling point and that will bring about an acceleration in prices. So, what happens then when the tipping point in the labor market that precipitates wages rises never comes? Taking digitization or the wide-spread use of AI as an example, structural changes in the economy are surely pushing down the demand for jobs with high/medium-productivity (or wages). The current strong phase of business cycle might only contribute to a sharp increase in the demand for jobs with low-productivity (wages). If this continues, then even as the business environment improves this may never bring about average wage rises over the whole of industry and hence price rises.

There seems to be two different reasons why central banks has decided to exit their extraordinary quantitative easing policies. The first is that price hikes have reached the set goal as expected. The second is that central bankers have realized that the assumed mechanism for inflation acceleration is simply wrong and, that the negative side-effects are becoming too serious to continue the policy. I believe that the FRB belongs to the first category while the ECB, which might be rattled by the statements of the new Italian government insisting the Italian government bonds in the current B/S of ECB to be there permanently, belongs to the second. The next question is, toward which exit is the Bank of Japan headed?
