Central banks open a new chapter

News from the financial markets

The global economy is no longer in the best of shape. But the fact that the major central banks are changing course so hard is still surprising. Apparently, interest rate cuts lie on the horizon for the second half of the year. This is an extraordinary change of course, in as much as the global economic winds are blowing at the pace of their long-term average. We are seeking explanations for this overly cautious route.

The Australian central bank has already put its money where its mouth is by announcing in early June a 25 basis point cut to the official overnight lending rate, which now stands at 1.25%. However, this easing move was unnecessary. For this year, Australia will likely report GDP growth of 2%. At the same time, inflation is well under control. This interest rate manoeuvre is indeed a novelty in economic history and a blueprint for what is to come. It appears that central banks are acting without any sign of acute danger on the horizon. In fact, both the European Central Bank (ECB) and the US Federal Reserve are also preparing to cut interest rates, despite the fact that there is no indication of the kind of economic excesses that would normally cause them to take corrective steps.

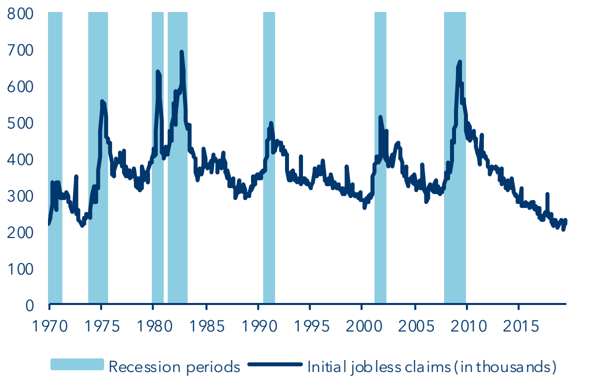
ECB will act

Frankly, the eurozone economy is not luxuriating on a bed of roses at present. The international trade disputes are weighing heavily on the export-dependent German economy, and this in turn is having a negative impact on the common currency area. The Italian economy is a "sick man", and therefore once again slowing the growth momentum in the EU. However, the recession risk has remained manageable until now. The probability of an economic contraction as calculated by VP Bank research currently stands at a mere 23%. So any necessity for monetary easing cannot be inferred from this. Nonetheless, the core inflation rate (i.e. excluding volatile food and energy prices) of 1% is still far away from the ECB's target rate of 2%. At the same time, inflation expectations have fallen recently and currently also stand at around 1%, entirely too low if you ask ECB monetary policy setters. It follows that an interest rate cut can be rationalised – albeit only with reservations, given the low recession risks. At –0.4%, the overnight deposit rate for commercial banks with the ECB is already in the ultra-expansive range.

Fed: a rate cut – but why?

Even more astonishing is the tack the US Federal Reserve is taking. The US economy still has a good chance of growing at a 2.5% this year. Moreover, the consumer price index core inflation rate is at a relatively high 2%. Only the personal consumption expenditure (PCE) price deflator ex food and energy is still below the Fed's target of 2% at 1.5%. So far, there is still no sign that the labour market will face a more pronounced slump: initial applications for unemployment benefits are close to all-time lows (see chart).

USA: no signs of a weakening labour market



Source: VP Bank, Thomson Reuters Datastream

So by just reading the current economic data, there is no immediate need for an interest rate cut. Be that as it may, the decision makers at the Fed have verbally rolled out the red carpet for even easier money in the coming months.

Stunning about-face

This rapid and clear move away from the normalisation of central bank policy is indeed a novelty. In the past, it was not rare that central bankers risked even a "hard landing", i.e. a recession, in order to prevent the economy from overheating. Now it would appear that they are already starting to backpedal at the mere hint of an economic downturn. The ECB stopped buying securities just six months ago, and the Fed raised the target rate last December. One can only guess about the possible reasons for the very abrupt shift into reverse gear.

The following arguments appear plausible:

- **Sluggish inflation trends:** Regardless of the relative strength of the upswings seen in various countries over the past few years, inflation rates have remained either too low versus the central banks' targets or only just nudged the desired 2% mark. Many consumer goods and services have become ever cheaper over the last few years– online shops and new electronic services are battling to offer their goods and services at continuously lower prices. But new hiring conditions are also keeping a damper on wage growth and hence inflationary pressure. Despite "full employment", reflected in the US jobless rate of 3.6%, wages have increased at a relatively lethargic pace of just over 3%. It follows that, with inflation remaining stubbornly below their 2% target rate, central banks have a greater degree of leeway in making monetary policy decisions than in previous episodes.

- **Economic developments:** The global manufacturing industry is suffering from today's trade disputes: the higher customs duties on goods exchanged between the USA and China are putting the brakes on world trade. In late 2018 and early this year, global export volumes have recorded annualised declines, and export-dependent economies like the eurozone are suffering as a result. The Old Continent's manufacturing sector is already in the middle of a recession in terms of output, and the manufacturing industry on the other side of the Atlantic does not go unscathed. However, the domestically oriented part of the economies worldwide are holding up reasonably well: private consumption and the construction sector remain the pillars of growth in many places, which is why the risks for the global economy as a whole remain within bounds. However, sluggishness in the manufacturing sector can certainly be used as a reason for loosening the monetary reins.
- **Fear of a severe economic downturn:** The 2008 financial market crisis and subsequent eurozone debt crisis led to an unprecedentedly expansive monetary policy. The ECB and Swiss National Bank (SNB) have not managed to raise their key interest rates despite the ensuing prolonged upswing. Making matters worse, their balance sheets are still bloated due to emergency purchases of securities and interventions in the currency markets. Only the Fed has been able to make any headway in walking back its expansive monetary policy. However, the Federal Reserve's own balance sheet total also remains far above the pre-crisis level. Here, too, the otherwise customary interest rate mechanisms have been undermined by the huge surplus liquidity in the US banking system. In short: even the Fed is still a long way from a normal situation. So if a serious recession were to occur, monetary policymakers would essentially have their hands tied. This is precisely why they are likely concerned about inadvertently letting the current cooling of the global economy turn into an economic contraction. Any false step and the limited room for manoeuvre comes to light. Thus the central banks' aim right now is probably to pull off a soft landing of the economy.
- **Political influence on the Fed:** Donald Trump makes no secret of what he thinks about the country's keepers of the currency: "They have no idea," as he let the world know via Twitter recently. With that, the US president is attacking the Federal Reserve's interest rate policy with unprecedented directness and acidity. In response, Fed Chairman Jerome Powell, himself a Trump appointee, has stoically pointed out the institution's independence. Nonetheless, the fear of committing a monetary policy error will loom large in Washington's environment of political hostility. Alternatively, the man in the Oval Office could attempt to install central bankers who are more "kindly disposed" to his way of thinking; after all, two seats on the Board of Governors are currently vacant. If Trump succeeds in getting re-elected in 2020, a prolongation of Powell's mandate would be uncertain. In any case, the political influence here is greater than ever.

Summary

Interest rate cuts are likely to be on the agenda at both the ECB and the Fed. Presumably, the ECB will announce an easing move as early as July, with concrete measures following in September. A further reduction of the deposit rate is conceivable. The Fed could also announce a rate cut in September. The SNB needs to take a watch-and-wait stance in this environment. The rate-setters are paying particular attention to the development of the Swiss franc: if it appreciates, interventions are almost sure to follow. We cannot rule out the possibility of an SNB deposit rate cut, but that is unlikely to be the central bank's first choice.

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