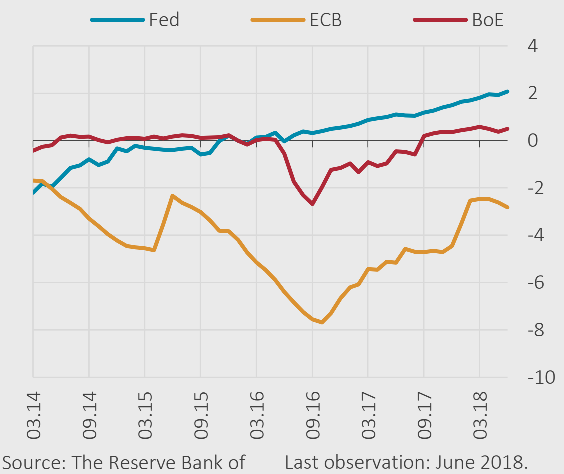
Box 2.1

Monetary Policy Normalization in Advanced Economies: Current Phase and Expectations

The importance of the pace of monetary policy normalization in advanced economies in terms of the global growth outlook and global risk appetite has been underlined many times; and a faster-than-projected tightening was defined as a significant risk factor. Bond purchasing programs with negative or around-zero interest rates have constituted the monetary policy scheme in advanced economies for a long time. However, central banks embarked on gradual monetary policy normalization to expand the room for policy maneuvers and safeguard financial stability. The sustained level of inflation beneath the target challenged normalization at the beginning, yet figures that were more consistent with the targets particularly since the start of 2018 have given a push to normalization. The normalization process has evolved gradually up to now, but its impact on emerging economies (EEs) has recently become more evident.

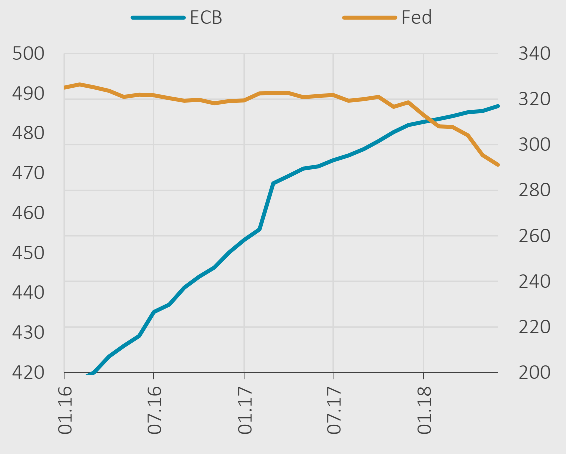
Currently, the Fed, the ECB, the Bank of England, the Bank of Canada and the Czech National Bank continue to progress toward normalization. The Fed ended bond purchases, and embarked on policy-rate increases and balance sheet downsizing. The Bank of England also completed bond purchases and implemented the first policy rate increase. The ECB is cutting down on bond purchases and has announced that the bond purchasing program will be phased out by the end of the year. Not opting for bond purchases, the Bank of Canada and the Czech National Bank also initiated rate increases. In addition to the policy rate, shadow short-term rates that reflect the effects of non-traditional monetary policies are trending upwards (Chart 1). Moreover, the Fed's balance sheet shrank and the growth rate of the ECB's balance sheet lost pace following the reduction of bond purchases (Chart 2).

Chart 1: Shadow Policy Rates (%)



Source: The Reserve Bank of New Zealand. Last observation: June 2018.

Chart 2: Balance Sheet Size (August 2008=100)



Source: Bloomberg. Last observation: June 2018.

June marks an important step for the Fed's and the ECB's decisions on the path to normalization. The ECB in particular conveyed clearer messages for the future. In fact, the rise in inflation trends of both economies invigorated the belief that central banks had attained a target-consistent inflation path permanently, which resulted in a more pronounced communication regarding the normalization process.

As expected, the Fed raised the policy rate by another 25 basis points, and median expectations for the policy rate rose by 25 basis points both for 2018 and 2019[1]. The Fed announced press meetings to be held following every FOMC meeting within the year as of January 2019 and also signaled for more than four possible rate increases. Hinting at a tighter monetary policy, an attempt was made to soften these decisions through Chairman Powell's statement that they would not react to an inflation shock which is not likely to be persistent as well as the emphasis on the risks of a faster-than-needed tightening.

The ECB kept its policy rate unchanged, but announced a decision for the future of the bond purchasing program following September. Accordingly, the ECB will reduce bond purchases by half in the October-December period to 15 billion euro and terminate bond purchasing at end-2018. Statements of forward guidance were kept intact as the principal payments from maturing securities purchased will be reinvested for an extended period after the end of net asset purchases (i.e. the balance sheet would not be downsized) and accommodative monetary policy would continue as long as it is needed. Meanwhile, the forward guidance for rate hikes was rendered clearer and it was stated that the policy rate was not projected to change until the summer of 2019. The table below summarizes "hawkish" and "dovish" elements in the announcements of both central banks.

Table 1: Decisions Taken in June Meetings of the Fed and the ECB

	Hawkish	Dovish
Fed	Policy-rate increase by 25 basis points Increase in expected median policy rates by 25 basis points each for 2018 and 2019 Press meetings to be held following all meetings as of 2019 Strengthening of some expressions in announcements on economic activity, special consumption and the labor market Omission of the expression from the announcement that the policy rate will remain below the long-term equilibrium for a while	Chairman Powell's press announcement of no reaction to an inflation shock that is unlikely to be persistent and emphasis on the risks to a fast tightening Preserving the expression that the monetary policy remains "accommodative" in the announcement (the minutes of the last meeting include debates over the omission or preservation of this sentence)
ECB	The announcement on tapering bond purchases following September and termination by the year-end Rendering the policy-rate projection clearer and announcement of no expected change in rates until the summer of 2019 Raising inflation forecasts and emphasizing cost pressures ,capacity utilization ratios and wages	Keeping the policy rate unchanged Maintaining expressions such as there is no ruling on balance sheet downsizing

[1] In fact, this points out an additional rate increase in total for 2018 and 2019. The median expectation, which was 3+3 previously, became 4+3. Moreover, it should be noted that these projections are median values. Median values went up due to a change in 1-2 members' forecasts. Nevertheless, it will be more accurate to conclude that the FOMC members slightly tightened the monetary policy stance.

Given the decisions and projections of both central banks, together with the Bloomberg survey of expectations, two base scenarios appear. Possible scenarios can be summarized as four rate increases in total in 2018 (two more hikes in the rest of the year) and three hikes in 2019 by the Fed; and one rate hike in the last quarter of 2019 by the ECB. Meanwhile, rates implied by options point that these scenarios have not yet been completely priced by the market (Charts 3, 4 and 5).

Rates implied by options are below FOMC median value for the Fed, and projections of the Bloomberg survey for the ECB. In other words, a development such as an increase in the inflation trend to cause the above-mentioned scenarios to stand out or render these scenarios more likely has the potential to exert pressure on the emerging economies' exchange rate and policy rates. On the other hand, if the expectation for a looser rate path compared to these scenarios comes to the fore, the outcome will be the exact opposite. The aim here is to emphasize that the market does not completely priced possible scenarios. For example, if the expectation for the Fed to implement a fourth rate hike in this year grows stronger, this may exert pressure on the exchange rate and interest rates. Against this background, the normalization process is believed to remain influential in emerging economies.

Chart 3: End-2018 Fed Funds Rate Mid-point (%)

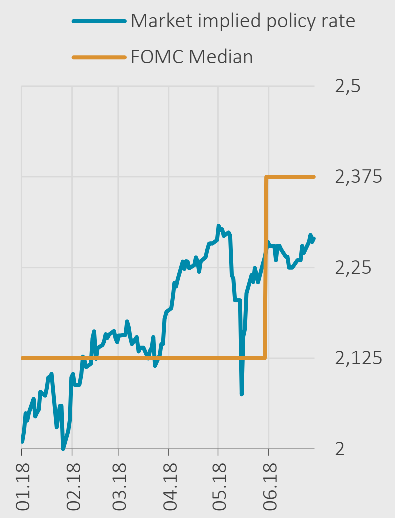


Chart 4: End-2019 Fed Funds Rate Mid-point (%)

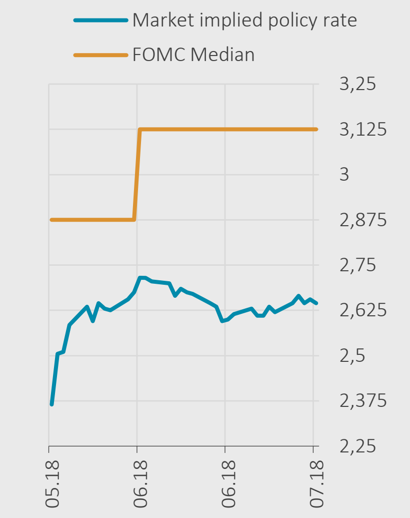
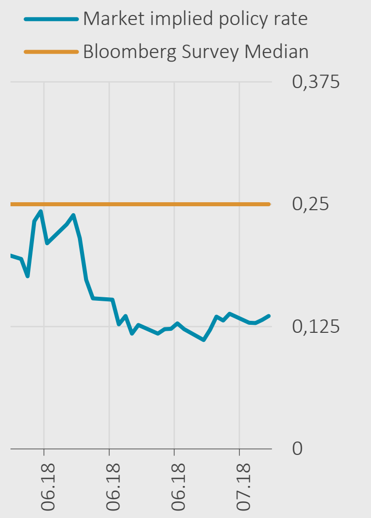


Chart 5: End-2019 ECB Main Refinancing Rate (%)



Source: Bloomberg.

Last Observation: June 2018.