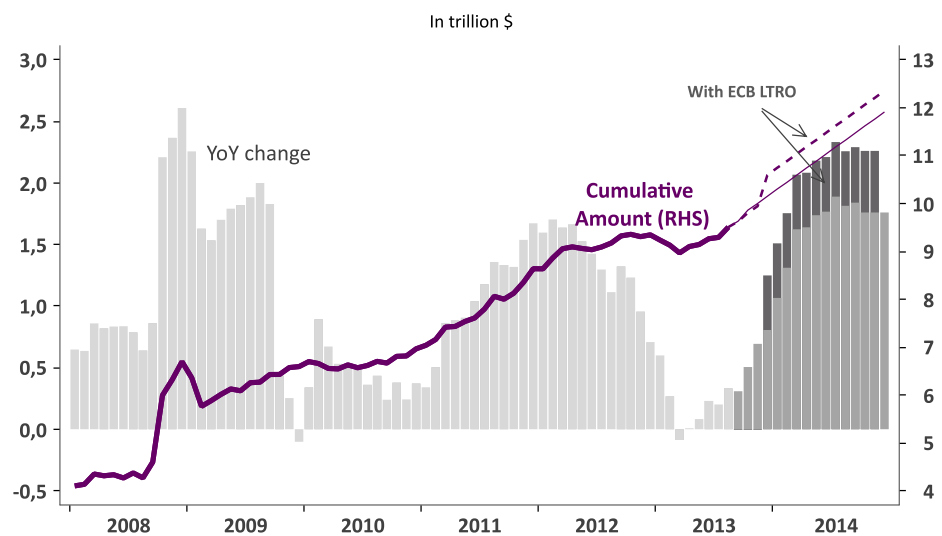


A Fresh Round of Central Bank Action Coming Up in 2014

If we're correct in assuming the Federal Reserve is not about to start scaling back its asset purchases, worldwide liquidity injections should hit a new high next year. Whereas the aggregate balance sheet of the four leading central banks showed little change in the first half of 2013, we can expect widespread central bank activism over the next few quarters:

- At a rate of 85 billion dollars a month, the Fed's asset purchases should amount to 1.02 trillion dollars a year.
- The Bank of Japan will be adding anywhere from 600 to 718 billion dollars to its balance sheet as it strives to meet its target of expanding Japan's monetary base by between 60 and 70 trillion yen a year (making it some 40 percent larger than at the beginning of 2013).
- The Bank of England will be buying 610 billion dollars' worth of Gilts in connection with its objective to purchase 375 billion pounds of assets via its Asset Purchase Facility.¹
- The ECB's probable upcoming LTRO is likely, in our estimate, to provide Europe's banks with between 250 and 500 billion euros, or 350 to 750 billion dollars.

Agregate Balance Sheet of the World's Four Leading Central banks



¹ This asset purchase program has no effect, however, on the size of the BoE's balance sheet.

The “Big Four” should thus be injecting a cool 1.6 to 2.5 trillion dollars into the system in annual terms (at a pace of 135 to 208 billion a month). This should continue, if not throughout 2014, then at least through the early part of the year. In the low-case scenario, that would equal 10 percent of American GDP; in the high-case scenario, it would equal almost the entire size of France’s economy in 2012! **But whether the ECB follows suit or not, the annual flow of fresh liquidity should return to the highs seen in 2011 and 2012—and for the ECB’s LTROs, could even set a post-2008-crisis record.**

Just what should we make of these numbers?

- An obvious first interpretation is that the shift in monetary policy will kick off an inflationary process as economies pull out of the crisis. The recovery has been hindered until now by uncoordinated—and therefore ineffectual—central bank responses (see [“Monetary Policy: Too Much Disparity to Be Effective”](#), dated May 7, 2013). According to this reading, once major central banks the world over start pulling monetary levers extensively, they stand a much better chance of spurring global growth—and inflation.
- But the trend taking shape may also be interpreted in a very different way: as proof that monetary policy action has failed miserably. Some supporters of this view point to the inefficacy of quantitative easing in forcing banks to lend money (you can lead a horse to water, but you can’t make him drink). Others argue that precious time was lost due to an “every central bank for itself” approach (the ECB was overly rigid, the Bank of Japan was slow to move, and China even tightened in 2011).

So while the bulk of monetary policy action could be considered temporary in nature until now, it clearly no longer is. It looks like central banks are caught in a trap, and although they may break free, they’re likely to lose a lot of feathers in the process. In particular, faith in their ability to keep interest rates under control will be undermined.

The U.S. Holds All the Cards

Which of these two interpretations makes the most sense? The answer will necessarily come from the other side of the Atlantic.

If, as most economists currently forecast, the U.S. economic recovery takes hold and a lasting, virtuous circle of growth ensues, an inflationary exit from the crisis will soon be a tangible reality. At that point, the Fed should be willing to scrap its extremely unconventional policies, especially as the factors pushing up long-term yields gather momentum.

On the other hand, a more chaotic scenario with persistently weak employment and investment growth in the U.S.—entirely plausible in light of the recent disappointing

productivity data—would substantiate the second interpretation. If such a situation comes to pass, it will virtually guarantee continued central bank activism. And while this would almost certainly eliminate the risk of a wholesale bond-market crash, it would also usher in an age of anxiety—perhaps even with serious instability thrown into the bargain. Our view of current trends unfortunately suggests this is the likelier scenario.

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