Economist Insights

Easing off

While the markets may have been preoccupied with the prospect of a Fed rate rise in September, last week's decision by the People's Bank of China (PBOC) to cut interest rates and reserve requirements served to reinforce the divergence that exists amongst the Central Banks. How will that leave the net position for global monetary policy, tighter, easier, or simply no change?

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September was all about monetary policy tightening: would the Federal Reserve hike rates? October was all about monetary policy loosening: would the European Central Bank (ECB), Bank of Japan (BOJ) or People's Bank of China (PBOC) ease policy further? In the end, it was only the PBOC that delivered, but the ECB in particular sounded far more dovish than expected.

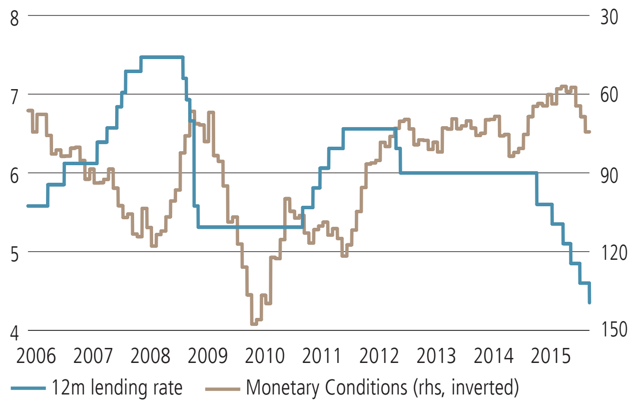
On the face of it, it looked a bit odd that the PBOC decided to cut rates and reserve requirements in the same week that GDP growth came in stronger than the market expected. Some might interpret this as the PBOC being as doubtful about Chinese growth data as the market. On the other hand, it could reflect pessimism about future growth, or more simply just that inflation remains well below target. But one other reason that the PBOC has for easing is that looser monetary policy is not really feeding through into looser monetary conditions.

The transmission mechanism of looser monetary policy is to lower real interest rates, increase lending and (often) to push down the exchange rate. But the transmission mechanism does not always work. Despite cutting rates, monetary conditions have not improved all that much (chart 1). The strength of the CNY bears much of the blame for that. Pegging to the USD when it is rising means that China has been running to stand still, with interest rates cuts simply acting to offset the tightening effects of the exchange rate (see *Economist Insights,* Running to Stand Still, 25 May 2015).

This is not the first time that the Chinese transmission mechanism has not worked. Back in 2007, China was hiking interest rates, but this failed to have much impact on lending growth. Following the Financial Crisis, monetary conditions tightened before policy managed to loosen them again. Now the PBOC must be hoping that eventually the interest rate cuts feed through into looser monetary conditions. Of course, the easiest way to achieve this would be to let the currency depreciate more.

Chart 1: Waiting for easy

China's 12-month lending rate and Bloomberg Monetary Conditions Index for China (inverted, high value is tight)



Source: Bloomberg Finance LP.
Note: Bloomberg Monetary Conditions index for China includes real interest rates, total loan growth and real effective exchange rate.

What about the other candidates for further potential easing? The ECB came out far more dovish, all but announcing further action in December. Not only has the ECB indicated that a second round of quantitative easing (QE) is possible, but also that a cut in the already-negative deposit rate is possible. The ECB can point to the experience of Switzerland, where the deposit rate is already -0.75% but has not resulted in big cash withdrawals from banks.

The rhetoric from the BOJ was a bit less dovish, arguing that the underlying health of the economy was improving. The market is not fully convinced. Not only is the data not that much better, but Governor Kuroda has a reputation for talking down the likelihood of easing so that he can surprise the markets when he does ease. At the current pace it is hard to see how the BOJ will reach its 2% target, so more easing is almost certainly necessary.

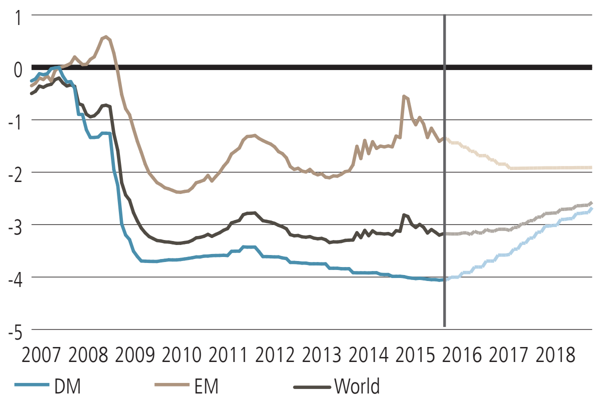
Easing off-set

If China is easing, and both the Eurozone and Japan may follow suit, where does that leave the Fed? Does it make the Fed more likely to hike, or less likely? The answer really depends on what one thinks is driving the easing in other economies, and whether the easing is ahead of the curve. So if China is cutting because they know something about growth that others do not, then that is bad news for the rest of the world. But if the PBOC is simply easing in advance of risks of further weakness, that suggests outcomes may be better so it becomes positive news. Similarly, if the BOJ and the ECB decide to increase QE because they are worried about inflation expectations, this is positive for the US. The Fed will care about growth in the rest of the world, not foreign inflation.

If the Fed hikes while the PBOC eases, will this be a net tightening or a net loosening of global monetary policy (see *Economist Insights,* Global Reflation, 9 March 2015)? Taking a weighted average of monetary policy across regions suggests that the two would pretty much balance each other out over the next year (chart 2). Ultimately there is likely to be a limit to how much the PBOC will cut rates, but the FOMC can easily continue to hike rates. That would leave global monetary policy tighter. Unless, of course, further QE from the ECB and BOJ added to global liquidity.

Chart 2: Re-converging by diverging

Change in weighted average of central bank interest rates since August 2007 (2013 current USD GDP weights)

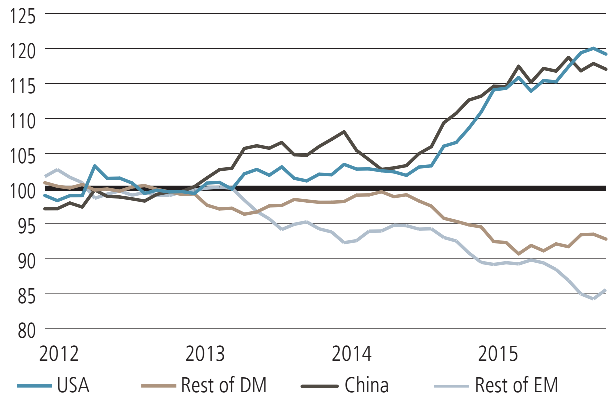


Source: Bloomberg Finance L.P., IMF, UBS Global Asset Management.
Note: assumes Fed hikes rates according to the median FOMC projections, the UK follows with a 6m lag, and the PBOC continues cutting rates until 2.1%.

Where the Fed cannot completely ignore the rest of the world is through the impact of the USD. More QE in the Eurozone and Japan would almost certainly push the EUR and JPY lower. Luckily for the US, China is doing the best at punishing its own exporters by preserving the USD peg. So the USD is only likely to rise against two of the three. Strength in the USD has started to stabilise, but with the USD and CNY both up about 20%, the rest of the developed markets (DM) and especially emerging markets (EM) are going to benefit a lot (chart 3).

Chart 3: Just diverging

Nominal effective exchange rate indices, 2012=100



Source: JP Morgan, UBS Global Asset Management

The strength of the USD is not enough to deter the Fed from its tightening, especially if that currency strength is driven by expectations of tightening. That means a rate hike this year is still on the table. So while September was about tightening, and October about easing, November is likely to be about no change. Then December brings it all together, being about both tightening and easing. The end of 2015 could bring about the start of the real divergence in global monetary policy.

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