GENERALI INVESTMENTS

# Focal Point

# Taking monetary policy to yet another level

September 17, 2020

**Christoph Siepmann, Martin Wolburg, Paolo Zanghieri**

- In its recent strategy review, the Fed formalised its shift to a structurally more accommodative policy stance. It will now target average inflation rate over a prolonged period and will consider only negative deviations from full employment.
- The low growth, low rates environment reduces the potency of the federal funds rate as an instrument, and requires a more intensive use of other tools like bond purchases. Given the expected slow rebound in inflation, we do not expect any rate hike from the current zero level before at least end-2024.
- At its recent (Sept 16) meeting, the Fed clearly stated that there will be no rake hike until the economy is at full employment and the inflation is steadily at 2%. No guidance was provided on QE are likely
- We expect the ECB to embark on additional policy measures at its December meeting. Its strategy review will likely endorse a symmetric inflation target, a higher role of underlying inflation and possibly average inflation targeting.
- Being rather at its policy limits, the BoJ concentrates on supporting fiscal policy and funding for lending.

The presentation of the new Long Term goal and strategy on August 27 marks a deep shift in the Fed's monetary policy. The new way inflation and the labour market will affect monetary policy will result in a marked downward bias to interest rates. In this piece, we assess what the new strategy, the operational detail already disclosed and compare it with the steps the ECB and BoJ have recently taken or are expected to take

## The new normal calls for less pre-emption…

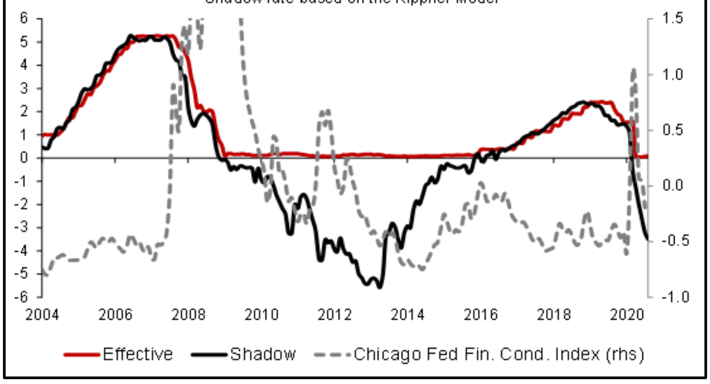
While hailed by some as a revolution, what chair Powell presented can be characterized as a way to organize and present in a coherent way the evolution in thinking occurred over the last few years. This derives from some fundamental changes in the economic landscape:

- **Trend growth is slowing down**. This and several structural factors (among which high saving over investment as population ages, strong demand for low risk assets) led to a slide in the equilibrium interest rate. This leaves the Fed with much less scope to cut rates in a recession. For example, in March, the Fed could cut the policy rate by only 1.5 points before hitting the zero bound, as opposed to the 5-point cut it enacted in 2008.
- **Inflation is lower and stickier**. The longest expansion in more than thirty years and the lowest unemployment rate in half a century did not manage to bring inflation back to the 2% target. Moreover, the responsiveness of prices to labour market conditions has declined (the Phillips curve got flatter, in economists' jargon), while the role of expectations has increased. Worryingly, expected inflation, from surveys or asset prices has trended down.

There are two main policy implications. First, the Fed funds rate has structurally a lower power in easing financial conditions (as the comparison between the current crisis and the post GFC shows), and tools formerly defined "unorthodox" will then play a bigger role.

**Federal Funds rate and financial conditions**

Shadow rate based on the Kippner Model




The most important upshot is a heavier reliance on QE and, therefore a structurally larger Fed balance sheet. With less scope for emergency rate cuts, quick and massive increases in the Fed balance sheet could become more frequent in case of market tensions. For QE to be effective, the Fed will have to own a large part of the market (or credibly commit to doing so). Currently, the Fed owns just above 20% of the total amount of Treasury's marketable debt, below the 50% owned by the BoJ. As a downside, a much bigger Fed footprint could create short-term problems to market liquidity.

Second, a “hot” labour market does not trigger a spike in inflation. On the contrary, unemployment falling much below the long-term average means a strong improvement in employment possibilities for lower-skilled workers and those belonging to racial minorities. Moreover, the concept of “equilibrium unemployment” has lost relevance as its measurement proved elusive: between mid-2015 and mid 2019 the FOMC estimate was revised down from 4.9% to 4.1% to catch up with the non-inflationary drop in unemployment

Then the Fed will no longer need to raise rates when unemployment drops below the estimated equilibrium value to avoid a subsequent increase in inflation. Rather, it will focus on maintaining maximum employment and will gradually increase rates only when data shows that inflation is persistently above the target.

Operationally, this means that the inflation target has been reframed as an average over “the business cycle”, implying that the Fed will tolerate prolonged periods of overshooting to compensate for past shortfalls. Moreover, only a negative deviation from maximum employment will matter, as overshootings are not deemed inflationary. Backward looking inflation targeting and the heavy asymmetry of the employment objective introduce a strong dovish bias in the long-term expectations for the policy rate.

## …but lack of ‘hard’ gauges requires better communication

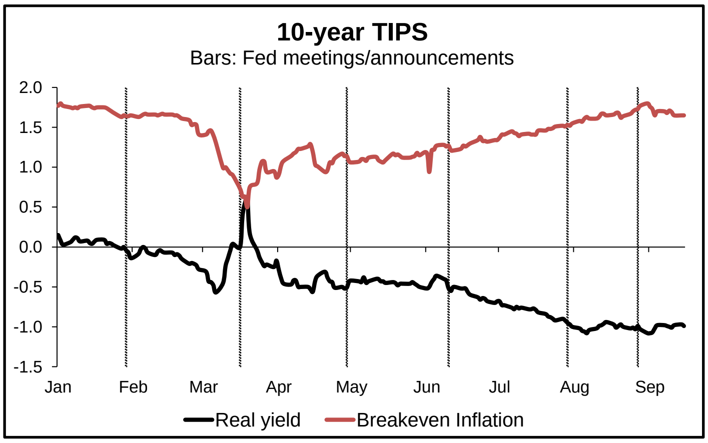
Yet, the Fed will not provide any hard estimate of neither the length of the window used to average inflation nor of what it means for “full employment”. This will allow for experimentation given the high uncertainty on the long run trends of the economy. This high degree of flexibility risks making it more difficult to form the expectations that are a crucial driver of inflation.

FOMC members are certainly aware that, as former chair Bernanke said, “Monetary policy is 98% talk and 2% action”, and our guess is that over the coming months the Fed and economic agents will engage in a mutual process of learning. The first signs are encouraging. Since the August 27 presentation by Powell, the increase in long-term expected inflation taken from Treasuries (while still low) has gathered speed, whereas the steepening of the yield curve has been minor, also due to QE. Given the gap between the consumption deflator used by the Fed to gauge inflation and the CPI considered by inflation-linked bonds, the breakeven rate will have to stabilize around 2.3%-2.5% to have confidence in the correct anchoring of expectations. However, by focussing too much on meeting expectations embedded in financial prices, which sometimes diverge widely from fundamentals, the central bank could end up in a (to quote again Bernanke) “hall of mirrors” between market expectations and hints from the central bank, possibly leading to poor macroeconomic outcomes. Guidance is still needed.

In the September 16 meeting the Fed offered more clarity on how to implement the new strategy. The policy rate will remain at the current 0% to 0.25% level until the economy is back to full employment, inflation has reached 2% and is showing signs of overshooting; the economic projections do not foresee any rate increase before the end of 2023. Anyway, monetary policy will remain accommodative until expectations are firmly geared to 2%. Chair Powell stated clearly that the FOMC will resist any urge to disclose or hint at a mechanical rule for rate setting.

On QE, the focus has shifted to providing more accommodation rather than avoiding a liquidity crunch, but the Fed has not indicated any change in the pace and composition of bond purchases. Easier financial conditions can be achieved by an extension in the duration of purchases. Capping the yield in some segments of the curve remains among the possibilities; however, it is doubtful whether committing to cap the short end of the curve would improve much on what the Fed has already achieved. For example, convincing investors that the policy rate will not move from the current 0%-0.25% band for the next two years is equivalent to capping the yield of the 2 year Treasury at the current 0.14% and involves a much less direct and distortionary intervention in financial markets.

So far, the bond market is responding to monetary policy in the way the Fed is wishing, as real rates are trending down and inflation breakeven are rising. Therefore, the FOMC is for the time being unwilling to commit to other pre-emptive measures unless there is a material deterioration in the economic outlook.




## Fed’s next rate hike no earlier than in 2024

The real test to the new strategy will not occur soon. Simulations with the Fed FRB/US econometric model show that, given the projections for employment and inflation, the first rate hike is unlikely to occur before the end of 2024. An extended period of very low rates may raise concerns about the possible weakening of financial stability and the risk of inflation eventually spiking out of control.

The combination of a low neutral (and therefore short term) rate, a flat Phillips curve and low underlying inflation can lead to increased risk taking and overleverage, also as a consequence of the compression of the long end of the curve induced by QE. The background analysis published by the Fed together with the new strategy acknowledges the risk, but reckons that they are not big. First of all the research on the financial crisis shows that the contribution of policy rates to financial vulnerabilities is minimal. According to econometric estimates, a 100 bps reduction in the general level over a long horizon of rates increase house prices by 2 to 4 percentage points, lift stock prices by no more than 5 pp and compress corporate bond spreads by 20 bps. The order of magnitude of these changes is relatively small compared to the price swings that preceded crises. Search for yield may weaken the quality of intermediaries balance sheet, but this may be a temporary phenomenon as old commitments based on high rates mature, being replaced by less onerous ones; moreover, recent research shows that lower rates reduce the shift of intermediation to the less regulated non-bank system.

Average inflation target is untested so there is no evidence on its impact financial stability. Arguably, fragilities may emerge only in the make-up period, when inflation is above target and rates have yet to increase, so it is not a problem for the time being. The inclusion of credit among the assets the Fed is now allowed to purchases, thanks to the capital provision by the Treasury, raises additional issues. It is not clear how quickly and easy the Fed may exit the program without creating trouble given the possible fragility of an overleveraged non-financial sector.

On inflation, while the short-term impact of the COVID crisis is definitely deflationary, what happens in the medium /long term is less clear-cut. A resurgence of inflation when the economy is not yet at full employment would leave the Fed in an awkward position. Yet the most frequently cited long term upside risks for inflation are related to the supply side of the economy (deglobalisation, lower potential growth, tighter labour market regulation, etc.. An adverse supply shock likely slows down growth in addition to rising inflation, and therefore tighter rates may be in the end counterproductive. Supply hurdles will have to be tackled with other policy tools and not by the central bank.

## ECB: back to pre-Covid-19 inflation path

The low inflation environment has been challenging the ECB for about a decade. The launch of QE in 2015, ample liquidity provision, credit support measures (LTROs, TLTROs) as well as regulatory easing has helped to prevent deflation and to stabilize inflation. But the ECB has been consistently missing its inflation target of "*below but close to 2%*" since 2013. Since the start of EMU in 1999 annual inflation averaged 1.7%, over the past decade it was only 1.2%. It now stands at -0.2% yoy and markets expect it to average only 0.7% yoy over the coming five years.

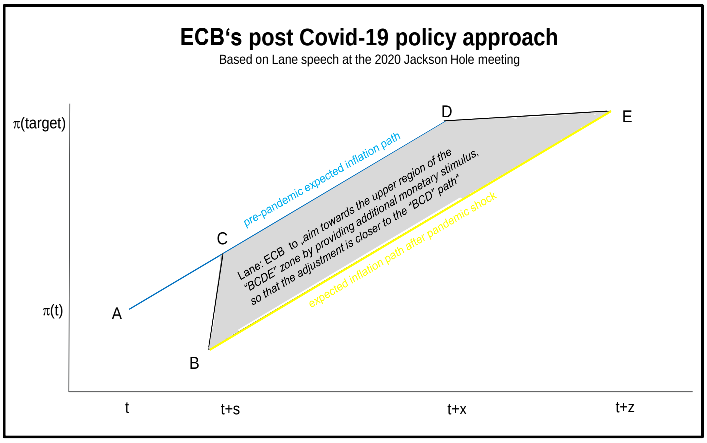
Already before the Covid-19 shock (referring to the December macro projections) the ECB had expected inflation of 1.6% by 2022, clearly below target. The Covid-19 shock was a setback in the fight for higher inflation given its disinflationary nature. The ECB responded among others by means of additional QE. According to ECB Chief Economist Lane these measures "*are projected to increase output by around 1.3 percentage points and inflation by around 0.8 percentage points cumulatively between 2020 and 2022*". But according to the September 2020 ECB staff projections inflation is set to rise to just 1.3% by 2022 and sees core inflation at 1.1% by then.

In its recent Jackson Hole speech Lane made clear that the ECB was not willing to accept the Covid-19 induced inflation trajectory due to a slower recovery because of higher real rates and the risk of lower inflation expectations becoming entrenched. The upshot is that he thereby indirectly paved the way for further stimulus measures. Moreover, the exchange rate development came on the ECB's radar screen given the latest EUR appreciation. It gained strongly, against the USD (+6% since early March) as well as on a trade weighted basis (broad definition, + 5.5% since early March). While the ECB – as a responsible central bank – clearly does not target the exchange rate directly it cannot ignore its disinflationary impact, something which President Lagarde also emphasized in the Q&A of the September press conference.

Bottom line, while we do not look for policy announcements at the October meeting this is likely to come in December. An extension of the PEPP in terms of size (of currently € 1350 bn) and duration (currently until June 2021) seems most likely to us. A protracted, dynamic EUR appreciation could even trigger measures reducing short-term rates meaningfully, e.g. a rate cut.

## 2021 strategy review to reflect low inflation world

Beyond that the ECB formally launched the review of its strategy, which it last modified in 2003, on 23 January 2020. The conclusion of the strategy review has been postponed from the end of 2020 to mid-2021 owing to the coronavirus pandemic. The ECB workstreams cover a wide range of topics, from climate change to the definition of price stability. With ECB officials having emphasized the disinflationary nature of the macroeconomic current environment and the need to push inflation higher we think that the ECB will follow the Fed in redefining its policy objective. We see a very high probability that the inflation objective will be symmetrically defined around 2% and no more as "*below but close to 2%*". Moreover, in the outline of its forward guidance underlying inflation gained a more prominent role. We would not be surprised if this was also reflected in the formulation of the inflation target.




Likewise, the ECB – as also other central banks – is concerned about inflation expectations becoming stuck at low levels. To address this issue there is a good chance that the ECB will follow the Fed and also embark on some form of average inflation targeting. Summing up, we see the ECB adjusting its strategy towards a low inflation world implying more policy support in the years to come than would be the case under the present strategy.

## Bank of Japan rather at its policy limits

The Bank of Japan (BoJ) currently faces three major issues:

- Firstly, the effects of the sales tax hike from 8% to 10 % on October 1, 2019 which pushed the economy into recession.

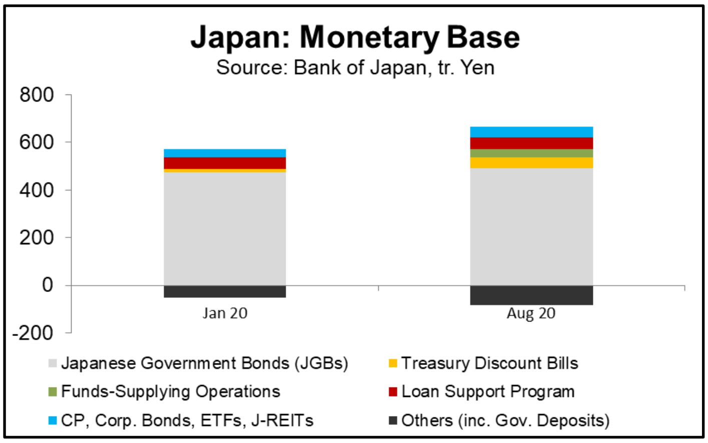
- Secondly, the Covid-9 crisis coming with the need to further support the economy and bridge financing of firms and
- Thirdly, the step-down of PM Abe, begging questions regarding the future of Abenomics.

As widely expected, the sales tax resulted in a drop of GDP in Q4 2019 by 7% qoq annualised (ann) which narrowed to -2.5% qoq ann Q1 2020. Thus, Japan was already in recession before the Covid-19 crisis hit the economy which additionally diminished GDP by another 28.1% qoq ann in Q2 2020.

Nevertheless, the BoJ did not change its monetary policy fundamentals, i.e. its yield curve control policy with a short-term policy rate of -0.10% and the 10-year Japanese Government Bond (JGB) yield target at "around" 0% (+/- 20 bps). In comparison, the BoJ looks in a much weaker position than its major central bank peers. After years of massive money expansion (the monetary base is now at 104% of GDP) the BoJ is now considered by many market participants as close to or at its limits. Accordingly, support for the economy has necessarily shifted back to fiscal policy. The government announced (on top of measures to buffer the negative impact of the sales tax hike) two packages with headline numbers adding up to about 43% of GDP and effective government spending of around 10% of GDP. Speculations about a third package have gained momentum of late. The BoJ responded to this shift in policy drivers by scrapping its formal limits on JGB purchases of ¥80 tr per year (although the BoJ undershot this limit by far of late). Implicitly, by scrapping this limit the BoJ signalled that it will absorb all government bond issuance that could get in the way of maintaining its yield curve targets. Clearly, the BoJ moved closer to "helicopter money", understood as financing fiscal programs by money printing.

That said, while the BoJ did not change the fundamentals it injected liquidity/credit and initiated a series of new fund supplying operations (complementing the government's economic support programmes). In one scheme, set up in March the BoJ lends cash to banks against their lending to the private sector against collateral (funding for lending). In April the range of eligible collateral was widened to private debt in general, also including household debt. Moreover, a positive interest rate of 0.1% was introduced for the refinancing of loans given by banks to the private sector under this scheme. Thus, banks face an effective negative interest rate. Qualitatively this is similar to the TLTROs provided by the ECB. Given the yield environment, this sweetener proved very successful. According to press reports, banks rushed into the program. Loan growth increased from just 2% yoy in January 2020 to 6.7% yoy in August. The amount matches the small portion of bank deposits at the central bank on which the BoJ applies its negative policy rate (within its three tiered system). Markets tend to see this move as more ground-breaking as just a Covid-19 emergency measure. Instead, it is considered as undermining the case for a negative interest rate policy. It looks like a means to support lending growth without jeopardizing esp. smaller regional banks and thereby contribute to the stability of the financial sector. Clearly, the rise in loans is not only due to the BoJ policy but stems from the need to bridge Covid-19 induced liquidity issues. Nevertheless, the BoJ would find it hard to ignore its success. Thus, in a wider interpretation the policy move could signal that the BoJ secretly allows the hollowing out of its negative interest policy.

Finally, former Chief Cabinet Secretary Yoshihide Suga, 71, who, has been Abe's "right hand" over the last eight years, was elected Japan's new PM. He is considered to guarantee continuity, as in his previous role, he largely co-authored this policy approach. Accordingly, we expect Abenomics to broadly continue. This also implies that the extremely loose monetary policy stance of the BoJ will be maintained. Governor Kuroda replaced his predecessor due to his support for Abenomics. Moreover, we continue to see fiscal policy in the lead while monetary policy is likely to guarantee the smooth absorption of fiscal debt. We do not expect the BOJ to change its fundamental policy approach while new bouts of Covid-19 could well lead to fresh extensions of fund supplying measures by the BoJ..



# Imprint

| | |
|---|---|
| **Issued by:** | **Generali Insurance Asset Management S.p.A. SGR, Research Department** |
| **Head of Research:** | Vincent Chaigneau (vincent.chaigneau@generali-invest.com) |
| **Head of Macro & Market Research:** | Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com) |
| **Team:** | Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)<br>Elisa Belgacem (elisa.belgacem@generali-invest.com)<br>Radomír Jáč (radomir.jac@generali.com)<br>Jakub Krátký (jakub.kratky@generali.com)<br>Michele Morganti (michele.morganti@generali-invest.com)<br>Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)<br>Dr. Martin Pohl (martin.pohl@generali.com)<br>Dr. Thorsten Runde (thorsten.runde@generali-invest.com)<br>Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)<br>Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)<br>Guillaume Tresca (guillaume.tresca@generali-invest.com)<br>Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)<br>Paolo Zanghieri, PhD (paolo.zanghieri@generali.com) |
| **Head of Insurance and AM Research:** | Michele Morganti (michele.morganti@generali-invest.com) |
| **Team:** | Raffaella Bagata (raffaella.bagata@generali.com)<br>Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com)<br>Mattia Mammarella (mattia.mammarella@generali-invest.com)<br>Roberto Menegato (roberto.menegato@generali.com)<br>Giovanni Millo, PhD (giovanni.millo@generali.com)<br>Antonio Salera, PhD (antonio.salera@generali.com)<br>Cristiana Settimo (cristiana.settimo@generali.com)<br>Federica Tartara, CFA (federica.tartara@generali.com) |
| **Sources for charts and tables:** | Thomson Reuters Datastream, Bloomberg, own calculations<br>Version completed: see front page |

**In Italy:**
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Via Niccolò Machiavelli, 4
34132 Trieste TS, Italy

**In France:**
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

**In Germany:**
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

**www.generali-investments.com**