GLOBAL ECONOMICS UPDATE

QT effects dwarfed by influence of past rate hikes

- **Any impact of QT has so far been modest and swamped by the effects of higher policy rates. Asset disposals might put some upward pressure on yields in the euro-zone in the near term, but the process of balance sheet normalisation will be slow and in some economies it is nearing an end. The biggest influence on financial conditions will continue to be the lagged impact of conventional policy tightening.**

- Sweden's Riksbank was the first to start "passive" quantitative tightening (QT) early in 2022 by not reinvesting the proceeds from some of its maturing bonds. It was joined by the Bank of Canada in April and the US Fed and Bank of England in June that year. At the advanced economy aggregate level, these asset disposals were initially offset by ongoing purchases by the ECB. But from the point that it ended its net asset purchases in July 2022, the advanced economies as a group were engaged in quantitative tightening.

- Now, several central banks including the Bank of England, Sweden's Riksbank and the Reserve Bank of New Zealand are engaged in "active" quantitative tightening, whereby they *sell* assets into the secondary market rather than holding them to maturity. Since the ECB joined the QT group this March – albeit with only passive balance sheet reduction – and the Swiss National Bank is selling FX assets, the Bank of Japan is the only major central bank not to have started running down its asset holdings. **For the advanced economies as a whole, asset holdings have fallen by 4% from their peak. But this is still very small compared to the 77% increase in asset holdings which occurred during 2020 and 2021 alone, let alone the run-up before that.** (See Chart 1.)

- **It is difficult to judge what impact QT has had, but it seems likely that it has been minor, not least because the reduction has been modest, gradual and well-signalled.** It is typically thought that balance sheet policy exerts its strongest influence through long-term interest rates, but the rise in 10-year yields across the advanced economies has not been unusually large compared to the rise in policy rates since the start of last year. Moreover, long-term yields have barely risen at all *this year* despite the continuation of QT. In other words, conventional monetary policy has been the key driver of rising rates, even at the longer end of the curve as expectations of inflation and real rates have adjusted.

- To the extent that quantitative *easing* (QE) lowered term premia by reducing uncertainty about the economic outlook and the future path of interest rates, there were some concerns that QT would have the reverse effect. **But US 10-year term premium has remained compressed.** (See here.) And while the ECB estimates that term premia in the euro-zone have risen, Isabel Schnabel argued in a recent speech that this was *not* related to anticipated QT. Instead, it has reflected an increase in perceived inflation risk and increased uncertainty about the future path of short-term rates since the ECB stopped giving explicit forward guidance beyond the very near term.

- **There are two good reasons to think that QT will continue to have only modest effects. The first is that, in some cases, we don't think it has much longer to run.** Our forecasts are that the US Fed and the Reserve Bank of Australia will stop running down their balance sheets when they start to cut interest rates (in September and mid-2024, respectively). The Bank of Canada has hinted that it will stop late next year. And while the ECB, Bank of England and Riksbank will probably keep shedding assets for longer, we expect them to do so at a modest pace. In $ terms, only the ECB's disposals will be significant at the global level and even those will be much smaller than the purchases that came earlier. (See Chart 2.)

- **The second is that QT would be abandoned quickly if financial market strains resurfaced.** Most economists believe that the biggest effects of QE came at times when liquidity shortages were acute. (See, for example, this speech by the Bank of England's Silvana Tenreyro.) So it stands to reason that QT would have the

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biggest adverse effects if it was undertaken at similar times. But in those circumstances, central banks would surely end, offset or even reverse it. Note, for example, that the decline in the Fed's balance sheet has been slowed recently by the provision of emergency loans to commercial banks. And the ECB has hinted that it could "apply flexibility in reinvesting redemptions" if needed to prevent peripheral bond spreads rising. So while the risk of a rise in long-term yields is perhaps larger than elsewhere given that QT has only just begun and is set to accelerate, we suspect that the ECB would step in to prevent a major increase.

- **In all, we think that expectations for conventional monetary policy will continue to be the more important driver of long-term yields, which we expect to fall between now and the end of next year.** (See here.) **Financial conditions will tighten, but this will reflect the lagged effect of previous policy rate hikes on market interest rates and broader credit conditions rather than QT.** Please see our recent *Global Economics Update* on this topic and visit our Central Bank Hub for further analysis by region. CE Advance clients can view and download our suite of monetary policy forecasts via the data dashboard here.

Chart 1: DM Central Banks' Securities Holdings* ($bn)

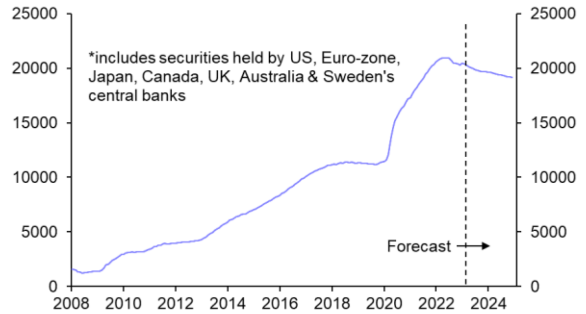
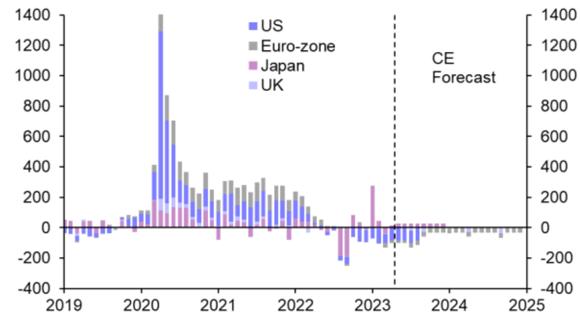


Chart 2: Change in Asset Holdings by Central Bank ($bn)



Sources: Refinitiv, Central Banks, Capital Economics

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