Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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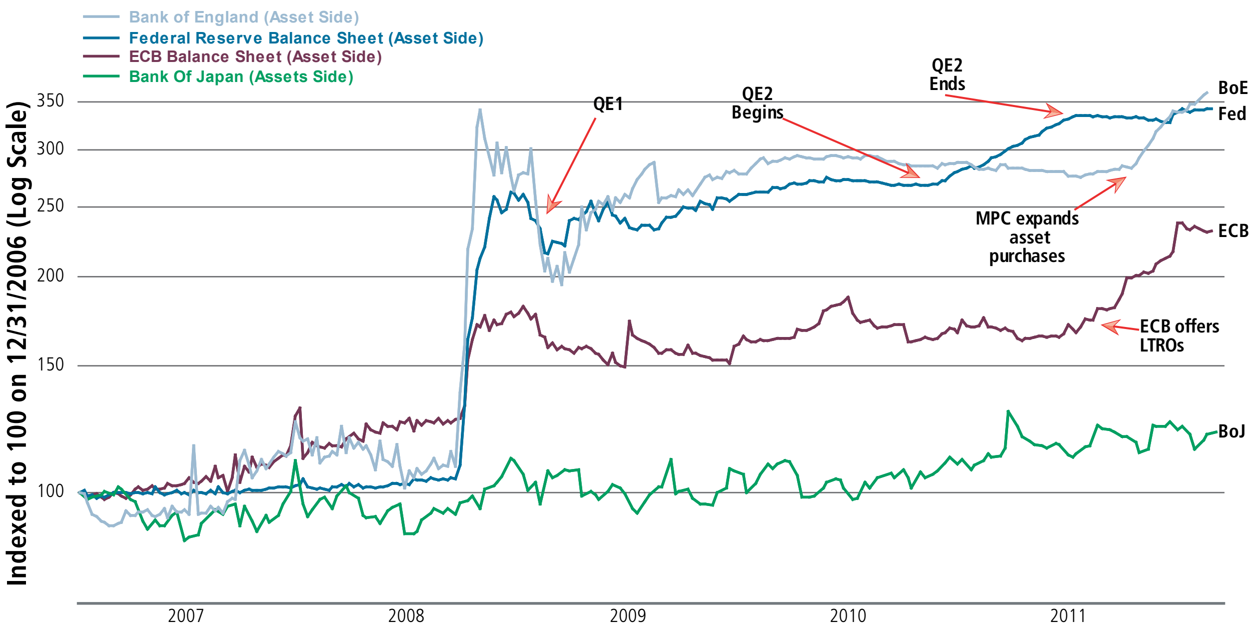
GLOBAL CENTRAL BANK BALANCE SHEET WATCH

Global central bank balance sheets are the new overnight policy interest rates.

For years, evaluating central bank policy meant a discussion of the overnight interest rate target for each central bank (e.g., Taylor rules and the fed funds rate). Now, with policy rates at or near all-time lows in the UK, euro area, Japan and the US, central bank policy evaluation is about the *size* and *composition* of each central bank's balance sheet.

The **chart below** depicts the change in size of the respective central bank balance sheet since December 2006. On this metric, the Federal Reserve and the Bank of England have been the most aggressive central banks.

GLOBAL MONETARY EASING SCORECARD



Sources: US Federal Reserve, European Central Bank, Bank of England, Bank of Japan ©FactSet Research Systems

Typically, balance sheet expansions occur when the central bank purchases assets and pays for them with new bank reserves (newly-created central bank money), but details differ across each central bank balance sheet and developments in recent weeks indicate the above picture will continue to change:

The Bank of England (BoE): For the BoE, asset purchases have consisted mostly of UK gilts. The Monetary Policy Committee (MPC) voted in January to further expand asset purchases, which means the BoE balance sheet will expand even more relative to other central banks in the months ahead. The fact that last week's CPI report showed headline inflation tumble to 3.6% year-over-year from 4.2% previously will provide cover for additional purchases.

European Central Bank (ECB): For the ECB, instead of purchasing bonds outright (for historical and institutional reasons detailed here), elected to lend to banks for longer terms against a wide range of collateral. Given the importance of good, liquid collateral to the financial system, banks can go to the ECB as "dealer of last resort". In short, the ECB's balance sheet is absorbing a portion of the European interbank market, much like the Fed absorption of a portion of the US/global interbank market with QE1. In addition, the ECB holds approximately EUR 300 billion outright, including about EUR60 billion in covered bonds and the balance in peripheral government bonds.

Bank of Japan (BoJ): Last week, the BoJ announced expansion of its asset purchases, with 10 trillion yen planned. However, one can see from the chart above that relative to other global central banks since 2006, the BoJ's actions have been extremely limited, explaining at least in part the record strength of the yen vis-à-vis the dollar and other major currencies. Thus far, the BoJ has ventured into a wider array of asset classes in making outright purchases, including REITs, ETFs, corporate bonds, commercial paper, bills and Japanese government bonds.

Federal Reserve (Fed): The Fed – at least for now – has no further plans to expand asset purchases (so-called "QE3"). But, the Fed plays a more pivotal role in the global financial system than your standard central bank. That's because the US dollar is the global reserve currency and plays a dominant role in cross-border banking activity. Perhaps the best evidence for this is the Fed's use of its balance sheet to provide USD loans (the central bank liquidity swaps) to foreign central banks.

Central bank balance sheets are important pieces of the global financial plumbing. With incredible prescience, the economist Hyman Minksy noted as early as 1957 that as financial market institutions and instruments evolved, central banks would be forced to follow to stabilize the financial system. Indeed, this is the short summary of the post-financial crisis central bank policy response: balance sheets evolving to meet demands for liquidity in the modern financial system. Further balance sheet expansion activities -- including renewed use of USD central bank swaps, 3-year LTROs, and expanded asset purchase programs – all announced since the height of euro area financial concerns last fall have no doubt contributed to the notable shift in financial market sentiment to start 2012.

Watch the global central bank balance sheets, not the overnight interest rates.

The most frequently asked question upon reviewing the unprecedented central bank action detailed above: when will this *"money printing" lead to spiraling, runaway inflation*? We will save that topic for the next installment…