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# Central banks battle the global slowdown

## Prospects for turning growth around appear limited, however

After a failed attempt to normalise monetary policy, central banks are loosening policy again. Prospects for a meaningful turnaround in growth are limited, however. Uncertainty around global trade and lacklustre productivity and investment are expected to remain headwinds for the global economy, along with tight capacity in major economies. Monetary policy is, by itself, unlikely to do the trick.

Source: iStock

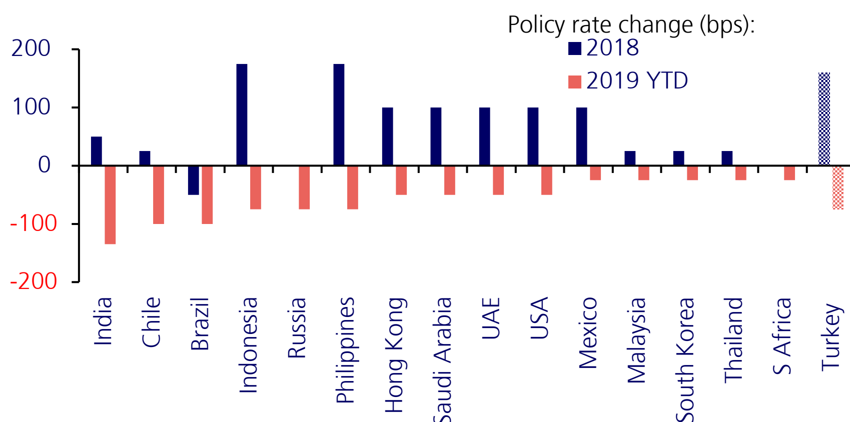
### Central banks shift stance as the global economy slows and uncertainty rises

Global central banks have responded en masse to the slowdown in manufacturing and global growth, which was triggered by past policy tightening and disruptive global trade developments. Over half of global central banks have cut rates over the past six months having rapidly hiked rates less than a year ago. The balance between the number of central banks that are loosening policy and those that are tightening policy is at the highest level since the great financial crisis. An unusually synchronised global rate cutting cycle is clearly underway.

This U-turn in global monetary policy has been facilitated by the Federal Reserve, which moved from a hawkish to a dovish stance at the beginning of the year and began to cut rates in July. This has freed up space for emerging markets (EMs) to loosen policy, with rate cuts implemented across continents. The Central Bank of India led the way when it lowered the policy rate in February, later followed by a swathe of rate cuts across Asia. Latin American central banks have changed stance in a similar way, despite a more challenging macro environment. Policy loosening has also been forthcoming in Russia, South Africa and even Turkey – where some of the sharp tightening measures that were implemented in 2018 have been wound back.

We argued back then that many economies were forced to tighten policy for external reasons – Fed rate hikes and a strong dollar – while internal conditions in many cases favoured looser monetary conditions. Reversing this externally imposed policy tightening will be favourable for the growth environment. With inflation low and a negative output gap in many EMs, there is room to grow.

### Central banks swing from rate hikes to rate cuts



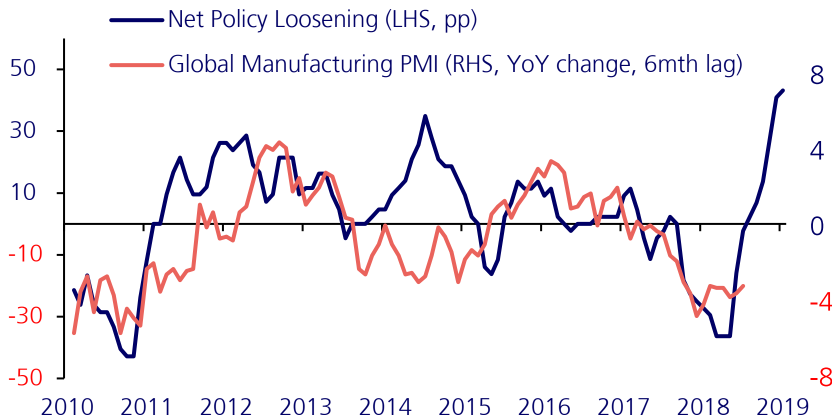

Source: Bloomberg

Note: Turkey is on a different scale, with 1600 bps of hikes in 2018 and 750 bps of cuts in 2019

### Central bank stimulus has helped in the past, but will it now?

This episode shares some similarities with the 2015-2016 period, when central banks responded to slowing growth and a collapse in commodity prices. Back then, monetary stimulus was significant and it helped fuel a synchronised recovery which led the global economy to expand at an above trend pace in 2017 and 2018. The question is whether this will be repeated this time around?

## Major shift in policy stance should support growth




Source: Bloomberg Note: Net loosening defined as % of CBs that cut relative to % that hike rates over past 3 months, 44 CBs included

### Prospects for global trade will remain uncertain

One reason why central banks are loosening policy is of course the US-China trade war. The global economy is fragile with large vulnerabilities that reflect high debt levels and weak underlying growth potential. The US-China trade war has amplified these fragilities. The multilateral trading system that has been in place since the Second World War and which has served businesses and the global economy well is being challenged. As it is unclear what the global trade system will look like going forward, uncertainty is pervasive. This uncertainty is also captured by the data – with measures of global economic policy uncertainty at historical highs.

Elevated uncertainty is weighing on business activity and investment spending, and helps to explain why the global manufacturing sector has fallen into recession. The investment cycle and the global trade cycle are interlinked – so it is not surprising that global trade growth has turned negative – for the first time in nearly a decade.

Although a near term trade truce between China and the US is a possibility, longer term questions around the emergence of China as a global superpower and the attempts by the US to contain it are unlikely to be resolved. We therefore anticipate this to have a longer lasting impact on global trade and economic activity, weighing on an already weak growth outlook.

The US-China trade war is a real shock to the global economy that is disproportionally impacting business sentiment and investment. As businesses are not generally lacking access to credit, a further loosening in monetary conditions is unlikely to be particularly effective in softening the impact on the global economy. Monetary policy could still help, however, if it succeeds in boosting those components of global demand that are less susceptible to the global trade cycle.

### Surplus economies are unlikely to respond strongly to monetary support

Economies that run large external surpluses (see chart below for examples) are vulnerable to the trade induced slowdown. They are heavily skewed towards exports as a growth driver and have seen activity decelerating over the past year. Their competitiveness and ability to produce more than they consume also make them more vulnerable to the current shift in the external environment, and this helps to explain why growth has slumped, in a rapid adjustment to a lower growth path.

Given the importance of exports in such regions, a broadening out of the support mechanism is likely to be needed to make up for the shortfall in external demand. Monetary conditions are already extremely favourable, as a result of a solid macro backdrop with healthy public finances and persistent trade and current account surpluses. Further monetary policy loosening is, in this environment, unlikely to lift domestic demand materially, particularly as the slump in trade and manufacturing is also associated with reduced job security and weaker sentiment more broadly.

However, while monetary policy is unlikely to be effective by itself in these surplus and heavily trade oriented economies, they account for a relatively small part of the global economy. Historically, these economies tend to lever global growth - they follow and amplify the global economic cycle, but they do not shape it.

### Emerging markets benefit from policy loosening, but vulnerabilities remain

There is another part of the world economy that is less affected by trade headwinds and will benefit relatively more from monetary loosening. Let's not forget that the Fed hiked rates by 225bps between 2015 and 2018. This forced many EMs to tighten policy with the more vulnerable economies – with a weaker fiscal or external position – impacted first, and most. These rate hikes are now being reversed. Macroeconomic vulnerabilities persist in these economies, but the lower global rate environment allows policy loosening to be delivered.

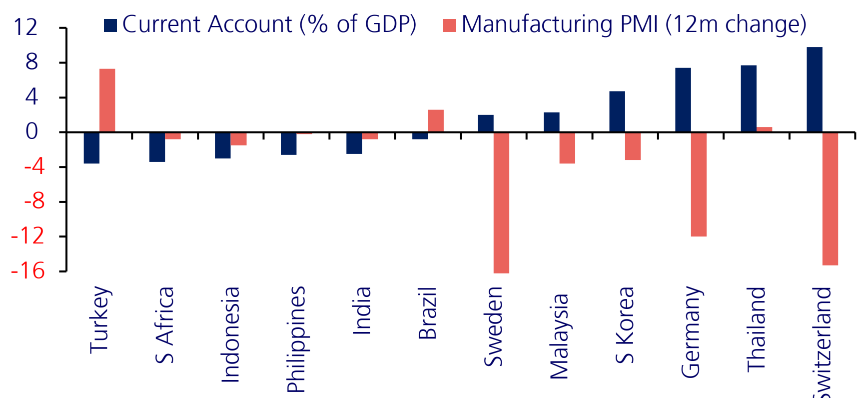
Looking across these, and similar, economies, monetary conditions have turned markedly more favourable compared to last year, but interest rates can fall further if the external environment remains favourable. Inflation is not a pressing problem, the output gap is in many cases negative and there is room to grow. The impact on global growth could be significant – emerging markets excluding China contribute, on average, by around one third to global growth.

However, many of these economies are more vulnerable to changes in sentiment and the potential for a stronger US dollar. As geopolitical and political risks remain high, there is still large uncertainty surrounding the growth outlook in these regions. Pinning the hopes of a turnaround in the global economy on these countries alone may therefore be too optimistic.

### Further rate cuts into negative territory are not helpful for the global economy

While rate cuts by the Fed are helpful for many EMs and will support global growth, policy loosening on the other side of the Atlantic – by the ECB – may well be less helpful for the global economy. The ECB has implemented a further deposit rate cut and more is possible. To offset the negative impact that NIRP (negative interest rate policy) has on bank profitability, this has been implemented alongside measures to protect the banking sector. This is helpful for a fragile banking system but it also limits the pass-through to the broader economy. What is left, therefore, is a rate cut whose transmission may disproportionally be tilted towards the exchange rate.

## Surplus economies are vulnerable to trade disruptions




Source: IMF, Bloomberg

The euro is the world's second most traded currency and the Eurozone is the largest trading bloc. Adopting policies that are – either by intention or by stealth – focused on the currency in such a dominant region is unlikely to benefit the global economy more broadly. Currency weakening can help an individual country to gain competitiveness and increase exports. However, one country's gain is another country's loss.

A focus on the currency is also not helpful as it could fuel countermeasures elsewhere. With external demand weakening across the world economy, more countries may well adopt similar measures, to weaken their currencies and support a fragile manufacturing sector and local jobs.

While not our base case, ever deeper rate cuts into negative territory therefore bring with them a risk of a further escalation in protectionist measures – this time aimed at currency manipulation rather than bilateral trade flows. If this were to happen, a worse economic outlook could easily materialise.

### The economic cycle is extended in major economies, limiting growth to improve

One key difference compared to the 2015-2016 period is that the economic cycle has become more extended. While there is still room to grow in emerging markets, capacity is much more constrained in developed markets (DMs). The unemployment rate is at or near all-time lows in major economies and businesses report difficulties in finding suitable staff. This is a large difference compared to 2016, when the economic cycle was less mature with more spare capacity and lower utilisation rates. This meant that it was relatively easy to grow at – or above - trend. The average rate of growth in a group of advanced economies – including the US, UK, Canada and Japan - rose from 1.5% in 2016 to close to 2.5% in 2018 – which is above trend. This time around, such growth acceleration will be more difficult to achieve.

### Investment could help, but monetary stimulus alone is unlikely to do the trick

One way to overcome tight capacity in DMs and extend the economic cycle would be through increased investment, which could generate both stronger demand and improved capacity.

In DMs, the cost of finance or access to credit do not appear to be limiting factors for businesses in these regions. A large share of global debt is negative yielding. US and European credit spreads are close to all time lows. Bank lending rates are favourable, also for small and medium sized companies. In fact, businesses have leveraged up significantly over the past few years as a result of very favourable financial conditions. This has however not led to a marked turnaround in investment and capacity. To some extent, this reflects the fact that companies have been encouraged to use cheap debt to buy back and retire costly equity capital, rather than to undertake real investment. This has led to asset price reflation rather than stimulating investment and economic growth.

Simply cutting policy rates is therefore unlikely to boost investment in major developed economies. Central bank actions will need to come alongside fiscal and regulatory measures to support growth dynamics, including investment in infrastructure and climate change mitigation and adaptation measures

Alongside a fundamental shift in fiscal policy, incentives for the private sector to invest also need to strengthen. Persistently weak investment show that hurdles rates remain high, despite favourable financial conditions. This appears to be a reflection of elevated uncertainty, both around technology, geopolitics and politics. Alleviating this uncertainty is likely to be as – or even more – important as generating looser financial conditions.

### More profound action is needed to more sustainably improve the growth outlook

To sum up, Fed rate cuts are supportive for the world economy, particularly as they allow policy loosening in emerging markets. While further rate cuts are set to be forthcoming, there is a risk that the Fed is not sufficiently proactive, given a tight US labour market and inflation close to target.

By contrast, further rate cuts into negative territory by other central banks are unlikely to improve growth prospects more broadly.

Additionally, the potential for growth to pick up – even with more dovish central banks - is limited. Global trade uncertainty is likely to continue to weigh on business sentiment and investment. In developed markets, the economic cycle is also extended, with limited capacity for growth to rise more strongly.

More profound policy measures are therefore likely to be needed to stabilise growth and extend the economic cycle. If not, there is a risk that interest rates fall further into negative territory, which may well be counterproductive for the global economy.

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