Economist Insights

International Monetary Fears

The IMF's attitude towards monetary policy has undergone a significant shift of late. No longer are they berating policy makers for maintaining a lax monetary policy too far into the cycle. But are their worries misplaced? The IMF are fearful of the outlook for Emerging Markets, yet they see the solution lying with the central banks of the world's developed markets. The logic of their argument is questionable.

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What a difference a decade makes. At least, if that decade has a global financial crisis in it, it does. Ten years ago the IMF was always the institution insisting that policy makers were leaving everything too late. Lax monetary policy and fiscal profligacy, they would insist, would simply build up bubbles and create problems later in the cycle. Arguably, the IMF was often proved right. But now the IMF has changed its tune and is asking central banks not to raise interest rates.

The IMF cites a number of reasons behind their call for caution. It worries that the outlook for emerging markets (EM) and financial conditions have tightened, and the knock-on effects from a slowing China are worse than feared. It notes that the drop in global trade is slowing growth globally. The IMF also points out that productivity growth has fallen remarkably.

This may sound bad enough, but what really gets the IMF worried is that there could be a realisation of a number of converging risks that would make things much worse. China could suffer a hard landing. Commodity prices could fall further, and could bring more problems for some EM than benefits it could bring for developed markets (DM). The USD could strengthen further, creating external funding strains for some EM that offset the trade benefits of their exports to the US becoming cheaper. In many EM corporate leverage is high and bank credit has been rising quickly, creating risks of financial turmoil.

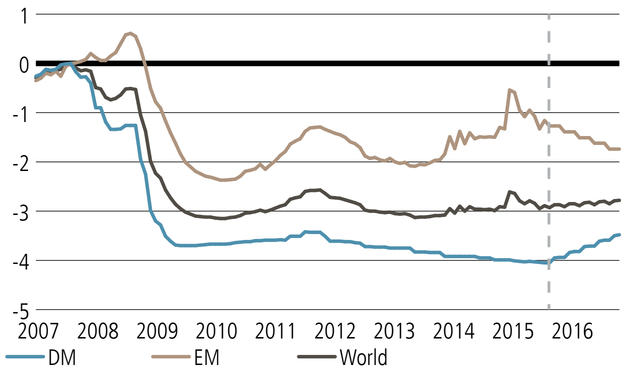
There is something very striking about these risks: they are all in EM. Yet the IMF is asking central banks in DM not to raise rates. In short, the IMF is asking the Federal Reserve, supported by the Bank of England (BOE), to act as central bankers for the world.

The Fed and the BOE are likely to give little heed to this warning. Their political masters want them to focus on their domestic economies. However, if the IMF's fears are realised, there could indeed be spillovers to the domestic economies of the US and the UK. But the Fed and BOE will be focused mostly on the domestic economy, which is more predictable, not trying to engage in unpredictable risk mitigation on behalf of other economies.

In any case, even if the Fed and the Bank of England were both very hawkish and hiked rates every quarter, in global terms this would still leave monetary policy very loose. And much of this tightness could be offset if the People's Bank of China, the Reserve Bank of India and the Central Bank of Russia all continue to cut rates, say at least once a quarter. Global rates would edge up, but by very little compared to recent years (see chart).

Chart: Cold rate war

World average policy rate by region, change since end 2007 in percentage points, and impact implied by Federal Reserve and Bank of England tightening 25bp each quarter, while People's Bank of China, Reserve Bank of India and Central Bank of Russia cut by 25bp each quarter



Source: MSCI, CPB, UBS Global Asset Management

In any case there are some points raised by the IMF that do not sit too well together. These points definitely would not sit well with their counterparts over at the Bank for International Settlements (BIS), which is now pretty much the lone institutional voice calling for tighter monetary policy. For the BIS the macroprudential risks, the risks of creating bubbles, must be better incorporated into monetary policy. Many of the contradictions in the IMF argument feed right into the concerns of the BIS.

If corporate leverage in EM is too high and bank credit growth too rapid, is this not the result of monetary policy being too loose? If monetary policy remains too loose, that leverage will continue to rise and bank credit growth will continue apace, just creating more problems later. A more macroprudential approach would be to tighten monetary policy as soon as possible, before worse problems are built up.

Perhaps the oddest complaint from the IMF is that risk and term premia are still too low, and that this makes markets vulnerable if rates rise. But ask almost anyone in the market why the market is pricing in such low premia and they will answer that it is a combination of quantitative easing and permanently low monetary policy. If central banks look afraid of ever hiking rates, the market will continue pricing low premia for shocks or future rate rises.

The IMF points out, rightly, that financial conditions have tightened in EM. But markets are forward-looking, so that tightening is in anticipation of rate rises. So when rates do rise, the marginal tightening of financial conditions could easily be less than the IMF is worried about. Not to mention that with the rise in the USD, the consequent relative fall in EM currencies constitutes a loosening of financial conditions (albeit not for those countries that made the mistake of borrowing in USD). But even more fundamentally, tighter financial conditions are part of what would bring corporate leverage and bank credit growth under control, and would also be reflected in more sensible risk and term premia. This is not an easy task as the amount of leverage accumulated in the system could cause a more widespread crisis. But trying to resolve the problem with the same tool that has caused the problem in the first place makes little sense.

If productivity growth is weaker than expected, then trend growth must by definition be weaker as well. So trend, or potential, output must have moved down, bringing it closer to the actual level of output. In short, the output gap must be smaller and hence there is less spare capacity in the economy. That means a lower level of growth is more likely to generate inflation. The logical consequence is that interest rates need to rise sooner, although they would not need to rise as far as in the past.

One way the IMF hasn't changed is that it is still advocating structural reforms. No surprise there if they are (rightly) worried about low productivity growth. But this is all easy to say: structural reforms are an easy win for international institutions. The main problems are for the politicians who have to implement them and upset a lot of vested interests, something they are reluctant to do even when they know they should. In any case, structural reforms would bring little benefit to the current conjuncture or make any difference to the Fed's decision. Historically, reforms have usually brought little benefit in the short run, but only over the following decades.

So, the IMF is still advocating hard long-term decisions, it's just avoiding any hard short-term ones. But it feels a bit like the IMF has been spooked by the market turmoil, and is deciding that this justifies rate hike delays. But this could be a case of the tail wagging the dog; a lot of the market turmoil could relate to the expected tightening of US interest rates. China may be a new factor, but unless there is a massive depreciation in the CNY the effects on the US and UK may be fairly limited (see *Economist Insights*, 24 August 2015).

There may well be good reasons to decide to delay hikes. For example, if wage growth does not materialise in the US despite labour market strength. Or if the UK's current account deficit becomes even more massive. Or if you are a believer in a structural stagnation. But if those risks do not materialise, avoiding rate hikes in some economies simply because of risks in others appears a touch too fearful and fanciful.