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Central Banks: Where Could It All Go Wrong?

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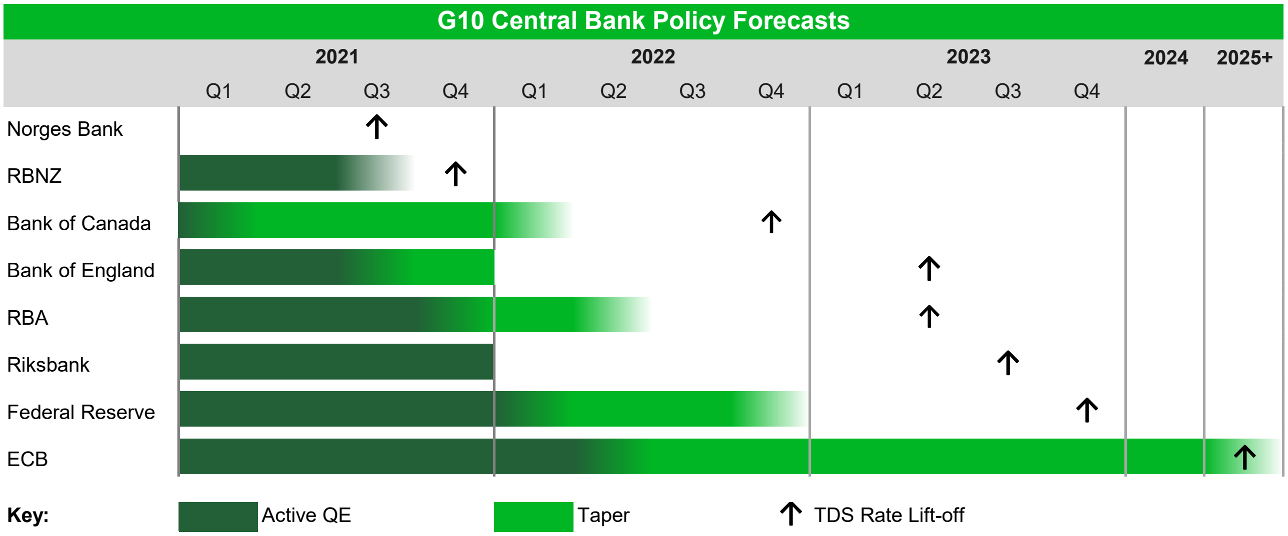
- Central banks are now turning their attention to removing accommodative COVID-related monetary stimulus. While well-telegraphed, this process is unlikely to proceed as smoothly as both central banks and markets hope.
- In this note, we explore five possible unanticipated central bank risks over the coming quarters. These scenarios include, among others, over-reacting to temporary inflation overshoots, delaying tightening on growth concerns, and mis-timing hikes relative to fiscal policy tightening and the path of the Fed funds rate.

Central banks and governments have provided unprecedented economic support to their economies over the past 18 months. But for many, as vaccines roll out at pace and economies recover toward (and indeed above) their pre-COVID levels, the time is now approaching for policymakers to consider easing back on their generous policy stances.

Central banks are trying to be as clear about their future policy intentions as possible. In almost all cases, the central bank playbook is the same: end QE (abruptly, or by tapering), pause for some time, then hike rates. But the economic backdrop and sequencing relative to other central banks and fiscal policy may be important determinants to how successful this gradual removal of stimulus will be.

The chart below shows our baseline projections for major G10 central banks, showing QE phases and lift-off dates. The central bank titans that set the tone for global financial conditions are the slowest to remove accommodative monetary policy, with the Fed tapering for much of next year and hiking in late-2023, and the ECB continuing QE until early 2025 and hiking that year. It's the smaller G10 central banks first out the gates, with most of their QE programmes ending by early 2022. For rate hikes, the Norges Bank is expected to hike this month, the RBNZ this autumn, and the BoC next year. The BoE, RBA, and Riksbank are all likely to hike only shortly before the Fed.



Source: TD Securities

Risk 1: Central Banks Continue to Tighten Despite Slowing Growth and (Eventually) Slowing Inflation

In this scenario, growth peaks in mid-2021 and slows more sharply than expected, due to a number of possible factors including fading fiscal stimulus, persistent uncertainty and caution due to COVID, and supply-chain disruptions. Key to this risk scenario is that inflation also slows in 2022 and beyond, largely as central banks currently expect, and perhaps even moreso, given weaker growth. In effect, central banks stick to their current anticipated paths, despite an adverse demand shock that eventually feeds through to inflation.

As the chart below shows, economists have downgraded year-ahead growth expectations in many countries over the last three months. As we recently wrote, we expect this trend to continue, with many regions seeing downgrades in the coming months. At the same time, most central banks expect sharp declines in inflation through 2022 & 2023, and view much of the strength in inflation this year as transitory—be it one-time price rises on higher costs as some sectors re-open, or because of catch-up to previous trends after sharp price declines last year (see chart).

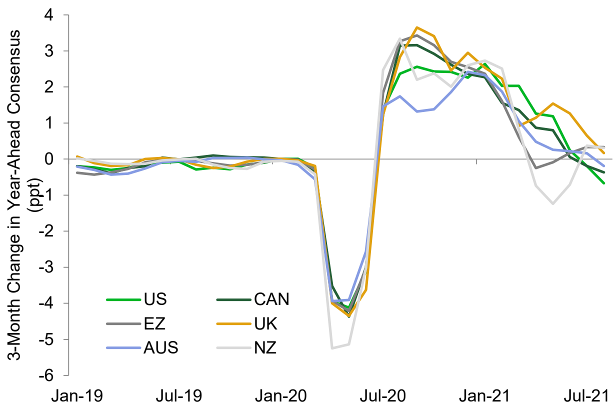
Who's Susceptible to this Mistake?

- **BoC**: Growth in Q2 sharply disappointed, contracting 1.1% q/q (saar), and much weaker than the BoC's forecast. Yet communication since then has glossed over the weak GDP print, with the Governing Council firmly set to taper QE and then hike in the second half of 2022. Governor Macklem's speech even hinted at an earlier phasing out of QE, despite weak growth. See Bank of Canada Progress Report and What Comes Next for QE.

- **BoE**: The Bank of England is a prime candidate. We've long felt that as one of the worst-performing economies during the COVID crisis, the MPC should hold off tightening until 2023 at the absolute earliest. But the MPC has become increasingly bullish in their policy stance, with QE now set to end in December and a rate hike in 2022 now favoured by some on the MPC. If the impending sharp rise in inflation proves to be transitory as many expect, the MPC may find themselves in a world of significant slack and slowing inflation.

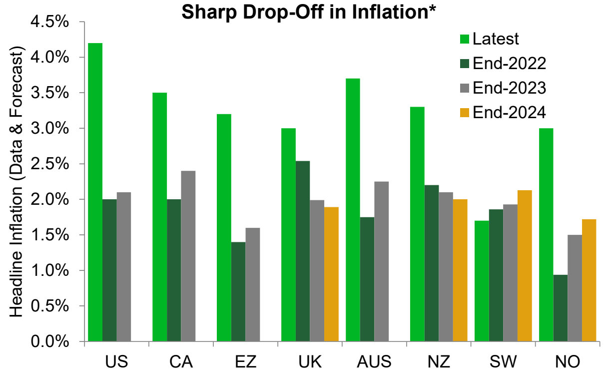
- **RBA**: Similiar to the Bank of Canada, the Reserve Bank of Australia is looking through current growth disruptions as it tapers its QE programme, with the view that the economy will rebound quickly once COVID restrictions are eased. Dynamics in the supply of government debt may also be driving some of the RBA's eagerness to continue with its taper through this year and 2022H1. The Bank may find that the COVID demand shocks are not quite as temporary as it expects, with inflation remaining weak and failing to make substantial progress towards its 2% inflation target over the medium-term.

Year-Ahead Growth Expectations have Stalled



Source: Haver, TD Securities

Most Central Banks Anticipate A Sharp Drop-Off in Inflation*



Source: Haver, TD Securities
* Shows forecast for last month/quarter of year (annual shown if necessary); For UK, Latest is TDS Aug forecast

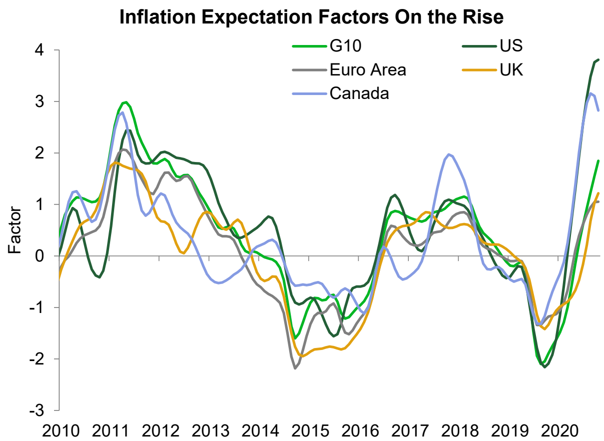
Risk 2: Central Banks Tighten More Quickly as Inflation Shocks Persist

There is a tangible risk that some central banks tighten more quickly than markets currently expect, as inflation shocks persist through year-end and into 2022. In this scenario, central banks remain focused on their mandates, despite slowing growth. One interpretation of this risk might be that central banks have quietly (for now) revised down their estimates of potential growth, meaning that inflation is generated with lower growth, requiring a more active tightening in policy. Another interpretation is that they over-react to supply shocks, which leads to more demand slack further down the road.

It may also be driven by inflation expectations, which remain central to most central banks' inflation-targeting frameworks. On this front, we have seen sharp rises in recent months. G10 central banks have had to deal with strong inflation as economies re-open, and this has happened at different times in different countries. The US re-opened early, and saw the earliest surge in inflation. The UK followed. The euro area has been more cautious, and has yet to see the strong inflation gains seen in North America and the UK.

Who's Susceptible to this Mistake?

- **BoC**: The Bank of Canada has been caught off-guard by rising inflation this year—its January forecasts saw 2021Q4 inflation of 1.5% y/y; its July projections revised that to 3.5% y/y. Like many other central banks, it has lowered its assessment that the increase in inflation is transitory, and consistent with the risk above, is easing off the policy accelerator even if growth has surprised to the downside.
- **BoE**: As one of few central banks to see inflation average higher than its target over the medium-term, the Bank of England's MPC is naturally inclined to a slightly hawkish stance. With the worst GDP performance in the G10, any over-reaction to what is likely to be transitory high inflation later this year, could see a policy mistake that pushes both growth and inflation lower over the medium term.



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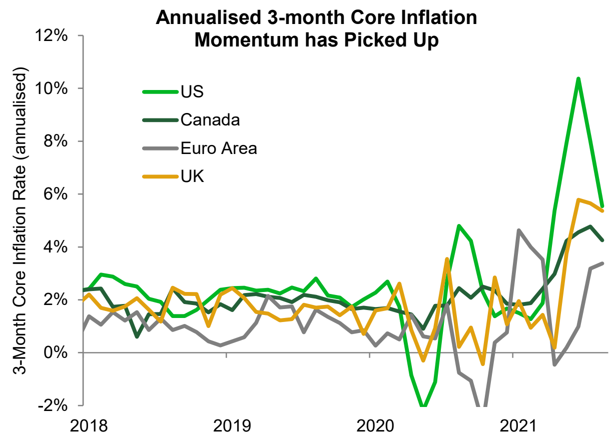


Source: Haver, TD Securities

Risk 3: Despite High Inflation, Central Banks Delay Tightening as Growth Slows

On the flipside, it's possible that central banks, under "flexible inflation targeting", focus more on the slowdown in growth and its implications for medium-term inflation. In this scenario, central bankers see current inflation strength as largely transitory, and worry about the impact that scarred labour markets and slower growth will have on inflation in the one- to two-year horizon. Consequently, they delay tightening by putting off decisions to taper or hike rates.

For some central banks, this will pose a challenge as limits of QE buying are coming into view. The Riksbank, for example, had to broaden the products it purchased as part of its QE programme as its dominance in the government bond market grew in size. In fact, we'd argue that for most central banks (bar perhaps the ECB), there is a growing dislike of QE. Many are keen to end existing programmes, even if it results in a prolonged period of rates at the effective lower bound.

For other central banks, who are firmly set to end QE programmes in the coming months, delayed tightening means flattening the yield curve via later rate lift-off expectations. This approach is fairly limited in scope, however: with few central banks expected to hike in the next year or two, the scope for impact on rates that matter most to households and firms is limited.

Who's Susceptible to this Mistake?

- **Fed**: The Fed's new mandate comfortably allows for an overshoot in inflation in order to achieve its employment mandate. Thus the FOMC may comfortably look through rising inflation if they become worried about growth, and delay tightening—whether that be a slower pace of taper, or a longer period before rate lift-off. A key concern for the Fed will be if private demand can offset the drag coming from the reduction in fiscal stimulus (this should fade in 2023). Another concern is distortions in the inflation data that might yield a slower pace of tightening. For example, declines in used car prices next year may mask the underlying inflation trend. The FOMC is likely to be more dovish in 2022 than it is now, likely with three new Biden-appointed governors.

- **ECB**: The ECB is a candidate here, but many would argue this is a desirable outcome given a long history of under-shooting their inflation target. While not aiming to *engineer* an inflation overshoot, it is something that the Governing Council will implicitly tolerate. The ECB's toolbox could be expanded easily enough, for example via an extension of the PEPP or higher APP purchases once the PEPP winds down. We discuss possible ECB easing options here: ECB Outlook: The Path of Most Persistence.

- **Riksbank**: Current Riksbank policy rate forecasts show no rate hike before 2024. Historically, the Riksbank has tended to toe the line with ECB policy. But in Sweden, GDP is now roughly back to its pre-pandemic level and inflation has sharply surprised to the upside. A "loose for long" policy stance to match the ECB's could lead to growing imbalances in the economy, in particular in the housing sector.

Risk 4: Can Other Central Banks Tighten That Far Ahead of the Fed?

Another risk facing some central banks—particularly those in smaller G10 countries—is that despite healthy domestic conditions, they are unable to tighten policy too far ahead of the Fed. Bear in mind that the Fed is expected to only start tapering at the end of 2021, and *tapering is still easing*. As the timeline at the top of this note shows, we expect most other G10 central banks to have completed their QE programmes by the first half of 2022 (the ECB being the main exception).

One notable feature of the post-financial crisis central bank landscape was that no central bank was able to deviate from the Fed Funds Rate for any prolonger period, despite idiosyncratic shocks. As the chart below shows, many central banks started hiking rates in 2010 and 2011, only to find that by 2013-15 they were re-converging with the Fed funds rate. With the Fed and ECB so firmly dominating financial conditions across the G10, there are real questions about how sustainable early rate hikes by the Norges Bank, RBNZ, and Bank of Canada might be.

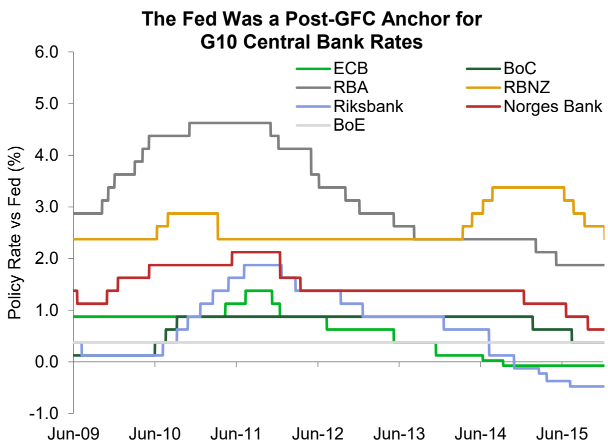
Another big unknown is where post-COVID neutral rates will be. The economic scarring from the COVID crisis is significant, and even if economies continue to recover toward pre-COVID trends, fundamental shifts to fiscal policy and labour markets are likely to have an impact on long-term neutral interest rates. Early movers may find out the hard way that they have far less policy room to manoeuvre than they might think.

Who's Susceptible to this Mistake?

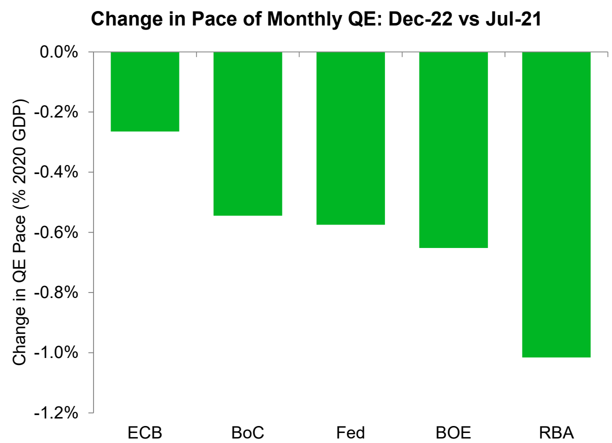
- **First Movers**: As the first G10 central bank to hike post-pandemic, the Norges Bank will test these waters, with the RBNZ following close behind.

- **BoC**: Historically, the Bank of Canada overnight rate tends not to deviate too far from the Fed funds rate, as the shocks facing the economies are often similar. However, small divergences can persist for long periods of time, and the Bank's current guidance suggests lift-off in Canada will occur roughly a year ahead of the Fed's. Once the BoC has reached 0.75-1.00%, we expect the Fed Funds rate will be become a binding constraint, and expect that the pace of subsequent BoC rate hikes will be very gradual.

- **RBNZ**: While the RBNZ delayed its widely-anticipated August hike, it only did so by a few months, and we now expect a hike in November (though October can't be ruled out either). For the RBNZ, it's a question of credibility vs bucking the global central bank trend: the domestic economy is already overheating (see here), and stimulus needs to be reduced to avoid a persistent inflation overshoot.



Source: Haver, TD Securities



Source: Haver, TD Securities

Risk 5: Fiscal and Monetary Policies Fall Out of Sync

As we noted extensively last year, the relationship between monetary and fiscal policy as it responded to the COVID shock was very strong. In many countries, new central bank QE purchases closely matched deficits resulting from the fiscal response to COVID. Central banks have unquestionably played a role in supporting sovereign debt markets.

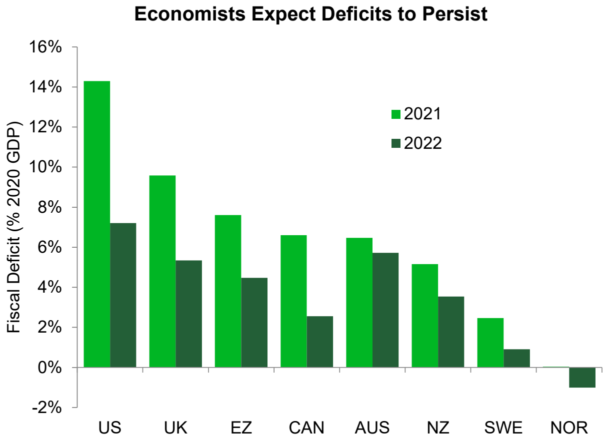
As we look forward, both central banks and governments appear keen to pull back on COVID-related stimulus. While easing was synchronised, the odds are that the pullback in stimulus occurs less smoothly. Any mis-step in fiscal or monetary policy may yield unanticipated and undesired effects. Already, some governments are starting to tighten fiscal policy. A mis-match between fiscal that results in more required QE and lower issuance/ deficits (or vice versa) may have distortionary effects on rates markets. If some central banks are keen to end QE programmes early, as discussed above, this may only put further pressure on the mis-match.

Who's Susceptible to this Mistake?

- **Fed**: With the deficit so large in the US relative to other G10 countries (see chart), there is a risk that rising risk premiums force an undesired tightening in financial conditions. This would result in the Fed delaying tightening, or perhaps even accelerating the pace of QE if necessary.

- **BoE**: Observers were swift to point out the similarities in size between the BoE's QE programme and the UK deficit last year, and the MPC forcefully pushed back on the perception that it was financing the government's spending. But there is arguably some truth here - QE has supported rates markets almost 1-to-1 not only in the UK but elsewhere. Furthermore, the UK government has been keen to reduce its deficit, already hiking taxes. With both fiscal and monetary authorities shifting gear (QE ends in December), the odds of a misstep in the not-so-distant future are rising.

- **ECB**: The ECB has played an important role keeping peripheral spreads stable through the COVID crisis. An early ECB communication slip-up was a painful reminder that markets don't see all euro area countries alike. Fiscal policy in the region remains in flux, with the Next Gen EU program now rolling out, but with the Stability & Growth Pact due to come back in 2023, some big questions need to be answered over the coming year about what should be done with the fiscal impact of the pandemic. This could have important implications for markets as the ECB looks to scale back its PEPP programme early next year, and may lose some flexibility in its QE programme.



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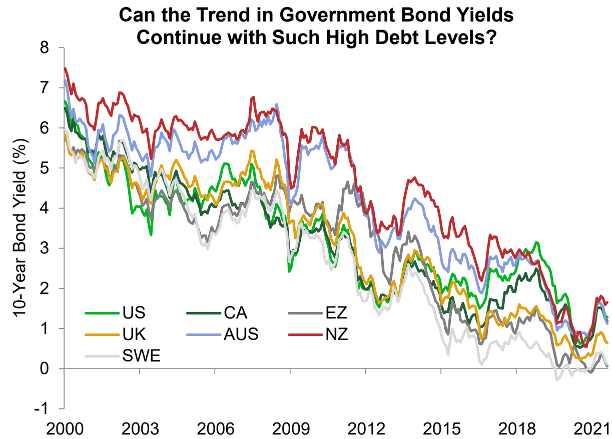

Source: Haver, TD Securities

Some Risks Are More Likely than Others

In conclusion, some central banks' preferences are skewed toward hiking sooner rather than later, while others are skewed in the other direction. The scenarios described above may well be avoided if central banks remain prudent and the global economy sees no major shocks over the coming year or two. But of course, benign scenarios are rare, and especially so during a pandemic. Central banks will need to be confident in their economic forecasts, and will have to hope that any incongruity between their policy path and those of domestic fiscal authorities and major foreign central banks, do not lead to major market distortions.