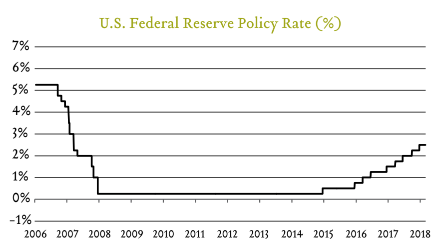
GREENLEAF TRUST
Perspectives
APRIL 2019
VOLUME 28, ISSUE 4

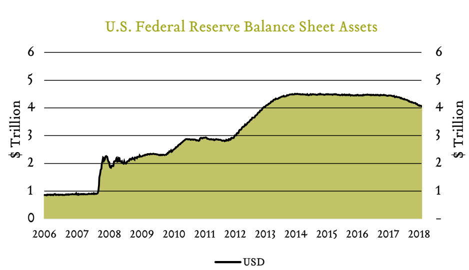
Monetary Policy 2019 World Tour

Nicholas A. Juhle, CFA®
Vice President
Director of Research

In response to the global financial crisis, central banks took swift and aggressive action to stimulate economic growth. This extreme level of monetary accommodation was necessary to jump start the global economy. In the decade that followed, central banks have grappled with when, and if, they could navigate a path back to normalized policy. Normalizing policy could help keep inflation in check, prevent asset bubbles, and enable accommodative action in future crises. On the flip side, it would increase financing costs, potentially pressuring economic growth. Major central banks have made varying degrees of progress towards normalization, but where do we stand today? Can policymakers continue to reduce stimulus without significantly dampening demand for goods and services? In this article, we explore the unique circumstances and challenges faced by key developed market central banks today.

US Federal Reserve

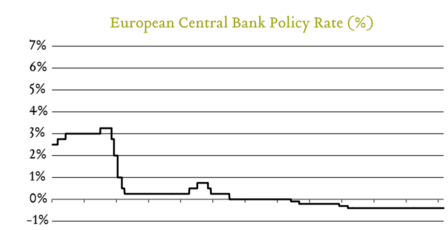


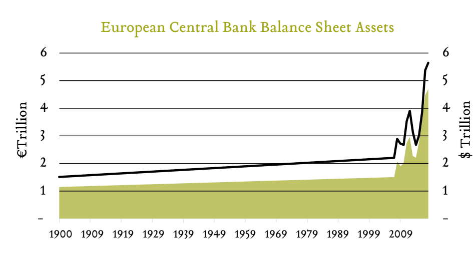


Recovery in the US outpaced other advanced economies and the Federal Reserve (Fed) has made more progress towards policy normalization. In response to the crisis, the Fed held interest rates at 0.25% for seven years and increased the size of its balance sheet from $870B to $4.5T (19.6% of GDP) over the same period. In 2015, the Fed began tightening with a single rate increase followed by another in 2016. The pace of increases accelerated (with economic growth) to three hikes in 2017 and four in 2018, bringing the target to 2.50%. As recently as December, the Fed was projecting two additional rate increases in 2019. The Fed also ceased new asset purchases in 2015 and began a balance sheet normalization program in late 2017.

At their March 2019 meeting, the Fed paused plans for additional tightening. Officials reduced projections from two rate increases in 2019 to zero, citing heightened growth concerns, and moved to slow balance sheet reductions starting in May, ending them altogether by September. This pivot demonstrates follow-through on the patient, data-dependent approach promised by officials amid decelerating economic growth and muted inflation. Time (and data) will determine the Fed's next move.

European Central Bank (ECB)

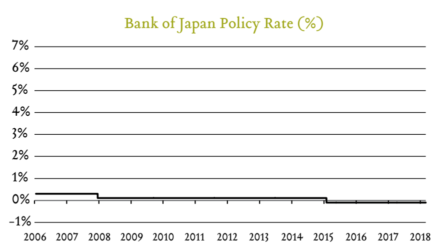


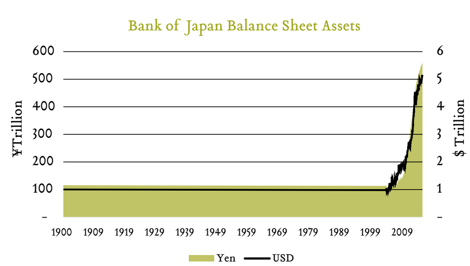


While slower to respond, the ECB took even more extreme measures to stimulate growth. European officials reduced short-term interest rates from 3.25% to 0.25% immediately following the crisis. 2011 brought a failed attempt at normalization and the sovereign debt crisis, after which rates were reduced to 0.00%, turning negative in 2014 and bottoming at -0.40% in 2016 where they remain today. The asset purchase program was also brought about in 2014, which expanded the balance sheet to €4.7T ($5.3T; 39.8% of GDP) through 2018, and introduced targeted longer-term financing operations (TLTROs) — essentially attractive loans provided to banks. Understandably, the ECB is eager to move towards normalization but has struggled to do so in light of economic and political risks.

Last year, the ECB seemed poised to begin policy normalization. Last June, officials announced intentions to cease balance sheet purchases by year end (which they did) and opened the door for a potential rate increase in 2019. More recently, the outlook and tone is decidedly different. In its March 2019 statement, the ECB announced additional stimulus in the form of a third round of TLTROs, and pushed rate-hiking plans out to at least 2020 amid weakening growth and heightened external risks. The ECB governs monetary policy for member countries with a range of economic drivers and vulnerabilities making it difficult to handicap for the most likely policy path from here.

Bank of Japan (BOJ)

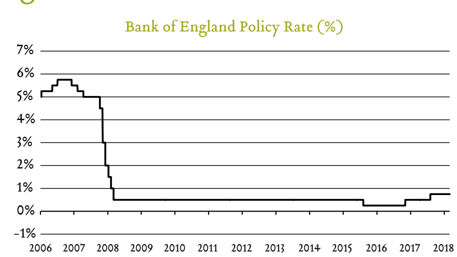


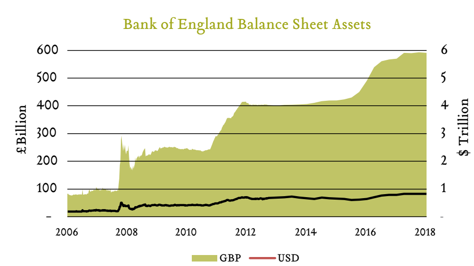


Country-specific economic challenges plagued Japan prior to the global financial crisis. Policy rates were already near zero entering 2008, leaving little opportunity for monetary easing through rate reductions. In the years that followed, the BOJ moved rates lower, and eventually negative at -0.10% where they stand today. In early 2013, the BOJ took the accommodative step of initiating an asset purchase program, growing the balance sheet to ¥550T ($4.9T; 100.6% of GDP) over the next five years. A portion of the balance sheet expansion relates to an innovative tactic known as yield curve control, initiated in 2016. In addition to managing short-term policy rates, the BOJ is buying longer-term government bonds to manage the 10-year yield to a target of 0.00%.

Today, the BOJ is in the unfortunate position of having pulled virtually every policy lever available, while still not getting the desired result of 2% inflation. The BOJ is both exceedingly far from normalized policy and likely far from initiating steps toward normalized policy. In a March statement, the BOJ maintained short-term and 10-year target rates as part of continued efforts to reach 2% inflation. Though given modest inflationary expectations, it may be years before the BOJ is able to raise interest rates or otherwise tighten policy as risks of dampening economic growth outweigh any concern for excessive inflation today.

Bank of England (BOE)





In response to the crisis, the BOE followed the Fed's lead by cutting interest rates to 0.50% and expanding the balance sheet with nearly £600B ($0.8T; 30.7% of GDP) in government bond purchases to stimulate the economy. In early 2016, the BOE seemed likely to once again follow suit by raising interest rates – a prospect that became increasingly uncertain after the UK voted to exit the European Union. Brexit uncertainty actually caused the BOE to cut rates to 0.25% in 2016, but an improving outlook justified increases in 2017 and 2018 to 0.75%.

Risks to growth are heightened in recent months, while

Brexit uncertainty remains as prevalent as ever. The possibility of a disorderly departure presents significant risk of business and trade disruption with far-reaching implications. It is unlikely the BOE will cut rates or take other steps toward policy normalization without clarity on Brexit.

Conclusion

Given the uneven nature of recovery, individual economies have managed varying levels of progress towards post-crisis policy normalization. Taken in aggregate, global monetary policy remains accommodative, though less accommodative than it once was. There seems to be a desire among central banks to continue normalizing, though their ability to do so is increasingly uncertain. In most cases projected "next steps" involve additional tightening, though timelines are extending amid heightened geopolitical risks and it seems increasingly likely the next wave of policy moves could favor accommodation.

If you would like to discuss these ideas and their impact on your portfolio further, please contact any member of our team. Thank you for the opportunity to serve on your behalf.

Sources:
Bloomberg
Council on Foreign Relations Global Monetary Policy Tracker: https://www.cfr.org
Yardeni Research: Global Economic Briefing: Central: Bank Balance Sheets
US Federal Reserve: https://www.federalreserve.gov
European Central Bank: https://www.ecb.europa.eu/
Bank of Japan: https://www.boj.or.jp/en/
Bank of England: https://www.bankofengland.co.uk/