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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

Deja vu? An Increasing Dovish Stance of Monetary Policy in Advanced Economies, etc.

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

 # Deja vu? An Increasing Dovish Stance of Monetary Policy in Advanced Economies (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Although the postponement of an interest rate hike in the US has brought us a brief moment of relief, Chinese and mostly resource-rich emerging countries' economies seems to be entering into the 'second stage' of economic adjustment after decelerating economic growth. This stage is represented by mounting downward pressures arising from capital stock and employment adjustments. Capital stock adjustments essentially impair bank lending (increases NPLs), and potentially induces expansion of fiscal deficits if zombie companies will be bailed out by the governments. And employment adjustments will naturally increase unemployment figures. The management of this second stage could also entail the `third stage`, which is represented by financial system destabilization and sovereign debt problem accompanied by increasing NPLs, and social unrest from fear of unemployment. Indeed, the current Chinese and emerging economies look very similar with the situation facing Japan in the 1990s. As the course of the 'second stage' merely depends on how the Chinese and emerging economies will manage their landing to the ‘new normal condition’ with 1) a short cut going through a turbulent; or 2) choosing a detour with an emphasis on stability despite the fear of a fuel shortage, a tense situation will likely continue for some time.

Meanwhile, the US continues to struggle to decide the timing of an interest rate hike under the circumstances of cyclical strength and structural weakness. Interestingly, the serious difference in opinions of FOMC members have been addressed in the media recently. This may be partial because whether to raise the interest rate within this year on the back of cyclical strength, or focusing on structural weakness and postpone the decision for the time being is closely connected to the orthodox idea of how the central bank should behave itself. In other words, whether the endless support from the central bank on structural weakness will eventually induce an asset bubble to be busted, or bubbles produced by quantitative easing could be helpful to smoothly implementing structural reforms, is a big question to be answered by the FOMC members. Hence, there is an element of truth on both sides, the uncertainties surrounding the US’s monetary policy would likely deepen for the time being.

In fact, the Bank of Japan is also facing the similar situation as the US. The effects of the “third arrow” has yet to be well noticed, while its potential growth rate continues to face downward pressure. In this environment, the business sentiment remains sluggish and often rumors of another recession loom despite the cyclical strength represented by the nearing full employment. Concurrently, there is a growing expectations of the “first arrow”, additional quantitative easing by the Bank of Japan. However, recent conditions are quite different from the time the “first arrow” started. Particularly, the core price trend (excluding energy sector, etc.) is significantly stronger as long expected by the Bank of Japan. Under such circumstances, whether the Bank of Japan will compensate the structural weakness by monetary policy, have to be carefully observed.