The end isn’t nigh
Central bank challenges as the era of cheap money enters a new phase
A special report from The Economist Intelligence Unit
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Contents

Preface 2
The global perspective: When central banks turn off the taps 3
US: A liquid landing 8
UK: New arrival, same problems 10
Euro zone: Hostage to politics 13
Japan: Fading afterglow 16
Emerging markets: Money in, money out 19
Bank regulation: Policy paradox 23
Preface

Since the financial and economic crisis in 2008, the world’s major central banks have flooded the financial system with money. They are still doing so, but the first reminders are now appearing that the era in which markets have come to expect vast injections of central bank liquidity cannot last forever. This is an unsettling prospect. The world’s most important central bank, the US Federal Reserve, has said that it plans to reduce and, perhaps next year, end the asset-purchase programme that it uses to keep monetary conditions ultra-loose. Financial markets have reacted badly, and seem to be pricing in both a tightening of liquidity and a global reallocation of assets.

Central banks in the UK and Japan are not yet at the same point as the Fed. For now their challenges are to ensure that the continued flow of monetary stimulus is effective and to acclimatise to changes in their leadership. But both the Bank of England and the Bank of Japan must logically face similar transitions at some point in the future. The European Central Bank, meanwhile, faces arguably the hardest task of all: it must stabilise and revive recession-hit European economies in the face of profound political disagreements between its members, while limiting the knock-on effects from monetary-policy adjustments elsewhere.

Can the global economy thrive without the monetary life support to which it has become addicted, and what will the adjustment mean for financial-market stability? As the title of this report—The end isn’t nigh—suggests, The Economist Intelligence Unit believes that the era of easy money still has a considerable way to run, despite financial markets’ rather premature anticipation of change; and that, when the time comes, monetary-policy normalisation will bring turbulence but need not spell disaster for the global economy.

June 28th 2013
The global perspective

When central banks turn off the taps

Weaning financial markets off cheap money will be a slow and perilous process. But most economies should cope.

There has been a faintly apocalyptic air to financial markets in recent weeks: not only because of a bracing sell-off across many asset classes but also because investors seem to sense that the era of cheap money is ending. For almost five years central banks have flooded the financial system with cash, part of their evolving response to the economic crisis of 2008-09. Now investors are starting to worry about what comes after “quantitative easing”, and even about a return to higher interest rates. As The Economist Intelligence Unit argues in this report, that moment is still a long way off, but the task of shepherding the global economy through the next phase of its recovery poses abundant challenges.

Central banks operate in the shadows of the global economy. The people who run them meet privately, communicate infrequently and speak in tongues when they do. Yet since 2008 central banks have carried the burden of shielding the global economy from a 1930s-style Depression. They have responded with a bewildering array of easy-money programmes, all of them designed to do one thing: provide funds to commercial banks, which in turn are expected to lend them to the people and businesses that live and work in the everyday economy.

The journey from inflation-fighting—the traditional and principal role of most central banks—to money printing has been complex, controversial and not obviously successful. The path will become even harder to navigate as central banks, led by the US Federal Reserve (the Fed), look for a way out as the financial crisis eases and economies recover. The road back to something approaching financial normality will be hazardous, but it need not be calamitous if central banks communicate clearly and act cautiously, and if investors can spot the signs of improvement in the global economy.

After a year of relative calm, financial markets have been badly rattled as the Fed plans a slow retreat from its ultra-loose monetary policy. Bond yields have climbed sharply in the US, and the higher cost of borrowing in Europe is threatening to push the continent’s debt-laden economies back into the financial quicksand. Emerging-market currencies have plunged as investors adjust to the prospect of less global liquidity and withdraw their bets on risky assets. Stronger financial returns in the developed world have also siphoned money from emerging markets. Equities everywhere have fallen as traders unwind positions and investors take stock of a new world in which central banks may no longer provide unlimited support.

Money for nothing

How and why were central banks thrust into the role of global economic saviour? The depth of the economic collapse in 2008-09 prompted the largest co-ordinated wave of government stimulus in history. The Fed cut interest rates to almost zero in December 2008 and the Obama administration...
implemented a fiscal stimulus of nearly US$900bn four months later. Other countries, from the UK to China, engineered their own stimulus plans. But as already-weak public finances became stretched even further, the fiscal taps quickly ran dry. Monetary policy became, in many places, the only game in town. With interest rates already near zero, a handful of central banks, led by the Fed, entered largely uncharted territory, easing monetary conditions further by purchasing bonds using newly created money.

Money printing, or quantitative easing (QE), on the scale practised by the Fed, the Bank of England (BoE) and the Bank of Japan (BoJ) would have left central bankers of an earlier generation gasping. In January 2008, just as the financial crisis was starting, assets on the balance sheets of the Fed, the BoJ, the BoE and the European Central Bank totalled around US$2.9trn. By January 2014, according to Economist Intelligence Unit forecasts, the balance sheets of those four banks will total close to US$8.8trn, a threefold increase. Much of the surge this year will come from the Fed and the BoJ, which in April launched a new QE programme that is, as a share of the economy, twice as large as the Fed’s.

Has this flood of cash done any good? Sceptics abound, but we believe that it has had a discernible, if modest, impact on the economy. Certainly, global GDP, which contracted by 2.3% in 2009, expanded by 3.9% the next year as the first waves of central bank bond-buying flowed into the economy. But subsequent rounds of central bank intervention failed to maintain that momentum: global GDP growth slipped back to 2.6% in 2011 and to 2.1% the following year. Critically, bank lending, a key barometer of whether central bank funds are feeding through into the economy, barely rose in many countries and continued to fall throughout much of Europe.

QE can, however, also work through financial markets. By depressing interest rates on cash and government debt, QE encourages investment in riskier assets—stocks, commodities, lower-rated corporate bonds and emerging-market securities. Indeed, the sell-off in risky assets since the Fed chairman, Ben Bernanke, began hinting at a pull-back in bond-buying on May 22nd shows clearly how much capital markets had come to rely on QE. And not for the first time: global equity markets have responded
well to each episode of Fed QE, rising by more than 40% during the first round, by 16% during the second and by a similar amount during the first eight months of the current QE programme.

The flood of central bank liquidity has kept bond yields of all maturities at exceptionally low levels. Ten-year German government debt has yielded as little as 1.2% in the past year, and US Treasuries of equivalent maturity have—until the recent Fed-inspired sell-off—commanded an interest rate of less than 2% for most of the past 18 months. In the US, at least, this has pushed borrowing rates for mortgages and consumer loans to record lows, boosting demand for cars, homes and other big-ticket purchases. Globally, companies have taken advantage of low interest rates to sell debt at attractive rates, pushing corporate bond issuance to record highs. All this has helped the economy, although it has not triggered the kind of strong, sustained take-off that might have been expected.

Extracting trillions of dollars in central bank liquidity from the global economy—a process that will begin slowly during the next year—was never going to be quick or simple. Each rumour of Fed easing during the past five years sent the price of risk assets higher; speculation of a retreat, even a small one, sparked sell-offs. The FTSE All Emerging All-Cap equity index, a global benchmark, dropped by 15% during May and June after Mr Bernanke’s remarks. Currencies ranging from the South African rand to the Brazilian Real to the Indian rupee fell in a range of 5-8% against the US dollar between May 22nd and June 25th. Mexico’s 100-year bonds, the world’s longest-dated instrument and one typifying the era of easy money, fell by almost 19% in price in the same period as their yield rose by more than 110 basis points.

Major shifts in monetary policy inevitably cause volatility in asset prices and can, if central bank policy is mistimed, push economies back into recession. If interest rates keep rising in developed economies, as they have since mid-May, the effects would be doubly dangerous for the global economy: higher borrowing costs could kill off the recoveries in the US and Europe while draining capital from emerging markets that rely on foreign capital to spur growth.

**Same punchbowl, smaller spoon**

In fact, neither has to happen. First, the Fed is not tightening monetary policy. Indeed, it has so far done nothing at all. It will, at some point this year, reduce the level of its bond purchases if the US economy maintains its momentum, but this will merely reduce the pace of monetary easing, not reverse it. Put another way, if the Fed halves its US$85bn in monthly bond purchases, it would effectively be lowering its benchmark interest rate by only five basis points a month instead of ten. Second, Mr Bernanke has been clear that any reduction in bond-buying would be gradual; indeed, if the economy faltered, the Fed has not ruled out an increase in debt purchases. The US economy is far from robust, and growth in employment—the key benchmark for the Fed—would have to continue at a strong pace before the Fed would feel comfortable taking its foot off the pedal. All of this suggests that the Fed will cut its bond purchases only gradually—and the pattern of cuts may be uneven. Finally, and perhaps most importantly, the Fed has not changed its timeline for raising interest rates; the first increase is not expected before mid-2015.

That said, market volatility is likely to be greater in the next six months than it has been in the past year. Markets react badly to unpredictability, and many investors are bemoaning the end of a consistent policy of ever-cheaper money. Mr Bernanke understands this and is, in fact, trying to send
two messages that he considers complementary. The first—and by far the less appealing—is that interest rates must eventually return to some semblance of normality as the economic and financial crisis abates. This message was never going to be well received, but Mr Bernanke is delivering it nonetheless. He is, at the same time, stressing a second theme—that the Fed will move slowly, tracking the economic data as they come in and responding accordingly. Richard Fisher, the president of the Dallas Federal Reserve and a monetary hawk, put it best: “I don’t want to go from Wild Turkey to ‘cold turkey’ overnight.”

Despite the recent volatility—some US$2trn in equity valuations globally has been lost in the past month—we consider the recent sell-off more of a “break the ice” phenomenon as the market comes to grips with a transition to a new environment and as the Fed considers its next steps. If the Fed and other central banks can signal their actions clearly and sufficiently far in advance, turmoil should be kept to a manageable level. Interest rates, to be sure, will be higher in the next 12 months than in the past year, but this is inevitable as economies slowly recover. Much of the financial turmoil in the past month has been a retrenchment from a frantic search for yield. That search had begun to inflate asset prices; some of the specious financial products that sprouted before the crisis and helped to bring down the global economy were beginning to reappear, especially in the property sector. Mr Bernanke

How quantitative easing works (or doesn’t)

Before the financial and economic crisis in 2008, quantitative easing (QE) was an obscure term to most people except those familiar with the Japanese economy. (The Bank of Japan, that country’s central bank, had been a pioneering user of QE several years earlier and was a curiosity to economists for that reason.) But since its adoption by the US Federal Reserve and the Bank of England, QE has become much better known. As the name suggests, central banks use QE to target the quantity of money when they are no longer able to influence the economy by adjusting the cost of money through short-term interbank interest rates, their conventional monetary policy tool. This situation occurred in the aftermath of the financial crisis because central banks had already lowered their policy interest rates to almost zero, thus encountering what some economists call the “zero bound”. In QE, a central bank uses newly created electronic money to buy assets such as government bonds and mortgage-backed securities from commercial banks and other financial institutions. These transactions result in money being credited to the accounts of the institutions that sold the assets, and are typically recorded as increases in the level of reserves that banks hold in special accounts at the central bank. In theory, higher reserves in excess of regulatory minimums should free commercial banks to lend more to businesses and individuals, thus stimulating economic activity. But the nature and effectiveness of the transmission mechanism remain the subject of debate. Critics of QE contend that banks have simply held on to their money, which earns a small amount of risk-free interest with the central bank, rather than lending it out into the real economy. Advocates of QE maintain that the policy is useful because, among other things, the newly purchased bonds are often of long maturities and therefore more likely to lower the everyday mortgage and car-loan interest rates that consumers pay. When the time comes for central banks to unwind the bond holdings that they have built up through QE, they may sell them back into the secondary market, passively let the bonds mature, or do both.
The end isn’t nigh
Central bank challenges as the era of cheap money enters a new phase

has worried openly about the effects of QE on financial stability, and seems determined to pull back on the reins. This is a welcome sign. The sharp market reaction reflects, at one level, an unwinding of asset trades built on low interest rates and heavy speculation in emerging markets. But it also amounts to a test for the Fed: after giving markets all they could ever want for the last five years, can the Fed be bullied into retreating now that it has set a course back to the centre? Not for now, it seems.

Lost in the recent market turmoil are the steady improvement in the US economy and the prospect of an end to recession in the euro zone later this year. US GDP is growing at a respectable annual rate of around 2%—and will probably accelerate later this year—and employers have created an average of almost 200,000 jobs a month in the past half-year. It is this modest upturn in the US economy that prompted Mr Bernanke to consider a gradual shift in Fed policy. The euro zone remains in recession, but industrial production has climbed for three months running, the first time that this has happened since 2010. If the global economy is indeed gaining traction—we expect world GDP growth of around 2.7% at market exchange rates in 2014—investors and markets will have something rather more substantial to focus on than central bank bond-buying.
US

A liquid landing

The US Federal Reserve likens the challenge of exiting quantitative easing (QE) to landing on an aircraft carrier. We expect some bumps on the descent, but cautious piloting should prevent disaster.

In mid-2013 Ben Bernanke, the Fed chairman, shook global financial markets by signalling the beginning of the end of extraordinarily loose monetary policy in the US. In particular, he laid out a timetable for slowing the pace of the central bank’s asset purchases and eventually ending the programme. Although the expectation of a gradual normalisation of monetary policy is welcome, given that it implies a return to self-sustaining economic growth, the Fed faces considerable challenges in bringing it about. The jumpy response of markets to Mr Bernanke’s message underlined the importance of clear and careful communication from the Fed, and for a gradual and adaptive approach to adjustment.

On the basis of the timeline announced by Mr Bernanke, the outlook for Fed monetary policy involves a slowing of the pace of asset purchases from the current rate of US$85bn per month, perhaps beginning as early as this September. A gradual “tapering” of the monthly bond-buying would bring it to an eventual end by mid-2014. The next question for the Fed will be how long monetary policy should remain neutral, with the economy neither requiring further loosening nor being ready for tightening. The Fed has said that the earliest that a tightening will occur is when the unemployment rate falls to 6.5% (it was 7.6% in May 2013). On this point, the Fed’s forecasts overlap with ours: we think that the unemployment target will be met by mid-2015, and that interest rates will start rising slowly at that point. This suggests a gap of around a year between the end of the asset-purchase programme and the end of extraordinarily loose monetary policy.

Grave expectations

The challenges and risks inherent in the Fed’s exit plan are enormous. The most difficult part is managing the expectations of financial markets. The initial reaction to Mr Bernanke’s more concrete timetable was not promising: stocks, bonds and commodities fell sharply as investors started to anticipate the withdrawal of stimulus. Long-term interest rates have now risen by some 90 basis points since the beginning of May. In the medium term, this is a welcome development that signals a stronger economy able to deliver higher returns to US investors. For now, though, this market-driven tightening of monetary policy risks choking off the economic recovery. For example, it could stifle the housing market if it translates into much higher mortgage costs. Far from tightening, the Fed might then respond with renewed bond-buying to push rates back down.

Mr Bernanke may not have intended to send a hawkish message; indeed, several Fed officials stressed in subsequent speeches that no changes were imminent. Even so, financial markets will draw their own conclusions, and they clearly have been rattled. As a result, many bond-holders are already sitting on sizeable paper losses, and the eventual transition to higher official interest rates will
exacerbate this dynamic. It is possible that Mr Bernanke is more comfortable with this financial pain being spread across a period of a few years than having it concentrated in a shorter time-span, but managing this process is dicey. In Mr Bernanke’s own tortured metaphor, it is like trying “to land the ship [sic] in a smooth way onto the aircraft carrier”.

Economic risks complicate the Fed’s timetable as well. Both headline and core inflation have been unusually low since late 2012, and have hardly responded to the current monetary stimulus. If inflation subsides further, deflationary risks may require additional monetary stimulus. Employment has been growing steadily, but unemployment has fallen relatively slowly. This has occurred for broadly positive reasons: as previously discouraged workers become more optimistic about their economic prospects, they return to the labour force, thereby preventing a faster decline in the unemployment rate. If this trend intensifies, the fall in the jobless rate could be slower than expected and thus delay the end to the asset-purchase programme. A delay could equally occur for a more negative reason—if the 2013 fiscal tightening has a lagged effect on the economy and growth decelerates in the third quarter of this year, for example. The government’s downward revision to first-quarter GDP growth, from 2.4% at an annual rate to 1.8%, on June 26th suggests that this may already be occurring.

Flexible approach

The uncertainty around the economic forecasts emphasises the need for the Fed to stay flexible. The central bank has long maintained that it will act according to economic conditions; that is, it will only slow its asset purchases and then withdraw stimulus so long as it believes the economy can continue to grow strongly. This is particularly important given that two previous QE programmes were time-limited and ended before the economic recovery had been secured. Yet, by laying out a potential timetable for ending the Fed’s third and latest asset-purchase programme, Mr Bernanke may have undermined his own message that the Fed will focus solely on economic conditions. We expect future Fed communications to emphasise the centrality of conditions-based tightening. Mr Bernanke has addressed one risk, however: he has said that the Fed intends to hold on to the purchased bonds after the asset-purchase programme ends, removing the possibility of these assets being returned to the market prematurely and causing a sharp rise in interest rates.

Clearly, the Fed’s mission is not easy. Yet, in one sense, it is in a better position than many other central banks. As the monetary authority for the world’s largest economy, it is not compelled to react to other central banks’ actions; in contrast, many emerging-market policymakers must now deal with the market effects of the Fed stimulus withdrawal. Moreover, the Fed’s monetary policy has been more effective in driving US growth than that of its developed-world counterparts. As a result, when the time comes for stimulus to be withdrawn, this will occur for positive reasons: because the US economy is growing and the recovery is self-sustaining. So long as the Fed keeps its eye on that final goal, it should be able to pull off this enormously difficult task.
UK

New arrival, same problems

Changes are likely at the Bank of England under Mark Carney, its incoming governor, but their impact will be limited by the UK’s weak economic fundamentals.

On July 1st, the former head of the Bank of Canada, Mark Carney, will take over as the new governor of the Bank of England. With the UK economy struggling to return to growth while the government implements an unprecedented post-war programme of fiscal austerity, the weight of expectation on Mr Carney has been enormous. Central bankers are used to managing expectations about monetary policy, but Mr Carney has had to manage downward expectations about his ability to revive the economy single-handedly. It is all but certain that his tenure will begin with a concerted attempt to bolster activity, but it is unlikely that Mr Carney has the tools at his disposal that would allow the economy reach “escape velocity”.

Mr Carney comes to the Bank of England (BoE, the central bank) with his reputation burnished by his success at steering the Canadian economy through the worst of the global crisis. But he faces a challenge of a different order in the UK. Rather than having to bolster an economy against an oncoming storm, he needs to restore to health an economy and a financial system that have already been ravaged by crisis, at a time of still heightened global economic uncertainty. He faces three key challenges. The first is to get the UK economy moving again. The second is to oversee the next phase of reform of the outsized banking sector. And the third is to steer the BoE through its own process of evolution as the Bank takes on greater powers to help prevent future crises.

The first of these challenges is by far the most pressing. When his appointment was announced in November 2012, Mr Carney fuelled hopes that he was contemplating a radical shift in policy with bullish comments that contradicted his predecessor, Sir Mervyn King, by stating that the expansionary policy options at the BoE governor’s disposal had yet to be exhausted. Fevered speculation ensued, much of which focused on the possibility of a wholesale shift in the monetary policy framework from one of inflation targeting to an explicit targeting of nominal GDP.

By March, however, it was clear that expectations had outrun reality. When the chancellor of the exchequer, George Osborne, announced a new remit for the BoE, it suggested less an overhaul of the current regime than a formalisation and extension of the kind of flexibility that Sir Mervyn has already introduced to the Bank’s inflation targeting. (With the exception of six months during 2009, inflation has been allowed to remain above the official 2% target since late 2007.) This was followed in April by comments from Mr Carney that were much more circumspect than his earlier ones. He said that a return to sustainable growth was not in the gift of central banks, but would rely on fiscal adjustments and structural reforms.
Communication issues
The most likely changes in policy when Mr Carney takes up the reins relate to “forward guidance” about policy and to the Bank’s £375bn (US$570bn) quantitative easing (QE) programme. On the first of these, it appears certain that Mr Carney will begin to provide the markets and the public with guidance as to the likely outlook for monetary policy. He is already in discussions about this with the BoE’s key decision-making body, the monetary policy committee (MPC). In practice, it will most likely involve signalling that the BoE’s main policy rate will stay at extraordinarily low levels—it has held at 0.5% since March 2009—and that asset purchases will continue for a long period, the intention being to encourage money to be borrowed, spent and invested rather than saved at negative real interest rates. Like the US Federal Reserve, Mr Carney may seek to augment such guidance by also adopting one or more threshold rules, which could include a target rate of nominal GDP growth that would need to be met for a period before policy was tightened. Unlike the Fed, however, it seems unlikely that the BoE would target an unemployment rate, given clear differences between the two countries’ labour markets (in a highly unusual development, and in sharp contrast to previous post-recession periods, UK employment has continued to grow strongly since 2010, despite weak economic output). All that said, given that the BoE policy rate has now remained unchanged for more than four years, and markets are currently pricing in an unchanged 0.5% rate until 2016 (we think it will be even longer), it is unclear how significant an effect any new forward guidance would have on households’ and companies’ plans.

With interest rates already so low, QE has become a key policy instrument. Thus far, it has proved less effective in the UK than the US, owing to the former’s liquidity-trap conditions, unresolved problems in the banking sector and the UK’s poor record on productive investment. Certain asset prices have been reinflated, but growth in the wider economy has not been spurred. Comparisons have been made with the aggressive expansion of QE by the Bank of Japan’s governor, Haruhiko Kuroda, but the context is very different. The shift in Japanese policy followed decades of deflation, whereas the UK has had years of elevated inflation. In addition, Mr Carney will have one vote out of nine on the MPC, which in recent months has had a solid 6-3 majority opposed to expanding the QE programme. It is likely that Mr Carney’s voice will carry more weight than his one vote suggests, and it is possible that other committee members have recently held off from voting for more QE until the new governor takes office, but the prospect of a surge in asset purchases is slim. Some increase is likely during 2013—our expectation is £50bn—but QE is unlikely suddenly to start to have an increased impact on growth.

Alongside a possible resumption of QE, the new governor is also likely to focus attention on the existing Funding for Lending Scheme (FLS) operated by the BoE. Recently extended to the start of 2015, the scheme provides below-market rate loans to banks and building societies, provided that this credit is then made available to the “real economy”, namely individuals or businesses. The more that the banks lend out, up to a predetermined limit, the cheaper the loans from the BoE. As with previous official lending initiatives, the impact of the FLS has been limited, at best. Anecdotal evidence suggests that it has helped to lower banks’ financing costs, but total bank lending to non-financial companies in the UK has continued to decline, as it has done each year since 2008. Given the ongoing weakness of demand, we expect that the FLS will disappoint in boosting credit flows to the wider economy.
Balancing act

Mr Carney should have more latitude when it comes to making progress on the second and third challenges: banking reform and institutional change within the BoE. The first of these is of great importance to the wider economy, but it is a huge undertaking and one on which only partial progress is likely by the time Mr Carney finishes the five years he has said he intends to serve. The widening of the Bank’s remit to take in supervision of the banking sector, as well as oversight of overall financial stability, will require careful management, not least because these new responsibilities may require action that inhibits—for instance by leading banks to further suppress lending—the growth that Mr Carney will be trying at the same time to encourage with monetary policy.

The economy’s recovery is going to require a return of business and consumer confidence. The initial response to Mr Carney’s appointment reflected a hope that the arrival of a young outsider with a reputation for success might lead to just that. But as the feasibility of radically new policies has waned, so has the hope that Mr Carney might have an instantly transformative effect on the UK’s economic fortunes. He is likely to be a more dynamic governor than his predecessor, which should help. But he is limited in what he can actually do to improve the real economy. Businesses may welcome forward guidance on interest rates and QE, but it is expectations about demand in the economy that are primarily holding back investment. And with the timeframe for ending the government’s programme of deep fiscal retrenchment proving much longer than initially planned, there is little chance of those expectations improving significantly any time soon.
The euro zone economy is stuck in a recession, outstanding credit is shrinking and the money supply is growing only very slowly. The rate of inflation across the currency union is just over 1% and the European Central Bank (ECB) acknowledges that inflation is set to remain below its target of “close to, but below 2%” throughout 2013-14. Economic indicators point to a stabilisation of output during the second half of 2013, but the risk of a more prolonged recession and a period of deflation remains high. Yet despite economic and financial conditions being worse than in the US, Japan or UK, the ECB will continue to run a tighter monetary policy than the other three major central banks.

The ECB’s caution reflects a number of factors: the disparate nature of the euro zone’s constituent economies, the institutional structures underpinning the currency union and the ideological positions of some of the region’s central banks, in particular the influential German Bundesbank. The ECB is not the central bank for one economy and polity, but for 17 sovereign countries that have agreed to share a currency. Although the euro zone as a whole needs higher inflation, some countries are much more in need of it than others. For example, the Bundesbank fears that monetary policy is already too expansionary for the German economy, where unemployment stands at its lowest level in over 20 years.

Unlike the conventional central banks of the US, UK and Japan, the ECB is not backed by a political sovereign whose Treasury explicitly (or implicitly) agrees to underwrite its operations. It also has a very limited mandate: the pursuit of low inflation, but no accompanying responsibility to ensure a level of economic activity consistent with low unemployment (as faced by the US Federal Reserve). The ECB is also legally bound to avoid anything that smacks of a bail-out of any particular member state of the currency union.

Ideology is an additional part of the explanation for the ECB’s caution. In much of Europe, the risks of excessively low inflation are often ignored, while the risks of inflation are exaggerated. There is little acceptance that when inflation falls very low, consumers and firms tend to sit on cash rather than spend it. This is what economists mean by a “liquidity trap”: households do not want to spend and firms do not want to invest, making a prolonged recession self-fulfilling.

No rush to the exit

What will the ECB do, given its legal mandate and the ideological predilections of many policymakers? In response to recent US bond market tightening, in late June the ECB president, Mario Draghi, reiterated that an exit from the ECB’s exceptional monetary policy measures remains a distant prospect. The Bank is already committed to offering unlimited liquidity at short durations until at
least July 2014, and will probably do so well beyond this date. If conditions deteriorated further and banks faced renewed problems accessing funds at longer maturities, it could consider new longer-term refinancing operations (as it did in late 2011 and early 2012).

The ECB also stands ready to do “whatever it takes” to prevent the euro zone from disintegrating. Since the announcement in September 2012 of a new facility—outright monetary transactions (OMT)—to contain government bond spreads in peripheral member states through potentially unlimited purchases in secondary markets, some degree of normal functioning has returned to Spanish and Italian debt markets. Thus, although yields on ten-year Spanish and Italian bonds have risen amid the recent financial market turbulence, spreads over equivalent German bunds have widened only slightly from the lows reached earlier this year.

No country has yet requested support from the OMT facility, which would be conditional on states applying directly to the euro zone bail-out funds for parallel support in primary markets and, in turn, undertaking strict political commitments to reforms. However, Portugal looks a likely candidate when its EU/IMF bail-out programme expires in mid-2014. Ireland and Spain may also apply in the coming years if their bond markets suffer as global liquidity conditions eventually tighten, which could force Italy to follow suit.

**Another rate cut?**

Despite all the ECB’s action to date, the region remains in recession, interest rates for households and companies in the euro zone periphery are still considerably higher than in the core countries, while lending in the weakest countries is falling (particularly to the corporate sector). At the moment, the Bank’s preferred strategy appears to be to hope that an economic recovery will take hold later this year, averting the need for more radical action to stimulate credit demand. However, with much of southern Europe having embarked upon multi-year fiscal consolidation and economic reform programmes, growth in the region as a whole will remain lacklustre for some time yet.

Against this background, the ECB may decide to cut the refinancing rate by a further 25 basis points to just 0.25%, but it is unlikely to cut the deposit rate to below zero in an attempt to discourage banks from holding so much cash with the central bank. A lower refinancing rate would help banks in the periphery that rely largely on ECB liquidity, but would have little impact elsewhere, since under the current policy of “full allotment” of liquidity at fixed rates, the deposit rate has become the most important determinant of market interest rates (with the overnight rate a little above zero).

The ECB is likely to follow the Fed (and potentially the Bank of England) in giving an explicit commitment to holding interest rates at close to zero for a specific length of time—so-called forward guidance. The argument in favour of such an approach is that companies and households will start to
spend if they are confident that interest rates will be kept low even once inflation starts to rise (that is, central banks will tolerate negative real interest rates for a prolonged period). A shift to forward guidance could have some positive impact in the euro zone’s case: there is little doubt that the impact of low euro zone interest rates on inflation expectations is limited by the fear that the ECB will tighten as soon as inflation starts to rise. A commitment to keep interest rates low could also help depress the external value of the euro, and thereby support exports.

**QE will remain off the table**

The ECB is unlikely to follow its counterparts elsewhere in embarking on a programme of quantitative easing (QE) of the kind seen in Japan, the UK and US, at least not unless an existential threat to the euro zone leaves it with no option. An aggressive programme of QE by the ECB would probably stand more chance of boosting money supply and nominal GDP—and with it debt sustainability—across the euro zone than a commitment to keeping interest rates very low for a specified period of time. Moreover, a bond-buying programme would not breach the EU treaties so long as the ECB concentrated its asset purchases on euro zone assets as a whole, rather than on particular member states. That is, it would have to be aimed at lowering the average borrowing costs across the euro zone and not at closing bond spreads.

Even though legal concerns could probably be overcome, the political opposition to such a programme would be fierce, with the Bundesbank and others arguing that the ECB was effectively monetising debt. It is also debatable how long QE by the ECB could be sustained, given the lack of an effective fiscal backstop behind the institution. Allaying such concerns would require further steps towards fiscal integration, for which there is little political and public appetite within many euro zone member states.

In summary, the ECB is all but certain to do too little more to propel the euro zone down the path to economic recovery, with the result that the currency union faces a period of faltering growth at best, and the very real threat of deflation and further rapid increases in debt ratios. But the ultimate responsibility for this will reside with the euro zone’s governments rather than with the Bank itself: this reflects a refusal to agree moves to turn the euro zone into a proper federation (for example, a fully fledged banking union) and failure to acknowledge that the central bank for an economy as heterogeneous and relatively closed as the euro zone needed to be modelled more on the US Federal Reserve than on the Bundesbank.
The end isn’t nigh
Central bank challenges as the era of cheap money enters a new phase

Japan

Fading afterglow

Almost three months after the Bank of Japan doubled its bets on QE, prospects for reflating the economy look mixed.

Of the central banks experimenting with unorthodox monetary policy, the Bank of Japan (BoJ) is intriguing in that it has previous form. The bank pioneered quantitative easing (QE) in 2001-06, and despite the fact that this policy approach proved of questionable benefit to the real economy (in terms of inflation and growth) at the time, the BoJ has come back for further helpings. A new QE programme, announced in early April 2013, initially generated optimism: boosting the stockmarket and, to the relief of exporters, prompting the yen to depreciate. But with the government’s broader economic strategy looking less than convincing, doubts about Japan’s long-term growth prospects are returning.

As in other economies, the BoJ’s return to QE in part reflects the fact that other options for reflating the economy are limited. Policy interest rates are effectively at zero and can go no lower, while Japan’s extraordinarily high level of public debt limits the scope for radical fiscal stimulus. In 2012 such debt stood at the equivalent of 220% of nominal GDP. The limited impact of earlier rounds of QE has not deterred the BoJ from trying again. Under its new governor—Haruhiko Kuroda, who took office in March—the bank has responded to criticism that in the past it was simply not injecting enough liquidity into the financial system. With political backing from a new prime minister, Shinzo Abe, the BoJ stunned observers in early April by effectively doubling its bets on monetary stimulus.

The latest QE programme is the bank’s most aggressive to date. Linked to an explicit inflation target—as a relatively recent innovation for the BoJ—of 2% within “about two years”, it aims to double the monetary base from ¥138trn (US$1.4trn) at end-2012 to ¥270trn by end-2014. To achieve this, the BoJ has set a new framework for bond purchases, with a monthly allocation of ¥7trn. This is slightly less than the US Federal Reserve’s US$85bn in monthly asset purchases, but it is much higher relative to the size of Japan’s economy. The bank has abandoned, for now, its previous practice of targeting its overnight policy rate. Under the latest iteration of QE, the BoJ has shifted to targeting the size of the monetary base. The new BoJ leadership is also seeking, through its asset purchases, to influence market interest rates along the entire yield curve. This is in recognition of the fact that previous programmes, which focused on purchases of debt with maturities up to three years, were relatively ineffective in stimulating growth.

Impact in doubt

The key question is whether the latest monetary-policy changes will alter inflationary expectations. Previous rounds of QE have not drastically altered price expectations, with core consumer prices (ie excluding fresh food) having declined in nine of the past 12 years. More recently, core consumer prices—the BOJ’s preferred measure of inflation—have fallen in year-on-year terms for the past six
The end isn’t nigh
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months in a row. At the same time, nominal wages have generally been falling much faster than consumer prices, suggesting that consumers have less money in their pockets to spend. This makes economic recovery difficult.

Wealth effects relating to the impact of QE on asset prices offer a little more hope for a sustained pick-up in private consumption. Anticipation of QE, and its subsequent announcement in April this year, initially prompted sharp rises in the stockmarket. Between end-September 2012 and late May 2013, the Nikkei 225 stockmarket index rose by 76%. More importantly, the real economy seemed to be responding to improved sentiment and a weaker yen, with real GDP growth accelerating to 1% quarter on quarter in January-March. This was almost certainly not directly down to the increase in liquidity from QE, but rather a reflection of the Abe government’s supplementary fiscal stimulus package in early 2013. The secondary impact of QE-related currency depreciation is likely to have been a factor as well.

It is unclear whether QE’s salutary effects will prove more than temporary. In recent weeks financial markets have gone sharply into reverse. At the time of writing, the Nikkei 225 was down some 15% since May 22nd, and in the same period the yen had rebounded from ¥103 to about ¥98 (boding ill for exporters). The change in market sentiment partly reflected international jitters about a potential tapering of the Fed’s own QE programme. But investors have also become more sceptical of the “third arrow” of Mr Abe’s three-pronged economic revival agenda—namely structural reform—which was intended to complement QE and fiscal stimulus. Reform plans unveiled in early June lacked detail, although more radical reforms are likely to be announced after the upper-house election on July 21st.

Obstacles on the path to reflation
The latest QE programme is not supposed to be open-ended, but if it fails to strengthen the economy as much as the BoJ hopes, the central bank may reconsider its monetary-stimulus options. Any decision is likely to hinge on the trajectory of core inflation over the next two years. The BoJ is hoping that a combination of a weaker exchange rate, faster economic growth (in nominal terms), the impact of planned rises in the consumption tax and stronger wage pressures will help it to get close to its 2% core inflation target. We expect
decent GDP growth in the first half of this year. This should give the government the justification it needs to go ahead with the first of two planned hikes in the consumption tax—from 5% to 8%—in April 2014. Meanwhile, the Fed’s tapering of QE, if effected, will contribute to downward pressure on the yen. Both the consumption-tax hike and the weaker yen should, in principle, contribute to stronger inflationary pressures.

However, if GDP growth subsequently proves to be weaker than the BoJ anticipates, and if significant wage rises fail to materialise, the chances of achieving the inflation target will fall dramatically. In this case, the BoJ leadership could find itself facing difficult questions about the effectiveness of QE, and its future policy options. Failure to reflate the economy would imply a need for yet further monetary stimulus, but the BoJ’s critics might ask whether it was worth continuing with a policy that had not worked.

A potential twist in this plot is that disappointing economic growth might also lead to the suspension of the government’s second planned hike in the consumption tax (from 8% to 10%) in October 2015. Ironically, this logical response to a weak economy would make the BoJ’s inflation target yet harder to achieve—not only denting Mr Abe’s economic recovery agenda but also dealing a serious blow to his political hopes.
Emerging markets

Money in, money out

Investors have reacted with some alarm to indications that the US Federal Reserve could soon scale back “quantitative easing” (QE). Recent weeks have seen a major sell-off in emerging-market assets as investors anticipate higher returns in the US. This has revived concerns about external financing in some vulnerable emerging markets. Although eventual monetary policy normalisation in the rich world need not be calamitous for emerging markets, many of which have stronger external balance sheets than in the past, vulnerabilities are rising. In addition, recent events may signal a more fundamental reassessment of emerging markets’ economic prospects.

It should be noted at the outset that the sell-off has not solely been the result of US monetary-policy signals, and that its start predated speculation about liquidity withdrawal by the Fed. Lacklustre global economic growth and disappointing data in a number of emerging markets, notably China, but also Brazil and Russia, have contributed to the shift in investor sentiment, as have recent protests in Turkey and Brazil. Nonetheless, the Fed’s change of tone since mid-May has triggered a more dramatic retreat from emerging-market assets. The inevitable process of adjustment, after years of extraordinary monetary accommodation since the economic crisis of 2008-09, will ultimately culminate in higher US interest rates. All else being equal, higher US rates would render emerging-market assets relatively less attractive to investors.

Markets are pricing in the change in US monetary policy well ahead of the event: even once QE is phased out altogether, the first rise in the Fed’s policy rate target is probably two years away, and in this sense investors are conflating a reduction in the pace of monetary easing with actual tightening—two very different phenomena. The Fed has been at pains to point out the difference, reminding observers that a reduction in its bond purchases under QE would constitute “letting up a bit on the gas pedal” rather than stepping on the brake, to use Fed chairman Ben Bernanke’s motoring analogy. Nonetheless, the mere expectation of a pullback in liquidity has caused market interest rates in the US to rise, rendering concerns about capital flight from emerging markets partially self-fulfilling.

The sell-off has been dramatic. Since May 8th the FTSE All Emerging All-Cap equity index has dropped by 14%. Virtually all emerging-market currencies, barring the Chinese renminbi, have fallen sharply against the dollar. The Brazilian Real, South African rand, Indian rupee and Turkish lira have fallen by 7-10% over the same period. The Indonesian rupiah has come under pressure, contributing to a decision by the central bank to raise interest rates in mid-June. The Mexican peso has also fallen sharply against the dollar (Mexico is one of the most liquid emerging markets, making it a prime target for the sell-off in risk assets). Yields on local and hard-currency emerging-market sovereign bonds have risen sharply.
Key vulnerability factors
Investors are now questioning what the end of the era of easy money could mean for emerging markets. Individual countries’ vulnerability to a sudden reversal of capital flows varies widely, given differences in their macroeconomic fundamentals, external debt profiles and quality of economic management. In broad terms, the economies most likely to come under strain are those that run large current-account deficits and rely heavily on inflows of volatile portfolio investment. This partly explains why Turkey, India and South Africa (with current-account deficits equivalent to 5-7% of GDP) have been affected by the reversal in sentiment. In these countries portfolio flows, which can be rapidly reversed when investors take fright, play an important role in financing current-account deficits.

In terms of assessing vulnerability, companies seem more likely than governments to encounter funding problems if global liquidity tightens, given the trend in emerging-market debt issuance. In recent years corporate hard-currency debt issuance in emerging markets has overtaken that of governments. Since the start of 2012 alone, emerging-market corporates have issued some US$540bn in bonds—a sum almost equal to the entire outstanding stock of emerging-market hard-currency sovereign debt. The fact that corporate borrowers generally roll over their debt more frequently than governments is an added source of vulnerability.

Many other factors determine investors’ willingness to keep their money in a given country. Turkey, for instance, has been racked by anti-government protests in recent weeks. In South Africa, the fall in the rand partly reflects labour tensions in the mining sector (which threaten exports) and plunging precious-metals prices (although the latter is also linked to the US Fed’s policy stance). Yet in both countries the policy environment is relatively sound. Turkey’s banking sector is well capitalised. It is a potentially different story for countries with more challenging circumstances, such as Ukraine, which is trying to defend a de facto currency peg to the US dollar with very low foreign reserves. Ukraine’s government is resisting energy and exchange-rate reforms that could enable it to access an IMF lending programme. Instead, with economic policy dominated by political considerations, the authorities have been resorting to increasingly quixotic and ad hoc measures, such as the mandatory sale of 50% of exporters’ earnings and limits on cash transactions, in an effort to counter mounting signs of economic imbalance and financial strain.

Stronger balance sheets
Despite the risks that a pullback in Fed liquidity poses, a number of factors should mitigate its impact on emerging markets and make the sorts of currency and balance-of-payments crises of the 1990s less likely. First, emerging-market balance sheets, by and large, are much stronger than they were a decade or two ago, while policy frameworks have improved (including a shift to more independent central banks and floating exchange rates). Many emerging markets have built up substantial foreign-exchange reserves. These offer some protection against balance-of-payments difficulties but remain susceptible to rapid depletion in a crisis. Non-OECD countries’ international reserves have risen from the equivalent of 45% of their external debt in 2000 to 155% in 2012. (The aggregate is, admittedly, inflated by China’s huge build-up of reserves, to around US$3.3trn.) This trend reduces the potential
for debts denominated in foreign currency to become unaffordable in local-currency terms. Many emerging markets have, in any case, become less dependent on foreign-currency borrowing by encouraging the development of local-currency funding markets.

A second mitigating factor is that the ultra-low-interest-rate environment engendered by QE in the rich world has enabled some emerging-market governments and corporates to pre-fund their needs by issuing debt at attractive rates. Recent rises in bond yields will make this more difficult and costly, but in retrospect those that did borrow before the market sell-off—including a number of governments and corporates in Latin America—now look quite savvy.

Thirdly, markets’ negative reaction to the prospect of QE “tapering” ignores the fact that any withdrawal of liquidity will be gradual and cautious, and that monetary-policy normalisation by the Fed implies an improvement in the US’s economic fundamentals that should benefit the rest of the world through increased trade and investment.

A pro-cyclical sting in the tail?
Yet while emerging markets are generally in a better position to withstand a global reallocation of assets than they were in the 1990s or 2000s, this does not mean that the adjustment will be smooth or that the absence of balance-of-payments problems will preclude difficulties of other sorts. Whereas the US Fed is rightly seeking to engineer a carefully planned and signalled exit from QE, abrupt and reactive policy adjustments may prove unavoidable for some emerging-market central banks if the asset sell-off continues. Brazil and Turkey have both tightened monetary policy recently, partly in an effort to relieve downward pressure on their currencies. Further tightening is almost certain in Brazil, given building inflationary pressures, and a possibility in Turkey. Yet such moves would be pro-cyclical given relatively weak economic conditions in both countries, and higher interest rates could choke off recovery. Compare, for example, Turkey’s situation with that in 2011, the last time there was a run on the Turkish lira and the central bank had to raise interest rates to attract capital inflows. At that time the economy was growing at about 9% a year. Now growth is about 3%.

Other potential disruptions abound. Brazil, for instance, has abandoned a financial transactions tax previously implemented in an attempt to stem appreciation of the Real. Given concerns over the government’s increasingly interventionist and statist policy model, this sudden U-turn—although welcome in removing a distortionary capital control—could reinforce foreign investors’ impressions of policy unpredictability. Currency weakness in a number of other Latin American economies is largely welcome for now, but continued depreciation, if coupled with higher inflation, could push monetary policy in directions not fully warranted by domestic fundamentals. Colombia’s central bank has already

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**Better buffers**

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Source: The Economist Intelligence Unit CountryData.
halted monetary easing, in part because of recent developments in global markets. In Mexico, a weaker peso might well encourage the Banco de México (the central bank) to hold off from cutting interest rates, despite tepid economic growth.

**Bigger questions**

Financial-sector skittishness may also mask more fundamental concerns. The growth outlook for emerging markets has darkened as data from China, in particular, have disappointed in early 2013 and as it has become clear that the world’s second-largest economy is undergoing a secular shift towards slower growth. A recent surge in interbank rates has hardly helped, fuelling fears about a financial crisis in the largest emerging market following years of rapid credit growth. The Economist Intelligence Unit is still relatively positive about overall emerging-market prospects. We forecast that aggregate GDP growth in non-OECD countries will accelerate from 4.7% in 2012 to 6.3% in 2016 as the global economy improves. Yet challenges loom, and policymakers may have to tackle them at the same time as a global shift in liquidity is under way. In recent years abundant liquidity has boosted emerging-market economies and financial markets, both by helping to prevent steeper downturns in the developed economies with which emerging markets trade and by suppressing yields on bonds in the rich world, thereby encouraging money to be channelled to developing countries. The start of the end of easy money is not yet here, but markets are starting to price it in—in prospect is a widespread reappraisal of emerging markets’ ability to sustain recent growth rates once monetary conditions in the advanced economies normalise.
Bank regulation

Policy paradox

At the best of times, it can be difficult to do two things at once. When one of those things is directing US$6trn in monetary stimulus and the other is promoting a safer, more conservative banking system, it becomes harder still.

The world’s major central banks are propping up the global economy with quantitative easing (QE), which works—in theory—by funnelling trillions of dollars of newly-created money via commercial banks to the real economy. To varying degrees, these same central banks also act as regulators and supervisors of commercial banks, with many receiving new or enhanced prudential powers following the global financial crisis. The responsibilities as a regulator to promote financial stability and a safer banking system often act in opposition to the goal of boosting credit and economic growth via QE.

The promotion of a necessary reduction in the size of overleveraged private and public balance sheets—a key financial-stability imperative, particularly in Europe—is hardly compatible with the flood of liquidity generated by central banks’ bond-buying programmes. Imposing stricter capital, leverage and liquidity requirements to bolster the resilience of banks is also problematic for credit growth; with equity valuations depressed and earnings power weak, banks have relied on shrinking their asset bases to improve capital and liquidity ratios. By some measures, banks have shed assets worth more than US$700bn since 2007.

This is the “paradox of policy”, as described by Sir Mervyn King, the outgoing governor of the Bank of England (BoE), during the depths of the financial crisis in early 2009. “Almost any policy measure that is desirable now appears diametrically opposite to the direction in which we need to go in the long term”, he said.

In 2010 global regulators agreed on the so-called Basel III standards, which raise the quality and quantity of capital that banks must hold, in addition to setting stricter criteria for leverage and liquidity. As written, these standards do not take full effect until 2019. Between now and 2019, banks need to raise some US$200bn in capital to meet the minimum requirements, a large sum that nonetheless can be met via retained earnings given the long lead time.

Regulators, however, are keen to bolster bank balance sheets more quickly and comprehensively. A welter of stress tests in the US and Europe in recent years has pushed banks to raise additional capital, revise the risk weights applied to assets and limit leverage. Many of these exercises imposed requirements in excess of what was agreed under Basel III or brought forward the timeline to meet the minimum standards. Most recently, the BoE, which regained regulatory and supervisory powers over commercial banks in April 2013, identified a capital shortfall of £27.1bn (US$41.7bn) at the UK’s eight largest banks; after incorporating assumed future losses and a “more prudent approach” to risk weights, lenders judged to fall short of a 7% core Tier-1 capital ratio—Basel III’s 2019 goal—must fill the capital hole by the end of 2013.
Officials at the BoE have been particularly outspoken on the need for tougher capital and leverage rules, at times suggesting that a doubling of Basel III’s minimum capital and leverage ratios would improve the safety and stability of the banking system without imposing undue economic costs. Voices from the US Federal Reserve are now making similar suggestions; the vice-chair, Janet Yellen, said in June that she was “not convinced” by efforts to bolster the largest global banks, proposing that a “steeper capital surcharge curve” than what is included in the Basel III standards may be necessary.

If banks met stricter capital-adequacy requirements by raising new equity, the impact on lending would be minimised. Banks’ form to date, however, suggests that cutting assets is the more likely course of action. The BoE’s Funding for Lending scheme is an attempt to address this tendency, providing cheap funding for banks only if they meet lending targets for small businesses and other priority sectors. There are growing calls for a similar system in the euro zone, given the reluctance of the region’s undervalued, overleveraged banks to extend new loans. This is doubtful, given the protracted negotiations over the European Central Bank’s role as a pan-regional bank regulator. In the US, economic recovery puts less pressure on the country’s banks in this regard; smartly rising mortgage and auto lending, for example, generates earnings that lenders can retain in order to improve their regulatory ratios.

Although capital-adequacy rules are one of the biggest regulatory drags on banks, there are other headwinds working against central banks’ monetary policy objectives. Banks also fret about the costs of other financial reforms such as the legal separation of wholesale and retail financial activities, the resolution regimes that force losses on creditors, and the momentum gathering for a fundamental revamp of risk-weighting practices. Not all of the lenders’ angst is valid, of course, but experience to date suggests that the push of QE is reversed, at least in part, by the pull of stricter regulation. For the institutions that direct both monetary stimulus and banking supervision, the risk is that the net effect of these opposing forces leaves economies stuck in place.
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