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World's central bankers braced for big divergence

Ferdinando Giugliano, Economics Correspondent

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The Federal Reserve

Since the global financial crisis, mankind has learnt to live with a third certainty along with death and taxes — monetary loosening.

Central banks have slashed interest rates to record lows and embarked upon unprecedented programmes of asset purchases in an attempt to raise inflation and restart economic growth.

The common path on which monetary policy makers have strolled, however, is expected to diverge this year. The timing of the partition and the way in which its side effects are managed hold big implications for financial stability and the global recovery.

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the US Federal Reserve and the Bank of England have ceased to expand their quantitative easing programmes and are eyeing a first rise in interest rates in nearly 10 years.

The European Central Bank, conversely, is in full loosening mode, having launched a €1.1tn scheme of asset purchases. In Asia, the Bank of Japan is busy with its own bond-buying programme, while the People's Bank of China has just cut interest rates three times in six months.

The immediate danger facing the world economy lies in when exactly the US's rate lift-off will take place. Growth has disappointed in the first quarter, with weak retail sales and industrial production figures last week showing that the US slowdown may be more than a seasonal dip.

Economists fear that the damage arising from a premature tightening by the Fed would go well beyond the US: a new recession in the world's most important economy would hurt exporters across all continents, as well as hitting confidence and investment.

Even with a well-timed rate rise, however, the global economy is far from safe. José Viñals, the director of the International Monetary Fund's monetary and capital markets department, warned last month that as higher rates in the US lure back investors from abroad, emerging markets face the risk of increased volatility and sudden stops of liquidity.

Some fear a so-called "super taper tantrum" could surpass the market turmoil unleashed by former Fed chairman Ben Bernanke in 2013 when he hinted at the tapering of the Fed's QE programme. They are calling for greater co-ordination of monetary policy across the world.

But central bank watchers warn that this may not be legal. Monetary authorities, including the Fed and the ECB, have a domestic mandate, and so cannot make decisions on the basis of the spillovers they might cause abroad.

Collaborating to manage exchange rates — another possibility — would also be problematic. As Charles Engel, an economist at the University of Wisconsin-Madison, notes, there is no agreed model upon which to determine the relative value of currencies. Add to that the immense political pressure that policy makers would face upon entering such negotiations.

What most analysts agree is that policy makers — and the Fed, in particular — can be clearer about their future steps than was the case in 2013. Indeed, some central bankers in emerging markets appear more concerned about the risks of excessive dithering by the Fed over a rate increase than about the decision itself.

As they brace themselves for the big divergence, some economists are also urging countries to find ways to share the risks arising from financial spillovers. "There needs to be an international insurance mechanism for emerging markets," said Eswar Prasad, professor of trade policy at Cornell University.

The IMF is one buffer. It offers assistance ranging from a full lending programme — rife with

conditions on structural reforms and budgetary policy — to more flexible credit lines.

But while Christine Lagarde, managing director, can preside over a multibillion dollar loan facility, many economists believe this could be expanded. Changes agreed in 2010 would see a marginal strengthening of the IMF's lending capacity, but they have been held up by the US Congress which has refused to ratify the capital increase.

As long as the US economy gathers enough steam, monetary divergence is inescapable. But policy makers have the means to ensure the transition to this new phase will be merely turbulent, rather than tempestuous.

Ferdinando.Giugliano@ft.com

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