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SPECIAL ISSUE

Policy Rates Opinion Compendium: Impact on Global Growth

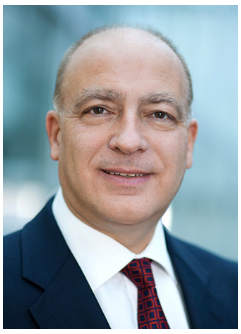
May 2015

Prof. Jagjit S. Chadha

Your entry to in-depth knowledge in finance

Marketing Material

Message from Phil Poole



In the years following the financial crisis, the European Central Bank (ECB), the US Federal Reserve Board (the Fed), the Bank of England (BOE) and the Bank of Japan (BOJ) broadly kept step in a synchronized pattern of low policy rates and, to one degree or another, additional "extraordinary" monetary measures such as quantitative easing. But things are changing and in 2015 monetary policy from major central banks looks set to diverge.

There has been an economic upswing led by the United States, but the pace of economic growth has not been uniform across the globe, leading to speculation about how monetary policy will play out differentially in the coming months and years. This leads us to ask the question of not only when but where policy rates will begin to normalize and what the implications will be for the global economy, financial asset prices and major currencies.

To offer investors a truly well-rounded, insightful perspective on this topic, I have launched an opinion compendium project together with Deutsche AWM. The compendium will tap the expertise of our key investment experts, product specialists and leading academics from the University of Cambridge and University of California at Berkeley, including New York Times bestselling author Professor Barry Eichengreen.

Deutsche AWM will publish a series of concise articles on this topic over the coming months, studying the global monetary policy story as it unfolds. It will approach the topic from three primary angles: 1) "How low for how long?", 2) "What will be the impact on global growth?", and 3) "How will financial asset prices respond?"

This particular piece is by Professor Jagjit Chadha from the University of Cambridge and University of Kent. He addresses probably one of the most over arching questions about the effects of normalising policy rates - how will it impact global growth? Prof. Chadha discusses this topic in light of Europe's recovery from the financial crisis.

I am very pleased to be collaborating with these leading international experts, both external and from within our own organisation, on this very relevant and timely topic.

Kind regards,

Phil Poole
Managing Director, Global Head of Research
Deutsche Asset & Wealth Management

Phil joined Deutsche Asset & Wealth Management in January 2014 with 30 years of industry experience. Prior to his current role, Phile was a managing director at HSBC, where he served as Global Head of Macro and Investment Strategy for its Global Asset Management business, preceded by a period as Global Head of Research and Chief Economist for Emerging Markets on the sell-side. Prior to HSBC he worked in senior sell-side research roles for Barings / ING Barings, and Barclays.
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Jagjit S. Chadha is Professor of Economics at the University of Kent, and Visiting Professor at the Faculty of Economics at the University of Cambridge. He was previously Professor of Economics at the University of St Andrews and a fellow at Clare College, Cambridge. He was trained at University College London and the London School of Economics and then moved to the Bank of England as an official working on monetary policy.

He has also spent some time as Chief Quantitative Economist at BNP Paribas. His research involves incorporating financial factors into macroeconomic models and he has acted as an advisor to many central banks throughout the world. He is also editor of the series Modern Macroeconomic Policy-Making by Cambridge University Press. He has published papers in many leading economics and finance journals.

What will be the impact on global growth?

Prof. Jagjit S. Chadha
May 2015

Could rising rates choke off the recovery or have post-crisis wounds healed sufficiently for the global system to take tightening policy in its stride?

Everybody seems to agree on the need for full employment and price stability. These twin objectives leave central bankers with a perennial dilemma when managing an economy: act too soon and prevent the attainment of full employment or act too late and damage price stability. It is less a matter of disagreement over objectives but one over the drawing of a fine line – one may even say precipice - for the correct path of interest rates. The terms of this trade-off are high in normal times but after a seven year famine in new economic activity, it is particularly challenging as growth needs to be nurtured but in some parts of the financial system, buoyed by ultra-accommodative policy, asset prices look elevated and risks may be building up in an acceptable manner. The problems facing the Fed are even more extreme as it is faced with not only setting out its plans for the policy rate as it moves back into more normal territory but also explaining to the domestic and foreign holders of US bonds how asset purchase operations will be reversed and gauging the likely impact on overall monetary and financial conditions.

In normal times, economic agents may be to deal with economic and financial shocks in a reasonable manner so that their actual decisions on matters such as consumption, investment and financial asset accumulation do not alter too much from what would have been their optimal levels in the absence of shocks. But in abnormal times, such as the ones through which we are currently living, an economy may become much more vulnerable to shocks as some of the normal mechanisms that help stability may be impaired. During the global financial crisis, financial markets and households have both undergone a prolonged period of deleveraging that prevented much of the normal smoothing of activity in response to shocks but also limited the extent to which capital has been recycled to new firms and acted to limit growth itself. Fiscal and monetary policies were also exhausted as public debt levels approached peacetime peaks and interest rates were bound to zero. The main policy lever to offset this prolonged deleveraging was asset purchases that increased private sector liquidity, helped reduce long term interest rates and shortened the maturity of government debt obligations held by the non-bank financial sector. The cessation and likely reverse of these purchases that will accompany any normalisation of interest rates, has itself been the cause of much of the increase in financial market volatility. And a mistake at this crucial transition time might plummet us back into a crisis from which escape would become even more difficult.

That said, it seems to me that the prospects for global growth are reasonable and the recovery in many parts of the Atlantic economies is advancing well. But two main risks will ensure that policy makers and growth will continue to emerge tentatively from this long hibernation. First, the Euro Area has entered another phase of crisis on which many paragraphs have already been spilled but will require lower rates for longer than previously anticipated. Secondly, emerging market firms and sovereigns have issued record amounts of local and foreign currency denominated debt securities in past few years, benefitting from a global search for yields, but if yields start to rise in the US, these new borrowers become vulnerable to deteriorating global funding conditions for emerging markets and exchange rate volatility. For that reason, we observe that even though financial markets do expect some tightening in the States compared to the Euro Area, even in two years' time both sets of rates are still likely to be low by historical standards.

The former general manager of the BIS, Andrew Crocket once said that "[t]he received wisdom is that risk increases in recessions and falls in booms. In contrast, it may be more helpful to think of risk as increasing during upswings, as financial imbalances build up, and materialising in recessions". As well as the build-up of risk in the upswing, in this deep and extended recession, there have been material increases in risk from the recession itself as the financial structures have been distorted by prolonged accommodative monetary policy. Like the wish for full employment and price stability, we all agree that interest rates must normalise. But it is only when we can be sure that the economy will respond in a normal way that we can get interest rates back to normal. Even though the foundations for robust growth are in place, they are not so soundly set that we can risk anything other than cautious, small steps in monetary policy and what may seem, by the normal metric, a continuation of accommodative policy.

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