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Global Risk Watch Newsletter

Challenges Facing Post-deflation Monetary Policies, etc.

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

 # Challenges Facing Post-deflation Monetary Policies (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 expansionary fiscal policy being proposed by the new Trump administration is about to change a major trend that has dominated the global economy to date. In the face of deflation, many of the advanced economies have been dependent on “ultra” loose monetary policies. They are “ultra” because, within the lower limit of 0% policy rates, many countries introduced unconventional measures such as quantitative easing and negative interest rates. However, with the Trump administration substantially changing the direction to fiscal stimulus measures, including drastic tax reduction and aggressive fiscal expenditure increase, a long-gone “strong and tangible” inflation seems to be finally coming into sight (I have also touched on this point in the December article “Premonition of inflation”). That is to say the period of ultra-loose monetary policy has come to an end, and signs of starting the era of inflation incurred by fiscal stimulus has gradually appeared over the horizon.

In fact, even though the core PCE (Personal Consumption Expenditure) in the U.S., one of the most important indicators for the U.S. monetary policy, has remained below +2% year-on-year (yoy), the core CPI (Consumer Price Index) has already reached +2.3% level yoy. Similarly in Europe, the core HICP (Harmonised Index of Consumer Prices) stays around +1% yoy, but the HCIP including crude oil prices etc. shows a dramatic jump from +0.6% yoy in November to +1.8% yoy in January. Also in Japan, price trends have not yet shown a dramatic turnaround, but increasing number of economists are now sharing a perspective that the core CPI will rise to about +1% yoy over the latter half of the year. Under such conditions, FRB (Federal Reserve Board) Chair Yellen presented a little hawkish stance toward interest rate hikes during the recent congressional testimony. As this result, the futures markets progressively put the chance of a rate hike at an earlier timing (as early as March or May) than in previously expected June.

It is not only in advanced countries that precaution for inflation has altered the tone of monetary policies. In China, starting at the end of last year, the People's Bank of China (PBOC) began to emphasize shift from "loosening bias" to a "neutral" monetary policy stance. What may have triggered such decision are said to be a sense of vigilance against gradually rising prices as well as housing bubble and capital outflows. Moreover, when looking at other emerging economies, more central banks leave interest rates unchanged or move to tightening rather than loosening as is the case up to last year. This can be seen as precaution for future turbulence in the foreign exchange market, as well as preparation for a potential rise in inflation owing to the currency depreciation in late last year and steady crude oil price.

By this means, central banks around the world have begun early working against the sings of inflation which were once supposed to be "extinct". In this environment, quite interestingly, more worries are surfacing over the conduct of monetary policy in the advanced economies, which have been "A-students" in the battle against inflation in the past. For instance in FRB, while Chair Yellen's hawkish comments stand out, two board of governor positions are vacant, and with Governor Tarullo intending to resign in April, the current US administration will need to appoint three board members. Additionally, both Chair Yellen and Vice Chairman Fischer's terms will expire next year. When the Trump administration's fiscal stimulus gets into full swing in the latter half of this year, it would not be an entirely "unexpected" scenario to find the line-up on the FRB board members to be questionable in terms of the central bank's independence. Similarly in Bank of Japan, which is already significantly "close" to the government, Governor Kuroda is fulfilling his term in early April next year, and it would be challenging to drastically shift policies even if inflation takes place before that. Lastly in Europe, it remains uncertain what ECB (European Central Bank) President Draghi who reigns as the "crisis and deflation fighter" would do if the Eurozone were to face an unforeseen inflation spike while concerns loom over the Southern European economies.

In the process of shifting from an inflation-fighting to a deflation-fighting mode, central banks have actually abandoned many of the "conventional wisdom" including distance from governments. In moving back to the battle against inflation, central banks may be questioned whether mere change in policy direction is sufficient to confront inflation.