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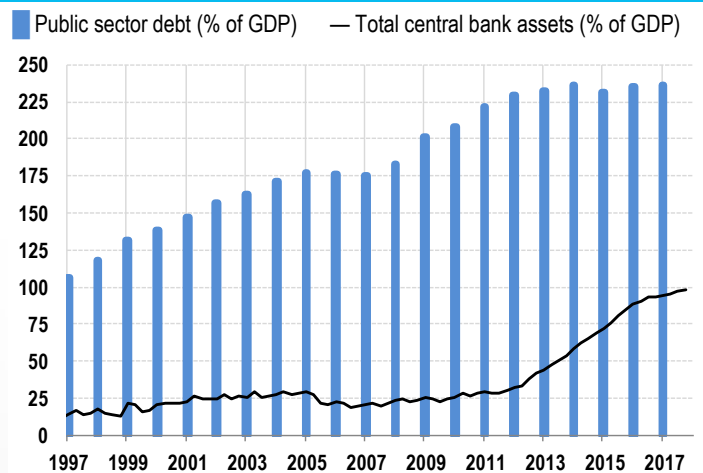
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Central banks: An effective upper bound to QE?

■ The balance sheet of the Bank of Japan is now equivalent to the country's GDP, yet inflation remains stubbornly low compared to the official target ■ Years of quantitative easing have caused distortions in equity markets and weighed on liquidity in the market for JGBs ■ There is concern that the marginal effect of BoJ purchases will wane, leading to an effective upper bound to QE. If this were to be the case, the relevance would go well beyond Japan and cause doubts about the effectiveness of more QE in case of a new downturn

Policy leeway is like an airbag in your car: the knowledge that it will be used in case of a shock provides comfort even when everything is still looking fine. In many if not most advanced economies, high public sector debt levels have reduced fiscal policy leeway very significantly. In the years after the 2008 recession, the zero lower bound of official interest rates has been reached. Moreover, the combination of a drop in the neutral rate of interest, a slow recovery and ongoing subdued inflation despite a big decline in the unemployment rate means that monetary policy normalisation has been slow (US, UK) or hasn't even started (eurozone, Japan). As a consequence, the cyclical peak in official rates should be well below previous peaks implying more limited leeway in terms of conventional monetary policy. Clearly, forward guidance and QE will be called upon when the next recession hits. With respect to QE, the size of the central bank balance sheet at the cyclical peak will determine the leeway for unconventional monetary policy during the downturn: one can suppose that eventually there would be an effective upper bound to QE. 'Effective' in the sense that beyond this point the effects of additional purchases become negligible and/or because of increasingly larger unintended consequences. These issues have received some attention in Japan, where the central bank balance sheet is now as big as the country's GDP. Concerning the unintended side-effects, research shows that bond market liquidity has declined whereas the BoJ's purchases of equity ETFs invested in the Nikkei index (where companies have weights corresponding to their individual share price) has caused valuation distortions compared to the Topix index, which is market capitalisation weighted. To the extent that portfolio rebalancing is an important transmission channel of QE, the bigger the balance sheet, the more downside pressure on risk premia, the higher the valuation of asset prices and the bigger the concern about a possible hit to asset prices when the central bank decides to shrink the balance sheet. These factors may end up weighing on the macroeconomic effectiveness of ongoing asset purchases. If this were to be the case the importance of this outcome would go well beyond Japan and cause doubts about the effectiveness of more QE in case of a new downturn.

JAPAN: PUBLIC SECTOR DEBT AND CENTRAL BANK BALANCE SHEET



Source: Thomson Reuters, BoJ, BNP Paribas.

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