In case you missed it: Central banks take a U-turn

As the Brexit plot thickens with more twists than a House of Cards episode, central banks around the world take a dovish tilt. But as we've seen with the Bank of Japan, ultra-low or even negative interest rates sometimes end up doing more harm than good. Does the ECB need to take note?

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In the European Union, high debt levels are a constant concern. But Switzerland faces the opposite problem and, paradoxically, it could be missing out on...

By Charlotte de Montpellier

Article | 22 March 2019

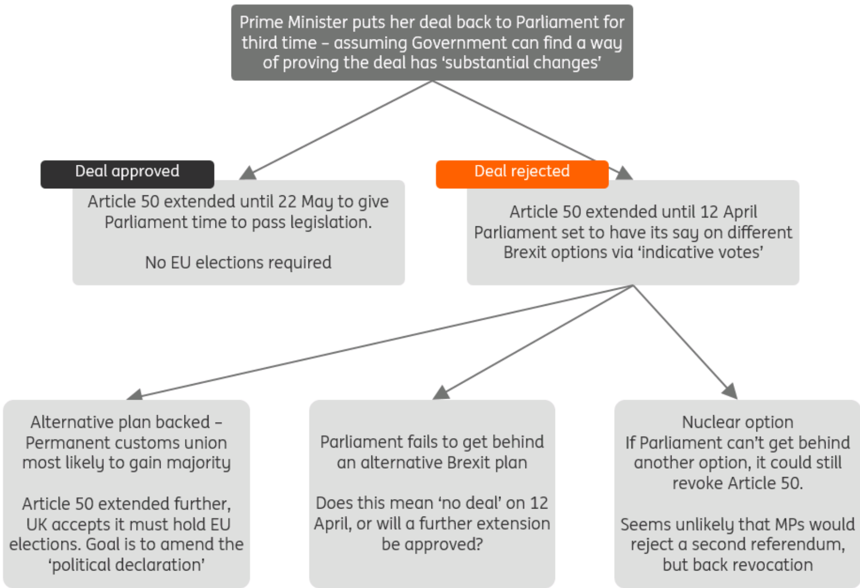
United Kingdom

Article 50 extended: Is a ‘no deal’ Brexit now more likely?

EU leaders have granted an extension to the Article 50 negotiating period, piling the pressure on the UK Parliament to agree a way forward on Brexit. The question is: will a majority of British MPs settle on a course of action before the EU’s 12 April deadline?

British Prime Minister, Theresa May and Donald Tusk, European Council President

The new Brexit timeline



Source: ING

What's been agreed?

After a classic marathon evening of talks at the March European Council meeting, EU leaders have agreed to an extension of the two-year Brexit Article 50 negotiating period. The decision, being dubbed a "flextension", gives the UK two options and piles the pressure on Westminster to agree a way forward over the next few weeks.

If May's Brexit deal is passed next week, the EU will grant an extension that lasts until 22 May - the day before European Parliament elections. This would give the UK time to pass the relevant legislation.

If the deal doesn't pass next week, then the UK will have until 12 April to decide a way forward. This coincides with the legal deadline for the UK to give notice on holding EU elections, and European Council President Donald Tusk made it clear that this was a key condition to unlock a longer extension beyond mid-April.

Before going into the implications, there is immediately some good news. There had previously been reports that the EU was considering holding a further summit next week to make the final decision on extending Article 50, which would come after May's third meaningful vote on her deal.

Perhaps fearing the risk of taking the Brexit saga to the eleventh hour, leaders decided against putting off the decision until next week. This takes some of the heat out of what could have been a nerve-wracking week, although Parliament still needs to get its act together and formally change the exit date in UK law before 29 March (although this shouldn't be too hard).

Will May's deal go through next week?

In short, probably not.

The momentum that seemed to be gathering behind May's deal last weekend appears to have faded. The Prime Minister's hint that she wouldn't be prepared to delay Brexit beyond June has altered the calculation facing MPs again, and many pro-Brexit hardline lawmakers may decide to hold tight in the hope that a 'no deal' outcome has become more likely. Talks with the Democratic Unionist Party (DUP), who are seen as key to unlocking wider support for Theresa May's deal, also seem to have stalled.

Of course, in order to have a vote in the first place, the Prime Minister needs to find a “substantial” change to the deal, to satisfy a requirement put forward by Speaker of the House of Commons John Bercow earlier in the week.

At an event held by the Netherlands-British Chambers of Commerce (NBCC) on Thursday, Brexit Minister Robin Walker reiterated that the government is confident it can navigate the Speaker's requirements. The government could argue that the EU’s Article 50 statement, combined with further crystallisation of Brussels' Brexit 'reassurances' from last week, could be cast as a 'substantial change' to the deal. If the government can also get a significant number of MPs to sign the motion, it hopes it can signal there is a will in parliament to hold a repeat vote.

However, the fact that the government is having to use these rarely-used mechanisms to force 'meaningful vote three' demonstrates that it will be very tricky for the Prime Minister to hold further votes on her deal again. Lawmakers will therefore be aware that this might be their last opportunity to vote on May's deal. Those Brexiteers that calculate a long delay is inevitable may therefore still decide to back it, while those more moderate MPs that fear ‘no deal’ may also decide to get behind it - although we suspect there will be nowhere near the numbers needed for May to get her deal passed.

Will parliament agree on an alternative plan before 12 April?

Assuming May's deal is rejected for a third time, focus will switch back to this idea of 'indicative votes' - a process where parliament will get its say on alternative Brexit options. Backbench MPs have put down an amendment for Monday, which will try to force these indicative votes later in the week.

If these votes do take place - which we suspect they will - the question is what, if any, option will get parliamentary backing?

> *The most likely option to get a majority is a permanent customs union*

A second referendum still lacks numbers, not least because a number of Labour MPs are wary given they represent leave-supporting areas. The so-called 'Norway Plus' option, which would essentially involve single market membership, could also lack majority support because of concerns surrounding free movement of labour.

The most likely option to get a majority is a permanent customs union. This alternative, that would avoid the need for tariffs/rules of origin issues in future, is not different to the current deal. The contentious Irish backstop includes a customs union, and in theory, when push comes to shove, many of the more moderate Conservative/Labour MPs could get behind it.

That said, this will really depend on how pressurised lawmakers feel. If the heat is taken out of the situation, for instance, if MPs still perceive the risk of 'no deal' to be minimal, then it's possible that 'party politics' will prevail. A permanent customs union is the Labour Party's policy, so some Conservative MPs may still be reluctant to get behind it.

Either way, the sequencing of these votes will be key. Advocates of the different options will want their plan to be voted upon last. The logic here is that if every other option is rejected, MPs may possibly judge the last one on the table to be their last opportunity to take Brexit in a 'softer' direction.

What happens if the UK hasn't decided on anything by 12 April

This is a real risk, given that May's deal is unlikely to pass, and there are no guarantees a different option will get a majority in indicative votes.

So what would the EU do if the UK came back just before 12 April asking for a further extension? Most commentators tentatively agree that the EU doesn't want to be blamed for no deal so may still be open to a second extension (as long as the UK holds the elections) even if the reason for doing so is a bit flimsy.

That said, Rem Korteweg from the Clingendael Institute told the NBCC forum on Thursday that some EU figures now view a 'no deal' Brexit as a "clean option". The logic is that it gives business certainty sooner (as bad as that certainty may be), and also avoids Brexit becoming a distraction in what is a key year for Brussels. After all, if the UK is to stay in for longer and participates in European elections, British MEPs will get some sort of say in the appointment of top jobs at the big European institutions - something which is not desirable for some Brussels officials.

In the end, we think the British Parliament will do all it can to avoid a 'no deal' Brexit - most likely by settling upon some kind of alternative plan, or even by taking the 'nuclear option' of revoking Article 50 altogether (less likely). We also suspect that most in the EU will continue to view a 'no deal' Brexit as highly undesirable.

We therefore still think 'no deal' will be avoided, although the odds of this happening on 12 April have undoubtedly increased.

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Snap | 20 March 2019 United States

Federal Reserve: Dovish Fed signals end to tightening

No policy change from the Fed, but the dot plot diagram shows FOMC members have gone signalling two possible hikes to no hikes in 2019. Should we be worried?

Source: Federal Reserve

VERY patient

As widely expected the Federal Reserve unanimously left monetary policy unchanged with the fed funds target range maintained at 2.25-2.50%. The Fed noted the ongoing "strong" labour market, but also highlighted that growth has "slowed from its solid rate" in Q4. The statement also repeats the argument that with "muted inflation" the Fed will be "patient" with regard to future moves in interest rates.

The accompanying forecasts and "dot diagram" indicate that the Fed will be very, very patient. Having signalled back in December that it was thinking they could raise rates twice this year they are now projecting no rate changes in 2019 at all. In a further adjustment, they will be tapering their balance sheet roll off to US$15bn per month of treasuries from US$30bn with the process being halted by the end of September.

Unsurprisingly the dollar has reacted negatively to this and treasury yields have fallen too. We had expected officials to take one of their projected hikes out of the diagram for this year, but removing both is a surprise. It seems pretty aggressive given officials have been repeatedly telling us that the US economy is "strong". Indeed, they have only cut their 4Q19 GDP growth forecast from 2.3% to 2.1% and left their core inflation forecast at 2%.

Creeping concerns

Such a move will only boost the market conviction that the next Federal Reserve move will be an interest rate cut. Concerns over economic headwinds such as trade protectionism, the government shutdown, weak figures from Europe and China (which Jerome Powell emphasised in the press conference) and the lagged effects of higher interest rates and the strong dollar all do justify caution. The recent weak run of US activity data has also been disappointing while core inflation has undershot expectations. However, today's sharp shift from the Fed may risk exacerbating any business and household concern about the outlook.

Should we be worried?

We had been thinking that a September rate hike from the federal reserve remained on the table given our belief that the US growth story was underpinned by a strong jobs market and rising worker pay and the expectation that in the coming months we will get a positive resolution to the US-China trade dispute. Indeed we continue to think the US economy can expand in excess of 2% this year with Jerome Powell also talking of "very strong" economic fundamentals. We additionally expect core inflation to grind higher to above 2.5%. However, this does not appear to be enough for officials and we will seemingly need to see even stronger figures to get the Fed to react.

Calling the top

Given such clear direction from officials and the continued emphasis on "patient", it looks as though we will have to take that September hike out of our forecast. For now, the Federal Reserve is still signalling a bias to tighten policy given the rate hike pencilled into 2020. But with a presidential election later in the year and President Trump keen to gain political capital out of challenging the Fed on any rate hikes, we are sceptical that would happen.

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Snap | 21 March 2019 **United Kingdom**

Cautious Bank of England could still opt to raise rates in 2019

While the Bank of England is clear it'll stay firmly on the sidelines amid the current uncertainty, there are still hints that it could be inclined to hike rates earlier than markets think. As ever, it all depends on Brexit

Source: Shutterstock

It all depends on Brexit...

The March Bank of England meeting is probably one of those that policymakers would have ideally liked to skip. The Brexit backdrop makes it very hard for the Bank to say much about the economic outlook, and as might you might expect, the statement contains various references to the ongoing uncertainty.

Unsurprisingly, the Bank has also kept its cards close to its chest when it comes to the prospect of rate rises, simply saying that further tightening may be required.

Importantly though, we think it's too early to completely rule out a rate hike this year - although of course, this depends almost solely on Brexit. Here are few possible scenarios:

1 Deal approved and the UK enters a transition period

There are reports that prime minister Theresa May will attempt to bring her deal back to parliament next week for a third meaningful vote. This relies on her finding a satisfactory way to duck Speaker John Bercow's requirement for a "substantial change", and even then, the odds still appear stacked against the prime minister's deal.

But if PM May does find a way of getting a deal through, then talk of a near-term rate hike could quickly return. Wage growth is running at a post-crisis high and given that this stems from skill shortages in various parts of the economy, we don't expect this trend to reverse rapidly. The Bank's forecast of excess demand at the tail-end of its forecast period implies that more tightening could be needed than currently priced into markets.

You could reasonably argue that with the Federal Reserve and the ECB seemingly on pause for the foreseeable future, it's hard to see the Bank of England going against the grain. But barring a more severe global downturn in growth, we suspect policymakers will be more inclined to play 'catch up'. For this reason, we've loosely pencilled in a rate hike for November.

2 Article 50 extended

For the Bank of England outlook, a lot depends on how long the Article 50 negotiating period is extended. A short extension until the end of May would keep the risk of 'no deal' firmly alive, and this would continue to keep a lid on economic growth. While further extensions might be possible, the risk of the EU saying 'no' could increase.

Unless PM May manages to get her deal approved over the course of next week (or before the 12 April deadline to trigger European elections), it seems like the EU might be more minded to offer Britain a long extension to the Article 50 period. In theory, a delay to the end of the year or beyond could open a narrow window for the Bank of England to hike over the summer – on the basis that it could help unlock some consumer spending and give businesses temporary reprieve.

This relies on the economy rebounding fairly quickly though, and it's equally possible that a long extension leads to a prolonged pause at the Bank. After all, having come this close to the cliff-edge, businesses will be alive to the possibility that it could happen again and investment will stay under pressure.

3 No deal - Brexit

We suspect parliament will do all it can to prevent a 'no deal' Brexit on 29 March, and we still suspect the EU will be reluctant to block an Article 50 extension too if it leads to the UK crashing out of the European Union.

But if we're wrong, then the Bank of England has suggested rates could go in either direction. On balance though, we suspect 'no deal' would cause a substantial hit to confidence (in addition to significant disruption to supply chains), which makes it much more likely the Bank would decide to cut interest rates in this scenario.

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Article | 27 February 2019 Thailand

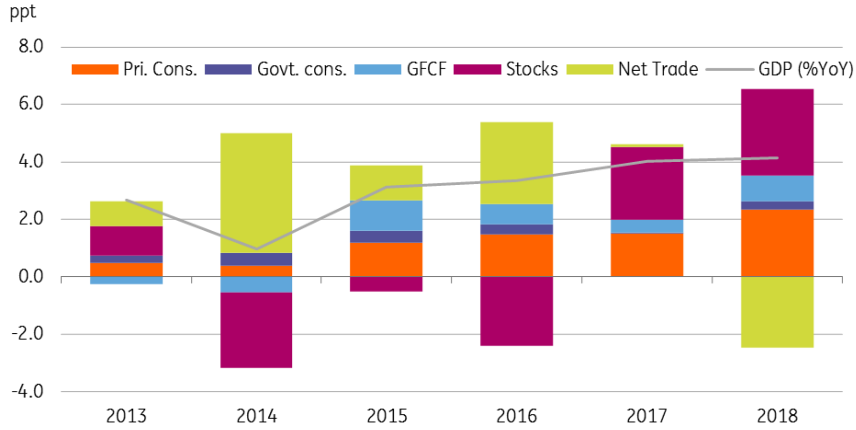
Thailand: Steady economy amid political risks

Prime Minister Prayut Chan-o-cha is likely to remain in power at the general elections next month, though the transition to the new government under him may not be smooth. Absent a significant political shock, the economy will be on a steady 3-4% growth path and the currency will continue to be an Asian outperformer in the medium-term

2018 wasn't all that bad with firmer growth

Thailand's economy grew by 4.1% in 2018, the best performance in the last six years. However, it was not much of an improvement from the 4% growth rate recorded in the previous year and underlying drivers of growth weren't very impressive either. As in 2017, a large contribution to growth came from inventory re-stocking, which isn't a healthy sign as the potential inventory overhang is likely to keep future output growth subdued. There was some improvement in domestic demand but the all-important investment demand continued to be anaemic and lacked a material boost from public investment. Meanwhile, narrowing external trade surpluses held headline GDP growth down.

Sources of GDP growth



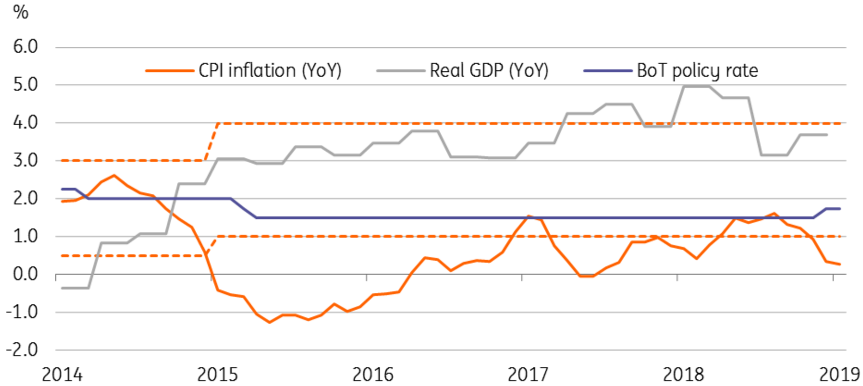
Source: CEIC, ING

The strong currency and lack of demand-side pressure have kept consumer prices subdued. The Bank of Thailand's (BoT) 1-4% policy inflation target has barely been achieved on a sustained basis in recent years. Last year was no different. Even though average CPI inflation of 1.1% in 2018 was the most in four years, after a brief return to the target level, inflation slid closer to zero toward the year-end. Apart from the pass-through of higher global oil prices to domestic fuel prices, which kept the CPI transport component elevated, and higher "sin taxes" on alcohol and tobacco products, there was no inflation in most other CPI components, not even in food prices, which have been the main driver historically, due to their 36% CPI weight.

On the external side, the current account surplus equivalent to 7.5% of GDP in 2018 represented a sharp narrowing from 11% recorded in the previous two years. Yet this remained the main source of currency (THB) strength. The Thai baht was unscathed and retained its top spot among Asian currencies during bouts of emerging market volatility owing to the trade war and contagion from the crisis in Argentina and Turkey.

Indeed, persistently low inflation was an argument against the Bank of Thailand following the US Federal Reserve in tightening. Even so, the BoT stepped up its hawkish rhetoric and moved policy with a 25 basis point interest rate hike in December. The first BoT rate hike in seven years was aimed at gaining policy space for the future. Meanwhile, fiscal policy remained expansionary with close to a 3% of GDP budget deficit.

Growth, inflation, and central bank policy



Note: Dotted lines are BoT's inflation target, currently 1 to 4%.

Source: Bloomberg, CEIC, ING

Could 2019 be ugly as politics overtakes the economy?

After frequent rescheduling, general elections are (hopefully finally) set to take place on 24 March 2019. Hopes rest on this ending the long-standing political uncertainty about establishing a civilian government after the military grabbed power in May 2014. That coup overthrew the last elected government of Yingluck Shinawatra (2011-14), the sister of the former Prime Minister Thaksin Shinawatra (2001-06). General Prayut Chan-o-cha initially promised elections within a year of the coup but has pushed out the timing until this latest rescheduling.

Will the transition from military to publicly-elected government be smooth, without any political turmoil? Maybe not, judging by Thailand's political history which has been marred by frequent unrest, military interventions, and short-lived governments. A glimpse of this came earlier this month when a Thaksin-linked Thai Raksha Chart Party announced Princess Ubolratana Rajakanya, the elder sister of King Maha Vrjiralongkorn, as its prime ministerial candidate for upcoming elections. A spike in political risk ensued with a public outcry against the move deemed unconstitutional and disrespectful to the royal family. The sell-off in local financial markets was associated with the steepest single-day depreciation of the THB since last October.

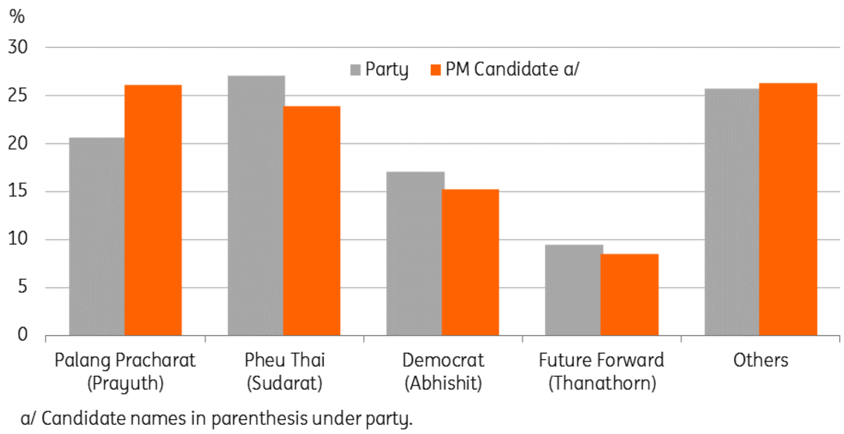
The King denounced the Thai Raksha Chart's move as unconstitutional, and the party now faces dissolution by the constitutional court on the grounds of violating election laws. This nipped in the bud Thaksin's bid to reacquire his grip on Thai politics via a royal family member and also bolstered the odds of Prayut holding on to power.

There are 68 prime ministerial candidates in the ring, including Prayut contesting from the military-backed Phalang Pracharat Party and former Prime Minister Abhisit Vejjajiva (2008-11) from the Democrat Party. Thaksin's Pheu Thai Party is also fielding three prime ministerial candidates, while the fourth major party in the fray is the newly-formed Future Forward Party led by Thanathorn Juangroongruangkit.

Moreover, the new constitution adopted in 2017 allows the military to retain its decisive role in future governments. The upcoming elections will be for the 500-seat lower house of parliament, but the 250-seat upper house, or Senate, is the non-partisan body of appointees from the Royal Thai Military. As such, the balance of power remains tilted toward Prayut. Yet, the passage to the new government may not be without any political gridlock or public unrest.

What pre-election opinion polls point to?

Average results of various opinion polls held since December 2018.



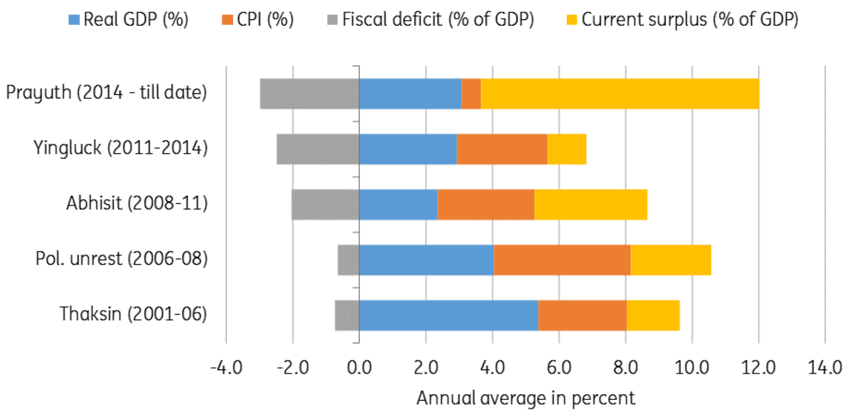
Source: Wikipedia, ING

Economic case for Prayut's re-election

Let's take a look at Thailand's economic performance under the current and previous regimes to assess Prayut's chances of continuing as prime minister.

Growth improved from a low of 1% in 2014 (the year of the military coup) to about 4% in the last two years, though the 3% average over these years was hardly an improvement over previous administrations. The economy enjoyed lower inflation under Prayut than previous regimes though this is more a result of weak demand and lower commodity prices.

How did the economy fared under recent governments?



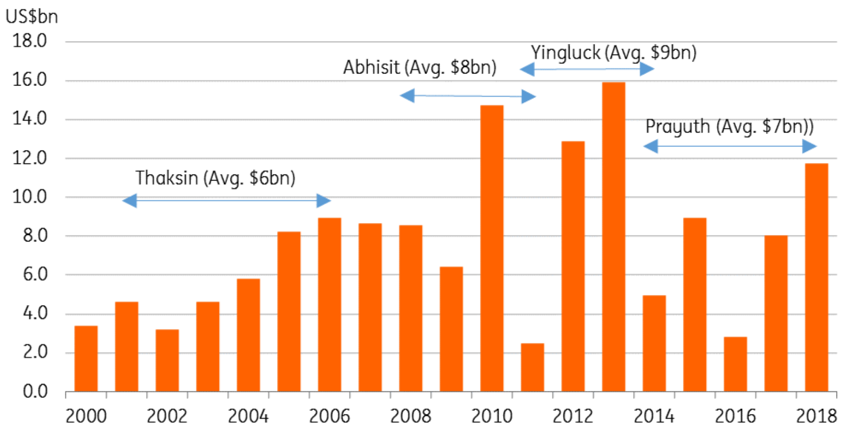
Source: Bloomberg, CEIC, ING

External situation - great, but thanks to weak demand

Of course, the external payments position had never been as strong as it was under Prayut, supported by a lumpy current account surplus and swelling foreign exchange reserves. However, a large current account surplus also reflects a gross economic imbalance, which has failed to correct despite expansionary macroeconomic policies. Having slashed policy rates by 200 basis points to 1.5% from late 2011 to early 2015, the BoT held policy stable until the latest hike in December 2018. The fiscal deficit averaged about 3% of GDP in the years from 2014, more than the previous administrations.

Foreigners have been pouring funds into local stocks and bond markets in recent years, thanks to the comfort of healthy external payments boosting the currency. And direct investment inflows also gained traction in the last two years. But real investment growth continued to be depressed under military rule (there is also a structural aspect to this as discussed in the next section).

Net foreign direct investment inflows



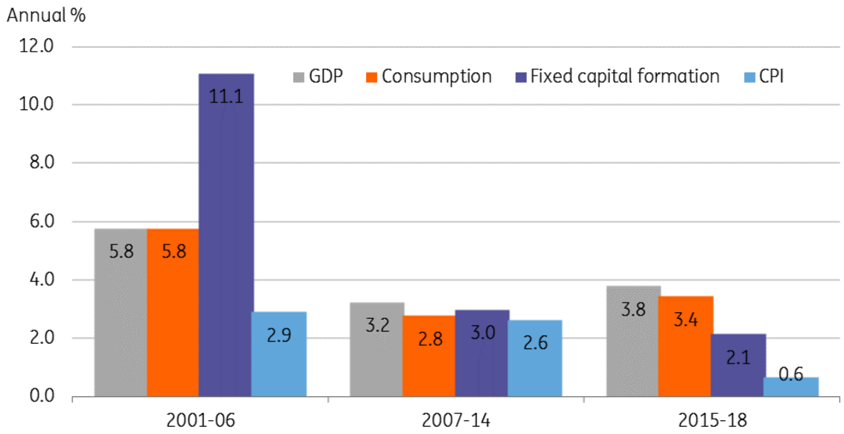
Source: CEIC, ING

Structural trends – plenty of slack in the economy

The post-Thaksin era was marked by a significant surge in political uncertainty taking a toll on the economy. This is evident from the almost permanent shock to growth via weak investment demand. Once an Asian tiger, Thailand's economy has struggled to grow in recent years with a steady slowdown from an annual average rate of 5.8% in 2000-06 (Thaksin era) to 3.2% in 2007-14 (years of heightened political turmoil). A slight improvement in recent years (military government) can be characterised as lopsided – persistent weak domestic demand – without stoking any inflation.

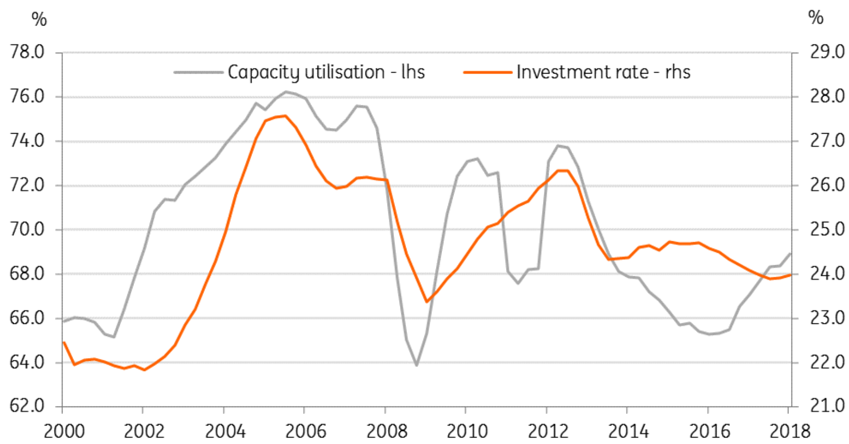
There is plenty of slack in the Thai economy as underscored by factories running at about two-thirds of their capacity. The elevated manufacturing inventory-to-shipment ratio points to the same feature. And this has dampened the investment rate (ratio of fixed capital formation to GDP), which has failed to reach the Thaksin-era highs, while politics has been a constant overhang on investor sentiment.

Years of political uncertainty has shocked growth lower



Source: CEIC, ING

Unused capacity weighs down investment



Source: CEIC, ING

Steady as it goes into the medium term ...

We expect the broad economic trends described above to remain in place in the medium term. Absent significant political risk, we see no reason for Thailand's GDP growth to break out of the 3-4% range that it's seen in recent years. The National Economic and Social Development Council (NESDC) projects 3.5-4.5% growth in 2019, as election spending is likely to provide upside to consumer spending. But with the prevailing external risks from the global trade war, GDP growth will likely be closer to the low end of the NESDC's forecast range.

Investment will persist as a weak spot. Hope rests on the continuation of the Eastern Economic Corridor Plan undertaken by the current administration under the new government. This is a long-term plan to develop three coastal regions into a special economic zone with airports, deep sea ports, and high-speed rail, and spanning a multitude of industries. Thailand is also seen among the destinations for potential supply chain relocation resulting from the US-China trade dispute, but is still not as attractive a destination as Cambodia, Vietnam, Myanmar or Laos – all up-and-coming countries with relatively cheap labour.

We see external trade imbalances narrowing gradually. A significant negative swing in the trade balance in January to a deficit of $4 billion from a surplus of $1.1 billion in the previous month heralds this trend. We forecast that the current surplus will shrink further to 4.5% in 2019, providing continued strong support for the currency's appreciation.

Key economic indicators and ING's forecasts

Thailand	2015	2016	2017	2018	FY2019 f	FY2020 f
Real GDP (% YoY)	3.1	3.4	4.0	4.1	3.8	4.0
CPI (% YoY)	-0.9	0.2	0.7	1.1	1.0	1.4
Unemployment rate (%)	0.9	1.0	1.2	1.1	1.2	1.1
Fiscal balance (% of GDP)	-2.9	-2.7	-3.5	-3.0	-3.2	-2.9
Public debt (% of GDP)	42.1	41.1	41.2	42.4	43.7	46.9
Current account (% of GDP)	8.0	11.7	11.0	7.5	4.5	3.4
FX reserves (US$bn)	156.5	171.9	202.6	205.6	220.0	230.0
External debt (% of GDP)	32.7	32.0	34.1	31.3	32.0	33.0
Central bank policy rate	1.50	1.50	1.50	1.75	1.75	1.75
3M interbank rate (%, eop)	1.63	1.59	1.57	1.86	1.85	1.85
10Y govt. bond yield (%, eop)	2.50	2.65	2.32	2.48	2.60	2.80
THB per USD (eop)	36.08	35.84	32.58	32.33	31.80	31.50

Source: Bloomberg, CEIC, ING

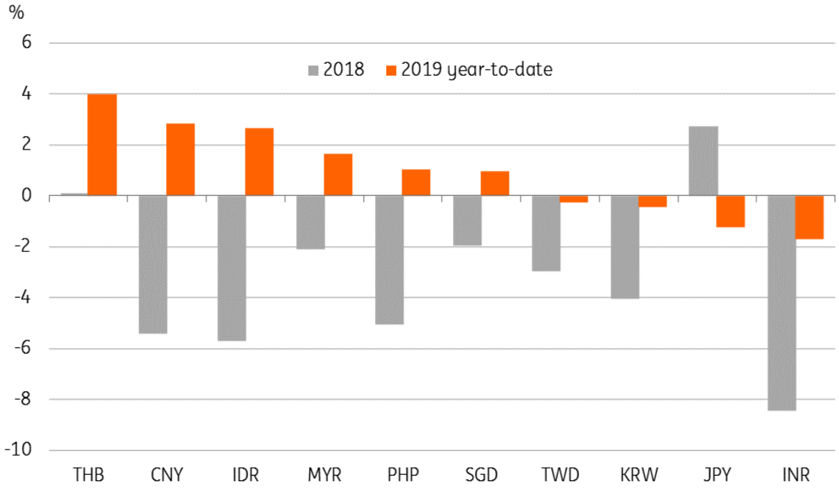
... thanks to continued policy accommodation

We aren't anticipating a near-term departure of monetary or fiscal policy from the current accommodative stances. Despite the sustained hawkish tone, the BoT has flagged policy to be data-dependent and yet likely maintaining an 'accommodative' bias for this year. We don't see anything significant in the data to cause another rate hike this year, nor do we expect any easing. This view of policy status quo hinges on our forecasts of growth slipping below 4% and inflation hovering around 1% in the current year.

Fiscal policy will remain accommodative, too. The state budget for the current financial year ending September 2019 is set to produce a deficit equivalent to about 2.6% of GDP, a consolidation from 3% in FY2018. But slower GDP growth will likely depress revenue, and together with the surge in election spending, this will see a wider budget gap than projected. However, we don't see anything here threatening the country's investment-grade sovereign credit rating underpinned by still sound external payments.

Still, there are more reasons for the authorities to be worried about the ongoing currency strength, which is detrimental to exports in the current environment of rising global trade protectionism. The BoT views recent THB appreciation as consistent with broader emerging currency trends supported by a dovish turn in US Fed policy and softer US dollar. Moreover, we think the reason for the currency's 4% year-to-date appreciation probably lies in investor confidence about the military Junta maintaining its grip on the government, and thus ensuring political as well as economic stability. Although we aren't ruling out some weakness in the run-up to March elections, the THB will remain investors' darling for the rest of the year.

THB remains top-performing Asian currency



Note: In descending order of 2019 performance.

Source: Bloomberg, ING

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Opinion | 21 March 2019 **Japan**

Japan’s central bank: Best intentions, poor outcomes

To add to a long list of things considered cornerstones of Economics, which I suspect are well-meaning but misguided, let me propose central bank policies, as rates approach or pass zero. This is of particular note for the Bank of Japan, but the ECB might also want to pay attention

Source: Shutterstock

An elderly couple celebrating a cherry-blossom viewing

Growing debate in Japan about the central bank's policy

Pensioners committing acts of petty crime to get locked-up and receive food and shelter is a trend that is on the rise in Japan. Who's to blame? Could you perhaps point a finger at the Bank of Japan (BoJ)?

While that claim may sound outrageous, it might not be so crazy after all. But in giving it the benefit of the doubt, it requires you to accept that much of what you may ever have been taught or learned about economics was either wrong or at best, only partly right. That shouldn't be too hard a concept to swallow surely? A recent article by Jim O'Neill - he of BRIC fame - suggests the same, though without any detailed consideration (at least that's my view). We try to go one better here.

So how does all this relate to the Bank of Japan?

Read the full article by Jim O'Neill here

Negative rates may be doing more harm than good

It isn't such a big stretch to make the claim that the Bank of Japan's extended relationship over the years with unorthodox monetary policy, qualitative and quantitative easing, zero and negative interest rates and negative bond yield targeting, has failed to achieve what was intended - a consistent increase in price level inflation, and faster nominal GDP growth. At present, the central bank has an inflation target of two percent. Right now, they aren't even close, and few believe it'll ever be achieved.

> *The subject I will focus on is the non-linearity of the investment-savings decision as rates approach zero or turn negative. Believe me, it isn't as dull as it sounds*

So why has it been such a big failure? There are many factors I could list here, but in this note, I will deal with only one of them. The subject that I will focus on here specifically, though acknowledging that there may well be many others, is the non-linearity of the investment-savings decision as rates approach zero or turn negative. Believe me, it isn't as dull as it sounds.

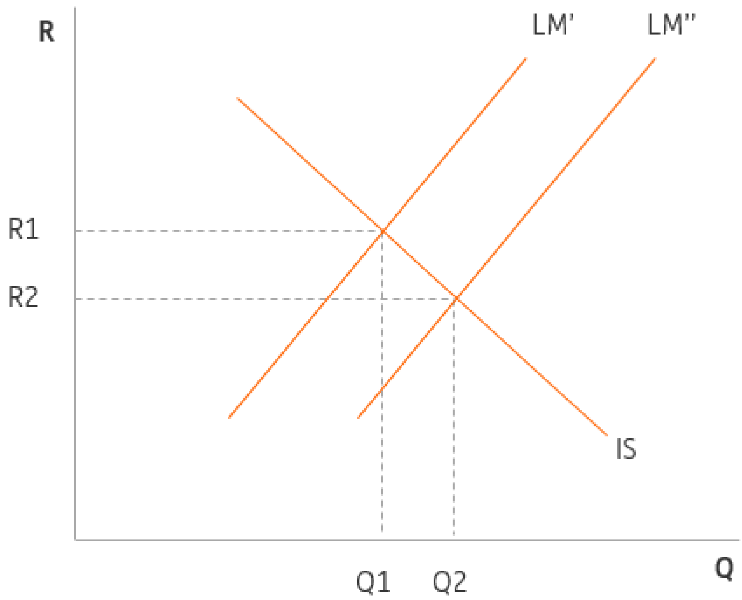
Most text-book economics is a big simplification

When you first get taught Economics, you will come across various versions of what is known as 'IS-LM' analysis. This combines the LM curve, which shows the relationship between the money supply for different interest rates and economic output, and the IS curve, which shows the substitution that occurs between investment and saving at different interest rates.

The basic notion is that at lower interest rates, people substitute investment (by which we mean any spending, which can include business investment) and saving (any part of your income that you don't save). This is called the IS curve, and in almost all textbooks, it is simplified - as is the LM curve - as a straight line. So as rates are lowered or the money supply increases (LM shifts right from LM' to LM'' as you can see in the chart below and output rises from Q1 to Q2.

This essentially is a boiled-down version of the thinking behind all central bank monetary policy - lowering rates or supplying more money with quantitative easing shifts out the LM curve, and (even if only for a short time before inflation or an appreciating currency erodes its influence) results in stronger growth and in the process, higher inflation.

Traditional IS-LM curve analysis



The problem is it doesn't work

The theory and the practice of this type of thinking worked reasonably well through most of the central bank era of inflation targeting, though it's worth reminding ourselves, that this era wasn't really that long, and that for much of the prevailing time, inflation was considerably higher than is typically the case these days.

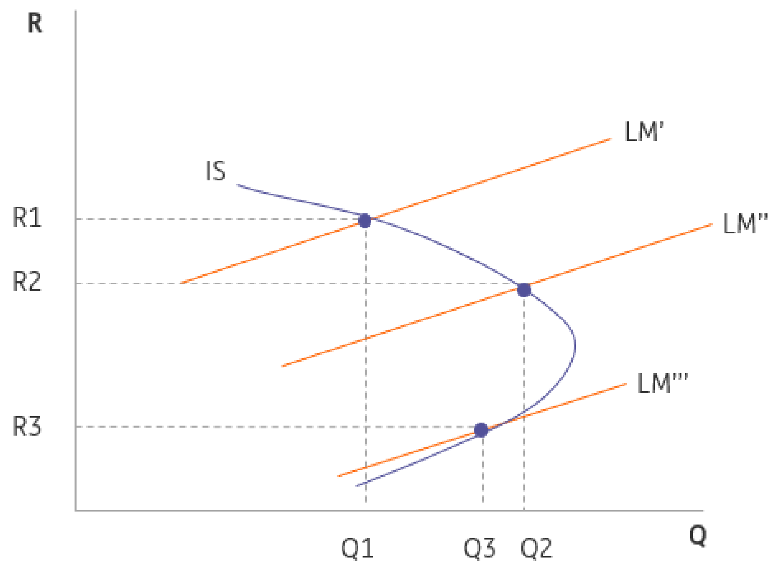
> *I don't think it's my imagination, but the power of low rates to boost economic activity seems to have diminished*

During the successive cyclical upswings and downswings, market bubbles and bursts, central bank interest rates have peaked and troughed at lower and lower levels, as have market bond yields.

I don't think it's my imagination, but the power of low rates to boost economic activity seems to have diminished. Now central banks talk about raising rates to have room to cut them, suggesting the level of rates are no longer the determining factor of output, even in the short term. Instead, only the rate of change seems to be important and even then, not very much.

One explanation for this could be that as rates approach zero, the IS curve becomes non-linear. Indeed, for what I am about to describe, the IS curve becomes 're-curved'.
(For the mathematicians reading this, please let me know the proper term for the shape of the curve illustrated below, as a quick search on Wikipedia didn't throw up convincing answers).

IS curve at low or negative rates



The power of the market...

Geometry, like that shown above, can be fiddly. So how about a real-world explanation to describe why we may have a curve this shape and what the implications of this may be.

Consider people from my parent's generation, born in the 1930s. They worked and earned in a world where there was inflation, from the 1950s through 1990s, with positive and significant interest rates. Borrowing was costly, and servicing that debt ate up a lot of disposable income. Cutting rates really did free up a lot of spending power. A bit of inflation also helped deflate away the outstanding pile of debt, so real interest rates were the important measure for how tight monetary policy was.

> *Consider people from my parent's generation. Higher rates meant they were encouraged to save more to benefit from greater returns. But in the process, they would spend a little less - and this is how monetary policy worked*

My parents could save, with even low-risk savings like bank deposits getting a non-trivial interest rate. And, thanks to the power of compounding, this helped grow their savings. Market returns were also higher, though of course, inflation was also a scourge on savers.

At the point of retirement, or of realising the value of a savings project for other purposes, not only would the pot of savings be considerably more than the sum of savings, thanks to non-trivial interest rates, but in the case of a pension, it could be harnessed to pay an income that might even be high enough to fend off starvation. Higher rates meant my parents would be encouraged to save more to benefit from these greater returns. But in the process, they would spend a little less, and vice versa. This is how monetary policy worked - and, for the most part, it did work.

...not really powerful any longer

Now take today's savers. A peak-earning person of middle-age looking towards a retirement date in the next ten years or so will look at the miserable rate of return on their savings, with bond yields and interest rates close to zero. In Japan's case, this is absolutely true or even generous as rates and bond yields can even be negative. In Europe's case, it is close to the truth, though bond yields still remain positive, they are in many cases very low. For these savers, a lifetime of saving may generate a savings pot of not much more than the sum of their savings.

Sure, inflation is low, but debt levels rose as rates successively fell, and borrowers now get no relief from higher inflation. Indeed, as rates have been cut towards zero, savings haven't always been reduced and substituted for spending. Instead, today's 50 - something will likely save even harder (resulting in Q3 in the chart above, where Q3<Q2).

The market is providing these savers with no boost in terms of compounded growth rates towards their pension goals and the projected income stream from the savings pot at retirement age will also be effectively zero, requiring the pot itself to be spent to support retirement income. The 50-something today may have to save many times as much as the same demographic 30 years earlier, and faces a poorer income in retirement. No wonder they save even harder as rates fall.

What does this all mean?

What this tells you is what most pensioners in Japan would likely tell you, namely, that running ultra low, even negative policy rates and bond yields is in net terms, doing more harm than good, even if there are some beneficiaries in the corporate world - but don't even get me started on zombie companies and productivity.

Keeping rates low to maintain a weak currency may also hurt these individuals. Pensioners spend disproportionately more of their incomes on food than working families - much of which is imported. So their savings incomes are squeezed, and then their cost of living rises as the yen depreciates. Double whammy - which is why a spot of shoplifting, even if apprehended, can seem a reasonable trade-off to an increasing number on the edge of poverty in old age in Japan.

> *What this tells you is that running ultra low, even negative policy rates and bond yields is in net terms, doing more harm than good*

Were the Bank of Japan (or dare I suggest the ECB) to actually abandon its current, and arguably failed policy efforts, it may find, higher rates aren't met with collapsing consumer spending, but the exact opposite. Yes, I dare say the yen would appreciate a bit and the headline CPI inflation rate would fall even further. But Japan seems to be managing quite well with an inflation rate of practically zero, and I don't believe households would start to panic if their incomes actually stretched further in real terms, even if that did mean a negative growth rate for the headline CPI index.

Why now?

Although this is the precisely the sort of unorthodox thinking that would get me kicked out of the monetary policy setting committee of most central banks, a recent quote from Japan's finance minister, Taro Aso suggests that some members of prime minister Shinzo Abe's government are also having a re-think about Bank of Japan's targets. "*For the general public, there isn't a single person out there saying it's outrageous that we haven't reached 2 percent inflation*". He recently added: "*You have to think about the possibility that things will go wrong if you focus too much on 2 percent*".

It looks as if the Japanese government is coming round to my way of thinking on the non-linearity of the IS curve as rates approach or pass zero, but the central bank might take a little longer. This sort of unconventional thinking is anathema to most central bankers and may take a little time to percolate. They would rather apply unorthodox policy remedies based on orthodox thinking, even if they don't seem to be working.

But in bravely taking the lead on this, Japan's central bank could provide a very useful lead to other central banks around the world who are clinging on to zero or negative interest rate policies, without much sign of any benefit. You know who I'm talking about...

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Switzerland: Negative rates will be new norm for a long time

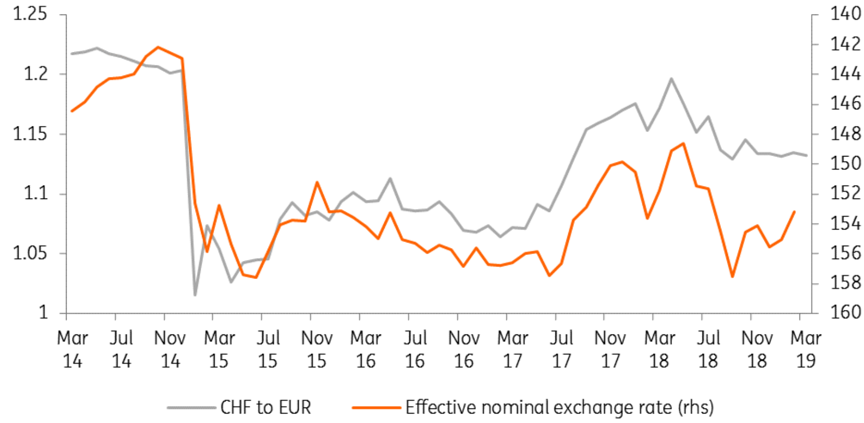
The Swiss National Bank has kept its easy monetary policy unchanged and revised its inflation forecast downwards. This suggests we shouldn't expect a rate hike for several years

Source: Shutterstock

Monetary policy unchanged

As expected, the SNB has not changed monetary policy, keeping rates unchanged: the interest rate on sight deposits held at the SNB remains set at -0.75%, and the margin of fluctuation of the Libor at three months remains between -1.25% and -0.25%. Despite a slight depreciation of the Swiss franc, the SNB still describes the currency as "highly valued" and continues to intervene on the foreign exchange market, if needed.

Swiss franc remains highly valued



Source: Thomson Reuters Datastream, ING Economic Research

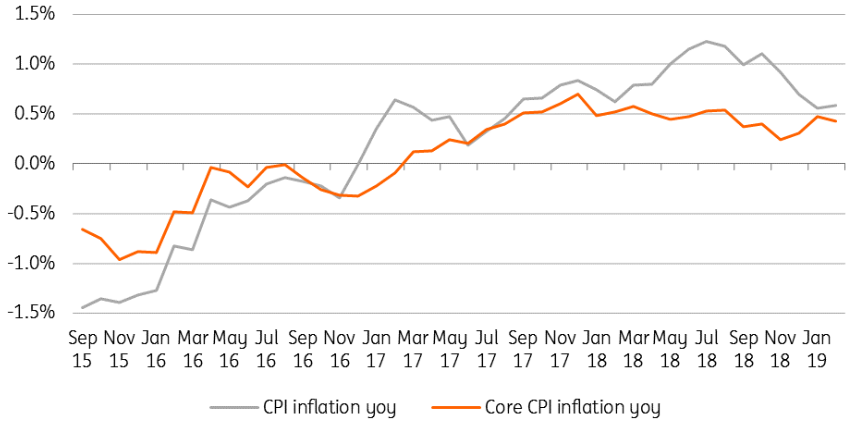
Expected inflation even lower

The SNB has also reduced its conditional inflation forecast (i.e. assuming an unchanged policy rate). For 2019, it expects an inflation rate of 0.3%, compared to its forecast of 0.6% in December and 0.9% a year ago. This downward revision is, according to the SNB, the result of lower growth prospects, weaker inflation and revised expectations about monetary policy around the globe. For 2020, the SNB forecasts an inflation rate of 0.6% and 1.2% for 2021. The revised forecasts are a sign that the SNB is more dovish than ever before and is not planning any monetary tightening over the forecast period. A first increase will not, in our view, be considered before the next economic cycle.

We believe these new forecasts also show that the SNB cannot act alone to avert periods of low inflation or outright deflation in Switzerland. Its power to fight this risk is constrained because it has reached the limits of the instruments it can put in place. In the event of a stronger-than-expected slowdown in growth, which would weigh on inflation, the SNB will no longer have the tools available to stabilise price developments. As a result, a more expansionary fiscal policy will probably be needed in the future, alongside the SNB, to fight against deflationary pressures in Switzerland.

Regarding GDP growth forecasts, the SNB recognises that indicators have deteriorated in recent months. However, it believes that they reflect a "moderately positive" dynamic and forecasts growth of around 1.5% in 2019. While the government predicts 1.1%, this forecast seems, in our opinion, relatively optimistic.

Low inflation



Source: Thomson Reuters Datastream, ING Economic Research

What's next?

The SNB's monetary policy review confirms our forecast: we believe the SNB will not be able to raise rates for several years. It will have to wait for the next economic cycle to have the opportunity to increase them. In the meantime, negative rates are likely to remain the norm for Switzerland. At the same time, we don't believe the SNB will further reduce rates in the event of a stronger-than-expected economic slowdown. It could, however, intervene more in the foreign exchange market if the Swiss franc were to appreciate too much. At the same time, we believe that a more expansionary fiscal policy is likely to be put in place, should the recovery falter.

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Article | 20 March 2019 FX | Video

Watch: The ‘stock picker’s market’ in FX

The lack of volatility in the FX markets means it's going to be local stories driving foreign exchange trends. And that, says ING's Chris Turner, is why the pound can be an outperformer amid all the Brexit confusion

Sinking volatility and a ‘stock picker’s market’ in FX

Watch video

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Belgian elections: A large Green coalition?

Opinion polls suggest that the centre-right government is unlikely to win a majority at the federal elections. A large coalition comprising the Green parties looks likely

Source: shutterstock

Caretaker government in place

After the fall of the Belgian government in late 2018, a caretaker government was set up, and this is expected to remain in place until the elections in May. The current situation is far from ideal and not conducive to taking necessary financial decisions. Bear in mind that before the government collapsed, it had lost its majority in parliament following the resignation of ministers affiliated with the New Flemish Alliance (NV-A). And a caretaker government has very little power. As a result, there has been no vote on the 2019 budget. A temporary budget based on 2018 expenditures has replaced this for now, keeping the public deficit at close to 1% of GDP.

That said, some plans which had already been discussed before the fall of the government have been voted upon by the parties making up the previous majority.

Prime Minister Charles Michel's aim was to find an alternative majority in parliament for other initiatives. But his efforts have largely failed- a situation we had anticipated, given that it can be difficult for parties to make concessions to opponents ahead of elections for fear of looking weak in the eyes of voters. We continue to believe that this situation will last until the elections on 26 May.

What kind of coalition to expect?

At this time, it's still hard to know what kind of majority could emerge after the elections. Nevertheless, a recent poll on voting intentions gives some important pointers:

- The previous coalition is unlikely to be renewed and will still lose seats compared to the polls conducted at the end of 2018.

- The progress of the Greens, which was already seen in the polls late last year, has been confirmed, and has perhaps even strengthened. Even if they are not essential for the formation of a majority, they are likely to be part of the next government. And that could mean some major changes to fiscal policy. It is also interesting to note that because of this progress in the polls and because of demonstrations in favour of stronger climate policy, climate change has been, up to now, the main (perhaps even the only) topic of the election campaign.

- A completely left or completely right coalition won't be able to reach a majority. Adding parties traditionally at the center of the political spectrum still won't necessarily be enough to form a majority.

- This means that a fairly large coalition of parties will be needed to reach a majority in parliament, which will likely slow down the process of forming a government. During this period, the caretaker government will remain in place, with no real power.

Fractured political landscape

The make-up of the next federal government remains very open. Given the fractured political landscape, it seems that the coalition will look like a patchwork of many parties. That could make it a bit more difficult to continue with structural reforms initiated by the previous centre-right government. On the other hand, a stronger emphasis on climate measures looks likely, especially as the probability of the Greens participating in the government has increased.

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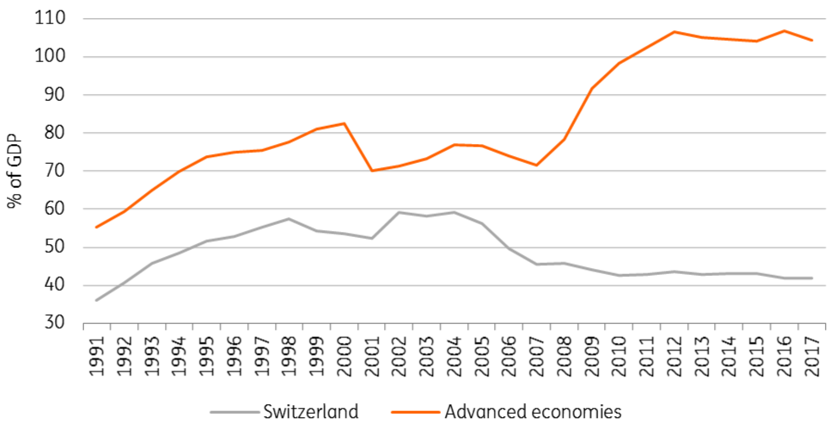
Switzerland: Why too little debt could be a problem

In the European Union, high debt levels are a constant concern. But Switzerland faces the opposite problem and, paradoxically, it could be missing out on extra revenue as a result

General government debt level (% GDP) in Switzerland and advanced economies



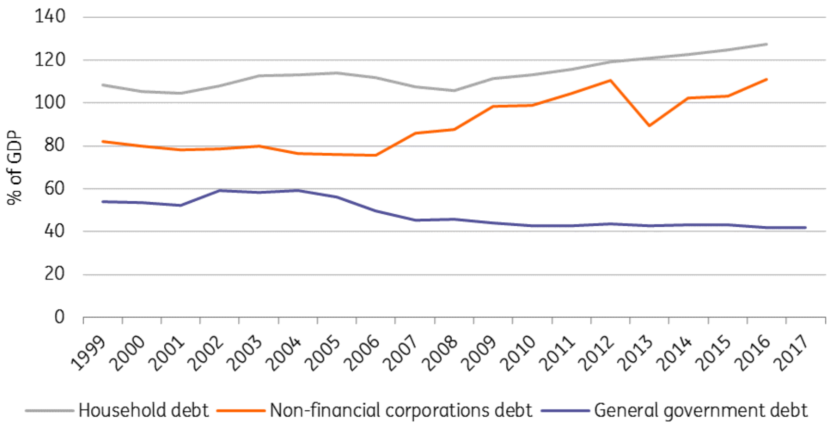
Source: IMF

Very low debt

Switzerland is an exception when analysing the level of its debt. Gross public debt was equivalent to 41.8% of GDP in 2017, according to the IMF, of which 14.5% of GDP is borne by the federal state (Confederation) and the remainder by the cantons. This is the lowest level of public debt in Switzerland since 1991 and is well below the average debt level of the EU (83.3% of GDP) or the euro area (89.1% of GDP). While other OECD countries have tended to increase their debt as a proportion of their GDP in recent years, Switzerland has seen its debt decrease every year.

This decrease in debt follows a succession of budget surpluses in previous years. The budget balance since 2006 has been positive almost every year (except in 2013 and 2014). For 2019, the Confederation's budget could lead to a surplus of 1.3 billion francs (at least). More surprisingly, the Swiss Confederation ends each year with a larger budget surplus than expected at the beginning of the year in the budget. For example, in 2018, the Swiss Confederation recorded a budget surplus of 2.94 billion francs, ten times more than expected, thanks to tax revenues which exceeded expectations, while spending remained under control. Since 2007, only the 2014 financial year closed with a result slightly below the budget forecasts.
To be sure, however, private debt (and especially household debt) is higher than in most OECD countries.

General government, household and non-financial corporations' debt level (% GDP) in Switzerland



Source: IMF

A debt brake in the constitution

The main cause of Switzerland's low indebtedness is a mechanism introduced by the Confederation to stabilise the federal debt: "the debt brake". Enabled in the Constitution since 2003, with a population approval rate of 85% in 2001, the rule has strong legitimacy and many cantons have introduced similar models. The principle: public spending should not exceed revenues over a full economic cycle. The formula allows for a deficit during a recession, offset by surpluses during an expansion period.

However, the implementation of this system has resulted in a significant debt reduction, rather than just stabilisation. This is because the rule is applied asymmetrically and expenditure tends to be overestimated each year, while revenue is systematically underestimated. Almost every year since the beginning of this system, federal authorities have missed their goal by overestimating expenditures or underestimating revenues.

Switzerland is paid to go into debt

This mechanism is largely supported by the Swiss population and illustrates a certain mentality which considers that debt is bad and that it is necessary to reduce debt as much as possible. Each year, the government uses the budget surplus to reduce the debt pile, which leads to a progressive deleveraging of the Swiss public authorities.

Nevertheless, this run of deleveraging poses major questions of economic policies, given current market conditions. Indeed, deleveraging implies a reduction in the supply of Swiss government bonds. However, Swiss debt is considered by the markets to be extremely safe and the demand for these securities is huge, especially when conditions lead to a "flight to safety". The consequence of this strong demand and weak offer is that interest rates on Swiss debt are extremely low, the lowest in the world. The Swiss Confederation borrows with an interest rate of -0.31% at 10 years, -0.62% at 5 years, -0.02% at 15 years. Only state bonds with a maturity of 20 years or more imply a positive interest rate for the Confederation. With these (strongly) negative rates, the Swiss state is actually paid to go into debt. The paradox is there: by reducing its debt, Switzerland is missing out on budget revenues.

Time to change?

According to some experts and academics, Switzerland's strategy of deleveraging is excessive and should stop. For example, Professor Philippe Bacchetta (University of Lausanne) believes that Switzerland is experiencing the "curse of regional suppliers of safe assets". According to him, given the global shortage of safe assets, global demand for liquid assets is being channelled to safer countries (including Switzerland as a first preference) that can offer such assets. These countries are experiencing capital inflows and upward pressure on their currencies. He therefore believes that additional indebtedness could reduce the upward pressure on the Swiss franc and thus relieve monetary policy.

The IMF has similarly endorsed these conclusions for Article IV Consultations in recent years.

- In 2016, the IMF wrote "Given the available fiscal space and constraints on monetary policy, Directors saw scope for additional fiscal support, including by fully utilising the room available under the existing debt brake framework."
- In 2018, the IMF became more insistent saying, "Given constraints on monetary policy, most Directors encouraged the authorities to adopt a balanced structural position by utilising the available fiscal space, which would allow for a more balanced mix of macroeconomic policies in support of domestic demand, facilitating the reduction of the high current account surplus".
- In 2017, the IMF suggested revising the debt brake rule to make it more symmetrical and dependent on debt levels: "A symmetric rule would also support a better macroeconomic policy mix—with a somewhat looser fiscal policy and a less accommodative monetary policy—in order to relieve pressure on monetary policy tools during periods of low inflation. In addition, as currently specified, the rule is independent of the level of public debt. Consideration could be given to allowing a larger (smaller) countercyclical response when debt is below (above) long-term sustainable levels."

Monetary policy in Switzerland is currently extremely accommodative, with a negative interest rate (-0.75%) and interventions on the foreign exchange market to weaken the currency when necessary. Despite a very accommodative policy, price stability remains a major challenge for the SNB, inflation remains very low and the risks of deflation have never been averted (in the last 10 years, annual inflation has been negative for six years). Given the global economic context, we believe that the SNB will not be able to raise rates for several years. Against this backdrop, the room for manoeuver of monetary policy to fight against a possible future recession is very thin. It seems, therefore, that calls for a less restrictive fiscal policy and a more appropriate policy mix will grow louder.

For now, however, the debate has not reached the political level in Switzerland. As long as every budget is well debated and parties have their own priorities for spending, the debt brake rule doesn't seem to be in question. Indeed, every budget surplus is greeted with a self-congratulatory round of applause on the sound management of public finances, rather than an introspective look at how things could potentially be even better under a different system. Still, there are some signs that the debate could gain momentum in the coming months and years. For example, the Federal Department of Finance has decided to look into the matter and a report is expected by the end of March 2019. To be continued....

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