

Market meltdown to test discredited central banks

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LONDON, June 24:

Financial markets are in turmoil after Britain's vote to leave the European Union. Global stocks are plunging while sterling has suffered a record drop, hitting 31-year lows of \$1.33. Money is instead flooding to the safest havens, such as US bonds, gold, and the dollar. Central bankers would normally be the first line of defence - but they have already been discredited.

Granted, rate-setters have shown they can act together when needed. Major central banks cut their official policy rates for the first time in history in 2008 to stem the worst global financial crisis since the 1930s. Their hope was to pump out sufficient new money into the financial system to revive economic activity, with the extra effect of re-inflating asset prices. They can decide to ease policy jointly again if things get bad enough, even though until now the U.S. Federal Reserve's next move was expected to be a tightening.

However, a lot has changed in the past eight years. First, even the most influential central bankers, such as Fed Chair Janet Yellen, European Central Bank President Mario Draghi, and Bank of Japan chief Haruhiko Kuroda have shown their powers are limited. The last two have slashed their policy rates again and again, even to below zero, and bought ever-increasing amounts of assets. Yet they have failed to push up inflation convincingly in their respective countries. While U.S. consumer prices are rising at a quicker pace, even Yellen has been buffeted by economic and market headwinds from abroad.

Second, rate-setters could end up a victim of their past success in inflating global asset prices. Investors have pushed global stocks up a long way from their March 2009 troughs. The MSCI All Country World Index has more than doubled since then, to 398.97. Valuations could hardly be considered cheap, even before the economic shock that the UK referendum result has the potential to inflict. For example, the STOXX Europe 600 Index was trading well above its 10-year average relative to 12-month forward price-to-earnings ratio. Huge political and economic uncertainty will now force a rerating. Central bankers are basically powerless to stop it.

(The author is a Reuters Breakingviews columnist. The opinions expressed are her own.)

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