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Are central banks ready to fight another recession?

Virginie Maisonneuve Chief Investment Officer, Eastspring Investments

When it comes to combating economic downturns, central banks have historically come to the fore. Despite the temporary trade truce between the US and China, with global growth slowing, do central banks still have the tools to counter a sharp slowdown if it happens?

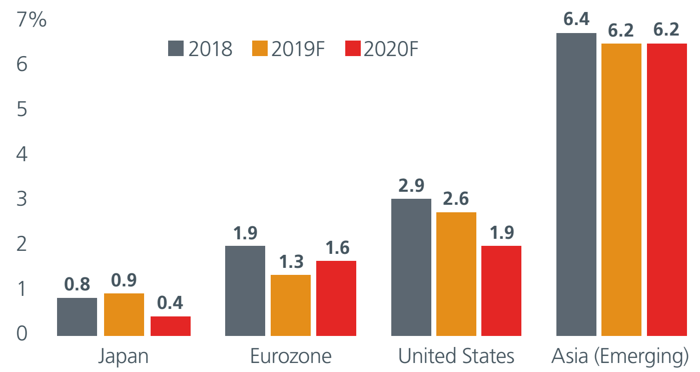
Following the 3.6% global economic expansion in 2018, the International Monetary Fund (IMF) expects growth to slow to 3.2% in 2019[1] as ebbing US fiscal stimulus and US import tariffs on China take a toll. Meanwhile, the still-uncertain outcome of Brexit potentially clouds the Eurozone's growth, although the impact of temporary factors (the dip in German car registrations and French street protests) is expected to fade and result in some recovery in 2020 (see Fig. 1).

Since the 2007/08 global financial crisis, central banks in the US, Europe, Japan and elsewhere, have introduced a mixture of interest rate cuts and quantitative easing (QE) – essentially large-scale asset purchases with newly created money – in a bid to spur economic output. Will they be able to do the same should growth turn down sharply?

RATE CUTS TO THE RESCUE

The impact of rate cuts, whether explicit, or implicit through its messaging, is evident in the US economy. Together with fiscal stimulus, the more dovish stance of the Federal Reserve (Fed) prior to its short-lived tightening from December 2015 to 2018 has led the US economy to experience 121 months of growth – its longest expansion on record. A reversal of its tightening stance in January also fuelled a strong rally in global equities in the first four months of this year.

Fig. 1: Slower growth in the global economy; are we headed into a recession?[2]



With the Fed funds rate at 2.38% in June[3], the Fed is one of the few developed market central banks with room to cut. Considering the benign inflation rate of 1.6% in June[4] – running below its 2% target – further rate cuts are less likely to result in inflation overshoots, thereby fortifying the case for rate-cuts. Majority of the Federal Open Market Committee (FOMC) members have forecast two interest rate cuts in 2019 (see Fig. 2).

WHAT ABOUT 'INSURANCE' CUTS?

That said, the still-robust economic data in the US begs the question as to whether the US economy needs pre-emptive 'insurance' rate cuts; or whether the Fed should cut rates only when there is evidence of significant deterioration in business and consumer activities. The already low rates suggest that as the Fed cannot afford to be drawn into a long cycle of rate cuts, it should make each cut count.

With a base-rate of 0.75%, the Bank of England (BoE) is another developed market central bank that has room to cut interest rates. This is especially so in the case of a 'no-deal' Brexit outcome, where growth could potentially contract by 0.3% in 2019 (see Fig. 3) - which will be the UK's slowest growth rate since the 2007/08 global financial crisis.

Asian central banks, with their still positive policy rates and low inflation rates, also have room to reduce rates further in the event of a sharper slowdown.

On the other hand, with the Bank of Japan's (BoJ) policy rate and the European Central Bank's deposit rate already at negative levels (see Fig. 4), these two central banks have less room for further rate cuts.

BUT THEY ARE NO PANACEA

Despite rounds of rate cuts to sub-zero levels, overall business activity in the Eurozone remains lacklustre, as seen by Germany's sluggish industry activity[8]. One reason for this is that many European banks have been unwilling to extend loans or mortgages at negative interest rates.

Fig. 2: Implied Fed Fund Target rate projections[5]

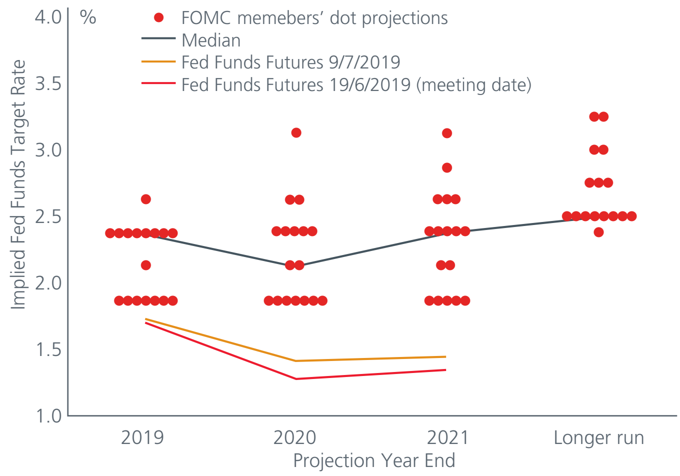


Fig. 3: UK GDP growth forecast for 2020 in three scenarios[6]

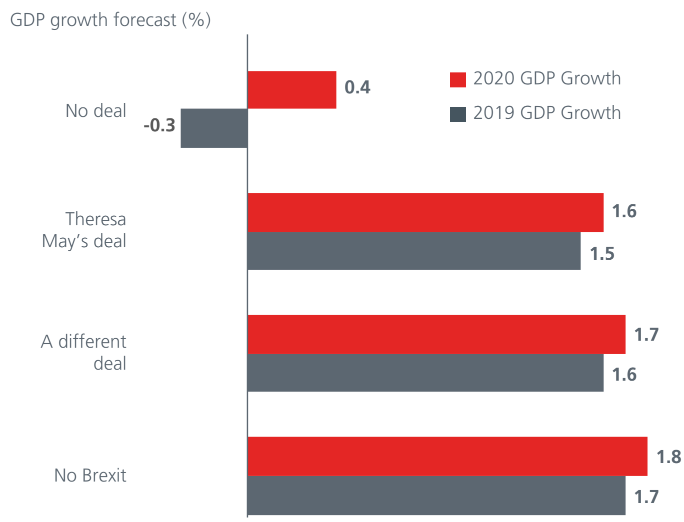
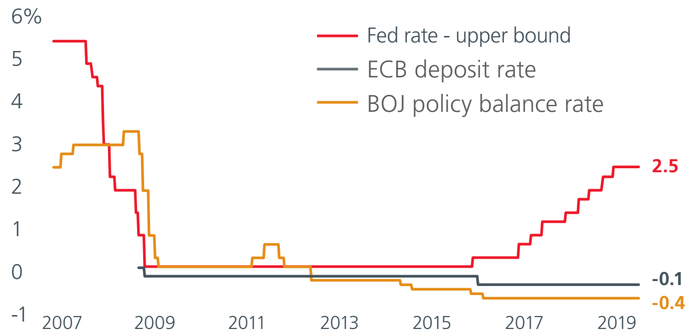


Fig. 4: Sub-zero interest rates in the Eurozone and Japan[7]



Negative interest rates also come with a cost. Over in Japan for example, bank profitability has suffered on the back of the BoJ's negative interest rate policy. Interest rate policy is not the only monetary tool, fortunately.

A FRESH ROUND OF QUANTITATIVE EASING?

The Fed engaged in large-scale asset purchases from 2009 to 2014, with research suggesting that the cumulative effect helped to reduce the US unemployment rate by as much as 1 percentage point[9].

Although the Fed has started shrinking its USD4.6 trillion balance sheet since October 2017[10], it cannot be ruled out that it would not embark on a fresh round of QE, if required. Besides government bonds, the Fed can potentially extend its purchases to riskier assets, such as BBB-grade bonds and real estate investment trusts (REITs).

In the Eurozone, ECB president Mario Draghi has signalled the central bank's willingness to resume rate cuts and asset purchases before he departs in October. However, it may first need to circumvent the self-imposed issuer limits which prevents it from owning more than a third of each country's debt. This limit has already been reached in countries such as Finland, the Netherlands and Portugal, according to Reuters[11], thereby restraining the ECB's firepower if it were to launch a new asset-buying programme.

This constraint may be avoided by stripping central banks of their voting rights, through a clause known as 'disenfranchisement'.

Ongoing asset-purchases, however, have their drawbacks.

QE, for example, has been criticised for lifting asset prices, rather than the real economy, and for subsequently hurting the income of savers as yields fall. In the case of Japan, QE has failed to revive the ailing economy, let alone achieve the BoJ's ambitious 2% inflation target.

In the Eurozone, while the asset-price boom led to gains for equities, the resulting decline in long-term bond yields triggered widespread protests by savers, especially those in Germany, who hold more of their wealth in life-insurance products.

Additionally, even for the boost to asset prices, the effectiveness of each round of QE appears to be waning as market participants have been quick to price in the generic lift in asset prices, based on their experience in the earlier rounds.

BEGGAR NOT THY NEIGHBOUR

Currency devaluation is another powerful monetary tool that can be used to spur economic growth. This is particularly true for countries that have significant international trade, where a weaker currency can help increase demand for its exports.

That said, fewer countries are likely to use foreign exchange overtly as a monetary tool these days given the threat of being labelled a currency manipulator. There are also dangers in devaluating currencies as this may lead to capital outflows and loss of confidence in the economy, which may be difficult to stem. If currency devaluation leads to competitive devaluations, this can also have adverse implications for economic and financial stability of the global financial system.

TIME FOR A NEW TOOL?

All in all, it seems that most central banks still have their toolkit handy although different tools are available to different banks.

The US appears best placed with the ability to cut rates and purchase assets. The UK and most Asia ex-Japan central banks can still cut rates while the ECB can launch a new asset buying programme but the constraint around issuer limits may limit the size.

The BoJ, on the other hand, seems to have its hands tied. Despite negative policy rates and expanding its balance sheet significantly more than any of the other developed market central banks since the early 2000s, the Japanese economy is still lacklustre, and inflation is still weak.

Going forward, however, given the low levels of interest rates and waning effectiveness of QE, central banks are unlikely to be able to counter a serious downturn by themselves. Having gone through an era of unconventional monetary policy, it will probably be fiscal's turn to play a bigger role.

Sources: [1]International Monetary Fund (IMF): World Economic Outlook Update, page 1, July 2019. [2]International Monetary Fund (IMF): World Economic Outlook Update, page 8, July 2019. [3]The Federal Reserve Bank of St. Louis' economic data, Effective Federal Funds Rate June 2019, updated 1 July 2019. https://fred.stlouisfed.org/series/FEDFUNDS. [4]US Inflation Calculator, annual inflation for the US for 12 months ended June 2019. https://www.usinflationcalculator.com/inflation/current-inflation-rates/ [5]Bloomberg, Thomson Reuters Datastream, as at 9 July 2019. FOMC meeting date: 19 June 2019. [6]FocusEconomics, December 2018. Consensus of 14 economic analysts. https://www.focus-economics.com/blog/brexit-scenarios-consensus-14-economic-analysts. [7]Tradingeconomics.com, citing European Central Bank, July 2019. [8]Reuters: Germany to face weak economic trend in second quarter – Economy Ministry, 9 April 2019: https://uk.reuters.com/article/uk-germany-economy/germany-to-face-weak-economic-trend-in-second-quarter-economy-ministry-idUKKCN1UA0PI. [9]The United States Studies Centre, The University of Sydney: https://www.ussc.edu.au/analysis/lessons-from-quantitative-easing-in-the-united-states-a-guide-for-australian-policymakers. [10]https://edition.cnn.com/2019/01/10/investing/fed-markets-balance-sheet/index.html. [11]https://uk.reuters.com/article/uk-ecb-policy-bonds/loophole-may-clear-ecbs-way-to-buying-more-state-debt-sources-idUKKCN1TR1LW

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