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Reasons to fear a ‘triple taper tantrum’

Manoj Pradhan

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Central banks have no contingency plan for a revival of growth

The “taper tantrum” during summer 2013 was a chastening exercise in exit communication. Since then, not only the Federal Reserve but also other central banks with enlarged balance sheets have been careful not to provide any reason for markets to overreact. The removal of monetary accommodation, as it becomes appropriate for each economy, is likely to be extremely gradual. Together, a gradual exit and careful communication should rule out the risk of another taper tantrum that could disrupt financial markets — at least that is what central banks and most investors expect.

Why then are we worried not just about a taper tantrum but a “triple taper tantrum”?

Because central banks do not have a contingency plan for success. Even partial success — stabilisation of growth rather than an outright revival — could be enough to derail their best-laid plans for a smooth exit from excessive monetary accommodation.

Specifically, a combination of data in the US that are good enough to warrant policy rate rises and a stabilisation of growth in the euro area and Japan will probably be enough to raise the risk of a triple taper tantrum. Let’s run through this argument in three stages.

First, what are the chances of growth in the G3 economies matching the profile that could spark a triple taper tantrum? US data have been weak, but may be taking a turn for the better. Rather than spending the oil windfall, consumers saved most of it. Recent surveys suggest they had little confidence oil prices would remain low, and held back consumption as a result. If oil prices do not rebound much further, conviction that the windfall is permanent would probably lead to improved consumption.

On the investment side, energy producers reacted dramatically, reducing investment in a front-loaded manner. The continuing weak net addition to the capital stock should slowly reverse as more energy-intensive manufacturing comes online.

Stabilising growth and reducing deflationary risks in the euro area and Japan is that much easier because monetary policy in both places has been procyclical. Growth in the eurozone and Japan had already bottomed before the European Central Bank and Bank of Japan delivered monetary easing that beat market expectations. How many times have we talked about deflation in the eurozone and Japan in 2015? Not many. In sharp contrast, that was all we talked about in the second half of 2014.

Second, there is already a distinct shift in the gradient of monetary easing in the G3 economies. The second half of last year was dominated by the dovish tilt and ultimately greater than expected monetary easing delivered by the ECB and the BoJ. As the US economy imported deflation and weaker growth from both of its trading partners, the Fed acknowledged risks to both of its mandates and adopted an appropriately less aggressive stance.

If growth does stabilise in the eurozone and Japan, and improve in the US, both the ECB and the BoJ will be unlikely to deliver further easing, while the Fed is likely to start removing monetary accommodation. G3 monetary policy will then have shifted from easing to removing monetary accommodation in aggregate.

Third, on our forecasts, the Fed is expected to start tapering its reinvestment about six months after its first policy rate rise (which we expect will happen only in December), and both the ECB and the BoJ are expected to begin tapering their purchases in the second half of 2016. The central bank playbook suggests none of the G3 central banks will discuss any part of the triple taper until the data make it clear that the economies are in decent enough shape. None of this is on investors' radars at the moment, if our conversations are anything to go by.

Why do we think these developments will lead to a tantrum? Consider the recent experience of bond markets. German Bund yields recently rose for reasons that were specific to the eurozone. Yet US Treasury yields rose too, even though US data have surprised to the downside.

Extending that experience to fundamentals is easy. Weak growth, disinflation and monetary easing in the euro area and Japan pushed global and US yields down last year. If this downward pressure dissipates, both US and global yields can rise, as the experience of the past few weeks clearly shows. Eager to avoid further downside to fundamentals, central banks may not have a contingency plan to deal with success.

Manoj Pradhan is global economist at Morgan Stanley