Coming to an accommodation

Will monetary policy ever get back to normal?

The post-Lehman period ushered in a new era of ultra-accommodative monetary policy in the developed world. When the financial crisis enveloped the global economy in 2008, major central banks quickly and aggressively eased monetary policy in a coordinated effort to limit the damage and support demand. But, after almost a decade, monetary policy rates at major central banks remain at near-record lows.

Of the major central banks, only the US Federal Reserve has managed to lift its policy rate a little. In the eurozone, Japan and the UK, new circumstances after the 2008 crisis have forced central banks to take even more steps to ease monetary policy further. Will monetary policy rates ever get back to what we think of as normal? Probably not for a very long time.

To understand why, monetary policy must be set to one side for a moment. Looking at the trends in monetary policy during the post-Lehman period can distract from the big picture. Instead, the critical information comes from the interest rates that are set by markets, such as government bond yields. Trends in US government bond yields provide a useful anecdote that matches broader trends. In 1981, 10-year US Treasury bond yields peaked at close to 16%. Since then, they have steadily fallen by around 40bps per year to their current level of just over 2%, with no major change in the shape of the trend since the financial crisis.

This decline in US Treasury yields, as well as most other sovereign and corporate bonds, reflects long-term trends much more than the ever-easier monetary policies of central banks.

First, after the ultra-high inflation of the 1970s and 1980s was brought under control, investors no longer require such high nominal interest rates to generate real returns. Second, major developed economies have reached the known frontier of technological progress. The rate of discoveries that yield large and widespread economic benefits has declined. This is reflected in the long-term secular decline in productivity growth, which has reduced long-term returns. Finally, lower bond yields also reflect increased risk aversion – since the Lehman crisis – by those that supply and demand such bonds.

While central banks can influence short-term fluctuations in demand by altering their monetary policies, they cannot improve the performance of the economy in the long run. As the example of Japan shows, the best efforts of a central bank to pump up demand cannot raise trend growth and are not a replacement for critical structural and regulatory reforms.

Central banks merely aim to set their policies in line with the underlying trends in the economy. But they cannot do much to affect trends in the long run. Central bank policy rates are low today because economic conditions require them to be.

Households and firms have spent the years after the financial crisis repairing their balance sheets. Low interest rates have made this process easier. There are signs that this process is drawing to a close.

For Western economies, the age of caution seems to be coming to an end. We can see the first phase of a return to the cyclical dynamics of boom and bust. Markets are rallying, demand growth is accelerating and business investment is picking up. In time, these economic conditions will cause underlying inflation to rise and more central banks will need to begin to raise policy rates. However, we are probably two years away from seeing a synchronised tightening in monetary policy across major central banks.

In the US and UK where the economic expansions are advanced, the Fed will continue to gradually tighten over the coming years and the Bank of England will probably hike for the first time in early 2018. In the eurozone, the recovery is some three years behind the US and the UK. The European Central Bank will therefore wait until late 2019 before hiking for the first time. Meanwhile, the Bank of Japan may struggle to hike its rate at all until Japan solves it structural inhibitors to growth.

But don't forget the long-term trends. Weak productivity growth mixed with a residual level of post-Lehman caution will keep interest rates low long into the future. Even as central banks begin to raise rates, the process will be more gradual than in previous cycles, and policy rates will remain well below those that have existed in the past.

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