BANKING ON KNOWLEDGE

Monetary easing prevails amidst better growth expectations, surge in bond yields

By Dr R Seetharaman

In the Federal Reserve meeting held last week, it stated that the US economy is heading for its strongest growth in nearly 40 years and it is pledging to continue with the monetary policy despite an expected surge in inflation.

Fed officials, in fact, expect economic growth to remain above trend for at least two years to come, at 3.3% in 2022 and 2.2% in 2023, compared to estimated long-term potential growth of just 1.8%. While inflation is expected to jump to 2.4% this year, above the central bank's 2% target, Powell said that is viewed as a temporary surge that will not change the Fed's pledge to keep its benchmark overnight interest rate near zero as part of an effort to ensure the economic wounds from the pandemic are fully healed.

After the rise in prices this year, the

Fed expects inflation to fall back to 2% in 2022. Fed officials now expect inflation to remain tame even as the unemployment rate drops, under their new approach that emphasises employment gains and downplays inflation risks. Powell noted the "strong bulk" of the policy-setting Federal Open Market Committee anticipates no interest rate increase until at least 2024, and he added that it was even too soon to talk about scaling back the $120bn of Treasury bonds and mortgage-backed securities the Fed is buying each month to further prop up the economy.

The FOMC's policy statement, which kept the benchmark overnight interest rate in a target range of 0-0.25%, was unanimous. The US 10-year yield ended at 1.721% by end of last week and 30-year yield at 2.4333% by end of last week. The yields surged even after the Fed meeting.

In the Bank of Japan meeting held last week, the bank will continue to buy equities up to a maximum of ¥12tn ($110bn) a year. But under the new policy, the central bank will intervene when the market falls rather than steadily increasing its holdings as a way to spur investment and stimulate economic activity.

The Bank of Japan has scrapped its pledge to buy an average of ¥6tn a year in equities as the central bank edged away from aggressive monetary stimulus in favour of a more "sustainable" policy. The bank said it would allow more fluctuation in 10-year bond yields and launched a scheme to subsidise bank profits so they did not suffer from negative interest rates. The central bank kept overnight interest rates on hold at -0.1%. It will continue to peg 10-year bond yields at "around zero" but they will be allowed to fluctuate by plus or minus 0.25%, instead of the previous 0.2%. The 10-year bond yield of Japan was at 0.113% by end of last week. It had surged to 0.162% in February, 2021.

In the Bank of England meeting last week, it held interest rates at 0.1% and its bond-buying programme at £895bn, thereby diminishing expectations of changes in the immediate future. The Bank of England upgraded its outlook for the UK economy, but stressed it was in no hurry to reduce its support to boost the recovery from the coronavirus crisis.

However, it said the Monetary Policy Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in "eliminating spare capacity and achieving the 2% inflation target sustainably." After the March Monetary Policy Committee meeting, the central bank said that financial market moves in the past six weeks, which have seen sterling and the cost of government borrowing rise, had been warranted by the better immediate prospects for recovery.

UK 10-year yields was at 0.838% by end of last week, however bond markets took the BoE's attitude last week as a reason to sell off again, further raising government borrowing costs. The yield on 10-year gilts rose more than 0.05 percentage points on the day to hit 0.9% during midday.

In the European Central Bank meeting held this month, it opted to keep interest rates unchanged on. The ECB also decided to leave its Pandemic Emergency Purchase Programme at its current level. The scheme was introduced in March 2020 in the wake of the pandemic and is currently scheduled to last until March 2022, totalling €1.85tn.

The ECB has called on the various governments to step up their fiscal responses, arguing that the burden cannot lie solely on the shoulders of the central bank. The European Union agreed to an unprecedented level of fiscal stimulus last year, but these funds are only due to be disbursed from this summer onward. On the whole, the central banks continue with their monetary easing policies amidst better growth expectations and surge in bond yields.

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