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Where is Monetary Policy going ?

I - The fundamentals are moving towards a "normalization" of US Monetary policy.

The US sets global Monetary conditions, with some time lags …

1. All lights are flashing :

- Employment is up : + 223.000 jobs creation in May,
- Unemployment is at its 18 years low at 3,8%,
- Inflation is hitting its target :

  2,8% for Global CPI on 12 months
  (2,2% for underlying inflation) while Fed rates (1,75% to 2%) are still negative in real terms (see **Graph 1**) ; inflationary expectations remain at 2,1%.
- Tensions are appearing on the labour market because of insufficient qualified workforce in many sectors, although, on a consolidated basis, global wage increases remain at a moderate level and at a lower one than anticipated. The output gap has closed (see **Graph 2**) ;
- Activity and growth are satisfactory (+ 0,5% increase in GDP in the 1st Quarter of 2018). GDP growth for 2018 is estimated at 2,7% ;
- The fiscal stimulus has increased corporate profits (+ 3,3% over a year) ; and is an additional factor of overheating ;
- Twin deficits are high (fiscal -5% of GDP, Current Account -3%) and persistent.

2. ***Therefore, Monetary Policy is, slowly, gradually tightened.***

- Interest rates (Fed Funds) have been on the rise over the last 2 years and, through 6 increases of 0,25% each, have now reached 2% (see **Graph 3**).

  Two more rises have been announced for 2018 ;

- We are seeing the timid beginning of a reduction of the Fed's balance sheet in terms of GDP (see **Graph 4**).

  The Fed's balance sheet has reached 4200 Billion $ following the QE policy.

It has announced in September 2017 a plan to reduce this stock : the refinancing amounts of maturities will be reduced monthly under evolving ceilings.

In a first phase, the reduction will be limited to 10 Billion $ a month, but the ceiling will be increased each quarter during a year in order to reach an amount of 50 Billion $ a month.

The total reduction could lead to a level of 2500 to 3000 Billion $ outstanding amounts in 2020.

3. ***Some margins are, thus, re-created for the moment when a recession appears.***

The normal unfolding of the cycle (US growth has been positive over the last 8 years - see **Graph 5** - in contrast with Europe that only got out of negative years of growth in 2014) calls for normalization.

So it is prudent, given the high degree of capacity utilization in the US and the achievement of full employment, to create sufficient margins in order to be able to reduce rates or, if needed, to buy assets when the next recession occurs.

And, if anything, the recent fiscal stimulus adds more urgency to this rather gradualist process.

4. ***However, financial conditions remain very loose.***

But although the Fed is gradually normalizing since the end of 2015, financial conditions are still very loose.

Graph 6 shows that, in spite of the rises in Fed rates, the "financial conditions index"[1] reflects, in fact, a loosening of financial conditions since mid 2016. This index is actually lower (more loose), as shown on the graph, than it was in 2013-2014 (although it has, recently, increased somewhat).

This plenomenon is an anomaly. During the previous tightening episodes, the financial conditions index used to move in tune with the higher interest rates.

So this time, things look different.

How can we explain the fact that other indicators of monetary normalization (other than interest rate hikes) do not react as in the past ?

The explanation seems to be on the following lines :

- QE has created a low interest rate environment of huge magnitude and over a long period ;
- QE - although officially over - is still playing a significant easing influence (because the reduction in the Fed's balance sheet is so gradual).

But when the market increases its interest rate expectations and that the fed's balance sheet reduction starts to bite, we will probably see, later on, a return to past behavior : financial conditions will then react in harmony with monetary tightening.

However one has to be cautious on the interpretation of these indexes.

They give a view of the stock of "excess liquidity" and market exuberance, but the flows - which are reducing - count perhaps more in market expectations.

Be it as it may, market sentiment is getting aware :

- Of the gradually tightening monetary stance of the Fed,
- and of the higher degree of pressure on resources.

But it seems too early to forecast a recession : the recent fiscal impulse may have prolonged the upper part of the cycle.

[1] *It is a composite Index that summarizes a range of asset prices. It is calculated by the Federal Reserve Bank of Chicago.*

II - The monetary policy stance is still very loose in Japan and in the Eurozone, reflecting differences in the state of the cycle.

1. *In Japan, the authorities are showing no sign of normalization in terms of monetary policy :*

As long as inflation has not durably reached its target of 2%, monetary policy will maintain its very accommodating stance (see **Graphs 7 and 8**) ;

Japanese growth rate - strongly above trend, at 1.7% in 2017 - is projected to moderate somewhat to 1.2% in 2017.

2. *In the Euro area, things are more complex for the following reasons :*

A) The conundrum of inflation.

We have to pay attention to the close relationship between inflation rates and the evolution of the price of oil.

Core inflation (i.e. consumer price index excluding food and energy) has been rather stable over the period 2005-2018 (see **Graph 9)** :

- In the US the core index has kept its level of around 2% (except for the dip in 2010-2011),
- and in the Eurozone the core index has been somewhat weaker but has only oscillated from 1,5% to 1% over the 13 years period.

The influence of the price of oil (see **Graph 10)** has been determinant in the evolution of headline inflation which is - in my view arguably - the ECB target.

The fall in the price of oil from :
120 $ the barrel in 2010
to 60 $ the barrel in 2015
has dragged down headline Euro inflation from :
3% in 2012
to – 0,5% o, 2015

This drop cannot be associated to a demand driven deflationary trend : it was essentially engineered by the price of oil.

Given that core inflation was stable in the Eurozone, I fail to understand the rationale behind the magnitude of QE in the Euro area.

And more recently, oil has been pushing up headline inflation as we see on **Graph 10**.

*B) Growth in the Euro area has been picking up (*see on **Graph 10B**), *albeit lately, since 2014, and is still fragile and heterogeneous between countries.*

- Unemployment, while reducing, remains high in the periphery of Europe (see **Graph 15**).

C) Financial conditions have been significantly loosened with QE.

- The ECB balance sheet has grown drastically (see **Graph 11**) :

    - 2014 20% of GDP
    - 2018 40% of GDP (doubling in real terms),

- Bank lending rates have converged downward (see **Graph 12**) :

    from 6% (Italy / Spain) in 2013
    to 2%

- Real rates (official) have been kept negative : a significant part of the Euro sovereign yields is in negative terrain (see **Graph 12B**) ;

- Since 2011, if deflated for core inflation, ECB rates have been constantly negative ;

- The output gap has been dramatically reduced since 2014 and is now on the way to be closed (see **Graph 13)** ;

- Contrary to the US, Labour participation rate has been increasing in the Eurozone (see **Graph 14)** while unemployment - albeit high - has also receded (see **Graph 15**) ;

- Wages have been increasing since 2013 (see **Graph 16**) ; the pace is significantly higher than in the US and Japan.

- *D) But there is a strong heterogeneity in the external current account balance of the Monetary Union* (see **Graph 17**).

  - With Germany and the Netherland running current account surpluses of 8,5% and 10% of GDP respectively,
  - and with the peripheral countries having now achieved external surplus,
  - while France remains the only country of the Eurozone to keep a -2% GDP deficit of its current account.

- *E) The link between sovereign risks and the banks is still present, notably in countries like Italy. But fiscal positions are improving in peripheral countries* (see **Graph 18**).

  This, given the sensitivity of public debt instruments in the South to any sign of monetary tightening, makes it more difficult to change monetary policy. Any hike in interest rates or move to reduce the ECB's balance sheet, could trigger a widening of spreads between Euro area countries and would, thus, compound fiscal issues.

F) The return to a more "normal" inflationary situation is probable, but its timing is uncertain.

Higher prices of oil are a cause of inflation, but not a monetary indicator.

The market is not yet convinced that core inflation is coming back.

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Eventually, on June 14, 2018, the ECB has announced that it would terminate its QE program (2,4 trillion Euros) by the end of the year. Until then, securities purchases by the ECB will be gradually reduced.

Monthly acquisitions will be halved by end September (from 30 to 15 Billion €) and then phased out by end December 2018.

However, official interest rates will be maintained at their 0 level until September 2019.

Nothing has been announced on a possible reduction of the ECB balance sheet.

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After this "middle path" decision by the ECB, challenges remain high because of mounting risks :

- The political situation in Italy that could affect the Euro ;
- and the threat of a global trade war triggered by the American Administration that could lead to higher prices in the US, to a recessionary impact in exporting zones as well as to a fall in investor confidence.

In spite of the announced exit out of QE, monetary conditions in the Euro area will remain loose as long as the ECB keeps interest rates low and continues to reinvest the proceeds of maturing debt acquired under the QE program.

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With hindsight, it seems fair to say that monetary policy in the Euro area has been facing daunting challenges :

- The difficulty of setting a single monetary policy in the face of very heterogeneous situations (growth and inflation wise) in the Union,
- The political inclination to use ("over-use") monetary policy in order to offset the insufficient or lagging structural reforms ,
- The overestimation (in my view) of the deflationary danger when QE was decided (because of the impact of declining oil prices on headline inflation) ;
- In an environment of high public debt, the temptation to use low interest rates to substitute - or mitigate - stricter fiscal policies.

It is however conforting to observe over the last couple of years a gradual, but significant, degree of a fiscal and structural adjustment in the periphery of the Euroarea. That should facilitate the expected exit from extreme monetary ease and restore a more acceptable policy mix.

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In concluding, let us hope that, in the future, after normalization, Central Banks will be less the "only game in town" to foster growth and will be able to focus more on protecting financial stability at large.

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