Central Banks Are Not Pushing on a String

They have more firepower than you think.

October 2019

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There currently seems to be a lot of cynicism about the power of central banks to influence global growth. A growing number of people appear to believe that rate cuts are no longer as effective as they once were and that central banks are therefore effectively impotent. I disagree.

Why? Well, I think it's important to understand the context. For more than a decade, global growth has been suppressed by deleveraging of one kind or another (and by "deleveraging," I mean reducing the pace of credit growth to the level of nominal gross domestic product growth rather than reducing the overall level of credit outstanding). The deleveraging has come in four phases: the global financial crisis; the eurozone crisis; the taper tantrum, which mainly affected ex-China emerging market countries; and the current wave of Chinese deleveraging. These phases of deleveraging have applied a series of powerful brakes on the global economy, one after another, over the past 11 years. As yet, there has not been any meaningful releveraging of the real economy to counteract them.

In addition to this, the global economy has had to contend with a series of uncertainty shocks over the past few years. Brexit, the rise of populism, trade wars—all of these have made it harder for consumers and businesses to make confident predictions about the future, which has hit growth through a reduction in capex.

Faced with these powerful headwinds, it is hardly surprising that central bank rate cuts have had less of an impact on growth than we'd usually expect. However, this does not mean that rate cuts have become inherently less effective—rather, they have not appeared as potent as in the past because of the context in which they have been administered.

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I believe that central bank rate cuts can still be very effective and that the current phase of central bank easing has the potential to offer much stronger support to the global economy than the cynics believe. In the absence of any new shocks to elevate uncertainty, I believe we are close to an inflection point in growth where the transmission

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of easy financial conditions kick in and spending on durable goods and capex follow. This should help to keep a recession at bay for a while yet—possibly for up to three years.

A recession will arrive at some point, but the next recession is unlikely to be as severe as in 2008, and it will probably be milder than in 2001 because the structural imbalances that would cause a major recession simply don't exist today. When it comes, the next recession likely will be caused by the labor market, which is beginning to look too tight. If the labor market overheats, profits will be squeezed and companies will, consequently, suspend capex and stop hiring. This is how the expansion peters out. Although the next recession is likely to have less impact on the real economy, it is likely to be painful for financial markets because companies have ratcheted up debts to undertake cash distribution to shareholders through stock repurchases and dividend payments.

Central banks will have less room to maneuver when the next recession comes around, but this does not mean that they are impotent. Monetary policy is not primarily about the level of interest rates but rather about directing capital flows to engineer loose financial conditions. In my view, central banks still retain some tools to do this. Many people were convinced that the European Central Bank and the Bank of Japan were running on empty last year, but since then, the 10-year German government bond yield has fallen from around 80bps to -50bps and the 30-year government bond yield in Japan has fallen from around 90bps to 35bps and financial conditions have been loosened substantially.

We should be wary of underestimating determined central banks.

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ID0002662 (10/2019)
201909-965693