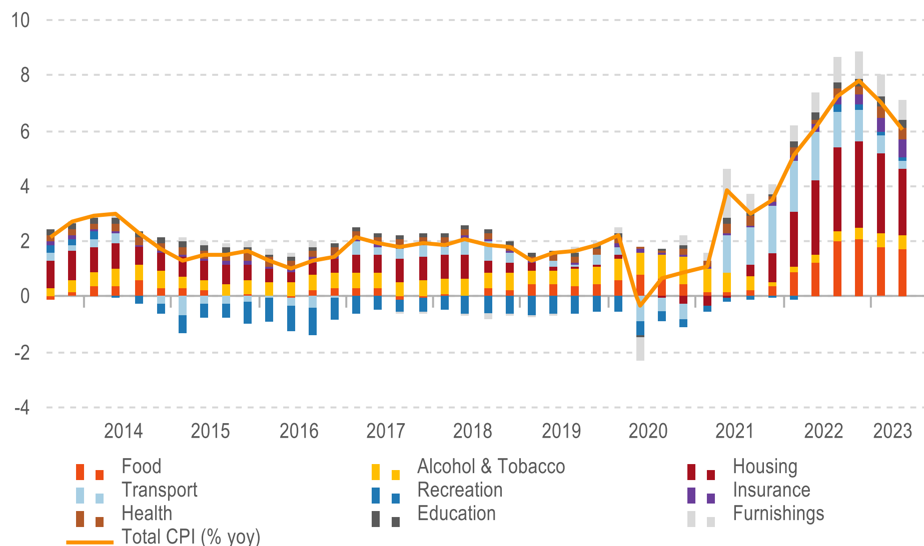
Global monetary policy

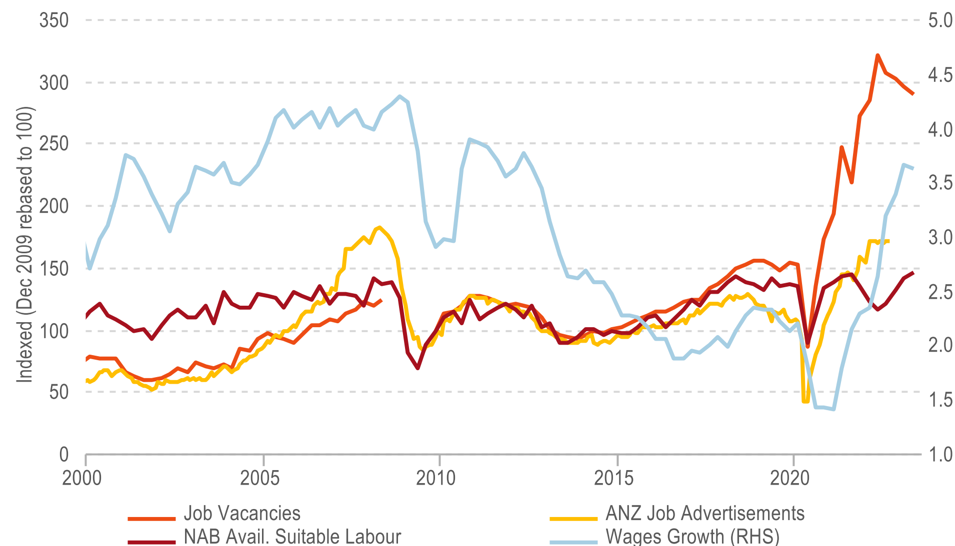
August 2023

Frontier
Advisors

Australia monetary policy



Source: Refinitiv Datastream



Source: Refinitiv Datastream

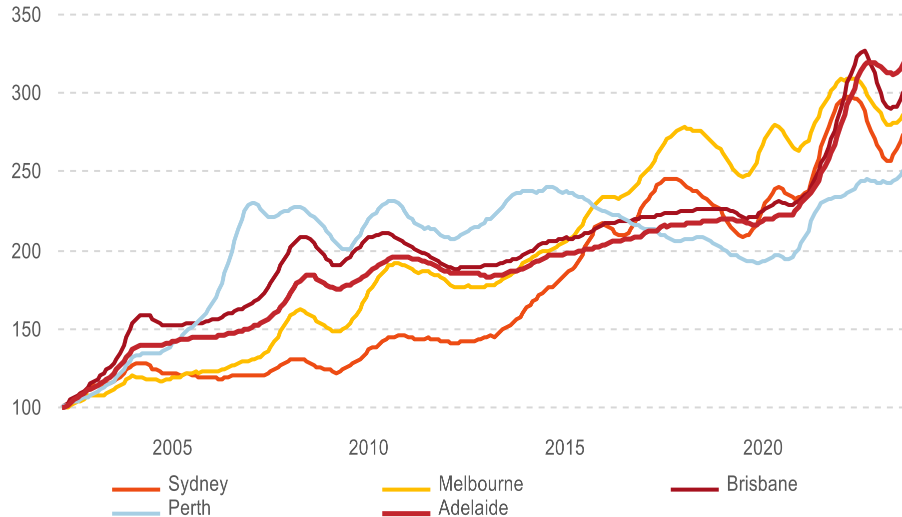
The Reserve Bank of Australia left the cash rate unchanged at 4.1% at its August meeting, extending the pause in July.

On the decision to extend the pause, the Board recognised two key factors: the significant increase in the cash rate (by 4 percentage points since May 2022); and the uncertainty in the economic outlook. These considerations prompted the decision to hold the policy rate at its current level. The Board also noted the pause will provide further time to assess the impact of delivered rate increases.

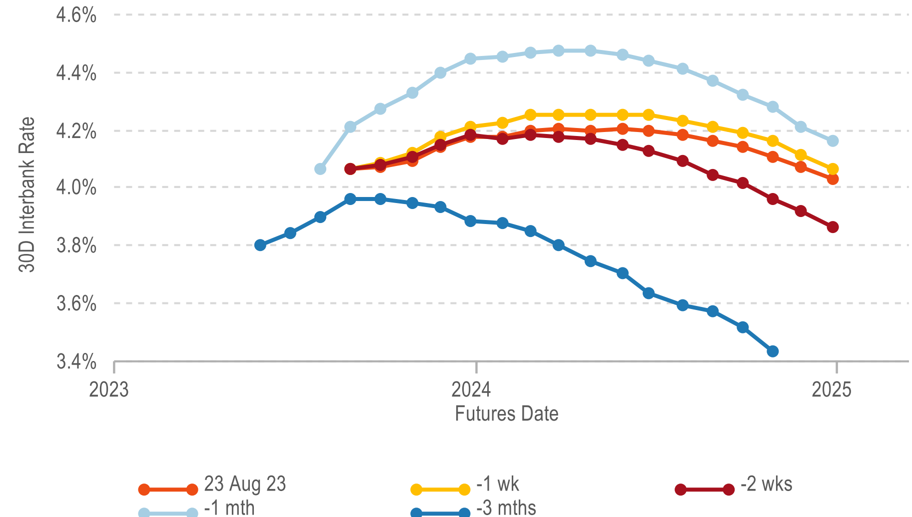
While inflation was moderating and is expected to continue declining, at near 6%, it remained very high, noting the rise in services and rent prices. The Board also noted the persistence in services inflation observed in overseas markets could occur domestically and the uncertainties linked to firms' pricing decisions and wages in the context of a slowing economy amid a tight labour market.

The Board has retained the position that "some further tightening may be required", contingent on how the economy and inflation evolve. There are some signs of moderating economic activity. Aside from moderating inflation, investment has remained weak, and there is some loosening in labour market conditions, which could ease some pressure on wages in the short-term. However, the inflation outlook remains uncertain because of the strength in services demand; strong employment conditions; housing market imbalances; steady return of immigrants; and higher house prices and higher deposit rates benefitting a sizeable share of households with no outstanding debt.

Australia monetary policy



Source: Refinitiv Datastream, ABS, CoreLogic from 2014



Source: Refinitiv Datastream

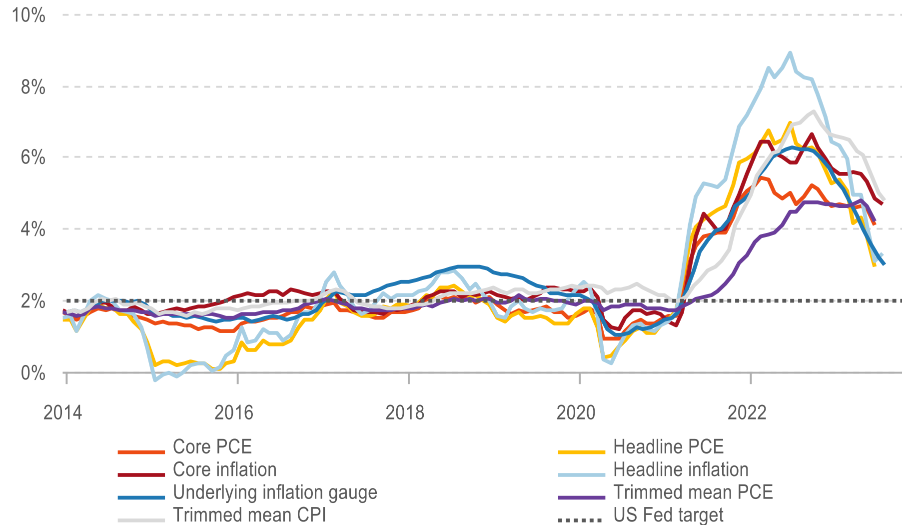
The impact of interest rate increases via the asset price channel has been mixed. While house prices declined through most of the rate hiking cycle in 2022, prices started rising since February amid housing supply shortage; returning immigrant demand; notable occurrence of cash purchases; and expectations around the end of the RBA's rate hiking cycle. The expectation is that higher borrowing costs will, on balance, constrain housing demand in this phase of the monetary cycle. However, some of the lags in cyclical adjustments and supply-side elements add uncertainty around the transmission of higher interest rates through to consumer prices.

The RBA's August policy decision does not appear to be a material change in policy, with the RBA likely to maintain restrictive policy rates in the short-term to control inflation.

There is limited evidence of a significant deterioration in debt serviceability at an aggregate level. But the fallout from expiring fixed-rate loans, particularly on households with less resilient cashflows, could surface over the next few months. A significant increase in mortgage or financial stress from overtightening, or a sharp deterioration in employment, are pertinent risks which could limit the scope and pace of future monetary tightening.

Market expectations have changed since July. Effectively, the market expectation is for a lower terminal cash rate of 4.2%, but for the cash rate to peak in the first quarter of 2024, and that the RBA will likely switch to cutting rates toward the middle of 2024.

US monetary policy



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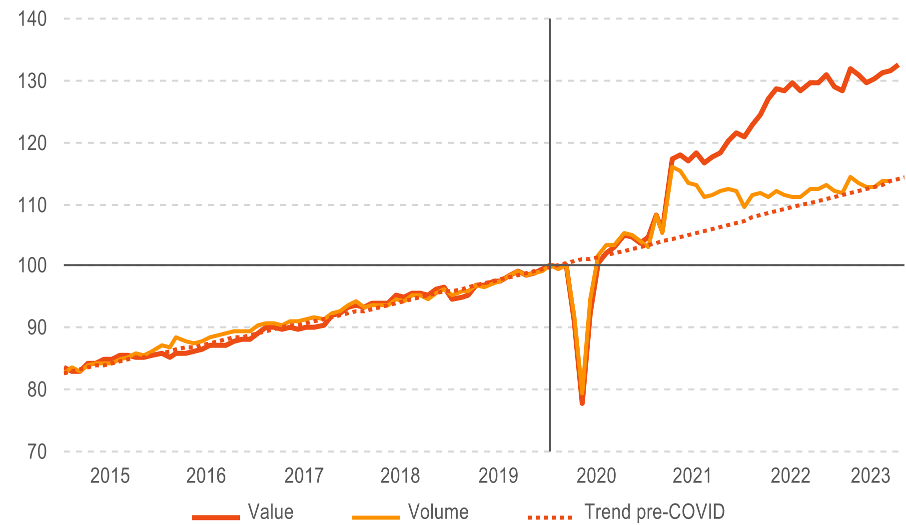


Source: Refinitiv Datastream

The Federal Reserve raised the policy rate by 25-basis points at its July meeting. This has lifted the policy rate target range to 5.25% - 5.50% – taking the Fed funds rate to its highest level in 22 years.

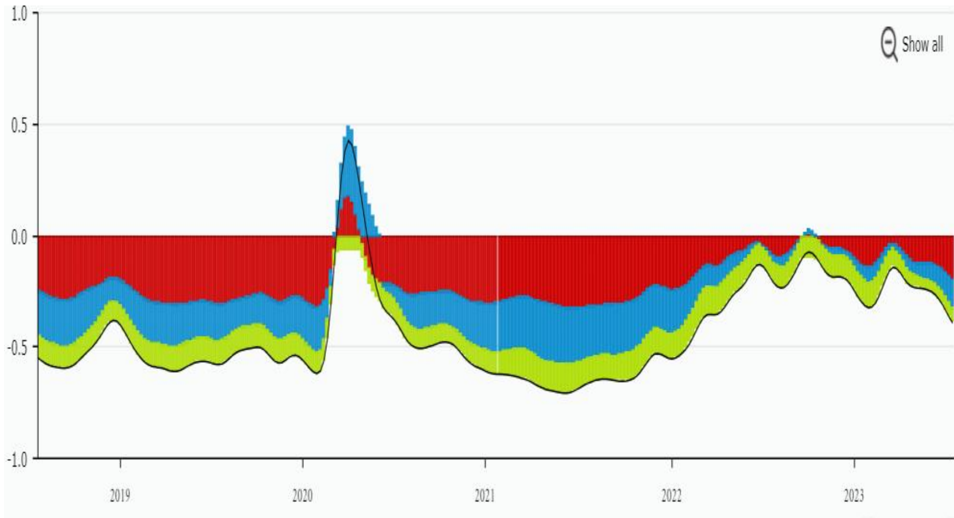
The Board reiterated its focus on taming inflation risks, noting economic activity is expanding at a moderate pace, but job gains have been robust over this period. It acknowledged tighter credit conditions are likely to weigh on economic activity, but the extent of its effects remains uncertain.

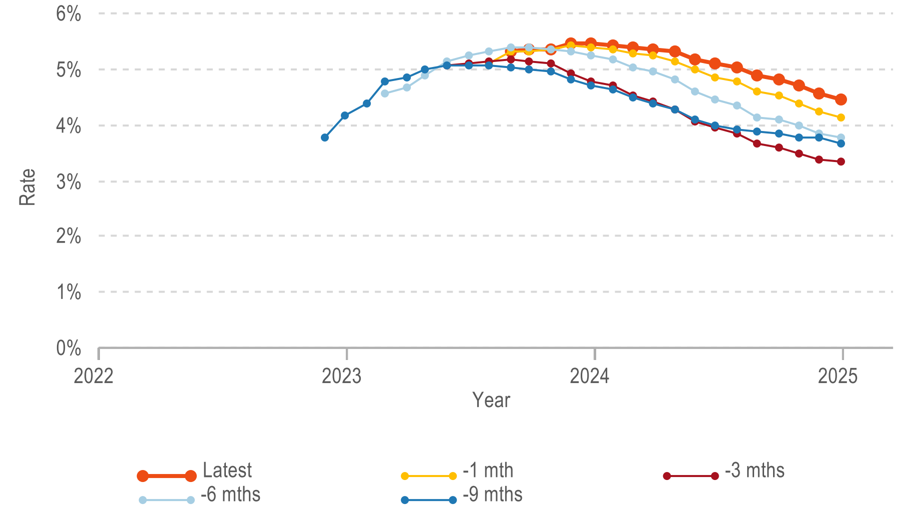
The statement issued in July maintained the potential for additional tightening in the future. It appears the Fed's monetary policy path will continue to be guided by incoming data on the labour market, household spending and related economic parameters.

The July decision may be surprising to some participants, particularly as annual consumer inflation eased materially to around 3% since June. While the headline rate appears to have eased significantly relative to a year ago, prices increased over the month (in June and July) and discretionary spending was still positive.

There are limited signs of a broad-based weakening in underlying demand. Although consumer spending is moderating, sales volumes have eased to around trend growth. Total employment has remained strong, continuing to support household consumption, and home activity picked up, with house prices rising in recent months.

US monetary policy



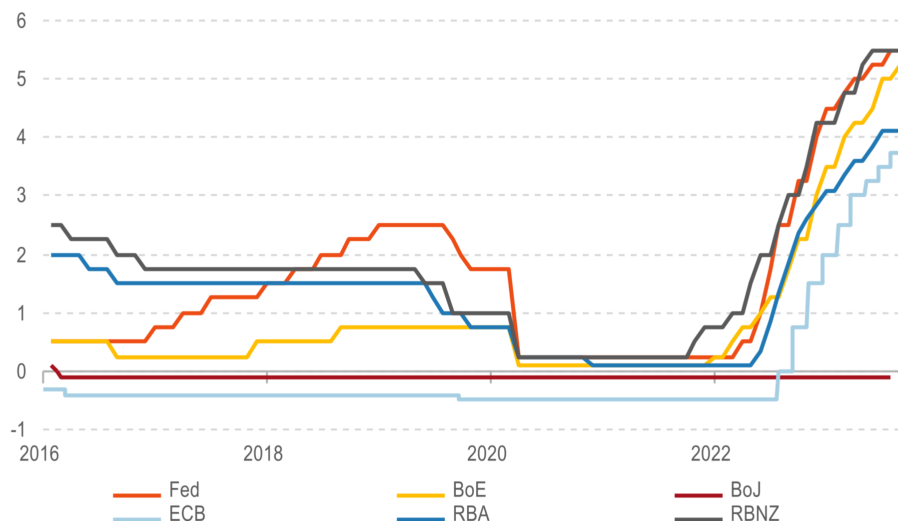


Bank lending standards have significantly tightened following the Fed's rate increases since last year. However, market-based measures of financial conditions suggest aggregate financial conditions continued to ease through early July. If the current market performance holds up, reflecting limited pricing of risk, it is possible financing conditions facing US businesses stay less restrictive than intended by the current monetary policy stance.

The Fed will be cautious as it balances inflation risks against overtightening risks, especially as the extent of structural weakness is not known. Current macro conditions still favour maintaining restrictive policy settings over the next few months to prevent a resurgence of inflation.

Markets expect the Fed to start cutting rates from the first quarter of 2024.

Japan monetary policy



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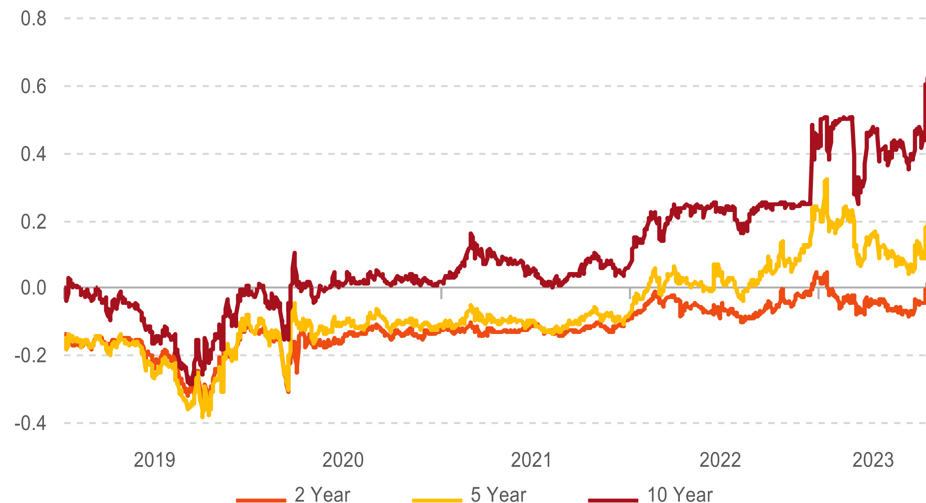


Source: Refinitiv Datastream

In a surprise move, the Bank of Japan loosened its yield curve control (YCC) at its July meeting. The BoJ said it will continue to allow the ten-year government bond yield (JGB) to fluctuate between +/- 50 basis points from the 0% target level, while conducting YCC with "greater flexibility" around the reference range. The BoJ will offer to purchase the ten-year JGBs at 1% through fixed-rate operations. This move effectively raises the central bank's tolerance by another 50 basis points.

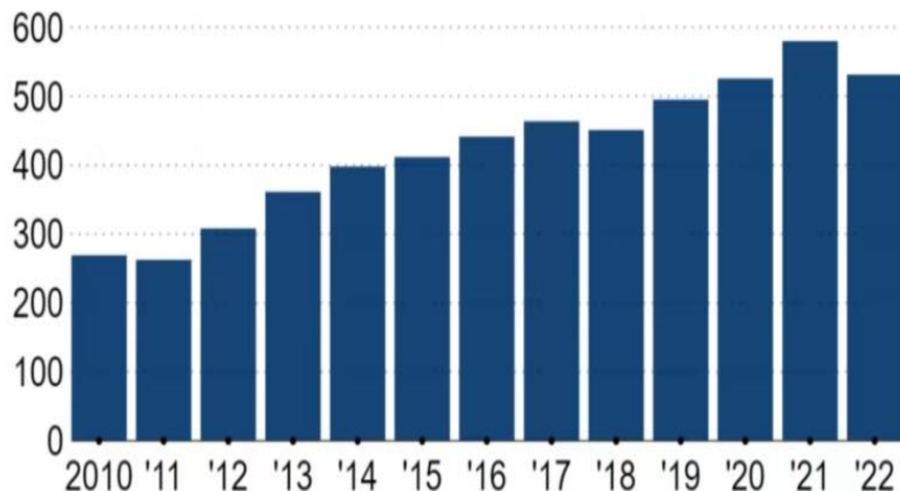
This is the second policy tweak by the BoJ, following the December 2022 decision which raised the tolerance range for the variation in ten-year JGBs from an initial range of +/- 25 basis points. The short-term interest rate target was left unchanged at -0.1% at the July meeting.

In its pledge to conduct YCC with "greater flexibility", the BoJ reiterated the need to remain nimble, given extremely high uncertainties for Japan's economic activities and prices. The BoJ governor said the step was intended to ensure the sustainability of YCC and not one intended toward normalisation of policy.

The BoJ's adherence to accommodative monetary policy at a time when global central banks have tightened interest rates has required the former to significantly increase its bond purchases to keep long-term interest rates low. This has caused the Japanese Yen to significantly depreciate against major currencies since 2022. The Japanese Yen surged, briefly appreciating by up to 1% against the greenback to ¥138.8 per USD following the announcement. But it reversed gains subsequently to settle at ¥145.4 per USD by 18 August amid cautious market sentiment.

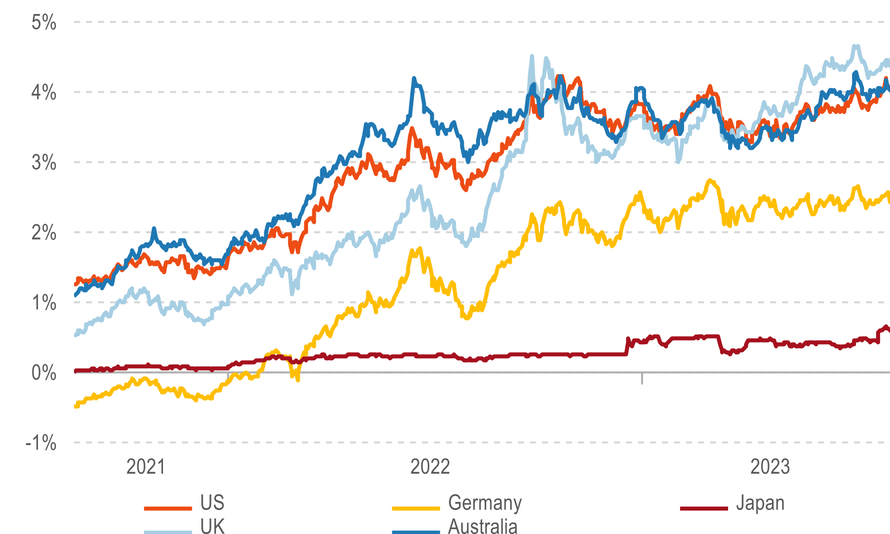
Japan monetary policy

Japan Overseas Portfolio Investment (¥ trillion, year-end)



Source: Ministry of Finance, Japan

10 year government bond yields to 22 Aug 2023



Source: Refinitiv Datastream

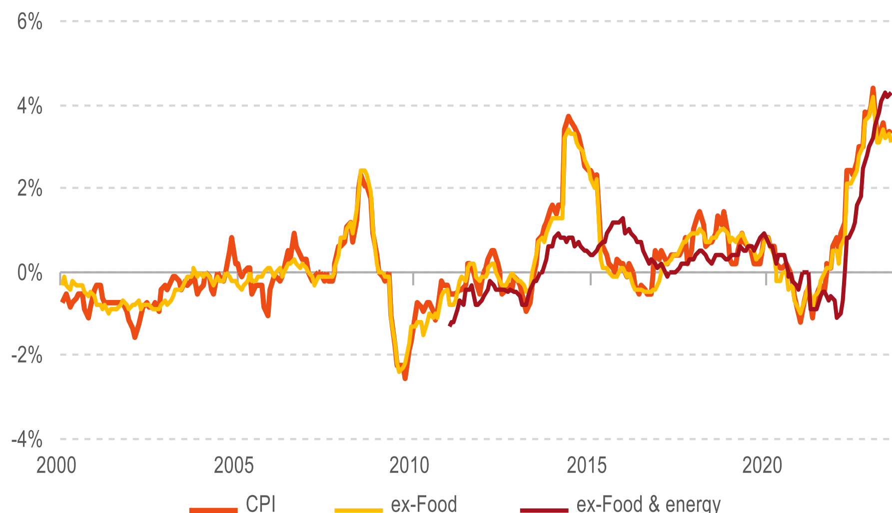
The prospect of higher JGB yields can have implications for global policy. Years of low domestic interest rates have driven Japanese investors to progressively increase their overseas investments. Japanese investors are now the largest foreign holders of US government debt and also hold European debt.

Higher yields on JGBs (less the exchange rate risk), if sustained, can increase the relative attractiveness of domestic bonds and potentially cause a repatriation of funds back home and thereby risk putting upward pressure on global interest rates.

The ten-year JGB yield rose following the decision and briefly hit 0.65% on 31 July – the highest level in nine years. A BoJ intervention to slow the yield spike has seen the ten-year yield recede since then to settle at 0.63% by 18 August.

The BoJ's management/tolerance of increases in the JGB yields will be important in determining the extent of spillovers on global bond yields.

Japan monetary policy



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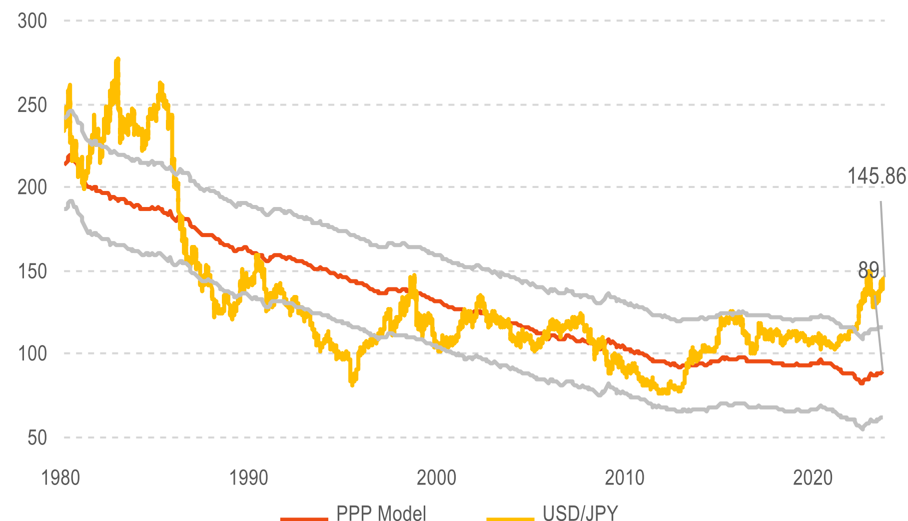


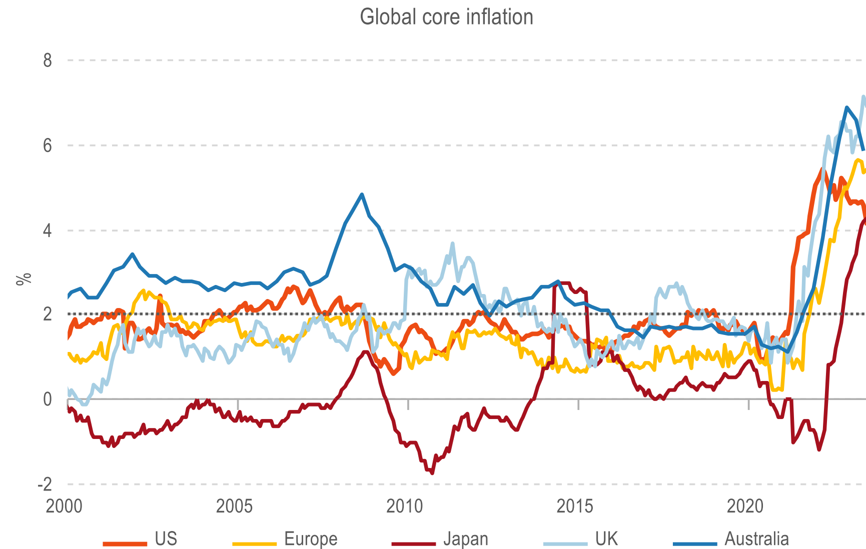
Source: Refinitiv Datastream

A combination of high commodity prices, a slower post-COVID-19 economic recovery and policy-induced wage incentives have caused inflation to rise and exceed the BoJ's 2% target for several months.

The BoJ is facing a policy dilemma at it weighs its growth objectives against inflation risk. Easy policy which supports higher domestic wage growth and lifts consumer prices (inflation) provides an opportunity for the Japanese economy to break out of years of stagnating growth. On the contrary, if years of low interest rates or higher wages cause inflation expectations to hold up, current monetary settings could reinforce inflationary pressures, erode real purchasing power and eventually undermine consumer confidence. With most central banks likely set to retain restrictive rates for longer, the prospect of rate differentials driving further depreciation of the JPY against major currencies could be another key consideration in favour of greater flexibility in YCC.

In rationalising the need to continue with monetary easing, the July policy statement noted that "sustainable and stable achievement of the price stability target of 2%, accompanied by wage increases, has not yet come in sight". The BoJ expects inflation to moderate to 1.9% in 2024 and further to 1.6% in 2025. How household consumption and markets respond to changes in short-term inflation and wage growth will determine the timing and scope for further tweaks and pace of exit from supportive monetary policy. A higher policy rate which raises the cost of funding Japan's large public debt can have significant implications for Japan's long-term fiscal sustainability.

Euro area monetary policy



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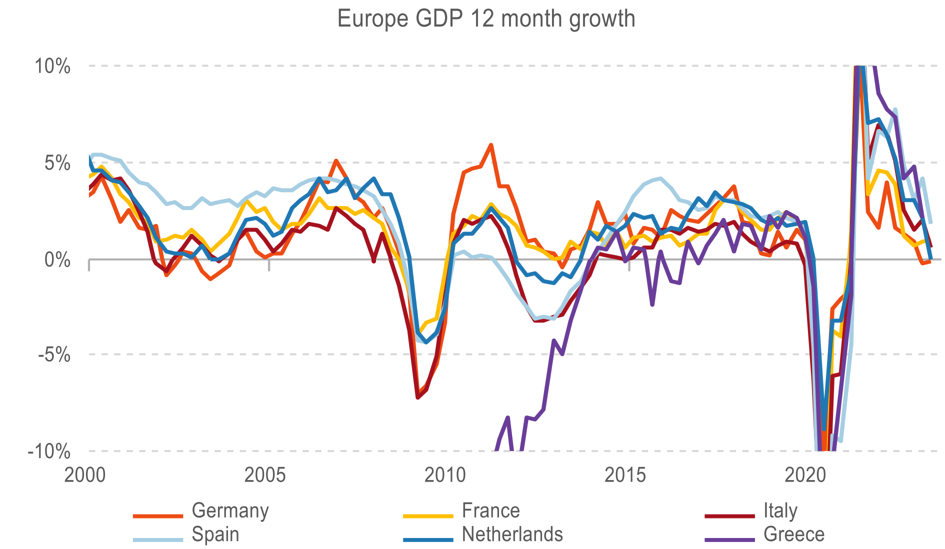

Source: Refinitiv Datastream

The European Central Bank (ECB) raised its benchmark policy rate by 25 basis points at its July meeting, lifting the deposit rate to 3.75%, in line with market expectations. The Council set the remuneration of its minimum reserves to 0%. This step, which ensures banks will not earn interest from the ECB on their reserves, is expected to preserve the effectiveness of policy by ensuring a full interest rate pass-through to money markets.

The ECB noted that while inflation continues to decline, it is likely to remain above the target level of 2% for an extended period. There was no clear forward guidance, but the Council stated future policy decisions will be guided by incoming economic and financial data and the strength of policy transmission.

The ECB has tightened monetary policy for a year to combat high inflation. Manufacturing production, business activity and household consumption have moderated amid tighter financing conditions. However, employment conditions remained strong and underlying inflation has proven to be more persistent, suggesting some further tightening may be required.

With the region's growth momentum moderating and amid a weaker global demand outlook, there is a pertinent risk restrictive monetary settings could induce a sharper economic slowdown in the European region. Market expectation is for some further tightening this year and that the ECB will likely switch to cutting rates closer to the middle of 2024.

The final word

- Inflation is moderating and past its peak in most advanced economies. The deceleration in consumer prices has been driven by lower energy prices, as well as easing supply chain constraints lowering goods inflation in most markets.
- While the deceleration in inflation is expected to continue, the short-term inflation outlook remains uncertain given resilient labour markets, strong services demand, lingering support from accumulated savings and housing market imbalances in economies such as Australia.
- Central banks in advanced economies, specifically the US Federal Reserve, RBA and ECB, are likely nearing the end of their rate hiking cycles as some measures of economic activity are moderating following months of aggressively paced monetary tightening.
- Uncertainty regarding the lags in monetary policy transmission, limited signs of a material deterioration in debt serviceability and risk of inflation being sticky have kept most central banks cautious, supporting the case for maintaining restrictive monetary settings in the short-term.
- The Bank of Japan's policy tweak to add greater flexibility to its yield curve control (YCC) is an important policy adjustment following years of more tightly managed interest rates. However, although it does represent a material change, the overall monetary policy stance of the BOJ remains very accommodative. The BoJ's policy considerations are different from that of most developed markets, aimed at sustainably achieving the 2% inflation target after years of stagnating growth. In comparison, most developed markets are focused on reducing inflation.

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