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Fed's failure to tighten financial conditions a cause for concern

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The Federal Reserve has raised interest rates three times since the end of 2016, and in September announced a reduction of its $4.5tn balance sheet. Despite the Fed's gradual removal of monetary accommodation, monetary conditions have not tightened — they have become looser. Corporate credit spreads have declined, long-term interest rates have hardly changed, stock markets keep going up and the dollar has not appreciated markedly. What explains this apparent paradox? There are three possible reasons.

The first is that investors simply do not believe that the Fed is serious. After years of ultra-loose monetary policy, they are convinced that the central bank will not risk any big setbacks in financial markets. They expect tightening to be very cautious and thus remain sanguine about buoyant asset prices. The Fed, however, is consistent in its forward guidance towards higher rates and has so far in 2017 done what it had promised. Investor optimism, therefore, is unlikely to explain the dearth of market reaction — and it certainly cannot explain why monetary conditions have actually eased. A second possible reason is that the healthy global economy has boosted equity and corporate bond markets, and this impact has outweighed that of monetary tightening. Higher growth, however, should also lead to rising long-term bond yields, something that has not materialised. Ten-year Treasuries have remained more or less flat since December last year.

The most plausible explanation for the monetary policy paradox is found in the global financial context. Not only the Fed, but also the European Central Bank and the Bank of Japan have an impact on the prices for global fixed-income assets. As long as they stick to a course of extreme monetary accommodation and keep interest rates on European and Japanese government bonds ultra-low, especially on the long end, the Fed's tightening will have limited impact on longer-term Treasuries. It will mainly flatten the yield curve, as we have seen in recent months.

The background is that bond yields in the euro area and Japan have become more important for global developments in recent years. The supply of safe assets has declined after the global financial crisis, while investor demand has risen. Eurozone benchmark bonds and Japanese government bonds have, to some extent, become substitutes for Treasuries as safe assets. Their prices, therefore, impact on Treasury prices. Empirical analysis substantiates this argument. The same, by the way, does not (yet) hold for China. The recent strong rise in Chinese bond yields has had no noticeable impact on global bond markets. Despite China's global economic importance, its government bonds are not seen as safe assets. Chinese monetary policies, recently geared towards slowing credit growth, seem to have a direct impact mainly on national bond yields.

The linkages between markets for safe assets, meanwhile, create difficult choices for policymakers. Since neither the ECB nor the BoJ look set to tighten measurably in the near future, the Fed's conundrum will endure. US financial conditions will stay lose even as the Fed tightens. This creates risk. The International Monetary Fund in its latest stability report reminded us that risks to financial stability and growth always build up in good times. Continued favourable financing conditions and soaring asset prices breed complacency and excessive risk-taking.

What are the plausible scenarios going forward? The fact that the ECB and the BoJ are behind the curve may force the Fed to take more hawkish steps than markets expect. This would strengthen the US dollar and widen the already large yield gap between Treasuries and German or Japanese government bonds. Financial markets would be caught off guard and prices of risk assets would tumble. As the Fed is aiming for gradual policy tightening, this scenario does not look very likely. The US tax reform is not expected to have a big impact on growth that would put pressure on the Fed.

An alternative scenario is that the ECB and the BoJ start tightening more vigorously than expected. This would also shake up global markets, which are counting on a long period of accommodation in these regions. Fundamentals might point in the direction of some monetary tightening at least in Europe, as growth is solid and capacity well utilised. But given current forward guidance of both the ECB and the BoJ, a more vigorous tightening in 2018 or 2019 seems very unlikely.

This leaves a rather bullish scenario for global markets. The impact of the Fed's tightening will remain limited, while a change of heart at the ECB and the BoJ looks unlikely. Other factors may spook markets, including geopolitical risks, higher oil prices or trade protectionism. But monetary policies are unlikely to be disruptive as long as inflation remains subdued, which seems likely. The result? Financial risk will continue to build up and market overheating becomes more likely. Investors will have to carefully navigate this paradox financial cycle if they want to avoid being caught off guard.