

The ongoing battle against global deflation: Unconventional policy becomes commonplace

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Unconventional policy is nothing new

Recent market tumult as a result of the COVID-19 outbreak merits a revisit of unconventional monetary policy. With global central banks dramatically cutting their benchmark rates and ramping up their respective quantitative easing (QE) programmes, it appears that market functioning has become increasingly reliant on unconventional stimuli.

Over the past decade, central banks have leaned heavily towards experimenting with unconventional approaches to monetary policy, ranging from QE and negative interest rate policy (NIRP) to Yield Curve control. Arresting domestic disinflation and (in a few cases) staving off deflation have become key priorities. Yet, despite the banks' efforts, we're yet to witness the expected resumption in economic growth and resultant inflationary pressure that typically follows such levels of monetary policy accommodation.

"The 2007-2008 Global Financial Crisis (GFC) was the worst economic disaster since the Stock Market Crash of 1929. It started with a subprime mortgage-lending crisis in 2007 and expanded into a global banking crisis with the failure of investment bank Lehman Brothers in September 2008. Huge bailouts and other measures meant to limit the spread of the damage failed, and the global economy fell into recession." Investopedia.com

The migration from one policy framework to another isn't uncommon. Central banks have, in the past, moved through various monetary frameworks in response to prevailing economic climates. For example, the 1980s were marked by ultra-tight conventional policies aimed at squeezing out stubbornly high inflation; and in the early 1990s, inflation targeting (after having been pioneered by the Reserve bank of New Zealand) was quickly adopted by other central banks across the globe.

The here and now is no different, with inflation struggling to gain momentum since the *Global Financial Crisis (GFC)*, despite unprecedented monetary policy intervention. The shift from conventional to unconventional monetary policy will remain a relevant and abiding theme in the forthcoming decade, given the economic damage deflation could render.

In forming a clearer picture of why unconventional policy is likely to remain prominent, we must ask ourselves:

- 1) Whether deflation is really the malady it's made out to be;
- 2) How effective have central banks been in countering deflationary pressure; and
- 3) What are the potential implications to bond yields, in light of unconventional policy intervention becoming more entrenched?

THE TAKEOUT: Unconventional policy is here to stay

With the prospect of deflation staring central bankers dead in the eye, unconventional monetary policy is here to stay.

1) Is deflation really the malady it's made out to be?

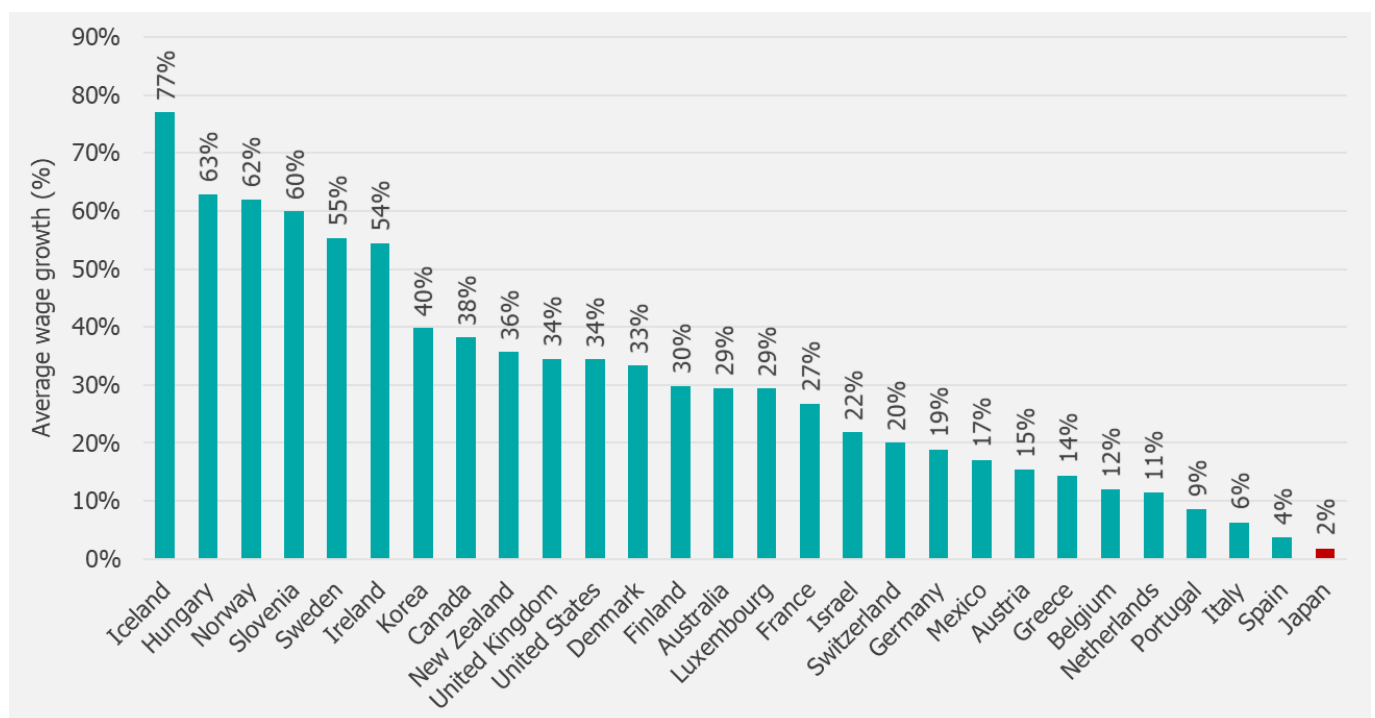
Most economists consider a consistent fall in prices as negative for economic activity. They postulate that a fall in prices would result in lower consumption expenditure, leading to lower aggregate demand as consumers start holding back on purchases with the expectation that they'll be able to buy goods at a lower price in the future. This becomes a self-fulfilling cycle, where lower price expectations and the withholding of expenditure begets lower actual prices, which in turn catalyses and sustains a deflationary cycle.

Japan serves as the customary case study of how entrenched deflationary price expectations could lead to lower actual inflation and lower economic activity. Since 1995 (the year that marked the peak of *Japan's 'lost decade'*) the country has had to overcome multiple recessions. The consequence of these recessions, specifically on the supply side of the economy, led to a sharp drop in the labour participation rate as workers became increasingly discouraged to seek work. The lower participation rate led to lower wage growth and consequently lower aggregate demand. Given that wage negotiations generally tend to be based on their most recent levels, it has become increasingly challenging for wages to rise given the 'lowflation' environment Japan finds itself in.

"Japan's 'Lost Decade' was a period that lasted from about 1991 to 2001 that saw a great slowdown in Japan's previously bustling economy. The main causes of this economic slowdown were raising interest rates that set a liquidity trap at the same time that a credit crunch was unfolding." *Investopedia.com*

Figure 1 below indicates that cumulative average Japanese wage growth increased by a mere 2% from 1995 to 2018. For wages to rise, Japan would need to anchor inflation expectations higher, and for this to come about actual inflation would have to remain elevated for an extended period of time. All said, the longer inflation remains low, the harder it is to re-anchor it higher. Despite a barrage of interventions, the Bank of Japan (BoJ) is still struggling to get inflation back up to its elusive 2% target rate.

Figure 1: OECD Cumulative Average National Wage Growth (1995 -2018)



Source: OECD Database, Futuregrowth

Deflation is considered digestible only when associated with higher growth and increased productivity. For example, technology-induced deflationary pressure, primarily as a result of improved productive capacity, has allowed consumers to purchase more products without inducing an economy wide deflationary cycle.

THE TAKEOUT: Deflation could pose a material risk

Deflation is generally associated with periods of lower economic activity. Lower prices ultimately result in lower demand for labour and wage growth suffers, leading to lower aggregate demand. Japan's 'lost decade' epitomises the implications of deflation on GDP growth.

2) Have central banks been effective in countering deflationary pressure?

Deep Dive

Quantitative easing

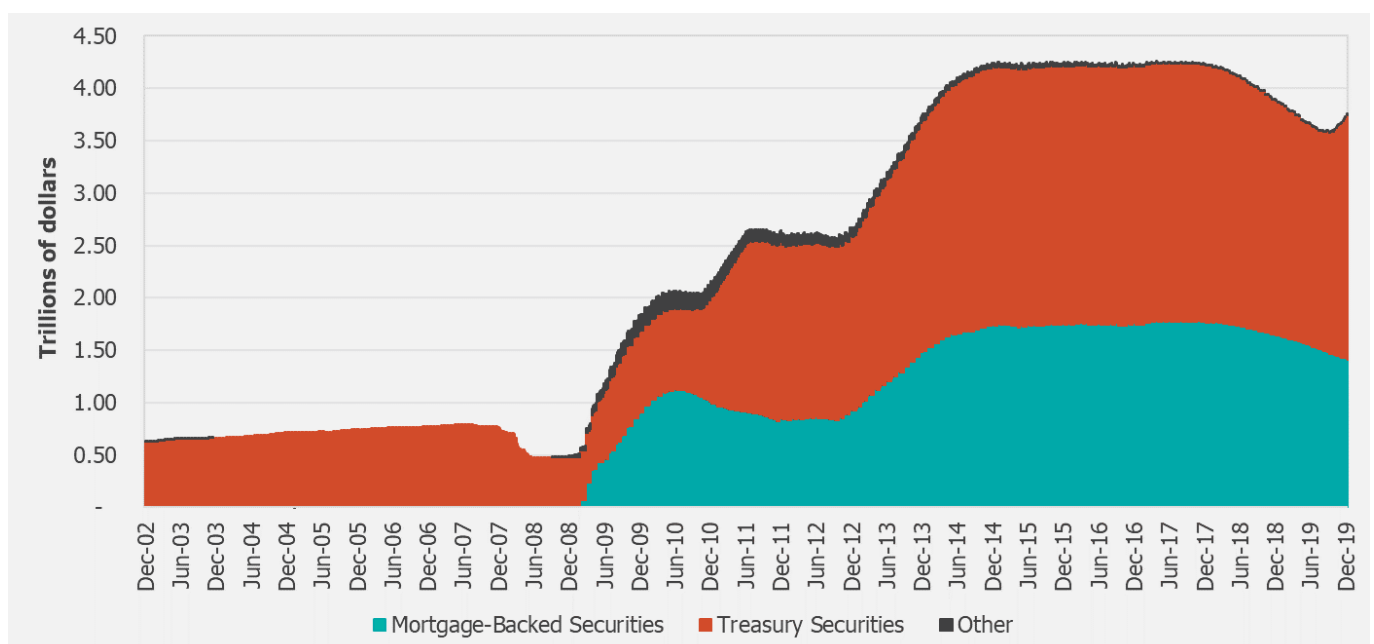
Central banks normally influence prevailing short-term rates by conducting standard open market operations. This entails stimulating demand by buying short-term debt (usually Treasury securities) from major commercial banks and other reserve holding financial institutions. Instead of paying cash for these purchases, the central bank credits the institution's central bank reserve balance, which has the effect of allowing short-term rates to change, but without directly increasing the actual level of liquidity in the financial system. Unlike standard open market operations, under QE, central banks pay for securities using cash, allowing them to inject liquidity into the market. The scope of purchasable securities is also much wider.

Following the Lehman bankruptcy and the ensuing global financial crises in 2008, major financial institutions stopped lending to each other. It dawned on central bankers that the market was entering what Keynesian economists call a liquidity trap – a point where, despite near-zero interest rates, banks, business and consumers still end up hoarding cash and avoiding bonds, believing that prevailing interest rates will soon rise, thus pushing bond prices lower. With liquidity all but non-existent, the US Fed became the buyer of last resort and, in so doing, embarked on a substantial quantitative easing (QE) programme.

Instead of just purchasing government treasury securities, the US Federal Reserve Bank (Fed) went as far as buying \$1.25 trillion toxic mortgage-backed securities in the wake of the crisis, to create liquidity. By injecting liquidity and creating synthetic demand, the Fed hoped that it would encourage lending, increase spending, and resuscitate growth which, in time, would give a leg up to inflation. So from 2009 to 2014, the Fed increased the money supply by an unprecedented \$4 trillion, via three tranches of QE.

The Fed expected that banks would take the additional supply of money and lend it out or invest it to stimulate growth. It transpired that the banks ended keeping just over half of it (approx. \$2.4trn) as excess reserves, rendering QE a lot less effective than what was intended. So although QE intervention opened up the interbank market and stimulated lending, which in turn averted a collapse in the real economy, it has been unsuccessful in shoring up the inflationary pressure initially envisaged.

Figure 2: US Federal Reserve : Treasury and Mortgage-Backed Securities held



Source: US Federal Reserve Bank, Futuregrowth

Deep Dive

Negative interest rates

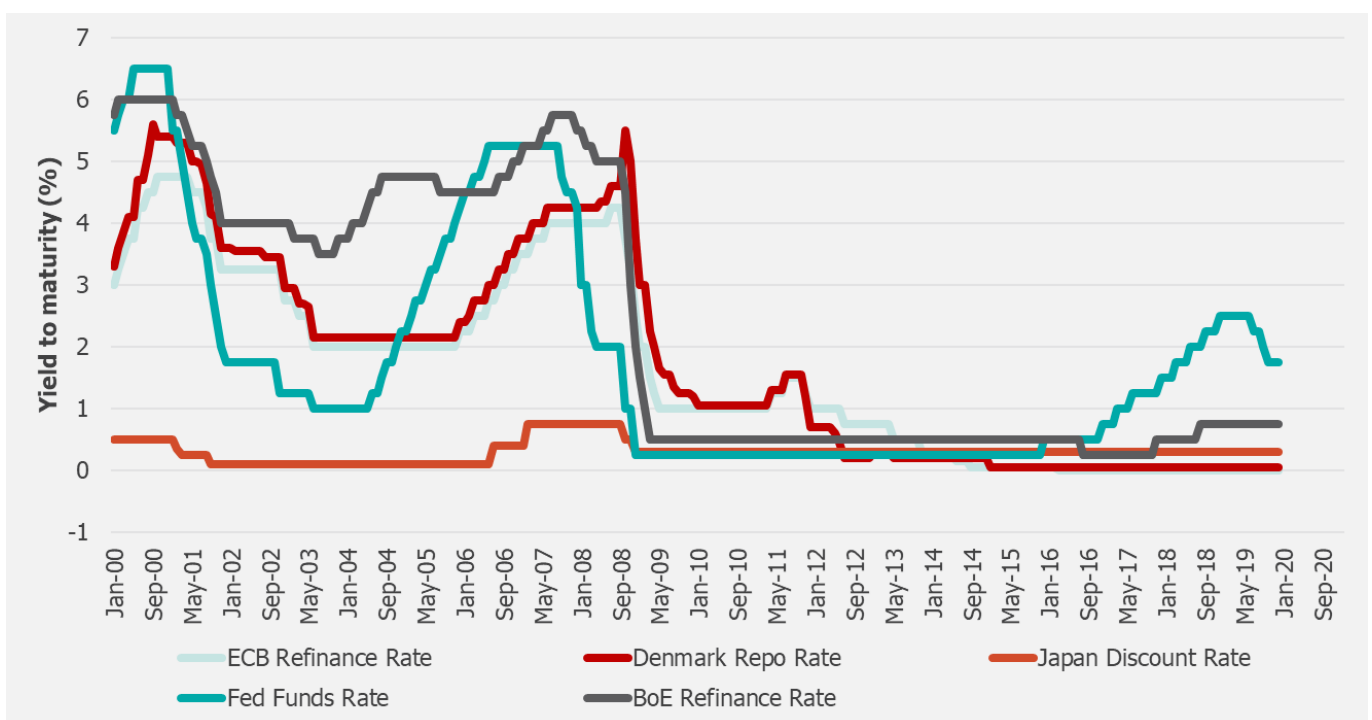
Imagine a world where lenders pay borrowers for borrowing and savers are penalised for saving? As disingenuous as it sounds, this is the reality faced by European and Japanese banks in today's 'lowflation' world.

Negative interest rate policy (NIRP) rose to prominence shortly after the 2008 global financial crisis when Sweden's Riksbank cut its overnight deposit rate to -0.25%. The European central bank followed five years later in 2014, when it cut its deposit rate to -0.1%. The primary reason for central banks moving from zero to negative rates was to help stimulate the supply of credit. The fractional-reserve banking system only works if banks lend money. If banks hoard deposits and fail to write loans, the supply of money to businesses and consumers cannot grow, resulting in fewer transactions and lower economic activity.

Post the GFC, central banks went to great lengths to make credit cheaper, to stimulate growth via quantitative easing, but as we've come to realise, these efforts were largely in vain given that commercial banks and reserve holding financial institutions failed to increase their lending, preferring to hold excess cash in reserve. To counter this, central banks implemented negative interest rates on these excess reserves, penalising commercial banks and reserve holding financial institutions for hoarding cash. Banks have been loath to pass these negative rates on to deposit holders, opting to rather let their interest margins take the hit.

Since negative interest rate policy (NIRP) is a recent phenomenon, it is yet to be seen whether it gains any traction in stimulating spending. So far, its only discernible impact has been to erode bank interest income margins. This comes as little surprise, given that the supply of money vastly outstrips investment demand. Ageing demographics across Europe (as well as Japan) have been a hindrance, too. Older people prefer to save, and negative interest rates are likely to incentivise them to save even more, exacerbating the situation.

Figure 3: Global short-term interest rates (2000- 2020)



Source: Bloomberg, Futuregrowth

Deep Dive

Yield curve control

Whereas quantitative easing focuses on impacting the level of interest rates, yield curve control focuses on the shape of the yield curve. In its most basic form, the yield curve is a collection of future short-term interest rate expectations. A positively sloped curve signifies expectations of an increase in future short term rates in response to higher inflation and growth, whereas a negatively sloped yield curve implies the opposite.

By controlling the slope of the yield curve, central banks hope to firstly contain long-term rates to ensure that long-term borrowing costs don't stymie credit expansion and the growth that tends to emanate from it. Secondly, to ensure that the yield curve remains positively sloped to signal an inflationary outlook.

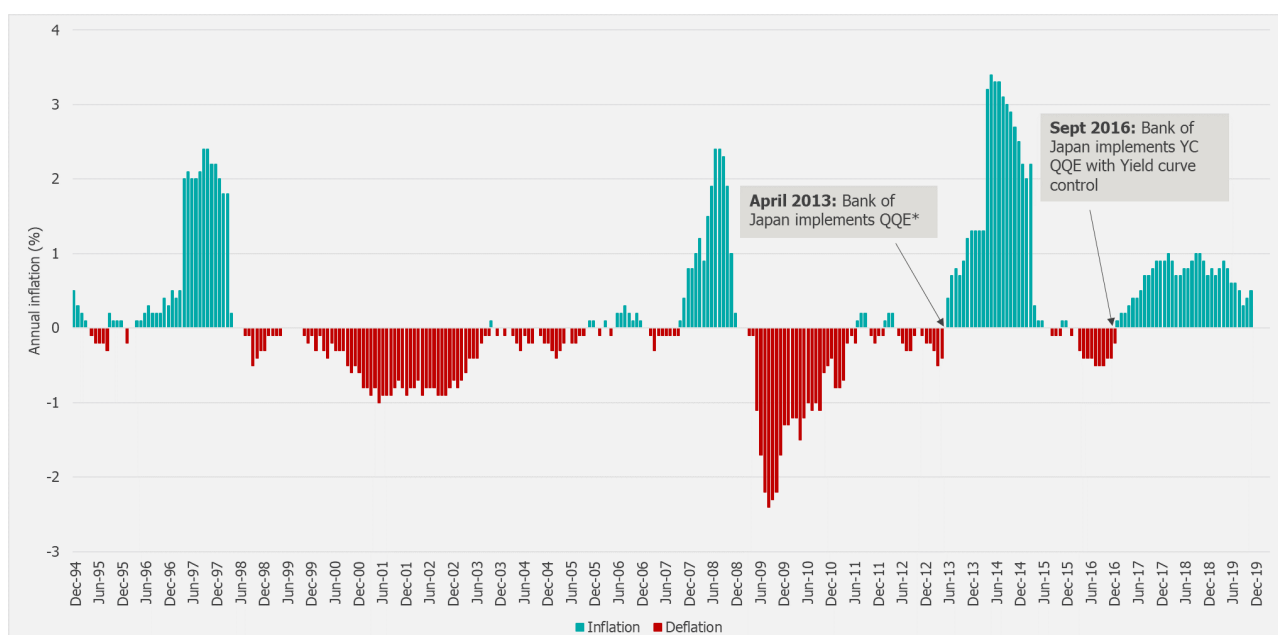
By pegging the rate at a specific point, the bank signals that it is willing to buy any amount of bonds the market is willing to supply at that yield or higher. In the same vein, it is willing to sell any quantum of bonds to increase the yield, if it is too low.

Yield curve control could also be considered as a support mechanism for fiscal policy. By fixing the long-term rate at, say, zero, the central bank is effectively signalling to fiscal authorities that no matter how much they borrow and spend, the cost of borrowing will remain fixed at zero.

The Fed first tinkered with yield curve control when it implemented 'operation twist' in 2011 and 2012. By selling short-dated securities and buying long-dated ones, the Fed managed to flatten the US yield curve, and in doing so, brought down borrowing costs on items such as mortgages. More recently, Japan implemented yield curve control, but instead of trying to flatten the curve, the BoJ opted to steepen it. Given that Japanese short term interest rates were negative, the BoJ committed to pegging its 10-year bond yield to zero, to create a positively sloped yield curve.

So far, yield curve control in Japan has produced mixed results. A glimmer of increased price pressure in the form of consistently positive monthly inflation followed the BoJ's yield curve control implementation in 2016. However, inflation is still very far from target, which, according to the BoJ has been a consequence of lower commodity prices, an increase in consumption tax and a slowdown in global trade.

Figure 4: Japan year-on-year headline inflation rate



Source: Bloomberg, Futuregrowth

THE TAKEOUT: Unconventional policy interventions remain a 'work-in-progress'

At or near zero nominal short-term interest rates, conventional policy tools become ineffective at influencing investor behaviour. Unconventional monetary tools such as quantitative easing (QE), negative interest rate policy (NIRP) and yield curve control aim to stimulate the real economy. So far, unconventional policy interventions remain a 'work-in-progress', where the long-term implications are yet to be seen.

3) What are the potential implications to bond yields of unconventional policy intervention becoming more entrenched?

As global central banks gear up to prevent the world from entering a deflationary spiral (which may easily be triggered by a COVID-19 induced recession) unconventional tools will feature more prominently and become more entrenched in central bank policy toolkits. Indefinite accommodation by central banks to offset what are considered by many as structural changes in inflation dynamics could bring about a prolonged period of low developed market yields.

Although the 'lower-for-longer' mantra for developed market yields will help uphold the constant flow of capital towards higher yielding emerging markets, the debt burdens of these economies could eventually become unsustainable. The market, in our view, has opened itself up to 'risk-distortion' in its quest for higher yielding but inherently riskier bonds. South Africa has been no exception, with investors slow to acknowledge the macroeconomic reality of low growth and the increasingly unsustainable debt levels the country is saddled with. The risk premium on South African local currency bonds has only recently begun reflecting this reality. We have long maintained a defensive position in light of this risk distortion and will continue to monitor and position our funds accordingly, as the risk distortion theme unfolds over the coming quarters.

"The 2007-2008 Global Financial "Full employment is an economic situation in which all available labour resources are being used in the most efficient way possible. Full employment embodies the highest amount of skilled and unskilled labour that can be employed within an economy at any given time.

True full employment is an ideal, and probably unachievable, benchmark where anyone who is willing and able to work can find a job and unemployment is zero. It is a theoretical goal for economic policymakers to aim for rather than an actually observed state of the economy.

In practical terms, economists can define various levels of full employment that are associated with low but non-zero rates of unemployment."

Investopedia.com

As we highlighted earlier, unconventional approaches to monetary policy have a bearing on fiscal policy. By reducing interest rates (and by implication pushing funding costs artificially lower) central banks are effectively handing their respective governments a license to spend with little consequence. Ideally, if the cost of borrowing were zero or lower, governments would have an incentive to spend up until *full employment* were reached. Further to this, the near-term likelihood of defaults would materially reduce, as governments would be able to refinance existing debt at a much lower cost. Ultimately, the proliferation of unconventional interventions such as yield curve control bears the risk of obscuring the lines between monetary and fiscal policy.

More recently, the shift of quantitative easing to tightening has stalled, and in most cases reversed, given the suboptimal inflationary impact, as well as recent measures aimed at offsetting the potentially damaging effects of COVID-19. With central banks collectively holding \$25 trillion in an array of financial market securities, the mechanics and implications of quantitative tightening (or the unwinding of quantitative easing) will remain a conundrum to central bankers and investors alike.

THE TAKEOUT: Bond yields will remain low

Permanence of unconventional policy implies that yields will likely remain lower for longer, which, in turn, should help anchor short-term rates globally. The lack of inflationary pressure as well as the long-term potential impact of a COVID-19 induced recession also hints at central banks remaining accommodative.

A new paradigm of unconventionally accommodative monetary policy coupled with a shift towards more fiscally driven stimulus has become an increasingly possible policy pathway for the near future - as well as the forthcoming decade.

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