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Global Risk Watch Newsletter

Central Banks are Faced with Deepening Agony as Monetary Policy Reaches its Limits, etc.

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 # Central Banks are Faced with Deepening Agony as Monetary Policy Reaches its Limits (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

At the beginning of July, the global financial market saw numerous events such as Brexit referendum in the UK and attempted coup d'état in Turkey. Since then, the market managed to overcome the EU-wide stress test results and financial crisis in Italy, whilst steady growth of employment figures have also been confirmed in the US. Meanwhile, for another interest rate hike the US FRB (Federal Reserve Board) remains cautious, and this has spurred a Gordilocks situation in the global market. This positive sentiment has also spilled over into the emerging markets where we see the stabilizing economy leading to bullish developments of foreign exchange rates and stock prices. Although the downgrading speculation loomed over Turkey and South Africa due to political unrest, these circumstances seem marginalized as strong optimism is sweeping over the market.

Meanwhile, central banks in major countries are facing increasing agony.　Employment figures are growing steadily, which has been repeatedly positioned by the US FRB as a key factor to decide the direction of interest rate. However, based on recent remarks by Chair Yellen and other officials, the FRB is maintaining a very cautious stance regarding further interest rate hikes. The reason behind this is said to be concerns over the secular stagnation of the economy and inflation that remains constant. In the meantime, San Francisco Fed President Williams indicated the need to raise inflation target. Perhaps this school of thought is seeping into the FOMC (Federal Open Market committee) which regard the prospect of long-term monetary easing inducing increased risk of a financial bubble still being less riskier than the risk of seeing inflation rate re-declining partly due to the resilient financial system being established after the crisis.

The Japanese economy and Bank of Japan’s policy are expected to absorb the most impact of the change in stance of the US FRB. Without Bank of Japan’s intervention to take further monetary easing measures, the strong Yen will persist while FRB remains cautiously to raise the interest rate. Nevertheless, three years have passed since the quantitative and qualitative monetary easing measures kicked –off under the Governor Kuroda regime, Bank of Japan is slowly running out of government bonds to purchase, thereby facing the ‘limit of quantitative measures’. Moreover, the introduction of negative interest rate has already met with fierce opposition from the financial community; therefore, Bank of Japan could be hesitant to further cut the interest rate. Under this situation, Bank of Japan announced it will undertake ‘comprehensive assessment’ of its policies in September. However, some market participants speculate that Bank of Japan has admitted its limitations, which ultimately take measures to reduce the size of ’Quantitative easing’ as well as postponement to achieve the inflation target.

The cautious stance of FRB, in the short-term, may foster a friendly environment for the US economy and asset market. At the same time, however, it is also likely to increase the fragility of the US economy against stress events, which include the rapid slowdown of Chinese economy, the military conflicts in South China Sea, Europe, and the Middle East, or relapse of EU destabilization due to rise of extreme-right sentiment. In terms of Bank of Japan’s revision on qualitative and quantitative easing, whether deciding to ‘reduce’ its size (in this case, will trigger relapse of deflationary risk in the short-term), or to ‘enhance’ it by relying on a kind of ‘helicopter money’ (in this case, will trigger stagflation risk in the mid-long term); could induce massive impact on the stability of the economy. Thus, in this way, central banks in major countries are being agonized before the question of “to be easier, or not to be” and such agony itself is unlikely to be “eased” anytime soon.