Central banks and no more aid: A $30 trillion challenge

Towards an exit strategy

El-Erian (Allianz): “There is very little time for markets to make a soft landing”

First the Lehman collapse, now the COVID pandemic — the central banks implemented enormous resources to address the consequences of two momentous crises. The four main institutions, USA, ECB, China and Japan, have quadrupled their budgets for an aggregate amount of US $30 trillion. In a context of economic recovery, we ask ourselves if and when the central banks will be able to reverse such a trend, that is, to stop the stimuli but not the economy. The Fed is ready to slow buying, and the ECB is at a crossroads. El-Erian (Chief Economic Advisor at Allianz): “It is still possible to guide the markets towards a soft landing, but the central banks need to hurry. The window is closing fast”.

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US $7
TRILLION
Before the Lehman Brothers collapse in 2008, the aggregate budgets of the main central banks were less than a quarter of what they are now

THE MOVES OF THE FED
Jerome Powell, Chair of the Federal Reserve: Indications on the monetary policy expected at the Jackson Hole Symposium later this month

Central banks, challenge worth 30 trillion: Stop the support, not the economy

Monetary policy. First the Lehman Brothers collapse, then the pandemic quadrupled the budgets
The Federal Reserve is ready to slow buying, Frankfurt still at a crossroads: the time frames and impact on the markets

Maximilian Cellino

Over $30 trillion: a figure difficult to conceive, even when referring to the world's four main central banks. Yet the budgets of the US Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China have risen to such heights, and it is not certain that they will stop there.

It is almost amusing to think that they used to be nearly four times less, around 7 trillion, before the Lehman collapse triggered unimaginable growth. But the best was yet to come, in terms of action by the central banks, that is. The budgets of the "big" countries grew steadily, reaching just under 20 trillion in 2019. Then came the pandemic, with countermeasures that no one would dare have imagined and that have led (so far) to the figures just recorded.

In terms of interest rates, not the effective ones at around zero or even into negative territory, but the ones corrected for the impact of the unconventional monetary policies (i.e. buying up securities and assets), the phenomenon is even more impressive, a fact we are reminded of with a study by Generali Investments. If we add the Bank of England and the Swiss National Bank to the club, the "shadow" rates went from an average of 3.5% in the late 1990s to 2.1% between 2001 and 2007 to -1.1% between 2008 and 2019, before brushing -2% post-COVID.

With a global economy that seems to be recovering from the heavy blow of the epidemic, it is logical to ask if and when the central banks will be able to reverse such a trend, but above all, what will be the consequences for the markets, recording historic highs virtually everywhere you go, "addicted" as they are to so much liquidity. "There are clearly limits on extending these policies further, and the recent peak in inflation with uncertainty around how temporary it will be shows how this might be difficult", underlines Paolo Zanghieri, Senior Economist at Generali Investments.

Given that something which was once classified as an unconventional weapon now seems to have become a "new normal", Christopher Jeffery, Head of Inflation & Rates Strategy at LGIM, points out that, "over the long term, the pandemic will force the central banks to deal with the collateral effects of their actions at the socioeconomic level, in particular on the property market", and that this is, "only the beginning". Everything seems even more complicated by the fact that there is no agreement on what the world will look like in a few years.

"There is a rift between those who predict a "Japanisation" of the main western economies, namely inflation below the target threshold caused by demographic trends and globalisation which would push the central banks towards continuous monetary stimuli, and those who fear a spike in interest rates linked to the increase in global public and private debt, similar to what happened in the 1970s", warns Angelo Meda, Head of Equities at Banor SIM, concluding bitterly that in such a scenario, "the central bankers will still be stumbling around in the dark".

The impasse is also evident in the actions that may be adopted in the coming months by the Fed and the ECB. While the Fed appears about to reduce its buyback activities (the dreaded tapering) which, according to Jeffery, “is inevitable, we only need to see when and how quickly it will happen”, the Eurotower seems to be trailing even further behind. “After years and years of failing to meet its inflation target”, adds the LGIM strategist, “the ECB must be careful not to prematurely exacerbate the policy, and to see any significant change, we will probably have to wait a few more years”.

Unlikely, however, that they won't influence one another. Also because, recalls Meda, “rarely have we seen such strong divergence between the two sides of the Atlantic, given that the global economies are, at this point, so connected that a strong position taken by one central bank has consequences throughout the world”. Backlash for investors can also be predicted. “Soft landings remain a myth, and ultimately the market will react while we move to the post-pandemic monetary regime, but it is impossible to know when this will become a main issue”, cautions Jeffery. When in doubt and awaiting the inevitable vacuum, we must be prepared, our seatbelts fully fastened.

-2%

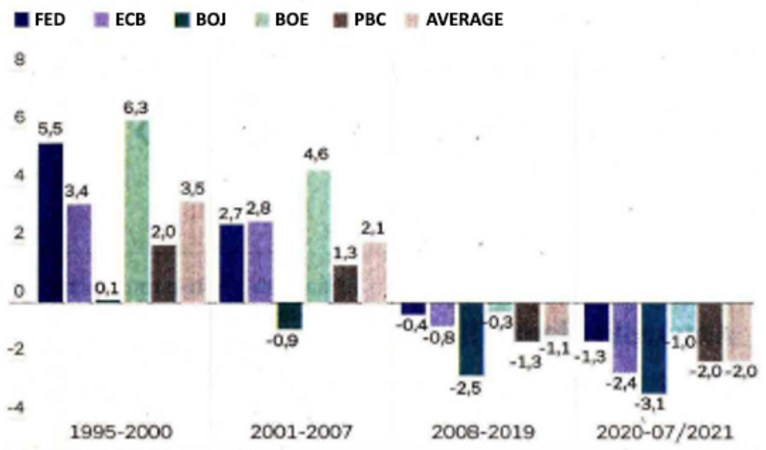
WORLD “SHADOW” RATES

The average rates of the central banks corrected for the impact of the unconventional monetary policies

All liquidity

SHADOW RATES

The interest rates applied by the main central banks corrected to take account of the unconventional monetary policies. *Figures in %.*

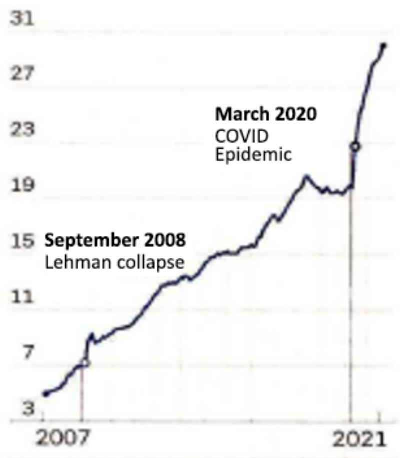


Source: Generali Investments using LJK macro finance analysis data

THE RACE

Sum of the Fed, ECB, Bank of Japan and People's Bank of China budgets

Figures in US $ trillions



Source: Haver Analytics