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More of the Same

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The tale of Goldilocks and the Three Bears was a popular analogy in markets in the years post the Great Financial Crisis, used to describe the global economy as not too hot, not too cold, but just right. Extending the idea to today's central bank policy: too hot would be embarking on helicopter money or large scale debt forgiveness; too cold would be abandoning tools like quantitative easing, possibly in response to criticism of QE's role in fuelling asset price bubbles; just right, then, is a continuation of current policy and hence central bankers need to hold their nerve in the face of rising inflation and provide more of the same.

Central bank policy used to revolve around managing short term interest rates. While the Bank of Japan embarked on quantitative easing to fight domestic deflation in the early 2000s, it wasn't until the Great Financial Crisis that the policy was adopted more widely. Having expanded their toolkit to include focusing on the term structure of interest rates, last year many central banks, including the US Federal Reserve, also began targeting the credit structure of interest rates by buying corporate debt.

Quantitative easing has been criticised for driving up asset prices while appearing to have only a limited impact on inflation. Higher asset prices favour current owners of those assets, hence the policy is also blamed for exacerbating wealth inequality. Lower interest rates are designed to encourage greater demand for money and greater spending: individuals will decide where that spending is ultimately directed. Where money finds its ways into assets, including land and premises, the marginal cost of production rises and companies will raise prices accordingly, thus delivering the desired inflation. Hence rising asset prices are part of the transmission mechanism of monetary policy and their appearance shouldn't stop central banks from doing quantitative easing, now or in the future.

There are those who advocate more aggressive policies, like helicopter money: sending households cheques in the mail. While appealingly egalitarian, handing out money blindly in this fashion has its drawbacks, as the Reddit trading experience perhaps shows (read my colleague Lorenzo La Posta's excellent blog from last week if you would like to know more about what happened).

Quantitative easing does not alter the risk-based way in which capital is allocated throughout the economy, merely the price at which it flows. Another option being contemplated is large scale debt forgiveness. Here again, there are problems with administering such a policy: should we forgive government debt or corporate debt? Which corporates deserve it? The success of the financial system rests on the faith of participants – why else would you accept a voucher as a means of payment? – and while participants have so far accepted quantitative easing and negative interest rates, writing off debt may well be the final straw. Hence our view is that central banks should continue using the existing tool kit rather than adding more levers at this stage.

The primary goal of monetary policy is ensuring price stability (somewhat confusingly, defined as some inflation rather than zero inflation/constant prices). Inflation expectations derived from government bond markets have been rising sharply, suggesting at first glance that current policy may be too loose. Short term rises are to do with base effects (prices had been crushed this time last year) and some supply issues, most importantly affecting the price of shipping containers, both of which appear short term in nature to us. So far central banks are saying the right things in terms of looking through these rises and longer-term expectations remain reassuringly anchored. We are following inflation expectations and measures of slack in the labour market closely and agree with policymakers' assessment that there are no signs of capacity exhaustion currently.

It is a case of so far so good regarding central bank policy and we advocate more of the same rather than a premature tightening of financial conditions. However, the law of unintended consequences still holds and hence we will be watching central banks closely for signs of a policy mistake.

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