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# GLOBAL MACRO RESEARCH POLICY OPTIONS IN THE NEXT DOWNTURN

JULY 2019

# EXECUTIVE SUMMARY

- China and the US have policy space, but the next downturn could see major central banks look beyond interest-rate adjustments
- We outline five of the most likely policy tools that central banks and governments may turn to in future years

**1** Alternative inflation targets

**2** Modern Monetary Theory

**3** Offsetting negative rates

**4** Macroprudential policies

**5** Yield curve control

- Of the major central banks, the European Central Bank and the Bank of Japan appear the most limited in terms of future policy options
- The Federal Reserve and People's Bank of China have considerably more options



# GLOBAL MACRO RESEARCH

## POLICY OPTIONS IN THE NEXT DOWNTURN

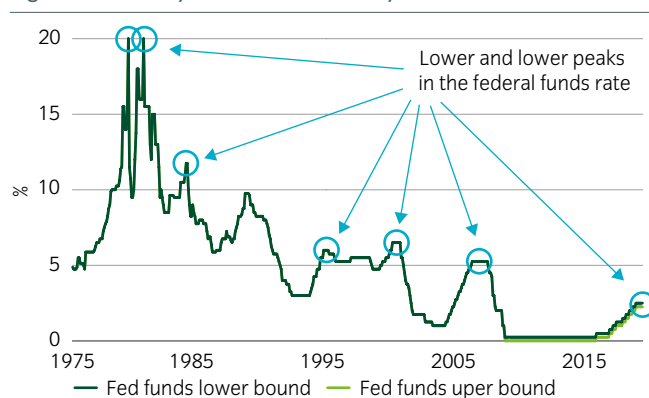
A KEY CONCERN FACING CENTRAL BANKS IS THAT INTEREST RATES ARE SO LOW THERE IS NO ROOM FOR MEANINGFUL CUTS TO COUNTER A FUTURE DOWNTURN. WE EXAMINE SOME ALTERNATIVE POLICY OPTIONS THAT COULD BE USED DURING THE NEXT ECONOMIC DOWNTURN.

### THE FINANCIAL CRISIS TESTED CENTRAL BANK LIMITS

Following the global financial crisis, banks were forced to repair balance sheets and deleverage to meet new capital requirements. Many of the channels that traditionally transmit easier monetary policy to the real economy became blocked or ineffective, forcing central banks to reduce interest rates to unprecedented lows and to utilise unconventional policies in an attempt to stimulate growth. Even in the US, the economy which has performed most strongly since the crisis, the tightening cycle has proven shallow and interest rates appear to have reached a peak well below historical levels. Elsewhere, in the eurozone and Japan, monetary policy is yet to have been tightened again before additional stimulus is being discussed.

With interest rate cycles since the 1970s peaking at lower and lower levels (see Figure 1), there is growing concern that current central bank policy frameworks will be insufficient to deal with a further downturn.

Figure 1: A history of US interest rate cycles<sup>1</sup>



Major central banks have already experimented with unconventional policies to varying degrees (see Table 1). Beyond traditional changes in policy rates, all of the major central banks except China have utilised quantitative easing programmes, although only the Bank of Japan has taken the step of directly supporting equity markets via purchases of exchange-traded funds. Both the Bank of Japan and European Central Bank have taken interest rates into negative territory.

Table 1: Policy actions have varied between central banks<sup>2</sup>

	Policy rate	Quantitative easing	Yield curve control	Negative interest rates	Exchange rate targeting	Reserve requirements	Open market operations	Forward guidance
Federal Reserve (Fed)	✓	✓				✓	✓	✓
Bank of England (BoE)	✓	✓				✓	✓	✓
European Central Bank (ECB)	✓	✓		✓		✓	✓	✓
Bank of Japan (BoJ)	✓	✓	✓	✓		✓	✓	✓
People's Bank of China (PBoC)	✓				✓	✓	✓	

<sup>1</sup> Source: Insight and Bloomberg. Data as at 30 June 2019. <sup>2</sup> Source: Insight.

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One reason why policy rates have remained low has been inflation, which has persistently undershot central bank targets, prolonging the hiking cycle

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## THE NEXT DOWNTURN COULD REQUIRE NEW OPTIONS

### 1 Alternative inflation targets

One reason why policy rates have remained low has been inflation, which has persistently undershot central bank targets, prolonging the hiking cycle. Symmetric inflation targets could be partially to blame for this – during expansions, central banks aim for their target and generally slightly undershoot. During slowdowns, central banks again aim for their target but, at least in the latest cycle, monetary policy has been constrained by the zero lower bound. This has made it difficult to reduce interest rates sufficiently to stimulate activity to the point where inflation targets are achieved and results in inflation undershooting the target over the whole economic cycle. This situation has then been exacerbated further by disinflationary forces which are out of the control of central bank – namely disruptive technologies, easy price discovery via the rise of internet retailers, and globalisation.

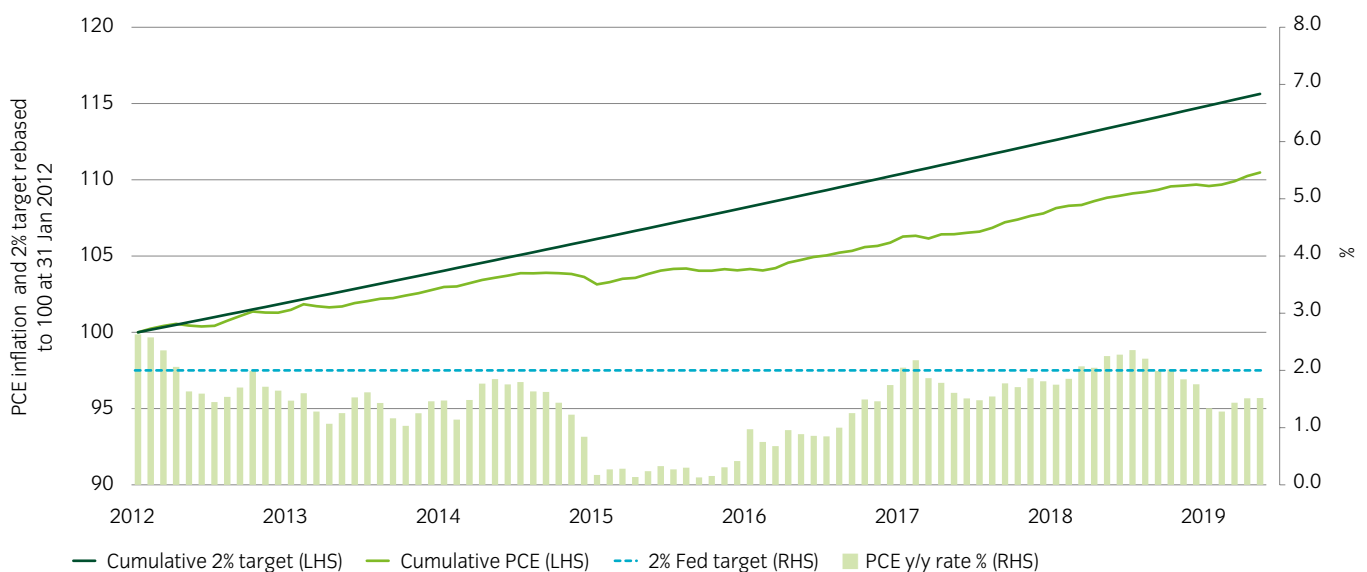
As a potential solution to this problem of persistently undershooting inflation, the concept of ‘smart’ inflation targets has entered the policy debate. Three of the most commonly discussed approaches are:

- **Price level targeting:** This model looks at inflation over much longer periods, with policy set to achieve a target over the long term. If there were a period where inflation ran below the central bank’s target for a prolonged period, then policy would be set to achieve a sufficient level of inflation to bring the overall level of prices back up to that long-term target level over time. Deviations from target are no longer forgotten, but need to be corrected over time.

There are drawbacks to this approach. If inflation undershoots the target for a sustained amount of time, the inflation rate required to reach the target price level could become damagingly high. Figure 2 below plots actual US PCE inflation prints versus the Federal Reserve’s 2% target since the introduction of the target in 2012. Persistently below-target prints have resulted in a significant gap between current and target price levels – to get back to target would clearly require an extended period of inflation well above 2%.

- **Temporary price level targeting:** Under this model, the inflation target remains at a symmetrical 2% when rates are not at their lower bound. When rates are at the lower bound, the central bank commits to not raise rates until the price level reflects a 2% inflation rate since the point when rates hit the lower bound. By committing to a medium-term price level target only during exceptional periods, it reduces the risk of dangerously high inflation rates needed to reach the target price level. It also allows central banks to ‘look through’ one-off shocks to inflation during expansions, taking a more pragmatic view of inflation. This would represent only a limited departure from the current inflation targeting framework, minimising the adjustment needed for markets and the public.
- **Average inflation targeting:** This model suggests that rather than having a single inflation target, there should be two. One should be in place during recessions and the other during economic expansions, with the idea being that the target is then achieved over an entire economic expansion. In a report issued in March 2019, Goldman Sachs research estimated that raising the inflation target to 2.2 to 2.3% during expansionary periods would be sufficient to achieve the Federal Reserve’s current 2% target over a cycle.

Figure 2: A large inflation gap has built since 2012<sup>3</sup>



<sup>3</sup> Source: Insight, US Federal Reserve. Data as at 31 May 2019.

## 2 Modern Monetary Theory

The concept of Modern Monetary Theory (MMT) has come into focus after being promoted by senior members of the Democratic Party, such as congresswoman Alexandria Ocasio-Cortez, and could become a mainstream policy depending on the choice of Democratic candidate for the 2020 presidential election. The premise is that, in economies that issue debt only in their own currency, the size of the fiscal deficit does not matter – if the central bank commits to funding government deficits, public liabilities equal central bank assets and the stock of debt becomes an accounting exercise. Fiscal policy then becomes the primary tool to stimulate the economy, with taxes adjusted to control for inflation and unemployment. Monetary policy becomes a secondary, passive tool. The extra government spending should be allocated to productive uses that reduce social inequality (as opposed to the unequal distribution of benefits from quantitative easing, which – it is argued – raise asset prices while having little effect on real incomes). Research carried out by the IMF on fiscal multipliers appears to support this argument, suggesting that in developed countries, fiscal multipliers jump to 1.5 (short run) and 3 (long run) during recessions. If accurate, it would mean that MMT-style fiscal expansion could actually lead to lower levels of debt-to-GDP ratios over time.

MMT is a controversial theory, and those that oppose it argue that it would likely fail if implemented in the real world. In Japan, the government has issued large amounts of yen-denominated debt for investment purposes, much of it bought by the BoJ, yet inflation has remained subdued. History also demonstrates that in the US, deficit spending to make up for recessions has resulted in

decades of incremental spending thereafter – resulting in the periodic need to adjust the debt ceiling. Another problem is how MMT would function if inflation accelerated to problematic levels. At this theoretical stage, it is difficult to tell if central banks would need to take policy action to counter the fiscal expansion, or if it would be possible, as proponents of MMT argue, to use taxation as a policy tool to dampen inflationary pressures.

## 3 Offsetting negative rates

One consequence of central banks taking interest rates into negative territory has been the impact on bank profitability. A significant proportion of bank deposits at the ECB are earning a negative interest rate. One way to offset this is deposit tiering. Under this system banks only start to pay interest to the central bank on reserves above a certain threshold. Below that, deposits would pay the main refinancing operations rate (MRO) which in the eurozone is 0% rather than the -0.4% deposit rate. The goal of this policy is to offset the side effects of negative policy rates on bank profitability and similar systems are already in place in Switzerland and Japan.

The ECB has started to assess the effects of negative rates given the length of time they have been in place and could well adopt a deposit tiering system once this review is concluded. The main drawback is the implicit forward guidance if tiering were introduced – the ECB would in effect be admitting that it expects negative rates for a much longer period of time, which could conflict with existing forward guidance on rates.

## 4 Macroprudential policy

Macroprudential policies have been used in certain economies in order to control certain aspects of the economy, complementing central bank policy.

- **Property:** Australia and Canada are both examples of countries which have effectively used macroprudential policies to cool house price inflation, reducing pressure for interest rate hikes which would have had a broader economic impact. These policies have included tax surcharges on foreign buyers, limits on interest-only loans and the introduction of stress tests to limit lending. These policies have proved highly effective and in Canada were instrumental in allowing the central bank to shift from a hiking bias to neutral in the first half of 2019.
- **Capital requirements:** Under Basel standards<sup>4</sup>, banks are required to hold capital in proportion to model-derived risk above a threshold. Local supervisors then have some discretion in how they implement capital buffers (to increase the threshold) and can also apply input or output limits within the risk-modelling calculations. By using Basel standards as a minimum and then varying discretionary buffers above this, it is possible to increase the efficiency with which monetary policy is transmitted into the real economy. Capital requirements can be tightened to complement rising interest rates when bank lending is growing too quickly, and loosened to complement rate cuts when a stimulus is required. The UK and Australia have applied stricter risk-modelling or lending-term restrictions to curb certain types of lending (e.g. buy-to-let mortgages) and to force banks to hold more absolute capital, while the People's

Bank of China routinely adjusts its capital requirements to complement monetary policy. The greater control that China has over its banking system and economy is possibly one reason why this policy is regarded as a more effective tool in that country. It's also easier to see how varying capital requirements can be used to tighten policy than loosen it, given that in an economic downturn banks' excess capital would be expected to shrink. The policy may help to stop banks from overly tightening lending, but would be unlikely to lead to any significant boost to lending.

## 5 Yield curve control

An evolution of quantitative easing, yield curve control commits to a price or yield target, then purchases or sells as much of the asset as required to achieve that target. For example, Japan has targeted a 10-year government bond yield of 0% and had achieved that with a high level of consistency, but it's arguable that yields would have been at similar levels even with no intervention. It is also evident that the policy has been fairly ineffective given that the Bank of Japan has consistently failed to meet its inflation target. This ineffective experience in Japan may mean that other central banks may be reluctant to attempt this, but it is certainly an option. A more likely strategy, however, would be one similar to the Federal Reserve's 'Operation Twist'. This saw the Federal Reserve sell short-term securities and buy long-term securities to flatten the yield curve, without a specific yield target.

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<sup>4</sup> Basel standards are a global, voluntary regulatory framework on bank capital adequacy, stress testing, and market liquidity risk. They are intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

## CONCLUSION

In November 2018, the Federal Reserve announced that it would be conducting a review of its monetary policy framework, with the results expected to be published by mid 2020. Some commentators believe it may change the framework to adopt an average inflation target, largely due to its relative simplicity and resemblance to current policy. Some of the policies discussed above could be utilised by any of the inflation-targeting central banks, so long as there is faith in their ability to generate the inflation required following a period of below-target inflation.

We outline which of the policies we believe are available to each of the major central banks in Table 2. It is clear from this exercise that

there is a wide variation in available policy space between the central banks.

In the eurozone there are legislative barriers to monetised fiscal expansion such as MMT. Article 123.1 of the Treaty on the Functioning of the EU has been commonly interpreted as prohibiting financing of government deficits in the eurozone. But in the US this has already become part of the policy debate. On the other hand, there are legal questions regarding whether the Federal Reserve would be allowed to pay negative rates on deposits, so negative deposit rates are unlikely in the US.

Table 2: Central bank policy options in a future downturn<sup>5</sup>

	PREVIOUSLY USED					
	Policy rate	Quantitative easing	Yield curve control	Negative interest rates	Exchange rate targeting	Reserve requirement
Federal Reserve	✓	✓	✓	✗	?	?
Bank of England	?	?	✓	✓	?	✗
ECB	✗	?	?	?	?	?
Bank of Japan	✗	✗	✓	?	?	?
People's Bank of China	✓	✓	✓	✓	?	✓
	NOT PREVIOUSLY USED					
	Alternative inflation targets	Monetised fiscal expansion	Offsetting negative rates	Relaxation of macro-prudential		
Federal Reserve	✓	✓	✗	?		
Bank of England	✓	✓	✓	?		
ECB	?	✗	✓	✗		
Bank of Japan	✗	✓	?	✗		
People's Bank of China	?	?	?	✓		

✓ Significant easing potential, ✗ Policy either exhausted or facing legislative barriers, ? Possible policy option

<sup>5</sup> Source: Insight.





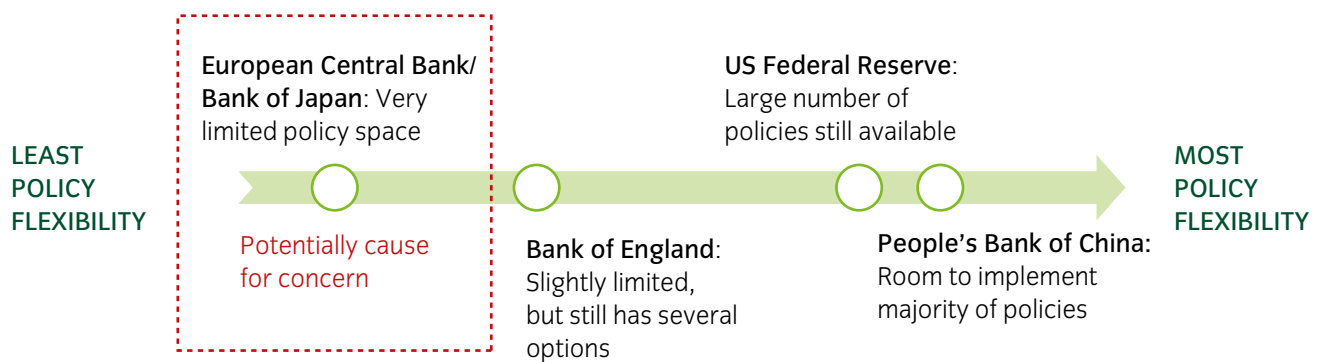
# Of the major central banks, the European Central Bank and the Bank of Japan appear the most limited in terms of future policy options



When we consider the policy options available to the major central banks, it becomes clear that the ECB and the Bank of Japan are now the most limited in terms of future policy space and this is

a growing cause for concern. The Federal Reserve and People's Bank of China have considerably more options.

Figure 3: ECB and BoJ options are very limited versus other major central banks<sup>5</sup>



<sup>5</sup> Source: Insight.

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