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Independent Thinking

Recession Watch: tightening with both hands

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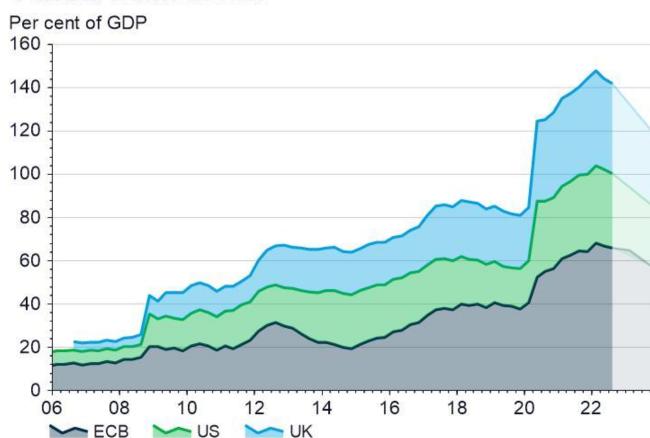
William Hynes

Headlines

- The Federal Reserve, European Central Bank and Bank of England are all expected to raise rates again in the first week of February, with the impact of last year's hikes still working its way through each economy
- Quantitative tightening by all three central banks will also contribute to tighter financial conditions this year
- Uncertainty over the impact of quantitative tightening on financial conditions and growth makes it more difficult for central banks to determine the terminal rate needed to restore inflation to target
- With their reputations at stake, we believe central bankers are more likely to tighten too much than too little in 2023

Economic growth has slowed sharply since this time last year, and with some economies — like the UK's — already in recession, attention is focused on how much further central bankers will tighten rates. Lest we forget though, there's another form of policy lever being used in the background. The Fed and BoE started to reduce their balance sheets last year, and the ECB plans to join the quantitative tightening (QT) club in March. Uncertainty over the impact of QT makes it even harder for central banks to calibrate the appropriate quantity of tightening needed to restore inflation to target. Will they do too much, too late, and cause deeper recessions than needed?



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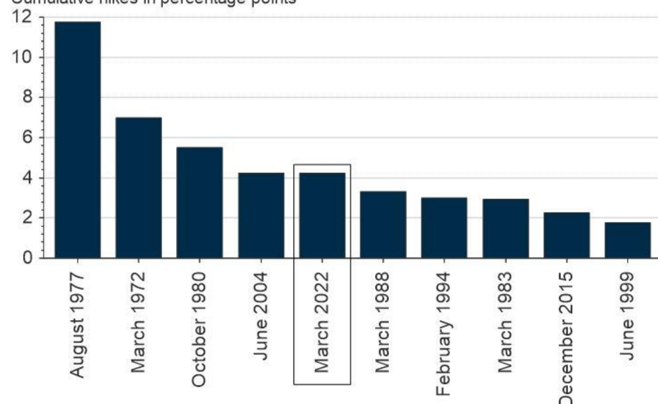
This cycle has seen the Federal Reserve hike by 425 basis points, the Bank of England by 340 basis points and the ECB by 250 basis points to date, and market pricing suggests that there is more to come. There are long and variable lags to the impact of rate hikes on economic activity, though, meaning that much of the impact of last year's hikes has yet to hit economic activity.[1] ECB analysis suggests that the impact on inflation of a 1% increase in rates reaches its peak impact in the second year after the policy change. Research from the Kansas City Fed suggests the lag in US transmission has shortened since 2009, with the peak impact occurring one year after the policy change.



Meanwhile, balance sheet run-down has started. This can be achieved passively, by not re-investing a defined level of maturing securities, or actively, through sales of bonds. The Fed has exclusively used the former approach and the ECB indicated in December it will start doing likewise from March. The BoE is the only institution that has used active sales.

QT will act as a headwind to growth, but to what extent is yet unclear. That is not surprising, given that conclusions on asset purchases are still evolving. The current consensus on QE is that its impact depends on the circumstances in which it is employed — the Bank of England has argued since 2020 that the effects of asset purchases are greater when conducted amidst market dysfunction. It is also agreed by central banks that QE helped to lower interest rate expectations when rates were at the lower bound, by indicating that rate rises were unlikely for a prolonged period (the signalling effect). In turn, these lower yields encouraged investors into riskier asset classes (the portfolio rebalancing effect).

[1]

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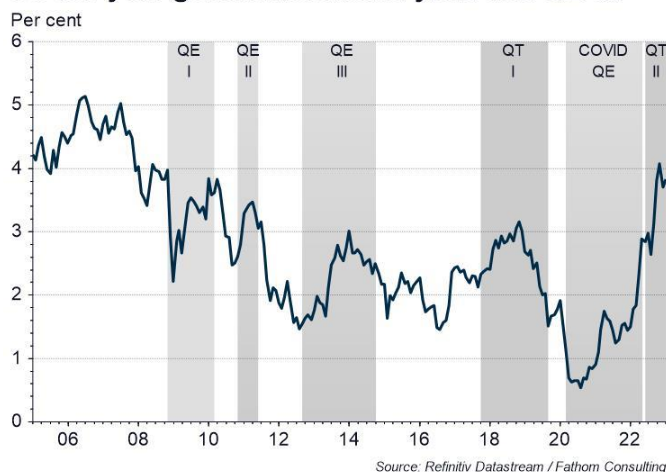

Is it safe to say that QT will just do the opposite? Philip Lane, the ECB Chief Economist, has suggested that the signalling effect will be less powerful as asset holdings are reduced, while QT is also being conducted among generally orderly market conditions. That would make at least two of these channels less powerful in reducing rates, which should also in theory dampen portfolio-rebalancing effects. Jim Bullard, the President of the St Louis Fed, also argued back in 2019 that QT causes only minor macroeconomic effects. “Nothing to see here” seems to be the message coming from central banks.

We are not certain that QT will ultimately have muted effects, though. As the evidence on asset purchases has changed with experience, we expect the same will be true of their reversal. It is of course still too early to tell. Aside from the Fed's more limited balance sheet run down between 2017 and 2019, there is no evidence to go on yet. While some channels may be weaker, others that were less relevant when the balance sheet was expanding may become more impactful. Indeed, as investors are forward-looking and central banks have communicated QT plans, some of these channels are already affecting financial conditions.

Balance-sheet reduction is reducing liquidity, for instance, raising liquidity premia in bond yields. QT may also expose vulnerabilities. For example, there is the possibility that upward pressure on peripheral euro area yields will prompt investors to re-assess debt sustainability in a higher-rate environment, in effect generating stronger portfolio-rebalancing effects. Furthermore, euro area asset purchases have been disproportionately[2] targeted towards high-debt countries like Italy, meaning that balance-sheet shrinkage may have a particularly strong effect on financial conditions in those economies.[3]

[2] Purchases have been greater than the capital key share of the total allocation.

[3] The ECB has proactively tried to limit that possibility through the creation of its Transmission Protection Instrument, which will enable it to purchase additional securities from individual countries if it considers yield increases to be “unwarranted by country specific fundamentals”.

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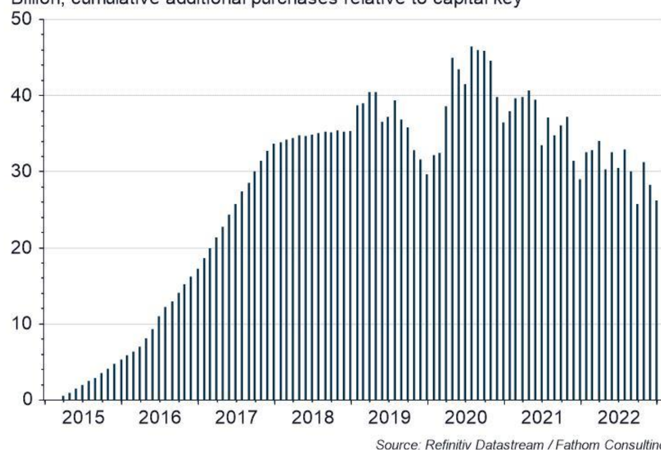

What if QT does have the same impact as QE but in the opposite direction? For asset purchases representing 10% of GDP, real GDP increased by a cumulative 0.4%-1.8%, depending on whether you believe academics or central bankers.[4] As evidence of the uncertainty regarding balance-sheet policies, there is some scepticism about whether QE has any material effects at all on economic activity, with a significant share of non-central banking research failing to identify statistically significant effects of asset purchases on output.

Let's take the midpoint of that range as our best guess for what QT's drag on growth will be. Based on announcements to date, central bank assets as a share of GDP at the end of this year will be 6% (US and euro area) and 8% (UK) lower than at their peak. That would suggest QT will reduce real GDP by between 0.5 and 1% in each of these three economies.[5]

As we pointed out in last week's Recession Watch, survey data for December suggested a sharp reduction in activity, indicating that a US recession may well be imminent. Meanwhile US inflation slowed in December for the fourth straight month, with the annual increase in core prices (5.7%) now a percentage point lower than at its peak in September. Core inflation is also 1.3 percentage points lower at 4.7% if shelter is excluded (this component lags current housing market conditions due to rental agreements typically only rolling over once per year).

The UK GDP data for November were stronger than expected, but this reflected unusually high food and beverage spending from an atypically scheduled football World Cup rather than any underlying change to the pattern of shrinking activity. The surprise to Fathom in the second half of last year was the euro area economy, which was impressively resilient to higher energy prices.

[4] See Fabo et al, 2021 for a summary of the findings on QE.

[5] Following the approach in the literature, the denominator for both points in time is nominal GDP when central bank assets were at their peak. This is 2022 Q1 for all three central banks.

QT increases the uncertainty over policy transmission, making the appropriate terminal rate even more difficult to identify. While inflation has peaked, it remains well above target, and labour markets are still exceptionally tight by historical standards. As the impact of energy on inflation has started to fade, the option for central bankers to blame elevated rates on the war in Ukraine and other factors beyond their control has receded. That will raise the political pressure to deliver on their mandates sooner rather than later. With credibility on the line, central banks will probably err on the side of tightening too much in 2023 rather than giving up the fight too early.

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Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
william.hynes@fathom-consulting.com
www.fathom-consulting.com

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