



To Fight or Not to Fight the World's Central Banks

For decades, financial firms, captains of industry and investors who have bet against central bank actions have mostly lost. Hence the credo: Don't Fight the Fed.

Once again, this fight-the-tide "trade" is the topic of debate: Should you bet that the Fed's colossal effort to reflate asset prices will end in colossal failure? What about the tidal wave of central bank activity abroad? Will it, against historical precedent, end in failure, too?

Confronted by more than 40 acts of interest rate and policy easing in six months' time by the world's central banks, investors in late 2011 and early 2012 have decided not to fight, bidding up risk assets and providing a reprieve from months of drubbing. Never mind that investors' long-time friend – the central banker – is acting in response to very troubling developments, not the least of which is the speeding up of debt deleveraging in Europe and slowing in the global economy. Heck, there's nothing that the central banker's printing press can't cure!

If only it were that simple. Deleveraging is a process, not an event. It takes time and all the central banker can do is help it along. Politics and public resistance to fiscal austerity complicate and slow the process, leaving the central banker to do the heavy lifting.

Printing press can't replace needed structural reforms

Low interest rates and liquidity schemes can't solve what ails the developed world. Societies must accept that in order to alter their current perilous course they must undergo great change, moving away from the entitlements to which they have become accustomed. The alternative is weak economic growth, a loss of competitiveness and negative external balances – a loss of face and place in the global hierarchy.

This issue of the *Global Central Bank Focus* features commentary from Tony Crescenzi on challenges confronting developed world central bankers as they attempt to reflate their economies, Ben Emons on the potential for multiple liquidity traps to stifle global risk taking, Andrew Bosomworth on the likely eurozone recession in 2012 and European Central Bank responses, Lupin Rahman on divergent policies and the near-term uncertainty in emerging markets and Isaac Meng on the policy focus for China in the coming year.

Forging such societal change is difficult. As Machiavelli said:

There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things, because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new.

Though they may be some 600 years old, the Italian philosopher and humanist's words ring true today, especially in Europe, where attempts to restructure labor markets, shrink the size of the public sector and introduce competition to tightly controlled industries has sparked public outcry. In the U.S., resistance to change prevented agreement last summer on a grand bargain on the federal budget, leading to a debacle in negotiations over the U.S. debt ceiling that wiped out trillions of dollars of investor wealth in a matter of weeks. Those losses and their economic impact ignited a spate of actions by the world's central banks.

To be sure, people generally don't want to see their pensions and other benefits cut. Politicians for decades endeavored to do the opposite, causing the size of government to grow too large, an effort that was aided and abetted by accommodative central bankers, who facilitated growth in evermore consumption. Meanwhile, the developed economies paid too little attention to the tradable goods sectors of their economies, focusing instead on paper pushing – the financial sector. We know how that ended.

Given the nature of what ails the developed world and the degree of transformation required of societies in the developed world to restore their economic vitality, the ability of central banks to sustainably reflate the economies of the developed world remains very uncertain.

Europe's three R's of risk in 2012

Investors in 2012 therefore mustn't become entranced by the very considerable reflation attempts that will likely be delivered by the world's central banks this year. The efficacy of policy actions must be considered, too, especially given the three R's of risk in Europe for 2012: rollover, ratings and restructuring.

Each of these events has potential to spark enormous market volatility that, in the absence of credible and forceful actions by European governments to reduce debt and to restore growth, competitiveness and external balance, the European Central Bank (ECB) could have difficulty stabilizing. Stay mindful of the fact that liquidity is no substitute for either private capital or the transference of risk to either the private sector's balance sheet or to that of the ECB, which has been reluctant to take credit risk.

On the other side of the pond, the Fed's January 25 announcement that conditions are expected to warrant keeping rates low until 2014 along with the central bank's new plan to specifically target the forecast of medium-term inflation at 2% together constitute a substantial change in Fed communication policy. This will likely do three things: flatten the forward interest rate curve, lower interest rate volatility and thus also lower the term premium in bonds and push investors out the risk spectrum.

So far so good, you can say, and investors seem to be in no mood to fight the Fed, or the European Central Bank, the Bank of England, the Bank of Japan, the Bank of China, the Bank of Brazil – pick the central bank – for that matter. Investors believe that history is on their side. It is. But past is not always prologue and these are extraordinary times. Stay alert.

The global liquidity trap

— Ben Emons

The financial markets increasingly fear the potential of multiple liquidity traps in the U.S. and Europe. This is visible in forward markets, where short-term interest rate expectations for most of the major central bank policy rates remain close to zero for the next two to three years.

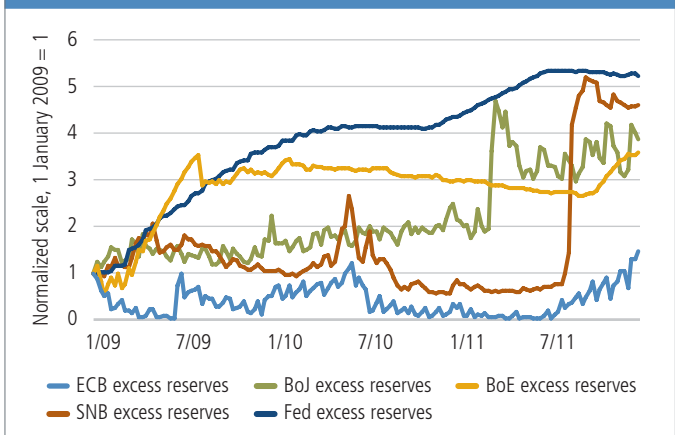
A liquidity trap has a two-sided definition. There is a demand liquidity trap that speaks to demand for money being inelastic to interest rates. That is, the level of savings rises well above the level of investment even with interest rates being excessively low. This is what's called a "Keynesian liquidity trap," where money is "trapped" between incentives to save and to spend. A liquidity trap could also be supply driven. In this case a central bank provides excess liquidity to the banking system, and the liquidity gets deposited back onto the central bank's balance sheet when it isn't taken up.

Either way, the money never enters the real economy. Liquidity is abundant, but it remains disconnected from risk taking.

Since the financial crisis, central bank balance sheets have dramatically increased, but so have their deposit facilities where commercial banks park excess cash. Despite dramatic monetary easing, the supply-driven liquidity trap has become very real, as shown in Figure 1. The economics of earning 25 basis points on excess reserves or cash on deposit appear to outweigh the benefits of reinvesting the funds into other assets or lending them out. At the same time, private sector deleveraging has continued in most major economies despite record low borrowing rates. These dynamics have led to a not seen before combination of both a demand *and* supply type liquidity trap, a reflection of potential "bimodal" outcomes. (Unlike a typical bell-shaped curve of statistical likelihood,

with a single peak and low-probability tails on either side, a flatter or even bimodal (dual-peaked) distribution suggests greater uncertainty over the range of potential outcomes, including extremes – "fat tails" – that may be more likely to occur.)

Figure 1: Global liquidity trap – large deposit facilities at central banks post financial crisis



Source: U.S. Federal Reserve, Swiss National Bank, Bank of Japan, Bank of England, European Central Bank. Scale indicates multiples of reserve levels based on 1 January 2009 level for each central bank. Data from 1 January 2009 through 6 January 2012.

What Figure 1 demonstrates as well is that the liquidity trap is not even: Some central banks have been more aggressive in providing liquidity (Swiss National Bank) than others, while some central banks are just catching up (European Central Bank). At an uneven speed of private and financial sector deleveraging, global central banks have to guard against additional traps materializing. Although there has been credit creation in the U.S., the risk of a credit crunch in Europe remains high and could serve as fuel to a global liquidity trap. This may require even more provocative forms of monetary easing, whereby central banks perhaps could end up lending directly to the real economy without bank intermediation. That would be the "tipping point" for the liquidity trap to dissolve into a potential bout of inflation. Until then, the policy rates have to remain near zero bound.

European Central Bank: Monetary policy alone cannot fix a challenged EMU

— **Andrew Bosomworth**

The underlying challenges facing the 17 members of Europe's Economic and Monetary Union (EMU) as they head into 2012 remain unchanged: current account imbalances owing to competitiveness issues and an inadequate governance structure stemming from the primacy of politics and fiscal policy remaining at the national level rather than the federal EMU level. It will serve investors well to bear these features in mind when judging the effectiveness of the ECB's policies and looking to what else it might do this year.

The ECB finished 2011 contributing a generous package of policies designed to alleviate Europe's problems, buying EMU countries ample time for them to restore confidence in fiscal policies and reinvigorate economic growth. In effect the ECB is engaging in both credit and quantitative easing policies: It has purchased outright large quantities of assets of very low quality, lowered the credit quality standards of collateral, cut minimum reserve requirements and allowed banks to freely determine the amount of liquidity in the system, an opportunity they accepted with relish. As of mid-January 2012, the ECB reported banks were depositing €400 billion to €500 billion of excess reserves each night. If there is already so much surplus money around, what else can the ECB do?

PIMCO expects the euro area to fall into recession this year as the effects of fiscal tightening, deleveraging and a blocked transmission mechanism prevent output from accelerating. The conventional monetary policy response to this would be to lower the policy rate and upon reaching the zero lower bound to embark upon quantitative easing. So long as EMU member states do not pursue a common fiscal policy, however, we do not think the ECB will engage in classical

quantitative easing as practiced by the Federal Reserve or Bank of England. Doing so would undemocratically exploit the ECB as a fiscal transfer agent. For example, when the ECB buys Greek and Portuguese government bonds, which are rated as junk and which the former government is defaulting on, it does so by creating reserves that all euro area taxpayers are ultimately liable for. The ECB's policy of buying some EMU countries' government bonds, but not others, could in time usher in the some of the liability features of a common fiscal policy.

What this highlights is that the ECB's policies can only be sustainable if they are embedded within an appropriate fiscal and political governance structure for the EMU. The ECB can force Italian bond yields down to 2% if it wants to simply by buying more of them, but those yields will not be sustainable unless the Italian economy can grow and markets trust the governance structure of EMU. Currently they do not. We are skeptical that fiscal austerity alone, as envisioned by the Fiscal Compact agreed by EMU member states, is sufficient for all countries to grow and remain solvent. Monetary policy cannot solve these fiscal and political challenges. But it can bridge the time to eventual solutions.

We thus expect the ECB to continue supporting the euro area with liquidity in 2012. We expect the ECB to cut the policy rate, as opposed to the actual overnight rate, to 0.5% this year and that it will cease to sterilize its purchases of government bonds. Therefore, our portfolios will very likely continue to emphasize positive curve durations and remain wary of credit risks.

Limited visibility on near-term global outlook complicates emerging market policymaking

— **Lupin Rahman**

Emerging market (EM) central bankers had a difficult year in 2011. The year started with EMs facing sharp capital inflows

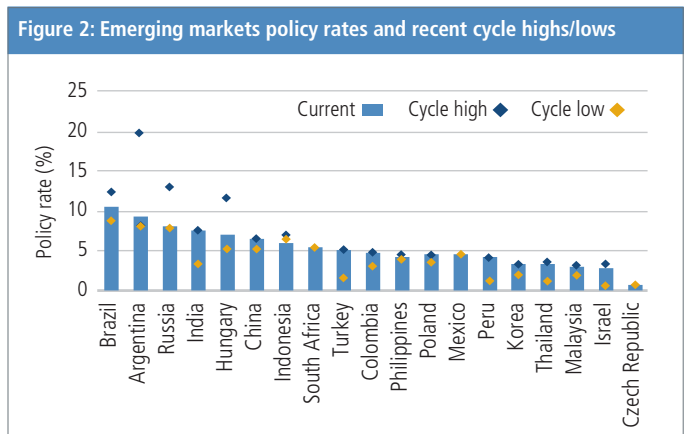
accompanied by overheating pressures, which then saw a sharp correction mid-year as the European crisis escalated and global recession concerns re-emerged. Looking ahead, 2012 is not likely to be much easier, as EM policymakers grapple with the continued uncertainty emanating from the eurozone crisis, coupled with an increasingly bimodal distribution for global outcomes and a limited policy arsenal for tackling further external shocks.

For EM policymakers, near-term visibility on the global economic outlook remains low. The global growth experience in 2011 reaffirmed that while balance sheets and fundamentals are better in EM as compared with developed markets, EM as a whole is not immune to the problems in the advanced core. With limited resolution on the European crisis, volatility in risk markets is likely to remain high, while continued debt deleveraging should keep U.S. dollar funding pressures elevated. All of this points to slower developed market growth at best or, if the European crisis escalates, a sharp global contraction with the associated spillover effects for EM growth.

The textbook policy reaction, given that EM inflationary pressures have peaked and output is moderating below potential, would be to engage in countercyclical policy stimulus by loosening monetary and fiscal policy. In fact, some emerging markets have already commenced cutting cycles, unwinding some of the hikes initiated earlier in 2011 (see Figure 2). In spite of this, EM local rates curves are pricing in only moderate cutting cycles over the next six months.

Several factors preclude a more aggressive loosening stance. First, an increasingly bimodal distribution for global outcomes is becoming apparent, including some probability for a resolution to the European crisis. This fact is further complicated by the recent FOMC (U.S. Federal Open Market Committee) meeting where policy was further loosened and

nascent signs that the U.S. economy may be able to avoid a significant downturn, thereby registering growth above the stall-speed feedback loop. Meanwhile in China, hard-landing risks could be overblown, with a soft landing emerging as a base case for growth. Together these signs could potentially warrant a re-examination of the left tail scenario for limited global growth or recession.



Source: Bloomberg, PIMCO. Current rates data is as of 20 January 2012; cycle range is September 2008 – January 2012.

Second, emerging market currencies have depreciated significantly during the risk-off episode that began in August 2011. Consequently, some EM countries with high levels of external vulnerability, e.g., Hungary and Ukraine, now face the real constraints of not being able to cut and instead are feeling pressure to hike policy rates. For others, this currency depreciation has done some of the heavy lifting of easing financial conditions in the place of monetary policy easing, particularly as pass-through effects are likely to be muted given more subdued growth dynamics.

Finally, the policy dry powder in EM is undoubtedly lower going into the current and evolving eurozone-based crisis than compared with pre-Lehman years. EM central banks had not unwound fully the cuts made during the 2008–2009 global crisis, resulting in real rates starting at much lower

levels than previously. At the same time, fiscal deficits remain approximately 2% of GDP higher than pre-crisis with limited scope for further expansion. Only with respect to the aggregate level of foreign currency reserves, which are approximately \$2 trillion higher than pre-Lehman, does EM have greater policy flexibility – an important policy arsenal given the potential for U.S. dollar funding stress as European banks deleverage and withdraw from funding trade finance and credit growth.

Taking these various factors into account, investors may want to hedge portfolios by looking to select emerging markets with the ability and willingness to cut policy rates both from a cyclical as well as structural perspective, staying mindful of how further bouts of risk aversion may weigh heavily across all EM local curves. Such opportunities may include Brazil, whose government is targeting a medium-term policy rate in the high single digits, as well as South Africa, where structural factors impeding growth are likely to keep rates low for the medium-term even if there is a global growth bounce.

People's Bank of China seeks to balance medium-term risks

— Isaac Meng

The People's Bank of China (PBOC) signaled a shift toward a more flexible policy stance in December 2011 with its 50 basis point cut in the Reserve Requirement Ratio (RRR). This policy is oriented toward stabilizing growth in a political succession year, while balancing lingering inflation and medium-term systemic risks. Three straight months of contraction of the HSBC Purchasing Managers Index (PMI) and export vulnerability due to the ongoing eurozone crisis suggests downside risks to growth. PBOC governors also admitted to facing complex challenges in managing the downturn in the property sector. Though food and energy

prices remain sticky, in the next 12 months the PBOC will likely enjoy more flexibility as industrial prices fall, core inflation weakens with property adjustments and the labor market softens.

The PBOC also acknowledged how the shift in foreign exchange markets, the global economic turmoil, bank deleveraging and shrinkage of the trade balance reduced both capital inflows and the Chinese yuan's appreciation expectations. As a result, the PBOC has room to unwind its sterilization operation, specifically via a further reduction in the RRR, which still stands at 21%. In 2012, we expect the PBOC to gradually loosen financial conditions with some 200 basis points of cuts in the RRR and eventually a cut in the benchmark rate, but only when the consumer price index drops below 3%, which we forecast by the second half of 2012. On the yuan, we expect policymakers to maintain the current gradual appreciation stance. As the PBOC deems the yuan is approaching equilibrium level and growth risks are intensifying, we could see a slower appreciation rate of 2%–3%, and a good chance of widening the trading band for increased two-way flexibility.

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