



Economy

What would happen if the Fed never raised its rates again?

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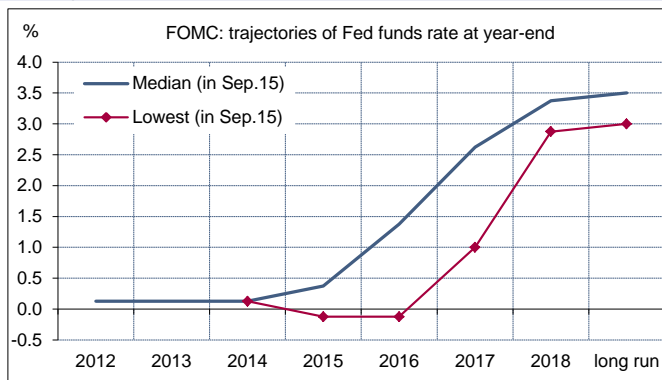
A large majority of the FOMC has declared itself favourable to the exit from the zero-rate policy (ZIRP) before the end of the 2015, but this is not an unconditional commitment on the part of Janet Yellen and her colleagues. Whilst the recent upsurge in volatility on the markets has pushed the Fed to defer this moment, we can imagine a different pretext at the next meeting and then at the following one, etc. In short, it would be worth considering the implications of a long (H2 2016), or definitive, postponement to the Fed's rate-hike cycle. The dollar could depreciate. A number of central banks (PBoC) might welcome this, but not the ECB or the Bank of Japan.

No monetary war...but perhaps a guerrilla skirmish

For the majority of market players, the Fed's decision to maintain its zero-rate policy (ZIRP) in September was anticipated. What was somewhat surprising, however, was the cautious tone employed by Janet Yellen at the press conference. Whilst not ruling out a first rates hike at the next two meetings, she expressed no great rush to launch a cycle of normalisation. That said, a number of FOMC members said that, for them, it was a close call. The Fed's central scenario (to which we adhere) is that rates will be raised within the next few months but then subsequently the pace of increase will be much slower than in the past.

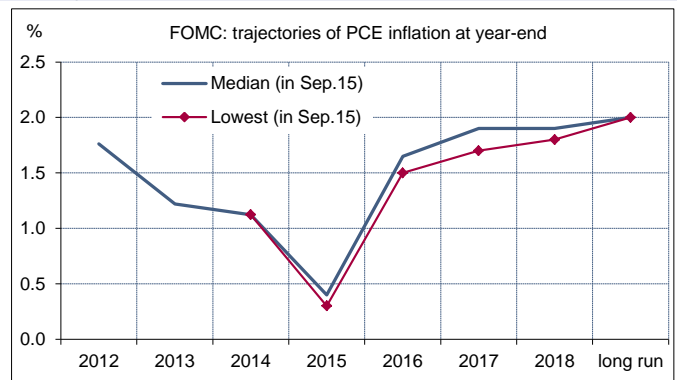
However, we cannot entirely rule out an alternative scenario in which the Fed is prompted to substantially push back the beginning of the rate-hike cycle beyond mid-2016 or even 2017¹. This is currently the opinion of a very small minority of FOMC members (left-hand chart). The macroeconomic situation in which the Fed would opt for such a postponement would be one where inflation remained well below the 2% target. Incidentally, even the more dovish members of the FOMC expect inflation to rebound next year (right-hand chart). It is not difficult to imagine the factors that could cause inflation to underperform in the short term: a fresh decline in the price of oil and raw materials, a slowdown in the pace of growth in reaction to the weakening of external demand or a correction in the financial markets. **Such a monetary scenario, because it is not anticipated by the market, would drastically alter the outlook for the dollar. It is very likely that the US currency would initially suffer downward pressure,** due to forces opposite to those which caused the increase in 2014 and 2015 (the anticipation of the end of ZIRP). In the following sections of this note, we have examined the possible reactions of the other central banks.

US: trajectories of real Fed funds rate



Sources: Fed, Oddo Securities

US: trajectories of inflation



¹ It is sometimes said that the Fed cannot raise rates in the middle of a presidential campaign, thus narrowing the window of opportunity to early 2016.

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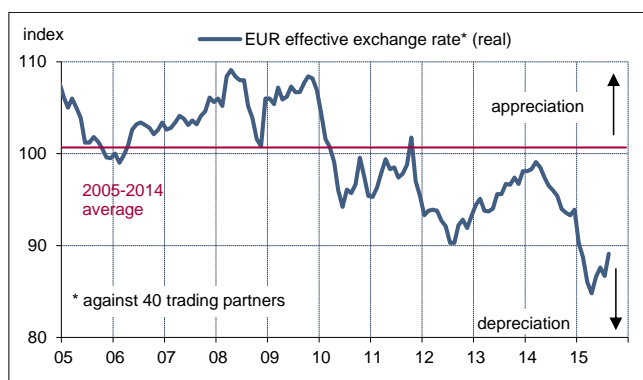
➤ The European Central Bank (ECB)

The ECB's mandate has not been altered since its creation (targeting 2% inflation in the medium term). However, in practice, monetary policy has changed a great deal since the arrival of Mario Draghi as head of the bank in 2011. After a tense debate last year, the ECB decided on a QE sovereign programme, rounding-out its zero/negative rate policy and generous liquidity measures. The ECB can be happy that the transmission channels of monetary policy were finally opened up thanks to its multiple initiatives. For example this has been reflected in the narrowing of the spreads on business loans in the eurozone and the gradual upturn in banking loans.

The nightmare for the members of the ECB is that an external shock will once again come to squeeze the mechanics of the monetary policy that has taken so many years to rectify. On several occasions last year, Mario Draghi laid out the ECB's reaction function². As such, we know that a substantial re-appreciation in the euro would be seen as an undesired tightening of monetary policy, providing an argument for a further easing in monetary policy. Over the past 12 months, the depreciation in the real euro exchange rate has varied between 7% and 9%, depending on whether it is measured against a broad or a narrow currency basket. Before the summer, the decline was close to 12% (left-hand chart). For the ECB, the increase in the euro during the summer is not yet alarming, since it failed to wipe off the previous decline and, above all, reflected a variation against more exotic currencies (rather than the major currencies). This is nevertheless a point to watch. Clearly, numerous comments issued by the ECB (Mario Draghi, Vitor Constancio, Benoît Coeuré, Peter Praet) reiterating that an extension to QE was possible, aimed of put some downward pressure on the euro.

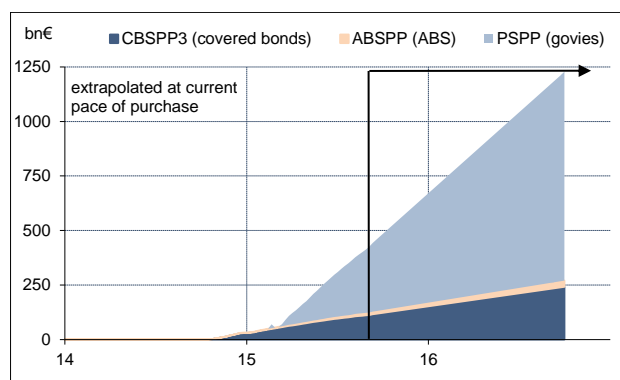
Assuming that the ECB wanted to further ease its policy in reaction to the prolongation of ZIRP in the US, what new measures does it really possess? With regards to conventional measures, the deposit rate (currently at -0.20%) could be reduced, pushing the overnight rate down, but the margin for manoeuvre will be reduced. New liquidity injections could be added beyond June 2016, but here again this would be a cosmetic measure. **Only quantitative measures will impress the market.** Since March, assets have been purchased at a weekly rate of € 14.2bn (81% of which is public debt), which, when extrapolated until September 2016, would place the QE programme at € 1.23tr, i.e. 12% of the eurozone's GDP (rhs chart). The ECB's vice-president recently reiterated that asset purchases currently represent 21% of GDP in the UK, 25% in the US and 64% in Japan. Given the public comments made by the ECB, the central bank does not seem to have clear ideas about the form that QE2 would take. It can extend the length of the current programme, increase the amount of monthly or weekly purchases or change the content of the purchases (by buying corporate debt, for instance). In any case, the ECB's goal is to make sure that the monetary cycles between the US and Eurozone remain disconnected for some time. **If the Fed intends to remain accommodative for longer than expected, the ECB can do no less than extend the timeframe of its monetary easing.**

Eurozone: the euro's real effective exchange rate



Sources: ECB, Oddo Securities

Eurozone: the ECB's asset purchase programme



➤ The Bank of Japan (BoJ)

There are similarities between the ECB and Bank of Japan. Both central banks have embarked on a reflationary strategy. One of the goals, which is more or less explicit, is to weaken the currency (imported inflation and stimulus for exports). The BoJ is much more aggressive than the ECB because since the launch of Abenomics at end-2012, the BoJ's balance sheet has risen from 30% to 70% of GDP. The impact of Japanese QE on the yen's exchange rate (-33% versus the dollar) and the stock market (+100%)

² In particular in the speech made on 24 April 2014, Monetary policy in turbulent times, and 21 November, Monetary policy in the euro area. See our economic note of 24 November "Mario Draghi in his own words".

is abundantly clear. That said, the economy's reaction is nowhere near as impressive. Core inflation is barely in positive territory (0.6% year on year) and could slow down once the effects of the yen's last depreciation die down (October/November 2014). Wages are continuing to barely increase even though unemployment is at 3.3%, its lowest point since 1997. There are rumours that the authorities might push back the expected time for inflation to reach its target to H2 2016. All of the ratings agencies have sanctioned this apparent failure of Abenomics by downgrading Japan's rating in recent months.

Given this disappointing state of affairs, there might be expectations of further easing measures, especially if the Fed's policy were to cause the dollar/yen exchange rate to drop. **Certain recent comments have suggested that the BoJ could step up its quantitative easing programme as of 30 October. There are nevertheless two obstacles.** The first is technical. The BoJ already holds around one-quarter of Japanese government bonds (JGB). At the current pace of QE, this share would increase to 40% at end-2016. Given the importance of JGBs as collateral for Japanese financial institutions, the head of the IMF's mission in Japan indicated that the BoJ might be short of buyers in 2017. An extension of Japan's QE policy would involve extending the purchases towards riskier assets, including equities. Here, we cannot imagine that the scale involved in sovereign QE could be reached. The second obstacle is confidence. Wouldn't a further extension of QE be seen as an admission of failure? In the past, Japan has intervened on the forex market directly to weaken the yen. This has not happened for a long time. But this option could be examined if forex were to take an unfavourable direction for a rise in inflation.

➤ The Bank of England (BoE)

In many respects, the BoE and Fed are facing the same problem. They both ended QE a long time ago but have held their interest rates at zero even though activity is progressing at a healthy clip. The recovery in the eurozone is positive for the UK. Unemployment is falling fast and is close to its equilibrium level. Unlike the US, wages in the UK are rising (productivity has recently seemed to be picking up too). This means that the BoE has just as many, if not more, reasons than the Fed to raise interest rates, but weak inflation, even though it reflects certain temporary phenomena (sterling's appreciation and fall in raw materials' prices) is a powerful argument for maintaining the status quo. Only one of the MPC's members voted in favour of a rate hike in the past two meetings.

For the past year, the BoE's officials have been able to tell themselves with confidence that the Fed would be the first major central bank to abandon the ZIRP, which would have provided them with a point of reference. But as the end of 2015 approaches, the risk is that the BoE might be the first to take the leap. This was the situation early 2014 (see our Eco Note published on 6 February 2014: "Bank of England: pilot fish for the Fed?").

➤ The Chinese Central bank (PBoC)

The Fed's policy has a direct impact on China given the close relationship between the dollar and yuan. From 2010 to 2013, China allowed its currency to appreciate against the dollar. But since mid-2014, it has been pegged to the dollar again (with a small margin of fluctuation). At the same time, the dollar has been on a firming trend due to expectations of a long disconnection between the Fed's monetary policy on the one hand and those conducted by the ECB and BoJ on the other. The result is that the yuan has spiked, which has very probably exacerbated the slowdown. We would therefore understand why China would scrap this peg to the dollar to regain some breathing space. Perhaps this was the underlying reason for the announcements made on 11 August? But the opposite effect was produced - faced with the surge in global volatility, the PBoC was forced to intervene to stabilise the yuan against the dollar and show that it had not started a currency war.

The PBoC is caught in Mundell's impossible trinity. A country cannot have a fixed exchange rate, an independent monetary policy and free capital flows at the same time. China is claiming that it will ultimately abolish all capital controls and allow market forces to determine exchange rates. But the current situation is very different: capital flows are still largely supervised and the PBoC is selling its currency reserves to prop up the yuan. Its main weapon for monetary easing is cutting interest rates and reducing compulsory reserves for banks. If the Fed declines to hike its policy rates for a long time and this drives the dollar down, the PBoC might allow itself to deregulate its forex system a little sooner. **If the US maintains an accommodative monetary policy for longer, this would have disadvantages in Europe and Japan but would be welcomed by China (and many emerging markets).**

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