Central banks signal no return to normal monetary policy

By Brian Milner
September 21, 2016 – *The Globe and Mail*

The world's most influential central banks have reaffirmed that a return to normal monetary policies isn't on the horizon, even as they head in opposite directions.

U.S. Federal Reserve Board policy makers left interest rates at a record low in the face of weaker-than-expected economic growth, but left little doubt that an increase in its benchmark rate is in the offing, possibly before the end of the year.

"The committee judges that the case for an increase in the federal funds rate has strengthened, but decided, for the time being, to wait for further evidence of continued progress toward its objectives," the policy-setting Federal Open Market Committee said in a statement.

The decision was not unanimous, with three of the 10 members calling for an immediate hike – an unusual level of dissent, even for the sometimes fractious FOMC.

Still, the central bank is likely to proceed under the caution flag. Fed chair Janet Yellen told reporters after the meeting that the Fed is not on "a preset course" and noted that by not moving too quickly, policy makers reduce the risk of having to reverse course if the economy falters and the labour market weakens.

Ms. Yellen described the committee as "generally pleased with how the U.S. economy is doing." But she added that there is still room for the job market to improve and inflation remains below the bank's 2-per-cent target.

The Fed's confirmation that it will move slowly on the interest-rate front came hours after its Japanese counterpart revealed that it was rebooting its own monetary-easing policy in its latest bid to revive economic growth and escape the deflation trap that causes businesses and consumers to consistently defer spending.

The Bank of Japan is changing tack to focus on steepening the yield curve – boosting yields on long-term bonds in an effort to shore up battered financial institutions and increase lending.

In its newest twist on monetary easing, the bank is ditching its fixed target of expanding the monetary base by ¥80-trillion ($1.04-trillion) annually and will shift its asset purchases to 10-year government bonds from those with longer-term maturities. The goal is to cap 10-year yields at zero per cent, while boosting yields on longer-term government debt, large swaths of which are held by long-suffering Japanese insurers and pension funds stuck with negligible returns.

The flattened yield curve has also hammered the profits of banks, which typically borrow short-term funds and lend the money at long-term rates.

It's the latest example of how the world's test kitchen for monetary policy keeps cooking up new recipes in an effort to lift Japan out of its economic doldrums and clear away the deflation clouds that have hovered over the landscape for much of the past quarter century. So far, the central bank has little to show for its massive monetary easing since current governor Haruhiko Kuroda took over the Bank of Japan's helm in 2013 with a mandate to wipe out deflation and get the economy out of the chronic-care ward.

The Bank of Japan kept interest rates unchanged Wednesday, but left the door open to a deeper dive into negative territory as a "possible option for additional easing."

It has also changed its target of 2-per-cent inflation, pledging to overshoot that mark, though it has not come close to reaching even that goal.

“The price stability target of 2 per cent has not been achieved,” the bank said, in stating the obvious. That, it said, “is largely due to developments in inflation expectations.”

So the bank’s solution is to boost those expectations “in order to achieve the price stability target.”

That will be a tall order, considering that the governor has regularly had to extend the time frame for reaching the elusive target, which has hurt his credibility.

“In our view, the pledge to overshoot the inflation target is a gambit on the part of the BoJ to disrupt that mindset and convince Japanese households and businesses of its intention to deliver on its 2-per-cent inflation target despite the challenges it has encountered,” Tim Quinlan, senior economist with Wells Fargo Securities, said in a note.

Then there is the uncomfortable fact that prices have been falling. Underlying inflation is expected to be zero over the next few months.

The bank rattled markets last January when it adopted a negative deposit rate for the first time to push banks to put more cash to work in the economy. But as with its other aggressive easing efforts over the past 3 1/2 years, any benefits were short-lived, as the yen strengthened, domestic lending and spending remained weak and bank profits took a hit.

Critics argue that the Bank of Japan and other central banks have run out of ammunition and that while they have managed to ward off severe recessions, they are not equipped to restore stable growth or stave off the deflationary pressures stemming from a darkening global outlook.

Mr. Kuroda remains determined to prove the naysayers wrong.

Meanwhile, Ms. Yellen is also feeling some political heat, mainly from Republican presidential candidate Donald Trump, who has attacked the Fed for keeping rates too low for too long, an argument supported by conservative Federal Reserve Bank presidents on the policy committee.

But anyone, including Mr. Trump, expecting an imminent return to more normal monetary policies anywhere is sadly mistaken.