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The Decline of Monetary Policy

This year has proved to be pivotal for the global economy's continuing recovery from the great recession. The world's largest central banks have newfound optimism towards recent global growth, leading to the dissolution of, what seemed, the perpetual reign of low interest rates and quantitative easing. Since the beginning of 2017, the U.S. Federal Reserve ("the Fed") has increased interest rates twice and the European Central Bank ("ECB") has signalled a desire to slow the rate of its bond-buying program. Concurrently, investors have developed extreme optimism towards the global economy, promoting equity markets to reach all-time high valuations.

The global economy is finally in a new era, one of optimism and economic growth. However, can monetary policy itself ever fully recover? After nine years of remedying stagnant growth and volatile markets, central banks are left with cumbersome balance sheets and deteriorated interest rates. The severely weakened strength and abilities of monetary policy will render developed countries' central banks incapable of providing the economic stability it was once revered for maintaining.

Post-Recession Reliance

Upon a recession, there are two institutions that can stimulate economic growth - the federal government and central banks. When the great recession occurred, affected countries' governments relied on monetary policy to provide economic support. Central banks were crucial in providing stabilization through money market intervention in order to restore market liquidity. Resultantly, central banks across the world implemented the most aggressive expansionary policies in their history by adopting record-low interest rates and massive bond and asset purchasing programs.

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Over the course of the economy's recovery, central banks' balance sheets have grown to insurmountable levels. Currently, the Fed has a balance sheet of USD 4.5 trillion, a USD 900 billion increase from its pre-crisis level. Included in this amount is approximately USD 2.5 trillion of Treasuries and USD 1.8 trillion of mortgage-related securities (Bernanke, 2017). This trend transcended globally - the world's most significant central banks bought approximately USD 14 trillion of assets since 2008 (MacKenzie, 2017).

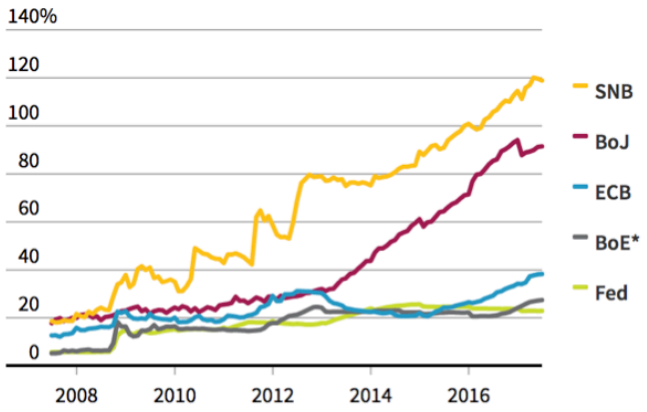
While banks have aggressively increased their balance sheets, interest rates have been set to all-time lows. With the goal of increasing investment, low interest rates have enabled corporate earnings to increase, and thus promoted high equity valuations. Developed countries' interest rates have since remained close to zero; some even negative in 2016.

A Fragile State

Persistent expansionary monetary policy has realized economic growth. This is predominantly because central banks' stimulus programs have enabled firms to enhance profits and fund new opportunities. However, it was not until the first quarter of 2017 in which these firm-level benefits were evidently converted into strong, sustained economic growth, particularly in the U.S., whose economy grew by 3.0% in the third quarter (Bureau of Economic Analysis, 2017). Although a prolonged recovery, recent growth is an immense achievement by central banks. There should, however, be critical concerns relating to the duration and degree of the policies actioned. Since monetary policy was the primary source of economic stimulus, financial markets' performance is now heavily dependent on the liquidity and stability provided by central banks.

The intensity to which central banks purchased securities post-crisis has caused their balance sheets to represent a daunting proportion of gross domestic product ("GDP"). For example, the ECB's balance sheet, which has more than doubled, now represents 36% of GDP. As this proportion increases, the financial markets of that country become increasingly reliant on the demand for government bonds and other assets to persist. Due to central banks' post-crisis asset purchases, equity markets received the signal of greater demand for certain securities. This led to high equity valuations amid stagnant economic growth, and therefore greater market instability due to prolonged reliance on market intervention. A critical concern of central banks having large balance sheets is that the bank must use additional resources to maintain its holdings. Most pertinent to post-crisis policy is the Fed's USD 1.8 trillion holding of mortgage-backed securities. In 2016 alone, the Fed bought USD 387 billion of mortgage bonds to maintain its holdings; such outlays drain the Fed's resources and flexibility (McCormick, Scully, 2017). While central banks purchased assets, they also substantially increased their liabilities. Whereas their post-crisis liabilities were mostly currency, commercial bank deposits are now also a significant proportion of total liabilities. In the case of the Fed, these were financed by writing checks on itself, thus placing greater risk in its ability to meet the associated obligations (Bernanke, 2016).

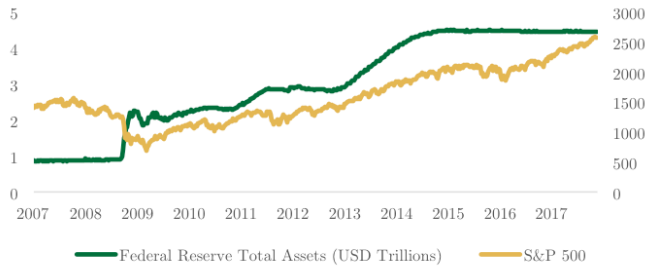
Central Bank Balance Sheet Assets, % of GDP in Local Currencies



Source: Wall Street Journal

Since growth in the global economy over the past nine years was predominantly encouraged by the monetary policies enacted, any dramatic change in policy would likely contract liquidity in the financial markets and potentially deter economic growth. This has led key central bankers, such as Janet Yellen of the U.S. Federal Reserve, to explicitly communicate when markets can expect interest rate hikes and the slowing of stimulus programs. Such actions demonstrate that central bankers are keenly aware of the financial markets' reliance on the current stimulus programs. It is consequently concerning that as central banks begin to increase interest rates and signal an intention to de-lever their balance sheets that the financial markets are at all-time high valuations. This is because recent market strength has been highly correlated with the liquidity provided by central banks (Mackenzie, 2017). As central bankers begin to slow those programs, the financial markets will quickly fall if such actions are rapid. Investors must be provided time to determine the effect of tighter monetary policy on firm investment and economic strength as a whole. Therefore, central banks are incapable of de-levering their balance sheets quickly without ensuing market volatility, thus forcing central banks to essentially maintain their current balance sheet levels with relatively minor, drawn-out reductions.

Federal Reserve Balance Sheet and S&P 500 Performance



Source: Federal Reserve Bank of St. Louis, Yahoo Finance

Facing the Future

As increasing the interest rate and slowing quantitative easing becomes the intent of developed countries' bankers, the weakened abilities of monetary policy is increasingly evident. The greatest concern for central banks' stability is resultant of i.) limited demand in the market for the securities purchased post-crisis and; ii.) the inability of interest rates to stimulate the economy.

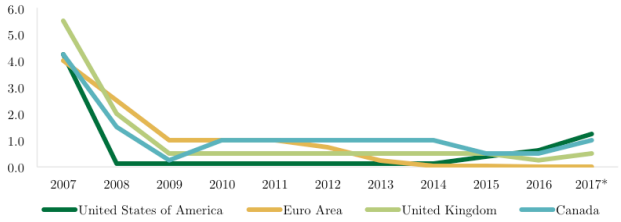
Although the ECB and the Fed intend to reduce their balance sheets, little demand exists for these securities in the open market (Fairless, 2017). With no clear plan on how to sell their assets, their balance sheets will be left relatively unchanged, particularly the level of treasury and mortgage-backed securities. Therefore, despite a willingness to sell them, central banks will maintain their position in these securities for the foreseeable future, a length of time by which another recession will occur. When this happens, central banks will be pressured to further increase

their balance sheets. This prospect is worsened when considering that many economists predict the next recession to be severe. Therefore, if governments continue to rely on monetary policy for economic stimulus, a cyclical pattern will worsen central banks' condition. Central banks would continue their aggressive stimulus policies, remain incapable of substantially reducing their balance sheets during periods of economic growth, and then further expand them when a recession occurs. Such a pattern would cause central banks to eventually collapse when they become unable to purchase and maintain the hefty balance sheets they acquired over the course of many recessions.

Since 2009, interest rates have been maintained in a near-zero range, which limits central banks' ability to make further reductions towards the widely accepted bound of zero percent. Therefore, interest rates have reached a point by which any further decreases would impose minimal to no stimulus for their respective economies. Normally, changing the benchmark interest rate is the easiest and most effective method for central banks to expand the economy; it does not require the banks to take on risk. If, however, interest rate reductions are too minimal to expand the economy, central banks are forced to purchase more assets and thus further aggravate the state of their balance sheets. At the current pace central banks are increasing rates, and if a recession were to occur in the next five years, central banks would have an extremely limited ability to stimulate the economy by decreasing interest rates. If a recession were to occur today, the Fed could only reduce its interest rate by 125 basis points. Additionally, central banks have been reluctant to significantly increase interest rates even as the state of their economies have improved. Understandably, they are fearful of discouraging economic growth, however revitalizing the power of interest rates is critical for ensuring the global economy's long-term stability.

To remedy interest rates' weakened capabilities, some economists have proposed setting them in negative territory, however the effects of implementing such a policy over a long period of time are both unknown and could fundamentally change the function of the overnight rate. With the hypothesis that a zero percent rate was not a boundary and catalyzed by desperation for economic growth, countries such as Japan, Denmark, Switzerland, Sweden and the ECB pursued negative interest rates in 2016. However, negative interest rates did not produce the desired economic stimulus to their economy. Instead of firms and consumers spending more and saving less, decreased consumer confidence caused consumers to increase their savings and reduce their debts in Denmark, Sweden and Switzerland (Pozen, 2016). Rather than creating alternative methods for changing the interest rate, banks must increase them during this current period of economic growth so they are undoubtedly capable of stimulating the economy when the next recession occurs.

Overnight Interest Rates (%)



*As at Q3 2017
Source: International Monetary Fund

Imperative Restoration

Due to federal governments' reliance on central banks after the great recession, the global economy is now rendered dependent on monetary policy. However, central banks cannot be depended upon during the next recession. They require the support of other market participants, especially governments, to de-level their balance sheets and slowly increase interest rates. Doing so, however, will require a consequential trade-off between reducing liquidity and slowing growth in both the economy and equity markets. Additionally, for central banks and monetary policy to regain their strength, governments' fiscal policy must be responsible for the appropriate stimulus during the next recession. Until then, governments, firms and investors should be wary of the economy's stability.

After finally realizing the desired result of their policies, central banks should be relieved. However, it is time for central bankers to look inwards at their weakened position and begin to recover themselves. The countries that do so will be best poised for the next recession.

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