Beyond boring: tough challenges ahead for central banks

At a glance...

Good central banking should be boring: or at least that was the mantra in the pre-crisis era. Typically this meant using one policy tool - the interest rate - to achieve one objective - price stability. However, this orthodoxy was blown apart by the global financial crisis.

Now central banks have the ability to target sub-components of the economy through macroprudential tools. For example, the Bank of England is to be given powers to limit loan-to-income and loan-to-value ratios for mortgages.

Central banking is therefore no longer boring. But with this power and reach, greater political scrutiny is inevitable, which could challenge their independence. We've seen examples of this happening already: take, for example, the pressure put on the Bank of Japan which preceded it setting an inflation target of 2% in January 2013.

How can central banks safeguard their independence? Lessons from history show that legal independence is not always enough - central banks also need to 'earn' their independence by demonstrating institutional strength or capability.

Now that central banks are expected to place more emphasis on maintaining financial stability, they also need to show they are capable of balancing monetary and financial stability goals and communicating this effectively.

What about immediate policy decisions?

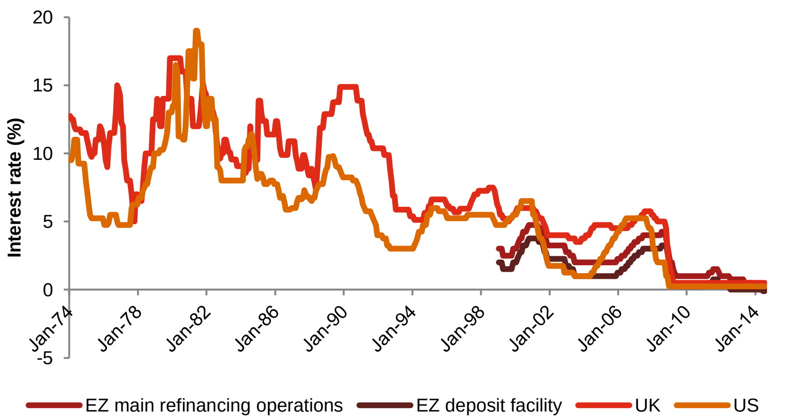
As well as facing these new challenges, central banks also have immediate policy decisions to consider.

In the UK, on the back of relatively strong economic growth (which we project to be around 3% on average this year), we would expect the Monetary Policy Committee to start to gradually increase Bank rate in either late 2014 or early 2015, depending on how the data evolves over the next few months (particularly on pay and productivity).

We have revised down our Eurozone growth projection to 0.8% for 2014 in the light of recent weak data and inflation remains very subdued. Following the rates out on the 4th September , we expect monetary policy in the Eurozone to remain on hold for now, but if growth remains sluggish and inflation stays low, then the ECB may start a quantitative easing programme later this year.

In the US, growth rebounded in Q2 and the economic fundamentals look reasonably strong. Assuming growth continues at an average of around 3% per annum over the next year, we expect the Fed to cease asset purchases before the end of 2014 and to start to raise interest rates during the second half of 2015.

Fig 1: The policy rate has approached its zero lower bound in many major advanced economies and the EZ deposit rate has burst through this bound



Source: Datastream

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Economic update: The unlikely champions - Eurozone periphery grows faster than the core

Around half of the Eurozone failed to grow in the second quarter

The "soft core" of the Eurozone was on full display in the second quarter of the year, as Germany, France and Italy all failed to grow. Germany shrank by 0.2% quarter-on-quarter; Italy slipped into recession for the third time since 2008; and France faced a second consecutive quarter of zero growth.

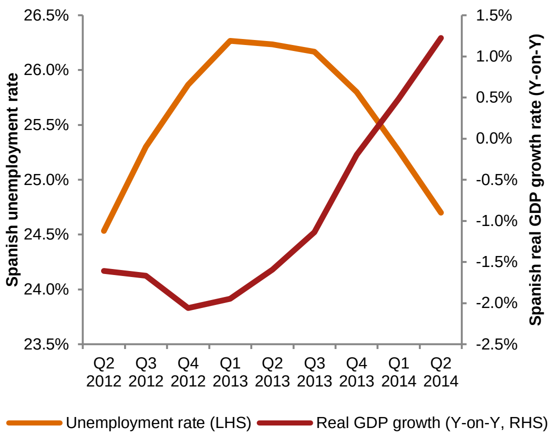
We expect that Germany will recover its form in Q3, as the Q2 contraction was partly driven by temporary factors: a strong Q1 and an escalation of the Ukraine/Russia stand off, while German fundamentals remain relatively strong. We're less optimistic about the other core countries.

Look out for the unlikely champions

Meanwhile peripheral economies like Spain and Portugal rebounded. Spanish output grew by 0.6% quarter-on-quarter, which is the fastest rate in more than five years. The effect of stronger growth can already be seen in Spain's unemployment rate, which has been on a downward path since the end of 2013 (see Figure 2). We expect a similarly strong performance to continue into Q3 for most peripheral economies on the back of a robust tourism season.

Based on this analysis, we have revised down our Eurozone main scenario projection from 1.1% to 0.8% for 2014 to reflect the weakness of the three core countries.

Fig 2: Spanish GDP grew at its fastest rate since the fourth quarter of 2007



Source: Eurostat

The outlook is relatively bright for the US with interest rate rises expected later next year

Growth has bounced around during 2014

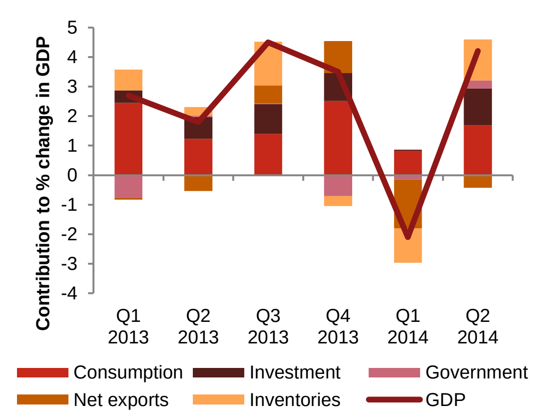
Concerns were raised about the world's largest economy after a disappointing first quarter in which US GDP shrank by 0.5% over the quarter (or by 2.1% on an annualised basis). However, this contraction was largely the result of temporary factors including adverse weather conditions and a correction in inventories.

The revised estimate for the 2nd quarter painted a much more positive picture with quarter-on-quarter growth of 1.0% (i.e. an annualised growth rate of 4.2%), driven mainly by personal consumption spending and a rise in inventories (see Figure 3). This rebound was broadly in line with our previous expectations, so we are still expecting average US growth of 2.1% in 2014, picking up to around 3% in 2015.

The outlook for monetary policy

Barring any major adverse shocks, we expect the Fed to stop buying assets and end its QE programme before the end of this year. Following on from this, we would expect the interest rate to start to rise during the second half of 2015, based on our growth projections.

Fig 3: After a disappointing Q1, growth bounced back in the second quarter



Source: US Bureau of Economic Analysis

The key economic fundamentals look reasonably strong

Alongside the strong Q2 growth rate, many of the key economic fundamentals in the US suggest the recovery is robust and that interest rate rises later next year are plausible.

Employment has been recovering well, with over 200,000 non-farm jobs added each month from February until July. The unemployment rate has also fallen by 2 percentage points in the two years from July 2012 to July 2014, to a rate of 6.2%. This implies that consumption is likely to remain relatively strong, helping to stimulate growth.

Household debt as a percentage of GDP has fallen from just over 98% at the start of 2009 to a little over 80% in the first quarter of 2014. This makes it likely that the observed increases in consumption will be sustainable as they are not exclusively reliant on consumer borrowing. This is reinforced by the recent upward revisions to the personal saving rate for 2011, 2012 and 2013.

The US has been experiencing a fiscal squeeze as the government seeks to cut the budget deficit. While the US is growing, this is prudent fiscal management that will limit the growth of government debt.

Another positive for the US is the rise in commercial and industrial bank lending. In the years after 2008, commercial and industrial loans fell significantly, but by July 2014 this had picked up by more than 40% from its low point. The Fed's QE policies seem to have had the desired effect of stimulating lending to the real economy.

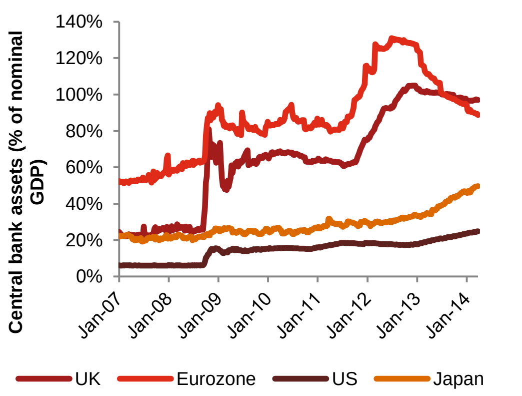
Key dates for your diary

These fundamentals suggest the US recovery is on track, but here are some key dates to watch out for that should give us more information:

- Next Federal Open Market Committee (FOMC) meeting – 16-17 September
- Q3 GDP release – 30 October
- Midterm elections – 4 November

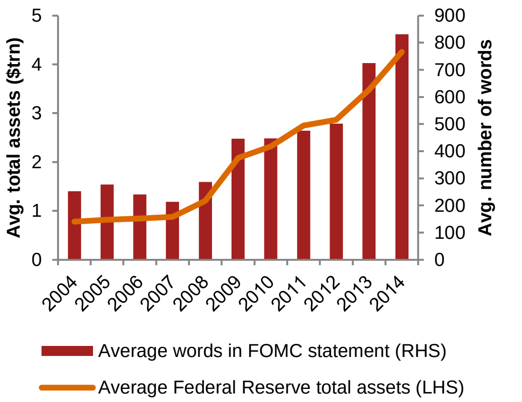
The stereotype of boring central banks has vanished

Fig 4: Central banks have adopted unconventional policy measures, boosting their assets



Sources: PwC analysis, National Central Banks and Datastream

Fig 5: The number of words in FOMC statements has risen alongside the size of the Fed's balance sheet



Source: Federal Reserve

Fig 6: "...we have devoted substantially increased resources to monitoring financial stability"

Source: Quote and wordle from "Monetary Policy and Financial Stability" speech delivered by Janet L. Yellen (July 2014)

A good central bank used to be a boring central bank

Good central banking should be boring: this was the mantra for most central banks in the pre-crisis era. It was borne on the back of the "Great Consensus" in monetary policy among academics and practitioners in which the "one policy tool and one objective" framework —typically the policy rate and price stability respectively — formed the cornerstone of the modern day central bank. Added to the mix was the concept of independence: the notion that monetary policy should be free from political influence, but accountable to government, making it more credible.

... this all changed during the 'Great Panic'

However, this orthodoxy was shattered during the financial crisis as central banks rushed to develop innovative policy responses after interest rates approached the zero lower bound (see Figure 1). In the years after the 'Great Panic'[1] of 2008 the world of central banking changed radically:

- The Fed's balance sheet ballooned from around $800 billion in 2007 to $4.4 trillion in August 2014 (see Figures 4 and 5) and its statement to markets has multiplied from about 250 words ten years ago to more than 800 today (see Figure 5);
- The value of assets held by the Bank of England as part of its quantitative easing programme is now nearly equal to the combined assets managed by the country's top 10 fund managers;
- Switzerland's central bank, the world's 20th largest economy, is now the 4th biggest holder of foreign exchange reserves;
- The European Central Bank (ECB), which is the monetary authority for 18 countries, has set negative deposit rates for the first time in its history (see Figure 1).

With great power, comes great scrutiny

One of the consequences of the financial crisis has been the disproportionate influence exerted by unelected central bankers. This has already caused elected government officials to challenge the democratic legitimacy of such a change:

- In the US, for example, lawmakers are pushing for the introduction of a rule-based monetary policy which could limit the manoeuvrability of the Fed, particularly at times of crisis.
- In other cases, the purchase of large amounts of sovereign debt by central banks has made governments nervous. It has also had some perverse consequences. For example, in 2012, the ECB made around €555 million in interest income from Greek Government Bonds (GGBs).

How can central banks safeguard their independence?

Lessons from history show that legal independence is not always enough; central banks also need to 'earn' their independence by demonstrating institutional capability.

To analyse what makes a capable central bank in this new, more complex era of central banking, we've drawn lessons from the 60s, 70s and 80s, the period which earned central banks their independence to conduct monetary policy in the first place. Our review suggests that successful central banks demonstrated their capability in three key areas: leadership, analytical competence, and communication.

The real test will come when central banks have to manage through conflicting economic and financial cycles, balancing monetary and macroprudential policy (see Figure 6) settings, and communicating this effectively. Let's hope they are ready.

[1] "The Great Moderation, the Great Panic and the Great Contraction", Charles Bean, 2009.

Projections: September 2014

	Share of 2012 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2013	2014p	2015p	2016-2020p	2013	2014p	2015p	2016-2020p
Global (market exchange rates)		100%	2.5	2.7	3.2	3.2	4.8	5.2	5.6	4.7
Global (PPP rates)	100%		3.0	3.2	3.7	3.6				
United States	19.5%	22.5%	2.2	2.1	3.1	2.4	1.5	1.8	2.2	1.9
China	14.7%	11.4%	7.7	7.4	7.3	7.0	2.6	2.5	3.1	3.4
Japan	5.5%	8.3%	1.5	1.5	1.2	1.2	0.4	2.5	1.1	1.5
United Kingdom	2.8%	3.4%	1.7	3.0	2.6	2.4	2.6	1.7	1.9	2.0
Eurozone	13.5%	16.9%	-0.5	0.8	1.3	1.5	1.4	0.5	1.2	1.5
France	2.7%	3.6%	0.1	0.4	0.9	1.7	1.0	0.7	1.0	1.5
Germany	3.8%	4.7%	0.2	1.5	1.6	1.3	1.6	0.8	1.6	1.7
Greece	0.3%	0.3%	-3.9	0.2	1.8	3.0	-0.9	-1.2	-0.3	1.3
Ireland	0.2%	0.3%	0.2	3.1	2.9	2.5	0.5	0.5	1.5	1.5
Italy	2.2%	2.8%	-1.8	-0.2	0.6	1.0	1.3	0.2	0.9	1.4
Netherlands	0.8%	1.1%	-0.7	0.8	1.5	2.0	2.6	0.9	1.2	1.4
Portugal	0.3%	0.3%	-1.0	0.7	1.7	1.8	0.4	0.4	0.9	1.5
Spain	1.7%	1.8%	-1.2	1.2	1.6	1.5	1.5	0.3	0.9	1.0
Poland	1.0%	0.7%	1.6	3.1	3.2	3.5	1.2	0.6	2.0	2.5
Russia	3.0%	2.8%	1.2	0.5	1.0	2.5	6.8	6.5	5.5	5.0
Turkey	1.3%	1.1%	4.0	2.6	3.8	4.5	7.5	8.6	6.9	4.8
Australia	1.2%	2.1%	2.4	3.2	2.8	3.1	2.2	2.6	2.6	2.7
India	5.7%	2.6%	4.7	5.2	6.5	6.5	6.3	5.6	5.9	6.0
Indonesia	1.4%	1.2%	5.8	5.2	5.8	6.3	6.4	6.2	5.9	5.1
South Korea	1.9%	1.6%	3.0	3.6	3.7	3.8	1.3	1.7	2.1	2.9
Argentina	0.9%	0.7%	2.9	-1.0	2.0	3.3	-	30.0	30.0	-
Brazil	2.8%	3.1%	2.3	1.3	2.0	4.0	6.2	6.6	5.7	4.8
Canada	1.8%	2.5%	2.0	2.1	2.5	2.2	1.0	1.8	1.8	2.1
Mexico	2.2%	1.6%	1.3	2.6	3.7	3.6	3.8	3.9	3.7	3.6
South Africa	0.7%	0.5%	1.9	1.6	2.5	3.8	5.8	6.1	5.5	4.8
Nigeria	0.5%	0.4%	5.5	6.0	5.9	5.7	8.5	8.5	8.6	7.3
Saudi Arabia	1.1%	1.0%	4.0	4.3	4.4	4.3	3.5	3.1	3.5	4.0

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index released by INDEC which is based in the fourth quarter of 2013 (therefore we do not provide a 2013 estimate). We will provide a 2016-2020 inflation projection once a longer time series of data is available. GDP projections for Argentina use the 2004 base year national account data (previously base year 1993). Our Nigeria GDP projections relate to the new rebased GDP figures but are subject to high margins of error. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise during the second half of 2015	16-17 September
European Central Bank	0.15% (June2014)	On hold following easing in June	4 September
Bank of England	0.5% (March 2009)	Rate to rise gradually from late 2014 or early 2015	3-4 September

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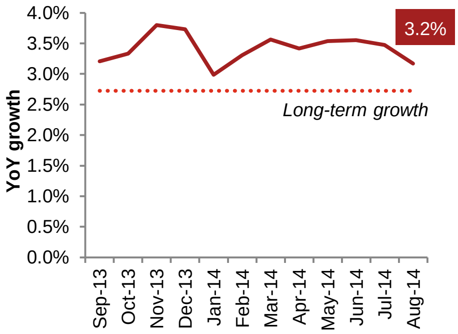
PwC's Global Consumer Index

Global consumer spending growth falls to 3.2% this month, the lowest rate since January this year.

Stock market performance has slowed and global consumer confidence has experienced a dip. However, industrial production has picked up slightly in Europe and the US, which could portend an improved outlook over the next few months.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit ***www.pwc.co.uk/globalconsumerindex***

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