Policy review

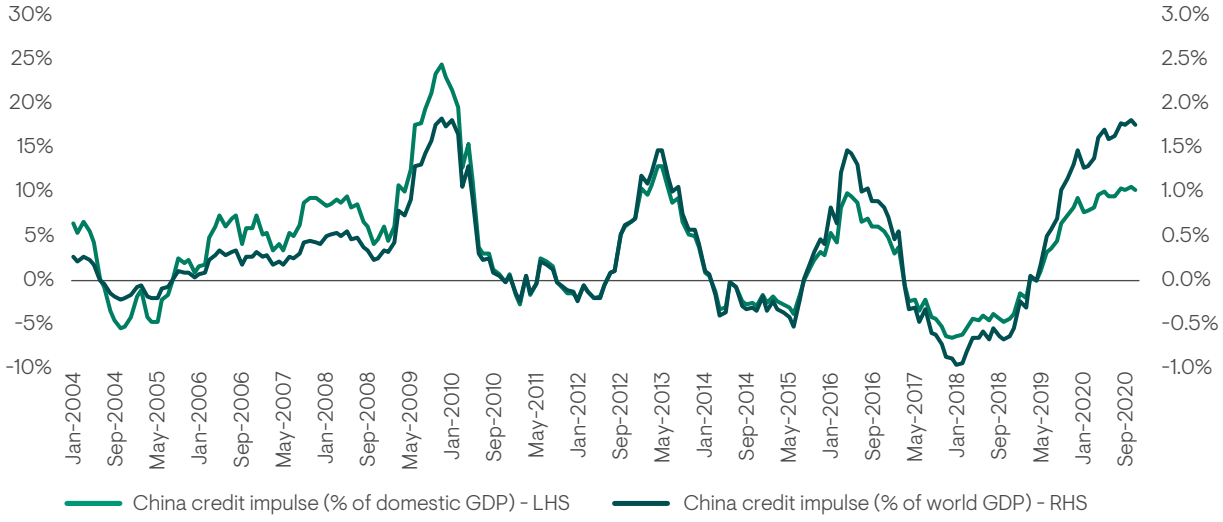


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The US Federal Reserve unveiled its new policy framework in Q3 2020 and spent much of Q4 explaining what it means in practice. For interest rates, expect a long period of near zero Fed Funds and for quantitative easing (QE), the Fed guided that it would continue to buy assets at US$120 billion per month until 'substantial further progress' is made toward its employment and price stability goals. The objective of this extraordinary action is to re-anchor inflation back to its 2% target whilst allowing the labour market to run as hot as possible. The Fed doesn't expect to have achieved this by the end of 2021, so it is safe to assume that it will pump an additional US$1.4 trillion into markets next year. We believe US fiscal policy will turn from a major economic tailwind to a major headwind in 2021 as emergency spending begins to unwind. The worst effects are likely to be somewhat mitigated by a bipartisan support package, but its scale and ambition are sub-optimal. With the incoming Biden administration having effective control of the Senate, we can assume fiscal policy will be looser than it otherwise would be. Nonetheless, given an estimated 15.8% of GDP boost this year, the best we can hope for is action to marginally offset the negative impulse coming in 2021.

China was the standout economy of 2020, having controlled the virus effectively whilst benefitting from huge demand for her exports. The monetary and fiscal response has therefore been low relative to other major economies. Over the past quarter, however, the People's Bank of China (PBoC) has been adding liquidity back to the banking system through its Medium Term Lending Facility. Indeed, credit growth in China has been strong, and whilst it is now topping out, it will likely continue to support growth in the months ahead. The modest fiscal response seen in 2020 means that, looking forward, China will have a less negative impulse in 2021, and so a smaller growth headwind. We expect monetary policy will be neutral from here, with rate cuts and further reductions in reserve ratio requirements unlikely.

Chinese credit growth will likely support economic growth in the months ahead



Source: Ninety One, Bloomberg as of 31 December 2020.

Amid the second wave of the virus, the European Central Bank extended its pandemic QE programme until March 2022 and added a third tranche, increasing the envelope size by another €500 billion to €1850 billion. In recent months, this money has been invested at a much slower rate, meaning the ECB has managed to taper purchases without any market stress, while also reserving firepower should financial conditions begin to tighten again. Concurrently, it also extended its preferential bank lending programme by twelve months. Policymakers are very clear that they intend to keep financial conditions ultra-loose to avoid any crowding out that the exceptional fiscal burden undertaken may create. In aggregate, the sheer size of 2020's 26.5% of GDP fiscal response will see a negative fiscal impulse into 2021, modestly offset by the EU recovery fund.

The Bank of Japan (BoJ), having been more dovish than all other major central banks earlier in 2020, actually dialled back the stimulus in the final quarter, which will stimulate upward pressure on the yen. We expect the taps will remain fully open with COVID-specific policy, such as their preferential bank loans, already rolled over beyond their previous expiry in March 2022. A third supplementary budget will also see the BoJ respond by soaking up the extra bond issuance — some JPY 22 trillion this fiscal year — which will see a further acceleration in BoJ balance sheet growth into early 2021.

The Bank of England expanded its Asset Purchase Facility by another £150 billion, bringing the total to £895 billion. This decision was taken in the context of 'risk management considerations' to mitigate downside risks, so the Bank is likely done with QE for now given early vaccine roll out and the possible release of pent up demand from Brexit uncertainty. The prospect of negative rates — still being debated — is unlikely given the negative impact on bank margins, the large number of retail deposit dependent small banks and building societies and continued doubts over the efficacy of negative policy rates more widely. Fiscal policy looks troubling, with the Office for Budget Responsibility forecasting a drop in government borrowing from 19% of GDP this fiscal year to 7.4% in 2021-22 and 4.4% in 2022-23. This colossal tightening would be a major economic headwind, if enacted.

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