



Central bank balance sheets as percentage of GDP have ballooned

Throughout the developed world, central banks have taken ever more assets onto their balance sheets. Initially, this reflected such programs as the Fed's Term Asset-Backed Securities Loan Facility (TALF) in the United States, intended to boost consumer lending in the aftermath of the financial crisis. Similarly, the Eurozone debt crisis caused the ECB's balance sheet to expand, well before the formal adoption of QE. In recent years, balance sheet growth has been strongest in Japan, reflecting its increasingly aggressive use of QE policies.

All of which makes it rather odd that so many hopes should still rest on central banks. After all, Japan already tried QE from March 2001 to March 2006. According to most empirical studies, this was of limited help in either boosting output or inflation. Indeed, it may even have strengthened the performance of Japan's weakest banks – further delaying the necessary clean-up of bank balance sheets. Markets were fairly unimpressed. Japan's initial dose of QE simply seems to have acted as a sedative. One down-side of loose monetary policy – and not just in Japan – is that it can reduce the pressure for reforms.

2. The limits of central banking.

So far, we have seen that there is little monetary policy can do to boost long-term growth potential. At most, it might provide breathing space for structural reforms (but with the caveat noted above). For investors, however, a more immediate question is whether central banks are also losing their ability to cheer up markets. Here, the evidence is mixed – and to see why, look no further than at Japan's previous attempt at QE.

Japan's structural problems are real enough, but they only tell half of the story. The other half is one of monetary impotence to do even the limited work central banks are usually charged with: making sure that actual economic growth is in line with potential growth rates. Central banking can prove tricky enough in normal times. As Rüdiger Dornbusch quipped in 1997, "None of the U.S. expansions of the past 40 years died in bed of old age; every-one was murdered by the Federal Reserve."³ But at least, central banks have plenty of historic data to rely on.

By contrast, economists looking at Japan since the early 1990s had to go back to the Great Depression to find anything remotely similar. Japan appeared stuck in a liquidity trap, the traditional bogeyman of central banking (see box). Much of the policy response in the rest of the world since 2009 can best be understood as an attempt to avoid such a fate.

³ Dornbusch, Rüdiger. 1997. "How Real Is U.S. Prosperity?" Column reprinted in World Economic Laboratory Columns, Massachusetts Institute of Technology, December.

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