WHAT'S HOT: CENTRAL BANK'S POLICY FLUX - I AM NOT STUPID. I AM A TOOL.

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17 Jun 2022

Poor craftsmen often blame their tools. Central banks, tasked with the impossible, will likely keep on innovating their tools as they tread new ground in this policy normalisation journey.

Forward guidance - an era-defining tool…

Modern central banks - often given a mandate to manage inflation as well as other policy objectives - have many tools at their disposal. However, they do not have infinite tools. Moreover, they lack the tools that can deal with the sources of inflation that are driving most of the inflation surprises today: mainly supply shocks in commodities and goods supply chains. Central bankers can't pump more oil out of the sea or plant more crops in the ground. Tools to adjust money supply are blunt in directing capital to where it's needed and withdrawing it from where there is excess. However, most central bankers agree that one tool that has been essential in their arsenal has been "forward guidance". To guide the market in terms of what the policy course will be, conditional on economic assumptions, has allowed central banks to avoid undue financial market dislocations that would otherwise interfere with their additional policy objectives of financial market stability.

…demoted in favour of speed

It is curious, therefore, to see why central banks have demoted forward guidance in favour of rapid action. After telegraphing a 50-basis point rate hike for so many weeks, the Federal Reserve (Fed) adjusted its script just several days before the Federal Open Market Committee (FOMC) meeting to guide the market on a 75-basis point rate increase that it delivered on Wednesday 15th June. The Swiss National Bank (SNB), which had given no indication that it would raise its policy setting, shocked the market with a 50-basis point hike on Thursday, 16th June, raising rates for the first time in 15 years. The European Central Bank (ECB) has been signalling a cautious rate normalisation path for months but changed its guidance recently to move more quickly.

Are central banks in control?

With central banks changing the narrative so abruptly, it seems they have lost control and desperately need to press on the brakes. The reality of the situation is that the stubborn sources of inflation (commodity shocks) are not going to be dealt with by monetary policy; the monetary transmission mechanism (the process by which asset prices and general economic conditions are affected because of monetary policy decisions) is long[1]; long-term inflation expectations are well anchored (i.e. most market participants don't think that we are living in a period of runaway inflation for a long period). We acknowledge that the Fed, having chosen to raise rates to counter inflation (regardless of its efficacy), could have started last year. But to change the script so quickly before a policy meeting has started to erode its forward guidance tool.

New tools, please

The ECB has been reminded of the consequences of moving the policy setting in a FOMO (fear of missing out) fashion. The complication of the euro area is that each nation issues its own bonds. The ECB is on the verge of ending its long-standing bond-buying program. The PEPP (Pandemic Emergency Purchase Program) has already stopped, and the APP (Asset Purchase Program) will end on 1st July. The ECB will then reinvest proceeds from maturing bonds for some time. Given its large balance sheet – cumulatively APP and PEPP holdings currently exceed 4.7 trillion euros ($4.9 trillion), the ECB will continue to be a powerful purchaser of sovereign bonds. Nonetheless, its role as a dominant buyer will gradually shrink. The market has become so reliant on the ECB that its withdrawal sent Italian 10-year bond yields skyrocketing to 4.2% on 14th June 2022 from 1.24% at the beginning of the year. That led the ECB to have its first emergency meeting since 2020 on 14th June 2022. The outcome of the meeting: it needs new tools! Something that can help counter the fragmentation of European bond markets as it withdraws purchases. There isn't a lot of detail offered yet on what it will look like, but most likely, the idea will be to tilt reinvestments into stressed sovereigns. Other ad-hoc interventions could also be part of the kit.

Asset pain could ease as appropriate tools are deployed

Central banks' hawkish tilts or volte-face has sent equity, bond, cryptocurrency and some commodity markets roiling in recent weeks. The Fed seems unconcerned right now about the equity sell-off. But with strong wealth destruction piling on top of a cost-of-living crisis, we wonder how long it will be before other central banks join the ECB to develop new tools to reduce the pain. As individual central banks step back, assess their unique problems, and design policy tools to suit them, we expect markets to settle. In the meantime, gold could serve as a market hedge. It is a metal with a long-standing history of prospering in times of heightened uncertainty. Equities focused on quality dividend factors could also weather the storm well.

Sources

[1] The average transmission lag is twenty-nine months according to Tomas Havranek and Marek Rusnak (Transmission Lags of Monetary Policy: A Meta-Analysis)

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