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EXECUTIVE BRIEFINGS
POLICY AND ECONOMY: GLOBAL MONETARY POLICY

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Keeping it slack

A few weeks into the Trump Presidency, bond markets in America jumped with yields spiking from 1.7% in November 2016 to 2.5% a few weeks later. Markets anticipated a reversal of the interest rate cycle, with expectations of higher economic growth driven by a combination of tax cuts and a spending stimulus. This was based on promises during Mr Trump's election campaign and subsequently reinforced by his new administration. With a rise in the payroll and falling unemployment, the United States Federal Reserve hiked interest rates by 50 basis points in two separate tranches, with prospects of further hikes during the course of the year. Economic output was expected to climb from 1.8% in 2016 to 2.9% this year.

Across the Atlantic, analysts began to convince themselves that the European Central Bank would taper its bond purchases with a fairly upbeat outlook within the Eurozone both on growth and price deflation. In Japan too, with a strong recovery in exports, economic output was expected to rise from 0.7% last year to 1.2% in 2017, accompanied by some hardening of prices. But in the months that followed a slightly different picture seems to have emerged, where underlying weaknesses of price deflation and fragility in the recovery process, remain entrenched.

Whilst the markets expect a hike in US dollar rates by the Fed in the coming weeks, they have no longer priced in sharper hardening in the rest of the year. The ECB too is moving cautiously with underlying inflation falling to 0.9% in May, far removed from a target of 2%. It must naturally be concerned as to the impact of a sudden rise in bond yields, especially on a wobbly economy like Italy, which is burdened with huge sovereign debt, a forbidding problem of bad loans in the banking system, high unemployment and puny growth. In Japan too, with inflation dropping to 0.2% in March, the Bank of Japan is unlikely to alter its tack on monetary easing in a hurry and bond purchases will continue for some time to come. With the collective balance sheets of large central banks on an expansion path, monetary policy will remain loose for a while yet or until 2019, as some analysts have now begun to believe.

In China, the world's second largest economy, the primary risks stem from large amounts of debt which rose steadily from 150% of GDP in 2007 to over 280% now. With a slowing economy and falling exports, the People's Bank of China is now increasingly cautious, clamping down on money supply to the shadow banking system, which is prone to risky exposures. Credit growth has slipped from 16% in 2016 to about 13% now with expectations of a further decline in the near term. The risks in China are heavily weighed on the downside and Fed officials together with their peers in the ECB must keep these considerations in mind before affecting radical changes in their stance.

As if in reflection of such beliefs, US bond markets have tempered their earlier flurry with yields moderating to 2.2%. Markets therefore anticipate short term interest rates to remain muted over the coming year. These developments will encourage money flows into emerging markets through the carry trade and we therefore expect greater liquidity and a marginal strengthening of currencies. The rupee, which gained 5.5% since January 2017, may rise further. This would provide some room to the Reserve Bank of India to reduce interest rates in the coming months.

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