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Monetary policies: what is the endgame?

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Upon the conclusion of its monetary committee meeting on 29 and 30 January, the US Federal Reserve (Fed) marked a pause in the cycle of raising its key rates that it had initiated in December 2015. The question of the irreversibility of ultra-expansionary monetary policies is particularly acute in these times of a global economic slowdown.

For central banks, raising interest rates is always a perilous exercise which, in certain configurations, can cause a recession and/or a financial crisis.

Referring to the global economic slowdown and political uncertainties, upon the conclusion of its monetary committee (FOMC) meeting on 29 and 30 January, **the US Federal Reserve marked a pause in the cycle of raising its key rates that it had initiated in December 2015**. It now considers that its key rates have reached a level where they can be considered as "neutral", i.e. that they neither adversely affect nor stimulate the economy.

Since the exit, at end-2015, from the zero-interest rate monetary policy adopted in 2008 to stimulate the economy after the deepest recession experienced by the US economy in eight decades, **the Fed has raised its key rates on nine occasions**, with rates moving from a range of between 0% and 0.25% to a current range of between 2.25% and 2.5%. **In doing so, it aimed to achieve three key objectives**:

- Avoiding an inflationary drift
- Rebuilding its policy arsenal for the next crisis
- Preventing financial instability

We have long considered that inflation and unemployment moved in opposite directions, as suggested by the Phillips curve. The US unemployment rate, which peaked at 9.9% in December 2009, has since fallen sharply to 3.7% at end-2018 – its lowest level since December 1969. Hence the **potential risk of an acceleration in inflation fuelled by wage rises**. However, underlying inflation (excluding the effect of transitory shocks) currently remains remarkably contained; the Phillips curve has flattened.

Second objective of the hike in interest rates for the Fed: **obtaining the room to manoeuvre necessary to lower its rates in the event of a new recession, thereby stimulating global demand**. When interest rates are close to zero, the effectiveness of monetary policy is considerably reduced as it is difficult for central banks to reduce their rates below zero. However, with rates at 2.25%-2.5% – therefore still historically low – the Fed could find itself with too little ammunition to support economic activity during the next crisis.

The last but not least important argument in favour of a hike in interest rates is that there is a **risk that the persistently low interest rate environment fuels the next financial crisis**. Since government bonds, deemed to be safe, are not very profitable, numerous investors and financial intermediaries (investment funds, hedge funds, etc.) are turning, in order to gain returns, towards more risky securities (speculative debt, equities, private equity, etc.) whose price increases under the weight of demand. At the risk of generating disproportionate risk-taking and financial asset bubbles. In addition, ultra-low rates encourage the use of debt leverage, with the danger of an excessive accumulation of debt.

Today,

- Global growth is slowing
- The indebtedness of developed countries has never been as high
- Speculative debt (leveraged loans and high risk/high yield bonds) has exceeded the peaks reached in 2007
- There continues to be a surge in shadow banking, i.e. financial intermediaries not subject to banking regulations
- Various financial asset classes, including US equities, are, according to certain criteria (e.g. the CAPE ratio developed by Robert Shiller winner of the Nobel Prize in Economics to value equities), expensively valued

Essential in times of crisis to contain sources of financial instability and avoid a deep recession, **virtually free money in the long run substantially alters investment decisions and financial flows, with a number of undesirable effects**. Which makes the exit from the low interest rate policy even more perilous.

Anxious not to disrupt growth, the US Federal Reserve, on 30 January, upon the conclusion of its monetary policy meeting, **proved more dovish than expected**, suggesting that it was going to be patient, as long as necessary in its rate hike cycle. It will examine the economic data before deciding on the next movement in rates – upwards or downwards.

Question: can central banks exit from their low interest rate policy? Has the US and global economy become sufficiently robust to support a return to “normal” interest rate levels?

Confronted with the risks for borrowers’ solvency and the stability of the financial markets arising from a hike in their key rates, **central banks are on a knife edge**.

What is the endgame? Nobody really knows; advanced economies are currently navigating in unchartered waters. However, we can clearly see the growing disadvantages of durably maintaining ultra-expansionary monetary policies.

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