Faith, Hope and Carnage: Central Banks and Financial Markets

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Policy Effectiveness in an Era of Scepticism

- Good central bank communications support policy effectiveness, accountability and legitimacy.
- Secular trends (Financialisation, Populism, Inequality, Public Debt, slower Productivity growth) have made Central Bank Independence more important while simultaneously challenging it.

Contrast: High frequency assessments – in markets and by policy-makers – with slower-moving trends.

Faith that Central banks will succeed (in reaching their inflation targets in a timely way) rests on (i) Hope that negative Supply shocks will soon end and (ii) a Charitable view that institutional strengths stay intact or deepen further.

Central banks become over-mighty citizens?

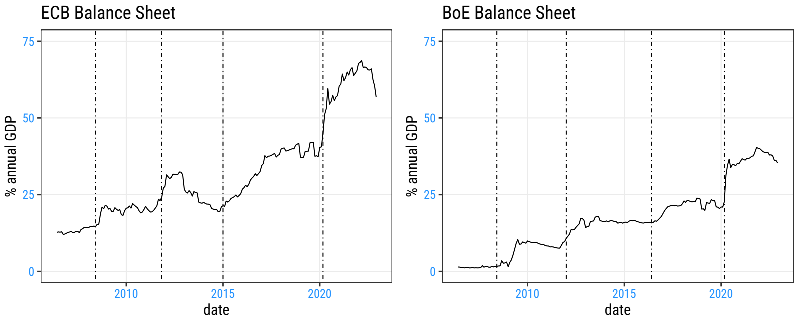
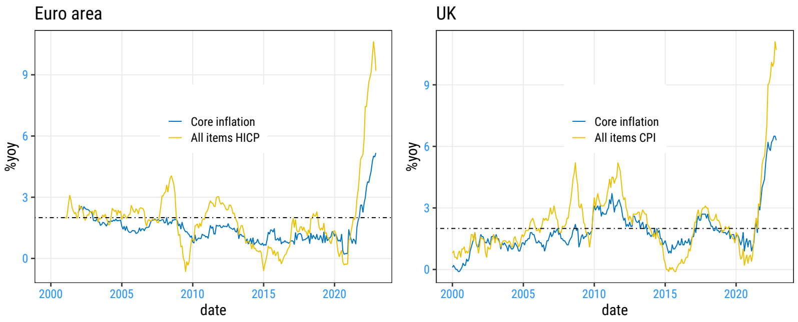


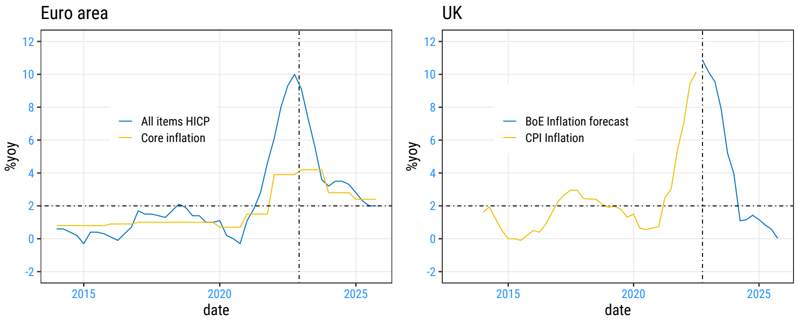
Figure 1: Expanded Central Bank Balance Sheets

- A 'ratchet' effect.
- A symptom of repeated shocks or Central Bank largesse and mission creep?

Now, amid high Inflation



Central banks (and financial markets) expect Inflation to moderate



- How the data in fact evolve will owe to several sources of News: Conditioning assumptions (eg Energy prices, Fiscal policy), Behavioural forecast errors and Model risk.

Slower-moving 'Business-cycle' Phases in ECB history

Table 1: A classification of ECB history (at business cycle frequency)

Period	Description
1: Jan.1999 - June 2003	The First Interest Rate Cycle
2: July 2003 - July 2007	Recovery and Rising Imbalances
3: Aug. 2007 - Sept. 2008	Financial Turmoil
4: Oct. 2008 - Apr. 2010	The Great Financial Crisis and Its Great Recession
5: May 2010 - June 2013	The Sovereign Debt Crisis and Its Doom Loop
6: July 2013 - Jan. 2020	Low Inflation Recovery and Effective Lower Bound
7: Feb. 2020 -	Coronavirus

Source: Hartmann and Smets (2018).

(High-frequency) Financial market reactions at ECB policy events

Altavilla *et al* (2020) database.

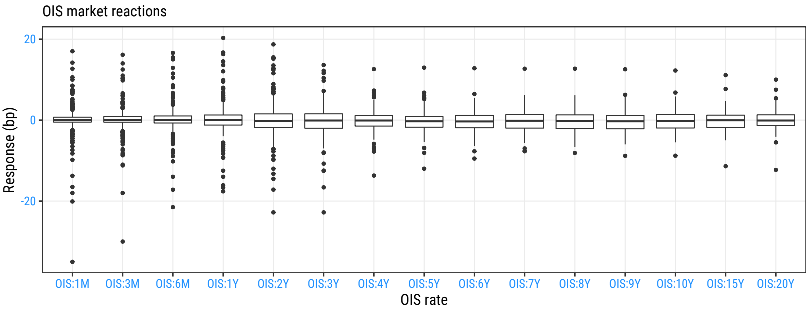


Figure 2: Market reactions in OIS rates across ECB Policy Events

Market reactions: Sovereign yields, Equities and Foreign Exchange

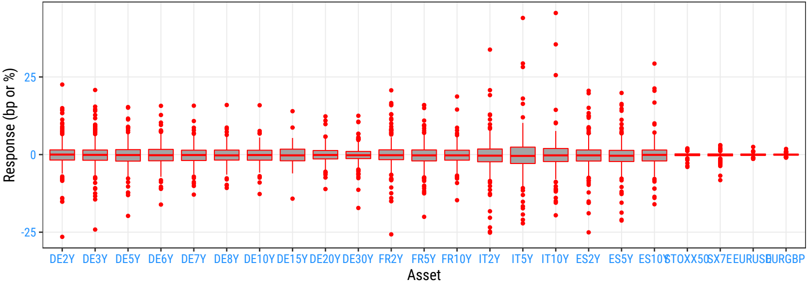


Figure 3: Market Reactions in Sovereign Yields, Equities and Currencies across ECB Policy Events

Classifying ECB Policy Events

Classify ECB Policy events based on the predominant macro news, then group into the distinct phases in ECB history.

	cov(r,Equities)>0	cov(r,Equities)<0
Var(rShort)>Var(rLong)	Growth	Conventional Mon Pol
Var(rShort)<Var(rLong)	Risk Premium	Unconventional Mon Pol

Classification based on Cieslak and Schrimpf (2019).

An initial look at correlations around policy events

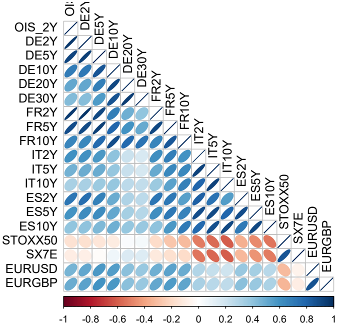


Figure 4: Correlation Matrix of Market Reactions in Sovereign Yields, Equities and Currencies

Reading the ECB News

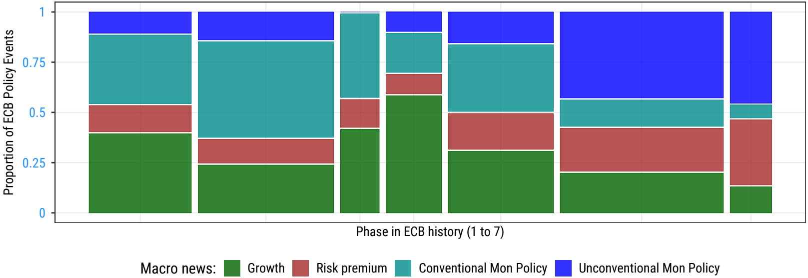


Figure 5: Macro News at ECB Policy Events by ECB Phase

- The recent era of Central bank activism involved policy acting to reduce risk premia. Justified in terms of maintaining integrity of the Euro, but also an example of mission creep.

Case study: the Jan-2015 ECB QE announcement

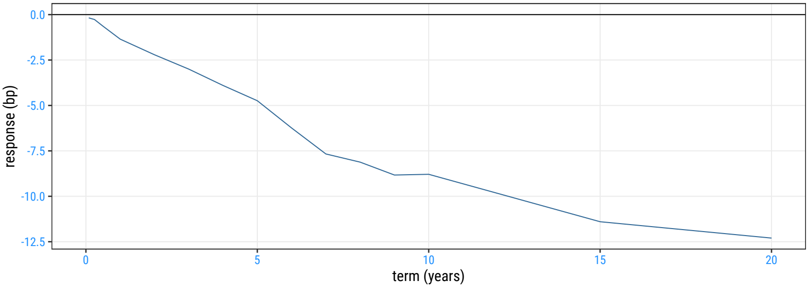
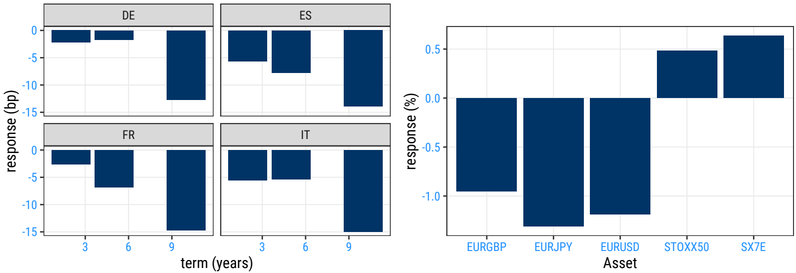


Figure 6: The OIS Curve Market Reaction to the QE announcement on 22 January 2015

Draghi announces Expanded Asset Purchases totalling EUR60bn per month to include sov bonds from March, until Sept 2016 or until a sustained adjustment in inflation.

Jan-2015 ECB QE announcement (II)



BoE Comms: Steering market rates?

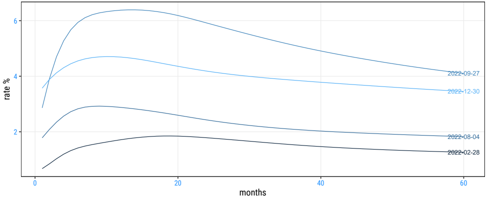
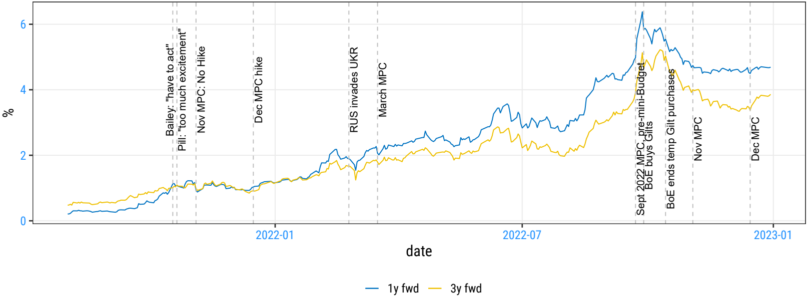


Figure 7: OIS Curves

Volatile Comms in a hiking cycle



Noise, Do No Harm and why policy-induced volatility undermines steering market rates

- Once a source of volatility, Comms discourage traders from taking a position based on fundamentals.
- Deters rational arbitrageurs from betting against the Noise traders (De Long et al; Black).
- Ex: Following Autumn 2021 volatility, BoE's reluctance to steer market rates created more space for Noise traders. Arbitrageurs reluctant to take 'BoE comms risk' and take the other side.
- Monetary policy is the OIS curve more than it is simply Bank Rate. But MPC doesn't act as if it owns OIS curve.

Why Nov 2020 was a (big) policy mistake

- BoE had rationalised QE based on (i) restoring market functioning (ii) signalling effect. Neither justified much more QE in Nov.2020 amid becalmed markets and low forward rates.
- Markets expected (£100bn) more QE, but only 'conditioned on' on a monetary financing view of the BoE. BoE had wanted to disabuse markets of that view but then delivered on that view and without a convincing explanation from data news.
- A 2m, pre-announced 12m QE programme (£150bn) stored up trouble
    - Sep 2021 MPC Minutes switches policy ordering?
    - Sep-Nov 2021 volatility as BoE toys with r$\uparrow$
    - ...as fundamentals detached from the long QE commitment.

Motivating its policy decisions? Or Bad DataViz?

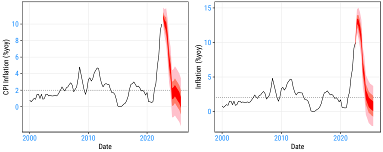


Figure 8: (Successive) BoE fan charts

- Fan charts communicate uncertainty in the outlook. They do not justify or motivate a policy decision or macro news.

Macro news: scale, persistence and source of news justifies policy decisions

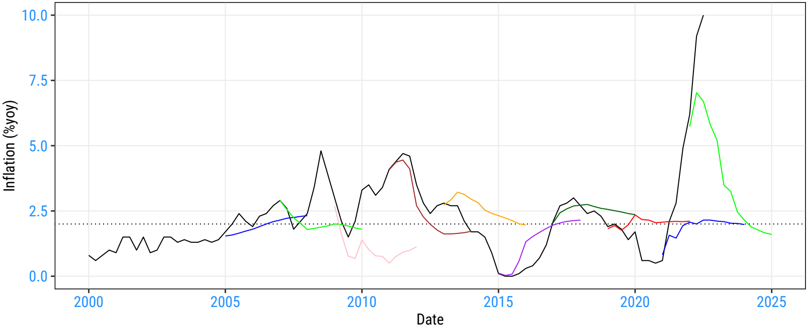


Figure 9: Communicating macro news

- How the data are evolving.
- News and how it will persist as a basis for policy decisions.

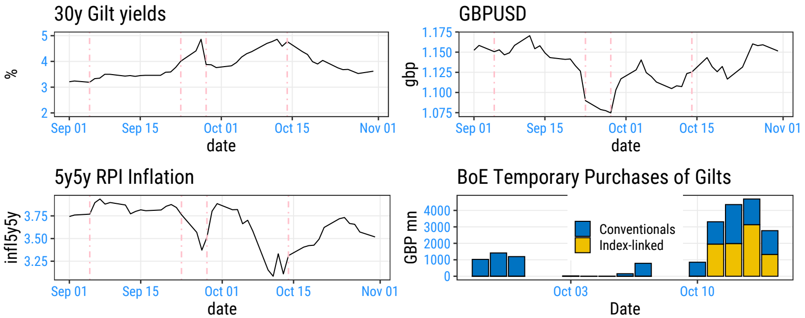
Communicating policy trade-offs

An Example (from fiscal, not monetary policy): The UK 'mini-Budget'

shock	10y Yields/Rates	GBPUSD
More demand:	+	+
Risk premium:	+	–

- The incremental news in the mini-Budget was £45bn in tax cuts versus £30bn expected. Risk premium TBA?
- The two shocks reinforce each other in Rates; but offset each other in FX.
- The 'Rates higher (+)' trade was more robust (to the source of the shock) than the 'Pound weaker (-)' view.
- The bigger impact, and the reason for the Risk premium, was a reassessment of where the UK was starting from. These are the bigger economic risks, more than the incremental news.

BoE stabilises markets affected by higher risk premium



- BoE makes temporary Gilt purchases between 28/09 and 14/10 after 23/09 mini-Budget.
- Crucially, no ratchet effect in this case.

Conclusion: Faith, Hope and Carnage

- **Faith** Inflation expectations stay anchored
- **Hope** The series of negative Supply shocks comes to an end
- **Carnage** €A sovereign debt crisis and UK mini-Budget as symptoms of institutional failure. The benefits of BoE's exit path.

Benign v. Malign outlook: Whether institutional strengths anchor expectations and series of negative supply shocks end *or* whether a longer period of above-target inflation erodes institutional faith.