The turnaround year

In the USA the monetary policy controls are set for a gradual return to normal. With the economy stabilizing, financial markets settled, and bank capitalization improved, the need for expansionary anti-crisis measures no longer exists. There are grounds enough for the normalization, since the long phase of ultra-low interest rates has rekindled the “hunt for return” and significantly raised market risk appetite for high-yielding bonds and equities. The longer the low-interest policy persists, the more financial markets get hooked and the graver the potential reactions when the wind inevitably changes.

The Fed has announced its intention to gradually reduce its unconventional liquidity policy of monthly bond purchases and probably halt it completely in late 2014. Only then will consideration be given to key rate hikes. The objective is to keep interest rates on government bonds and mortgage loans low for as long as possible. However, once the Fed’s own thresholds for unemployment (6.5%) and inflation (2%) are reached, market pressure with regard to rate hikes will probably mount.

And what about exit scenarios at the ECB? Only recently it signaled its intention to maintain its expansionary stance and, if necessary, step it up. At first glance it has good arguments. The eurozone debt crisis is not yet resolved and the banking market is still not functioning properly. Moreover, inflation in recent months has dropped below the central bank’s reference value. But there are undeniable risks in keeping the floodgates open too long: Financial markets tend to get carried away, government reform zeal falters and there is a massive redistribution between savers and borrowers. The ECB should therefore abandon its expansionary path soon, at least with regard to the level of interest rates. The supply of central bank money to commercial banks should, however, remain sufficiently high to avert speculation about liquidity bottlenecks in the banking system. But why does liquidity have to be provided practically free of charge? For a while that was warranted in order to enable banks to boost their profits and shore up their capital base. But things cannot stay that way forever. Slightly higher key rates would be tolerable, making it more attractive for well-cushioned banks to offer funds on the money market (particularly with ECB deposit rates at zero). Liquidity-strapped banks would tidy up their balance sheets more quickly to get themselves fully fit for the money market and garner better terms.

A sudden about-turn in ECB interest-rate policy would certainly provoke astonishment at present. But given the foreseeable economic recovery, it could send a healthy signal to the financial markets that monetary sustenance is not going to last forever. Although there is a risk of a possible appreciation of the euro, given the Fed’s simultaneous change of course this is by no means inevitable.