The end of unconventional monetary policy

David Hale | David Hale Global Economics | 29 January 2014

KEY CONCLUSIONS

- Strong growth in the US and UK is setting the stage for unconventional monetary policies to be unwound as such policies are ramped up in Japan.
- The robustness of the US and UK economic data calls into question those banks' forward guidance policies.
- Whether people who have left the US labor force return as the economy recovers is the most important issue the Fed faces today.
- If the unemployment rate approaches 5.5% and wage growth accelerates, the Fed may contemplate a rate hike this December.
- Rising gilt yields demonstrate that the market does not believe that the Bank of England will stick to its forward guidance.
- The Bank of Japan could intensify its unconventional monetary policies if the looming VAT hike does more damage to the economy than expected.
- The market appears to believe Mr. Kuroda when he says that he will achieve his goals of eradicating deflation and reviving nominal GDP growth.
- Elections in developing economies that saw large sell-offs in their currencies last year will have a big impact on market sentiment about them.

1. THE GLOBAL FINANCIAL CRISIS LED TO UNCONVENTIONAL POLICIES

Central banks engaged in remarkably accommodative monetary policies during the five years after the 2008 global financial crisis. They held interest rates at record low levels. The Federal Reserve and Bank of England significantly expanded the size of their balance sheets through asset purchases. The European Central Bank loaned commercial banks over €1 trillion of liquidity in order to help resolve potential funding problems. The Bank of Japan (BOJ) embarked upon massive balance sheet program last April. It is likely to be far larger than the balance sheet expansion at the Federal Reserve and Bank of England.

2. THE END OF UNCONVENTIONAL POLICIES IS IN SIGHT IN THE US AND UK

Monetary policy at the Federal Reserve and the Bank of England is likely to move in a more restrictive direction during the year ahead. The Federal Reserve announced on December

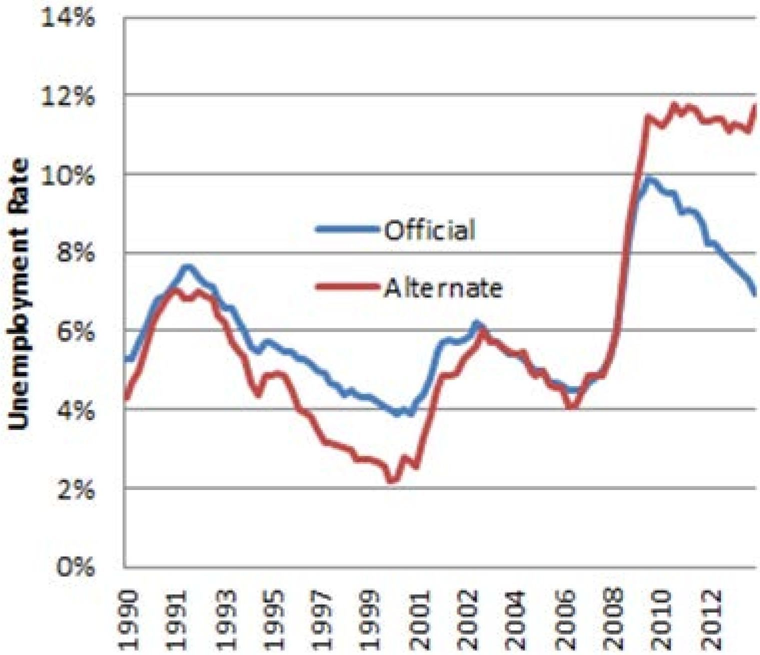
18th that it would start to curtail its asset purchases at the rate of $10 billion per month. Barring unexpected surprises, the Fed is likely to stop new asset purchases by the autumn of this year. The Bank of England stopped its asset purchase program in 2012, but the new governor, Mark Carney, began his term in July 2013 offering forward guidance that interest rates could remain unchanged until 2016. The surprising resilience of the UK economy will test that promise later this year.

3. LABOR FORCE PARTICIPATION RATE MOST IMPORTANT ISSUE FOR FED

The new Federal Reserve chair, Janet Yellen, has favored a highly accommodative monetary policy since 2008. In her speeches she expressed concern about the modest pace of the post-2009 economic recovery and low rate of inflation. She was especially distressed by the high rate of unemployment. The Wall Street Journal did a review of all speeches by Fed governors and district presidents since 2007 and found that Ms. Yellen had the best forecasting records. She probably does not expect to raise interest rates until late 2015 or 2016. The problem for Ms. Yellen is that the rate of unemployment is falling much more rapidly than most economists had thought possible. The total unemployment rate is 6.7%. The unemployment rate of those who are unemployed for less than six months has fallen to 4.2%, a level which many economists think is a potential harbinger of rising wages.

The falling unemployment rate has created problems for the Fed's attempt to use forward guidance. In October 2012 the Fed issued what came to be called a "pledge" to keep its core lending rate near zero through mid-2015. The market accepted this forecast and priced financial assets accordingly. At its next FOMC meeting, the Fed abandoned date-based forecasting and pledged instead to keep interest rates near zero until the unemployment rate fell to 6.5%. The Fed emphasized there was no conflict between its old and new targets because it did not expect unemployment to fall to 6.5% until mid-2015. The unemployment rate is now close to hitting this target fifteen months earlier than the Fed predicted.

Figure 1: Unemployment rate if pre-GFC labor force participation rate
1990 - 2013



Source: Bureau of Labor Statistics

The reason unemployment has fallen more quickly than expected is a sharp decline in the labor force participation rate. It has fallen from 66.0% in 2008 to under 63.0%. If it were still at 2007-08 levels, the unemployment rate would be closer to 11.5%, not rapidly approaching 6.5%. The Federal Reserve Bank of Philadelphia recently wrote a report about why the participation rate is declining. It found that 40% of the decline could be explained by an aging population with people dropping out in order to retire. The other two major factors were disability (22%) and people's lack of confidence in their ability to get a new job (22%). Many workers were able to obtain disability benefits when their unemployment benefits expired. Other workers made efforts to find new employment but were unsuccessful, so they also dropped out. The unemployment rate fell sharply in December because nearly 350,000 people left the labor force. As the economy has been creating nearly 200,000 jobs per month during the past year, it is surprising that people are still dropping out of the labor force. This process could accelerate during the next few months because the Congress has allowed a program which offers extended unemployment benefits to the long-term unemployed to expire. About 1.3 million workers lost these benefits during January and may soon drop out of the labor force. During 2014 as many as 4 million people could lose these benefits and also drop out of the labor force. If they do, the unemployment rate could fall to 6.0% by the second quarter and 5.5% by year end. The Fed has traditionally regarded an unemployment rate of 5.5% as de facto full employment.

Wage gains in the US have been remarkably subdued since 2008. They were only about 1.6% last year. There are signs, though, that the labor market is tightening and that wage growth could now accelerate. The Fed's latest Beige Book noted labor shortages for a variety of labor skills in several sectors of the economy.

If wage growth finally begins to accelerate, firms will have to raise productivity or attempt to pass cost increases on to consumers. The Fed will then have to confront the possibility of rising inflation for the first time in eight years.

Janet Yellen may respond to concern about the total unemployment rate by focusing on the number of long-term unemployed. In December there were 3.9 million people who were classified as long-term unemployed, or 2.5% of the labor force. This number is down from a peak of 4% four years ago, but it is still well above the average of the past four decades. The previous time the long-term unemployment rate reached 2.5% was following the 1981-82 recession, but it declined to near 1.0% by 1984. As the long-term unemployment rate may not drop to 1.0% until 2016, Ms. Yellen will want to move cautiously in tightening monetary policy.

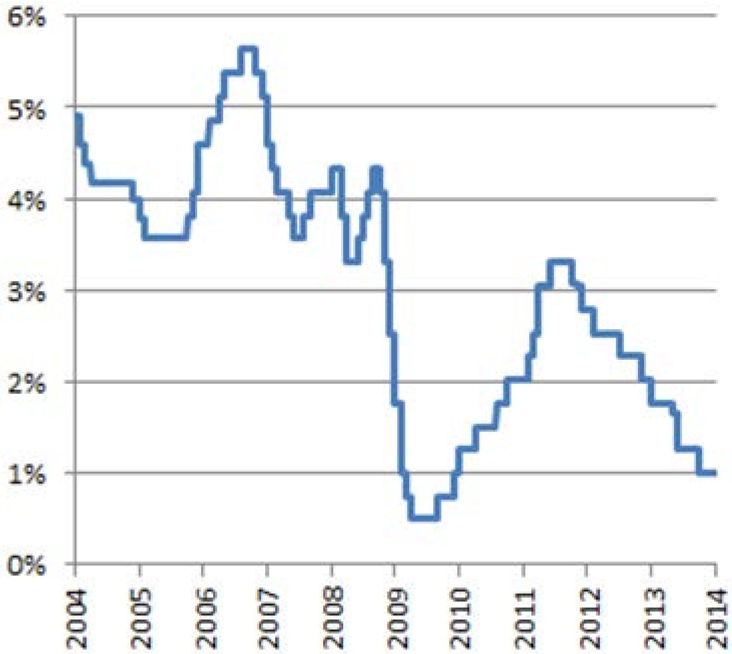
4. THE FED MAY TIGHTEN INTEREST RATES SOONER THAN EXPECTED

Most members of the FOMC expect to raise interest rates next year. The latest survey of its members show the median forecast is for the Fed funds rate to reach 0.75% by the end of 2015 and 1.75% by the end of 2016. In the long term, the members think the funds rate should rise to 4.0%. If unemployment drops to 5.5% during late 2014, it is possible to imagine scenarios in which the Fed speeds up the tightening process and reaches a 2.0% Fed funds rate in the first half of 2015.

Former Fed Chairman Ben Bernanke has stressed that the Fed will not automatically change policy when the unemployment rate drops to 6.5%. It will also have to examine why it is declining. Is the job market robust? Is the labor force shrinking? If the declining labor force is the major explanation, the Fed will take its time to make policy changes in the hopes that some discouraged workers will once again seek employment, but the fact that the unemployment rate is 5.5% and that the Beige Book is reporting labor shortages in several districts will prompt discussion about the need to raise interest rates more aggressively than FOMC members thought likely in December.

There have been four hawks on the FOMC during recent years who opposed Mr. Bernanke's policy of quantitative easing. They were the district presidents in Kansas City, Dallas, Philadelphia, and Richmond. They will also favor moving quickly to raise interest rates later this year. The new wildcard in the Fed outlook is Stanley Fischer, the new Fed vice chairman. He has had a distinguished career as an academic, deputy managing director of the IMF, and governor of the central bank of Israel. He has the potential to be as important in the policy deliberations as Janet Yellen. In recent speeches, he has endorsed quantitative easing as "dangerous" but "necessary" while condemning forward guidance. He does not believe central banks can forecast the economy looking out two years, so he thinks it ridiculous to offer long-term guidance on interest rates. He was also remarkably aggressive as central bank governor of Israel. He slashed interest rates dramatically during 2008. He was the first central banker to raise them during the second half of 2009 and kept increasing them through 2010-11 to 3.3%. He then slashed them to 1.0% following the 2012 global economic slowdown. He was also aggressive at using intervention to manage the exchange rate. As he does not waste time changing policy, the odds are quite high that he could respond to a low unemployment rate by favoring a quick move towards raising interest rates. Mr. Fischer is a very collegial person, so he will not challenge Ms. Yellen publicly, but in the privacy of FOMC meetings he could be an effective voice for a more hawkish policy. The big risk therefore in the US financial markets during the year ahead is that the Fed could raise interest rates faster than expected. As the bond market begins to recognize this danger, Treasury bond yields could rise to 3.5% during the next few months and reach 4.0% early next year.

Figure 2: Bank of Israel interest rate: 2004 - 2014



Sources: Bank of Israel

5. STRONG UK RECOVERY FORCING A RETHINK OF POLICY GUIDANCE

The big challenge for the Bank of England during the year ahead will be moving away from the forward guidance offered by Mark Carney last July. George Osborne recruited Mr. Carney to guarantee an accommodative monetary policy in order to lessen the risk that the UK might have a triple dip recession in its economy. Since Mr. Carney arrived there has been a major improvement in both the UK manufacturing and service sectors. There has also been a rebound in home sales and large gains in home prices. The British Chamber of Commerce survey of its members shows they are now the most optimistic they have been for several years. The UK economy could easily achieve a growth rate of 3.0% this year and possibly next year as well. Mr. Carney probably does not want to raise interest rates until after the next parliamentary election in May 2015, but gilt yields are likely to rise in the expectation that the economic data could force him to move sooner.

Mr. Carney's dilemma confirms Stanley Fischer's doubts about the value of forward guidance. As Mr. Carney was appointed in order to promote faster growth and there was no possibility of expanding asset purchases, he decided to offer forward guidance on interest rates. The economic data have now raised widespread doubts about this guidance. The Bank of England is now so concerned about the risk of a new property bubble that in November it terminated a special lending program designed to support the residential real estate market.

The Bank is also encouraging the chancellor to terminate a special home lending program introduced in his March budget. After the financial crisis, UK banks became far more restrictive on home lending than they had been in 2006 and 2007. They demanded 25% down payments compared to token numbers or nothing seven years ago. As many people could not satisfy these higher requirements, the chancellor offered to loan homebuyers 20% of their down payment if they could produce enough money for 5%. He was effectively creating a new subprime mortgage market financed by the Treasury. Such a special program is no longer necessary because banks are competing more aggressively to offer home loans while home prices are rising more rapidly.

As the UK economy performed very poorly during 2012 because of high levels of consumer debt and the impact of the European recession on exports, it is not surprising that Mr. Osborne broke custom by appointing a foreigner as Bank governor and that the new governor tried to promise an accommodative policy through forward guidance. However, the UK economic data has surprised every-one, so Mr. Carney will now have to contemplate policies he would not have imagined necessary when he took the job. He could be the first G-7 central banker to raise interest rates during the next twelve months.

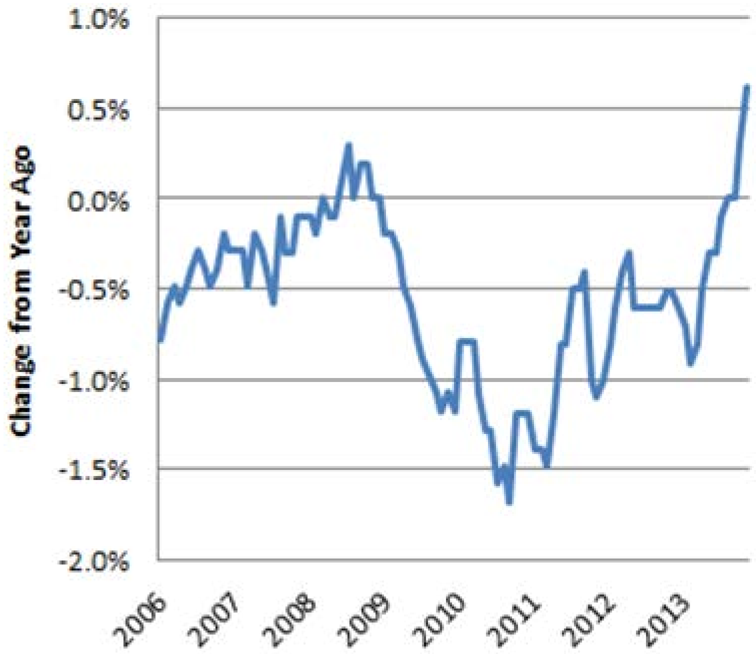
6. JAPAN'S UNCONVENTIONAL POLICIES WILL LIKELY BE RAMPED UP

The election of an LDP government in Japan during December 2012 has set the stage for a radical change in Japanese monetary policy. The LDP provided strong hints it would change policy during May 2012 when it blocked appointments to the BOJ monetary policy council of people it perceived to be unwilling to reverse Japan's long history of deflation. These people supported the policies of the then governor, Mr. Masaaki Shirakawa. As a result of the LDP opposition, Prime Minister Yoshihiko Noda named two economists who favored more reflationary policies. After Shinzo Abe took over as prime minister, he appointed Haruhiko Kuroda as the new BOJ governor. Mr. Kuroda had been the former vice minister of finance for international policy and president of the Asian Development Bank. In 2002 he wrote an article in the Financial Times criticizing the BOJ for not doing enough to reverse deflation. At Mr.

Kuroda's first policy meeting in April 2013 he announced the most radical monetary policy changes in Japan's modern history. He said that he would double the size of the monetary base during the next two years and increase it to about 55% of GDP. This would be a far more dramatic change than occurred in the US under Ben Bernanke or the UK under Mervyn King. The Fed's balance sheet is currently about 25% of GDP. It is also quite possible that Mr. Kuroda will go even further. The Japanese value-added tax will rise from 5% to 8% on April 1st, draining over ¥8 trillion from the household sector. Most Japanese economists expect real GDP to contract 4% to 5% during the second quarter. As such a severe downturn could jeopardize the recovery, the odds are high that Mr. Kuroda could increase asset purchases from ¥7.7 trillion of government debt per month to ¥10 trillion. In such a scenario, the BOJ monetary base could rise to 65-70% of GDP.

There are an increasingly large number of signs that Mr. Kuroda sees many parallels in his circumstances today with those that his predecessor Takahashi Korekiyo faced in the 1930s. After a long history in the Japanese government, Mr. Takahashi became finance minister in 1931. He immediately took Japan off the gold standard and devalued the yen by 40%. He then embarked upon a highly stimulative fiscal policy financed directly by bond sales to the BOJ, which he also controlled. These policies took Japan out of the Great Depression, but in 1935 Mr. Takahashi became concerned that government spending was excessive. He tried to cut back on military spending after three years of large gains and soldiers murdered him in February 1936. There had been many assassinations in Japan at that time, but his death confirmed the military was totally in control. Mr. Kuroda thinks that Mr. Takahashi is a potential role model because he is trying to reverse fifteen years of deflation and bring Japan back to a nominal GDP growth rate of about 3.0%. He may also be concerned that deflation has reduced his own salary to ¥24 million from the ¥39 million earned by BOJ governors during the 1990s.

Figure 3: Japanese core inflation growth rate: 2006 - 2013



Sources: Statistics Bureau (Japan)

The large rally in the Japanese equity market since October 2012 suggests that investors believe he has a reasonable chance of achieving his goal. Corporate profits are booming. The unemployment rate is very low. The Abe government is giving firms tax allowances if they raise wages by more than 2%. The yen is weak and could fall much further if US bond yields rise to 4%. All of these factors suggest that Japan should survive the VAT hike and that inflation could rise to at least 1.5% by 2015. If Mr. Kuroda's policy is successful, it will vindicate those economists who believe that central bank asset purchases can provide effective stimulus in a deflationary economy.

7. ELECTION OUTCOMES WILL IMPACT EMERGING MARKET CURRENCIES

The possibility of tighter monetary policy in the US will have global ripple effects. It could generate selling pressure on the exchange rates of developing countries with large current account deficits because of concerns that they will find it more difficult to import capital. In mid-2013 the mere discussion about the possibility of Fed tapering led to severe sell-offs in the currencies and equity markets of Turkey, India, Indonesia, Brazil, and South Africa. Some countries, such as Indonesia, Brazil, and India, have tightened monetary policy in order to support their exchange rates. As the coming uptick in US interest rates will be driven by an improvement in the US growth outlook, there could be an upturn in world trade which could help the developing countries to reduce their current account deficits. There have been many times in the past when the Federal Reserve tightened monetary policy without creating a crisis in the developing countries. The situation in 2013 was unusual because US policy had been highly accommodative for nearly five years and Mr. Bernanke's comments about tapering took the market by surprise. If developing countries offer a compelling story about their growth prospects, they will be able to generate capital inflows to finance external deficits. All five of the vulnerable countries will also have elections this year. The elections in India and Indonesia could have a major impact on confidence because existing governments have lost investor credibility. If India elects the BJP candidate, Narendra Modi, as prime minister, there could be a major rally in both the rupee and the equity market.

The prospect of the Fed tightening policy will give an upward bias to the dollar which will be welcomed by central banks in the dominions. Australia, Canada, and New Zealand would all like to devalue their currencies. Australia sees currency depreciation as a way to help the economy adjust to the unwinding of its recent mining boom. Canada is concerned about its underlying competitiveness because during the period 2000-2011 American unit labor costs fell 17% while Canadian unit labor costs rose 21%. Canadian non-resource exports have been weak. The Canadian government named Stephen Poloz, the former head of its export-import bank, as central bank governor last May in order to encourage a weaker currency. New Zealand's reserve bank believes its exchange rate is overvalued, but it is being supported by expectations that the bank will probably hike interest rates this year because of the economy's resilience. As New Zealand could be the first industrial country to raise interest rates since 2010, it would be very happy if American monetary policy could produce a rally in the US dollar.

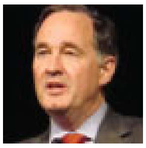
8. EQUITY MARKETS WILL BE DRIVEN BY EARNINGS GROWTH AND BUYBACKS

Equity markets have benefited from both earnings growth and rising price-earnings multiples since 2012. Investors regarded Fed policy as a justification for rising equity valuations. The Fed's shift to a less accommodative monetary policy and the possibility of rising interest rates will therefore pose a challenge for equity markets. The major factor driving equity prices will now have to be earnings growth, not multiple expansion. If the US economy continues to grow at a 3.0% annual rate through 2016, earnings gains could produce further modest appreciation of share prices.

The other factor which could influence US share prices is corporate share repurchases. In the four quarters through September 2013, American firms restrained investment spending and devoted around two-thirds of their free cash flow to share repurchases. The capital stock is now the oldest it has been since 1958 and productivity growth has been lackluster. If the US is to sustain a higher growth rate, firms will have to reduce share repurchases and increase capital spending. The equity market therefore faces a conundrum. If managements remain focused on share prices and restrain investment, the risk will increase of higher inflation and Federal Reserve tightening. The only way the American economy can sustain a growth rate much above 2.0% is through higher capital spending. Ironically, the only way the stock market can continue to rally is if managements focus less attention on their share prices, and turn their attention instead to long-term business development.

9. FINAL VERDICT ON UNCONVENTIONAL POLICIES REMAINS YEARS AWAY

There is a broad acceptance among economists that Ben Bernanke's monetary policy in 2008 helped to stave off the risk of another global depression. As an academic who had written extensively about the depression, he was the ideal candidate to run the central bank during the financial crisis. There was far more controversy about his decision to engage in quantitative easing during 2012 and 2013, but the policy did promote growth through low mortgage rates for homebuyers and rising asset prices. He also helped to offset fiscal drag equal to 4.5% of GDP after 2010. The ultimate legacy on quantitative easing policies will not be known until we see the results of Mr. Kuroda's monetary expansion in Japan. All we know for certain is that a unique era in monetary policy is coming to an end in the US and the UK because their economies appear to be achieving sustained growth momentum. The next chapter will be how Janet Yellen and Mark Carney navigate the transition to monetary tightening as central banks return to their traditional focus on inflation.



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