# FUNDAMENTALS

# Freedom for the central banks


In the next economic downturn, central banks will likely have to reach further into their unconventional playbook. But which policymakers have the most freedom to act and what does that mean for asset prices?

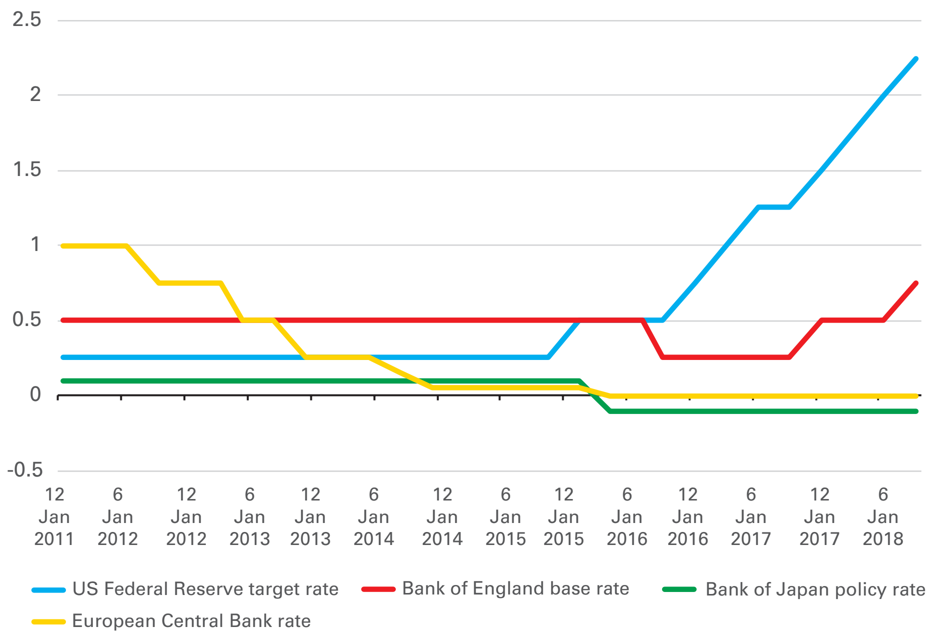
Alex Mack is a portfolio manager. He manages global interest rate exposure in LGIM's Active Fixed Income portfolios.

Chris Jeffery works as a strategist within LGIM's asset allocation team, focussing on discretionary fixed income and systematic risk premia strategies.

Our previous research has established that when it comes to the next downturn, central banks have a lot less space to act than they did a decade ago[1]. The days of simply cutting interest rates in periods of economic and market stress are behind us: without alternative options, and the freedom to enact them, there is a risk of a protracted economic slump that seriously undermines corporate earnings and drives up default rates.

With that in mind, we need to consider the potential for truly unconventional monetary policy instead. We ask what central banks can learn from the Japanese monetary policy experience before examining the political and legal hurdles to 'outside the box' policy in the UK, US and euro area.

**Figure 1: Only the US has space for conventional interest rate cuts**




1. Unconventional policy in the next downturn, LGIM, 2018

Legal & General
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## IS CENTRAL BANK INDEPENDENCE AN ILLUSION?

In most advanced economies, decisions about monetary policy have been taken out of the hands of the government and delegated to an independent central bank.

However, independence only goes so far: governments appoint central bank governors and can legislate to change their mandates. Nonetheless, operational independence should insulate day-to-day decisions about monetary policy from the whim of politicians and campaign promises. Given the obvious temptations to stimulate the economy according to an electoral cycle, such separation is vitally important.

However, the lines between fiscal and monetary policy get increasingly blurred amid zero interest rates and quantitative easing (QE). In a world where central banks are intervening in government bond markets, it becomes harder to hide behind the fig leaf of independence.

## THE BANK OF THE RISING SUN

Just as other policymakers looked to Japan's experiences with QE when designing their own bond-buying programmes, we think policymakers will look to Japan's experience of combining fiscal and monetary policy in future recessions.

The Bank of Japan has the weakest tenet of independence of all major central banks as evidenced in the text of the Bank of Japan Act (1997) and the recent joint statements[2] from the Bank and Ministry of Finance announcing explicit "policy coordination".

### BANK OF JAPAN

**¥480tn** securities held outright

**83%** of Japanese GDP

**¥6tn** exchange traded fund purchases per year

Japan is also 'Patient Zero' of unconventional monetary policy, having adopted a 'zero interest rate' policy in 1999 and started QE in 2001. It was also the only major central bank to have initiated an equity purchase programme as part of its reflation efforts (since 2013).

There are likely to be two major takeaways of the Japanese experience for other central banks:

### 1. The government really needs to spend

Quantitative easing is most effective when it is co-ordinated with a government commitment to boost spending. The economist Paul Krugman infamously described Japan's conundrum as the need to find a way to make a "credible promise to be irresponsible". If the central bank is buying bonds at the same time as the government commits to spending money, it can directly increase aggregate demand without the crowding out effect of higher interest rates.

But we think second-mover policymakers will conclude that the Japanese government didn't *really* commit to spending. Although fiscal stimulus was one of the three arrows of 'Abenomics' – Prime Minister Shinzo Abe's economic programme – Japan's primary deficit actually shrank every year from 2012 to 2016. Japanese policymakers tightened, not loosened, the fiscal purse strings. If they had really wanted to jolt the economy, they should have actually increased spending. For economies in a deflationary funk, the fiscal rules need to be put to one side.

### 2. PR matters

The central bank and Japanese government have always distanced themselves from suggestions that they are engaging in 'helicopter money' – permanent monetary financing of the fiscal deficit. They have been at pains to suggest that such a move would be illegal under the Japanese constitution.

However, the distinction between the bank's actions and the stated disavowal of helicopter money is quite semantic. Second-movers determined to drive up inflation expectations will need to focus on the 'permanent' part: including the associated willingness to overshoot inflation targets in the long-run.

That is a dangerous path to tread. One of the biggest challenges of the coming century will be how to pay for the retirement and healthcare promises made by the state. Increasing tax receipts requires either more GDP growth, which is hard to conjure up, or more taxes, which are unpopular. Governments might be inclined to use monetary policy to ease fiscal burdens. Treasury control of monetary policy levers would make soft sovereign 'defaults' through higher inflation a more likely outcome.

2. Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth, Bank of Japan, 2013

### LEGAL AND POLITICAL CONSTRAINTS ELSEWHERE

Central banks in the UK, US and euro area have significant operational freedom in conducting monetary policy. However, each is faced with a unique set of legal and political constraints.

Both the European Central Bank (ECB) and the Bank of England (BoE) would have little trouble implementing the 'augmented QE' outlined in our previous article *Unconventional policy in the next downturn.* The Federal Reserve's (Fed's) situation is more interesting, and hints at the impact of political pressure on 'independent' central banks.

### ECB: DRAGHI'S DIRECTIONS

In the European Union, central banks are prohibited from directly financing government activities by EU treaty. The word 'directly' is the key distinction – participating in government bond auctions is illegal. Buying bonds in the secondary market (even if they are recently issued) is not. That flexibility has been exploited to launch an alphabet soup of bond purchase programmes inside the euro area: the SMP, OMT, CSPP and PSPP[3].

Away from that explicit prohibition on monetary financing of governments, the ECB has broad discretion. Broadly speaking, provided that its actions do not come into conflict with the principle of an 'open market economy with free competition', the ECB pursues whatever action it sees fit. In recent years, the ECB president, Mario Draghi, has openly discussed buying "all assets but gold"[4].

> **EUROPEAN CENTRAL BANK**
>
> **€3tn** securities held outright
>
> **24%** of European GDP
>
> **€175bn** in corporate sector purchase programme

### THE FED: HEMMED IN?

Given the robust state of the US economy, we previously established that the Fed may be the only central bank that has enough room to stimulate the economy using only tried and tested tools (rate cuts, conventional QE and forward guidance). Such a buffer is particularly valuable at the Fed because, compared to other central banks the Fed has less freedom in unconventional monetary policy.

> **FEDERAL RESERVE**
>
> **$4tn** securities held outright
>
> **19%** of US GDP
>
> **$400bn** reduction in holdings in 2018

The Fed went into the financial crisis of 2008 with a large amount of flexibility embedded in its enabling legislation[5]. Under "unusual and exigent" circumstances, policymakers were permitted to deploy emergency lending authority to broad sectors of the economy: securities dealers were supported, the commercial paper and asset-backed securities markets were supported, loans were extended to investment banks (Bear Sterns) and insurance companies (AIG). All of these were outside of the normal operating framework of lending to depository institutions against the highest quality collateral.

Since then, the Fed has seen Congress try to reign in its flexibility and has had to fight challenges to its post-crisis actions in the courts. For instance, the $85 billion loan granted to American International Group (AIG), granting the government a majority stake, was initially deemed in violation of the Federal Reserve Act but the central bank successfully appealed the decision. The Fed now has a reduced freedom to act but, perhaps more importantly, may be less willing to act 'creatively' since doing so would be seen as acting definitively against the spirit of the amended law. Former chair Janet Yellen's 2016 testimony that the Fed "can only purchase U.S. Treasuries and agency securities" seems to us a narrower and more conservative reading of the Federal Reserve Act than we would have expected in 2007.

The (relative) inflexibility of the Fed highlights the importance of the political environment – creative policy action in another downturn is likely to require legislative change. The US Congress is not always an easy place to get things done given the breakdown of bipartisan politics and the current prevalence of blocking minorities on both sides of the aisle.

3. Securities Markets Programme, Outright Monetary Transactions, Corporate Sector Purchase Programme, Public Sector Purchase Programme
4. Mario Draghi, ECB press conference, December 2014
5. Specifically, sections 13(3) and Section 14 of the Federal Reserve Act

### THE BOE - MOST FREE?

Similar to the ECB, the Bank of England enjoys significant flexibility when choosing how to implement monetary policy. Until the UK leaves the European Union, it is bound by the same monetary financing prohibition as the ECB.

However, the underwriting of the BoE's balance sheet is clearer than in Europe. The government acts as the owner and guarantor of the central bank's balance sheet. Until recently, this meant that the Bank had to ask HM Treasury to underwrite the risk of major asset purchase programs. Following recently announced plans to further shore-up the BoE's balance sheet, the Bank will now have the flexibility to buy another £750 billion of assets before needing to seek permission from the Chancellor of the Exchequer. That underlines and enhances its operational independence.

However, operational independence only goes so far. The most interesting part of the Bank of England Act (1998) is:

> **"The Treasury, after consultation with the Governor of the Bank, may by order give the Bank directions with respect to monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances."**

The power to take emergency action only lasts for 28 days after which it must be approved by parliament. In theory, any current or future Chancellor could define a radical policy of financing government expenditure within defined limits to be in the public interest and order the Bank of England to make billions available. All that he or she would have to do to make the action permanent would be to persuade a majority of MPs to vote for the measure within the next 28 days.

**BANK OF ENGLAND**

**£435bn**
securities held outright

**20%** of UK GDP

Plans to wind down balance sheet when rates reach **1.5%**

When compared to the US and euro area, a few things stand out about the British political system:

- Governments regularly enjoy working majorities
- There is no codified constitution prescribing checks and balances on the power of the executive
- Policy is largely decided by one person (the Chancellor) or a small group of people from the same political party (the Cabinet), rather than being formed from the consensus of large groups serving different interest groups (the US Congress, the ECB's Governing Council)

These legal and political considerations lead us to believe institutional constraints on policy are the least restrictive in the UK. **In another global downturn, we believe the UK is therefore more likely than the Eurozone or the US to be the forefront of policy experiments.**

**OUTSIDE-THE-BOX POLICY**

The euro area and the US would require significant market pressure to force statutory changes through difficult legislative processes. The Federal Reserve has more space for tried-and-tested conventional responses, including interest rate cuts and forward guidance, and so may not require untested unconventional policy options. The fractious nature of EU politics, and the likely necessity of constitutional reform (rather than primary legislation in the US), make it probable that even more pain is needed in the EU than in the US before drastic action would be taken.

However, in our view the UK is the most likely market to both require unconventional policy measures and have the legislative leeway to enact them. In our view, this optionality should have negative implications for the pound, given that most reflationary measures can be expected to lead to an (initial) fall in the exchange rate. Therefore, in the next economic downturn, investors should be aware that sterling is likely to (once again) suffer alongside risk assets.

*Data sources: Bank of England, Bank of Japan, European Central Bank, US Federal Reserve, Bloomberg, LGIM calculations. As at 9 November 2018.*



Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA www.lgim.com

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