John Mourmouras: Divergent monetary policies and global capital markets

Speech by Professor John Mourmouras, Deputy Governor of the Bank of Greece, at the session “The role of central banks today” of the XXIV International Banking Congress, St. Petersburg, 4 June 2015.

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Governors,

Ladies and Gentlemen,

It is a great pleasure for me to be here in St. Petersburg and I would like to thank the Governor of the Bank of Russia, Elvira Nabiullina, for inviting me to this international congress attended by distinguished representatives of the finance industry and the central banking sector. I would like to make a few remarks on the potential financial consequences of divergent monetary policies, which remain a dominant theme in the global financial environment. Afterwards, I will be happy to answer any questions posed by the panel or the floor.

1. Introduction

Global growth and inflation prospects, while not as dire as a few months ago, are far from robust. Notwithstanding the slow steps by the Federal Reserve (Fed) towards normalisation of monetary policy in the US, the central bank community today remains ultra-loose, with the certainty of further stimulus in Europe and Japan in the months ahead and the likelihood of monetary easing in China and elsewhere. The Greek debt crisis still remains pending and there are also downside risks on the geopolitical front, even in this region (e.g. the events in Ukraine, particularly with the Minsk II ceasefire under increasing strain). Several central banks (including all four major, i.e. the US Federal Reserve, the ECB, the Bank of England and the Bank of Japan) have engaged in unconventional monetary policies, including large-scale asset purchase programmes, and forward guidance about the future path of monetary policy. We have also lately witnessed discretionary policy actions by an increasing number of central banks with direct effects on the foreign exchange value of their currencies, naturally raising concerns about a recourse to *beggar-thy-neighbour policies* and competitive devaluations. The consensus among analysts is that a period of divergent monetary policies among central banks will last for quite some time, giving rise to a number of important questions to be addressed, to mention but two: (a) what are the effects and the channels of the international transmission of monetary policy today, (b) what are the spillovers from the policies of major central banks to the rest of the world, including emerging markets, in terms of capital flows, bond markets and exchange rates, and if there is any scope for global monetary policy coordination.

I propose to focus on the following three remarks. *Firstly*, I will discuss the ECB’s ongoing expanded asset purchase programme (QE) and its impact on the euro area economy. *Secondly*, I will discuss how divergent monetary policies among the world’s leading central banks may trigger excessive volatility in global financial markets. *Last but not least*, I will examine if there is any scope for global monetary policy coordination that can effectively address the risks that lie behind “asymmetric” monetary policies.

2. Draghi’s qe: an early evaluation

First of all, I will explain why it is that we talk about low inflation, rather than deflation, in the euro area. Inflation is expected to remain very low or slightly negative in the coming months, with an average inflation projection of 0.3% for the year 2015, against a yearly average of

0.4% in 2014. In advanced economies, the inflation rate will stand at 0.4% on a yearly basis in 2015, according to the latest IMF forecasts, which is the lowest level in the last 30 years, and in EMEs at 5.4%, one of the lowest in the last 20 years. Although in the euro area, there is more than a 50% risk of the inflation rate hovering below one percent in the short-run, the risk of deflation is quite low at less than 10% in the short term (in the next one to two years) and effectively zero (1% risk) in the longer term (in the next five years). Despite recent monthly inflation "dips" to negative levels there is no *deflationary bias* embedded in wage contracts and consumer behaviour in the euro area, as opposed to the inflationary bias we have experienced over the past three decades (1980s-1990s-2000s). Ultimately, the ECB should fulfil its mandate, as the Harmonised Index of Consumer Prices (HICP) is expected to reach 1.8% in 2017, which is consistent with the primary goal of price stability, i.e. maintaining the euro area inflation rate below, but close to, 2% over the medium term.

Let me now quickly refer to the key features of the ECB's recent asset purchase programme and focus mainly on the impact of QE, which judging from preliminary evidence, is really encouraging. The key elements of the programme are the following: (a) Monthly asset purchases will amount to €60 billion of private and sovereign debt. The programme will amount to a total of €1.1 trillion in asset purchases carried out from March 2015 until September 2016. (b) Loss-sharing is reserved for those purchases that are carried out by the ECB, accounting for 20% of the total purchases. The remaining 80% of all purchases – i.e. purchases made by NCBs – will not be subject to loss-sharing.

Since the announcement of the ECB's QE on 22 January, projections for real GDP growth in 2015 and 2016 have been revised upwards (to 1.5% and 1.9%, respectively) compared with December 2014. Furthermore, model-based estimates indicate that market-based measures of inflation expectations have reacted positively to the progressive expansion of the ECB's balance sheet over the last few months and have been revised upwards, as well. As far as financial markets are concerned, the impact of the asset purchase programme accounts for most of the fall in euro area long-term sovereign bond yields since last December, as market participants anticipated the ECB's QE programme. Government bonds across a wide range of euro area countries traded at historically low, and often negative, yields. The decline was most pronounced in the longest maturities, with yields on French and German 10-year bonds falling by around 60 basis points, while those on Italian and Portuguese bonds of the same maturity shrank by 70 and 90 basis points, respectively. The major European stock markets have risen since end-2014 by about 17%. Furthermore, the euro depreciated by 11% since last December, hitting a 12-year low against the dollar (for a more detailed assessment of the ECB's QE, see my earlier speech at the 33rd Meeting of Central Bank Governors' Club in Shanghai on 15 May 2015, available at: http://www.bankofgreece.gr/Pages/en/Bank/News/Speeches/DispItem.aspx?Item_ID=317&List_ID=b2e9402e-db05–4166-9f09-e1b26a1c6f1b).

Following the ECB's accommodative monetary policy (with standard and non-standard measures) other central banks adopted similar policies. For instance, in Europe, the Central Bank of Denmark cut its key policy rate, taking it to the negative territory of –0.75%, while the Central Bank of Sweden (Riksbank), with a base rate of –0.25%, has announced it will expand its quantitative easing programme (the Riksbank pledged to buy between SKr40 billion and SKr50 billion (US $4.8–6 billion) of government bonds, taking the total stock of Swedish sovereign debt held by the central bank to between SKr80 billion and SKr90 billion and its share of all Swedish government debt to 15%) in an effort to stimulate the economy. In total, from the start of the year, 22 central banks lowered their official rates (including the Bank of Russia, which, since last December's drastic rise to 17%, lowered its interest rates three consecutive times, the last time being in April, when rates were cut by 1.5 percentage points to 12.5%). In light of all this, one can speak of a period of truly global monetary easing!

3. Divergent monetary policies and capital markets

Some theory

Many analysts believe that purchases by central banks are the dominant cause of low bond yields today. Apparently, this has to be a factor since a QE programme, by its very nature, is an extension of the intervention horizon of monetary policy and as such it has a direct impact on long-term interest rates (the average maturity of the securities bought by the ECB under its QE programme is 8.1 years). However, a far more important determinant of low bond yields today is the expectation that short-term rates will stay low, which in turn reflects expectations of low and persistent inflation and of a weak and uncertain recovery. Perhaps theory is useful here. Theory suggests that long-term interest rates should be a weighted average of expected short-term interest rates plus a *term premium*. The premium should normally be positive, even in the absence of default risk. Longer-term securities are riskier than short-term ones, because their prices are volatile. Expected short-term nominal rates should be determined by expected real interest rates and expected inflation, and expected changes in real interest rates should, in turn, be determined by the expected balance of savings and investment. Finally, other factors, such as risk aversion also affect the prices of long-term bonds. What do all the above suggest about the future path of yields? The sharp rises in expected short-term interest rates and hence in long-term yields (the *term structure of interest rates* in theoretical terms) are only likely to follow a strong recovery and subsequently a sharp rise in inflation expectations (in empirical terms, historically, sovereign bond yields and, to a lesser extent, exchange rates track nominal GDP growth rates). We are not there yet: only with a robust recovery in Europe and a monetary policy normalisation in the US can markets start pricing risk in a traditional manner.

The recent bond sell-off

It is true, though, that the last days of April saw the beginning of a sharp sell-off in sovereign bonds across the euro area bond markets, leading to soaring volatility in European bond markets, a sharp steepening in the yield curve and an appreciation of the euro. The figures are quite spectacular as is often the case with the markets: in just 17 working days, the global sovereign bond index lost more than €0.5 trillion of its value! This is an upward correction in bond yields from an early overshooting of bond prices (early undershooting of the exchange rate), which marked the first significant adjustment in European sovereign bond markets since mid-2013 (triggered in turn by the Federal Reserve's tapering of its asset purchases). The 10-year Bund yield increased from a historical low of 7.5 bps on 20 April to over 80 bps by early June. As for the other euro area countries, yields in France and other core countries increased in a similar way, while the spreads of peripheral bonds over the Bund have narrowed. Turning to the US government bond market, and given the strong co-movement of 10-year German and US government bond yields (with a high correlation coefficient of .80), the 10-year US Treasury yields rose substantially to reach their highest closing levels this year in the region of 2.30%, as the contagion from the European bond sell-off was the main driver of their recent rise. Given the fact that recent US macro data were mixed and the uncertainty surrounding the Fed's rate hike timing, there was additional volatility in US yields spilling over to Bunds and other euro area countries, with the interest rate differential set to remain in the region of 1.50%. In addition, the widening gap between US and euro area interest rates is also driving US companies to issue more euro-denominated debt as it seems cheaper in interest rate differential terms.

In short, apart from some technical conditions (e.g. shorter-dated German Bunds which became eligible, while they were previously not, because of their negative yields, and hence there was less need to buy longer-dated bonds and/or volatility clustering in global bond markets, namely that volatility in itself generates further volatility), this recent bond sell-off reveals vulnerabilities in the current low-yield/low-inflation environment and can also be regarded as an evident financial implication of divergent monetary policies. One should not forget that there is still another trillion left from Draghi's QE programme to be paid. Finally,

some analysts claim that an issue of macroprudential policy arises here which, as is well-known, addresses risks to the financial system as a whole. More precisely, the ECB's implementation of the expanded asset purchase programme in the current juncture might necessitate the use of existing macroprudential tools to oversee any fallout from the credit expansion preventing or at least moderating asset market bubbles, or even the creation of new tools, for instance to address pressures in the insurance sector as a result of the low-yield environment in which they operate today.

Capital flows

The repercussions on the world economy of the redirection of a major central bank's monetary policy and/or of divergent global monetary policies which sharply alter global exchange rates, is one of the oldest questions in international monetary economics and was posed again recently, when the Fed launched its Quantitative Easing (QE) programme. At the time, the Governor of the Central Bank of Brazil expressed his strong dismay at the loosening of the Fed's monetary policy and its impact on emerging countries, in the form of large capital inflows triggering a sharp appreciation of their currencies and a decline in exports. It is indeed quite difficult to predict the precise form of (sometimes conflicting) spillover effects stemming from such a change in the monetary policy stance. For instance, the Fed's Quantitative Easing 1 (QE1) programme was followed by capital flows out of emerging economies (EMEs) into US Treasuries, while the second round of Quantitative Easing (QE2) had the exact opposite effect. Since then, the Fed's change of tack has once again spurred intense reactions in EMEs (see recent statements of the Reserve Bank of India Governor): the tapering of the Fed's asset purchase programme has resulted in massive capital flows into advanced economies and a subsequent sharp rise in interest rates in emerging economies to prevent a sharp devaluation of their currencies (the currencies of Brazil, South Africa and Turkey were particularly hard-hit). Their large current account deficits are typically financed with short-term portfolio flows and in the case of Brazil and South Africa, falling commodity prices added further pressure. Up to now, there are no clear indications of international portfolio rebalances due to the upcoming interest rate hike by the Fed and/or the QE programme currently implemented by the ECB.

4. Monetary policy coordination?

We have just looked into the negative spillover effects from divergent monetary policies. Of course, a central bank's mandate is domestic, but its policy may have global implications. Furthermore, in an international macroeconomic environment of subdued and uneven growth and high unemployment, zero lower-bound interest rates and a tight fiscal policy stance, certain nations may attempt to use their monetary policies – through standard or non-standard measures – in order to influence their exchange rate to bolster their economy and boost employment. The question thus arises whether monetary authorities should act in a coordinated manner during this final stage in the exit from the global crisis and at a time when foreign exchange rates are not an official monetary policy objective in advanced economies. ECB President Mario Draghi, answering a relevant question in an ECB Governing Council press conference on 6 February 2014, stressed that *international monetary cooperation cannot be ruled out*.

Examples of international monetary policy coordination are not rare, but Olivier Blanchard captured reality with the caveat: "it is like the Loch Ness monster that is much discussed, but rarely seen" (15 December 2013). As a matter of fact, a recent notable example of monetary policy coordination among major central banks took place at the onset of the global crisis of 2008, when the world's four leading central banks (the Federal Reserve, the ECB, the Bank of England and the Bank of Japan) took coordinated action, affirming the need to go beyond traditional ways of conducting monetary policy in order to continue to provide liquidity to the financial system and prevent a collapse of transactions and a global crash. Hence they established liquidity swap arrangements with the intention to provide foreign currency funding

to the banking systems in their jurisdictions. The US Federal Reserve provided US $500 billion to other major central banks over the 2008–2010 period, while the others used liquidity swap lines to a lesser extent. While international cooperation between central banks has been quite common in the field of foreign exchange markets, this occasion marked the first multilateral central bank cooperation in the money markets field, which is central to the implementation of a central bank's monetary policy. It is worth reminding that in the past, serious initiatives for coordinated monetary policy have been taken under the *1985 Plaza Accord* and the *1987 Louvre Accord* in order to stabilise the dollar exchange rate.

If things move towards such a policy coordination, it should in my view take the following form: i) the Fed could perhaps extend a new swap line to the central banks of EMEs, like the swap lines it offered at the start of the global crisis (a kind of formal policy coordination), and/or ii) a commitment on the part of the four major central banks to communicate their monetary policies in a clear and timely manner within the context of their forward guidance policies, as was agreed in a G20 Meeting in 2014, (a kind of informal policy coordination, whereby major CBs are mindful of the consequences of their actions). Such forward guidance will enable emerging economies to promptly protect themselves against sharp and significant capital flows and develop policies to avoid exclusive dependence on speculative capital flows which render them vulnerable to excessive volatility in the financial markets. At the current juncture, major central banks should signal future interest rate changes in a timely manner, without any concerns about causing market panic, otherwise investors will continue to overborrow and this would potentially be destabilising.

All in all, in the era of globalisation and especially against the background of low and persistent inflation today, some form of coordinated action between major central banks should perhaps be put on the table, particularly given the fact that governments are unable to protect themselves against central bank decisions, which trigger significant capital flows, and the available tools to limit such capital flows are not efficient.

Thank you very much for your attention.