RUBRICS

The Ghosts of Central Banks Past

Fixed Income Macro View

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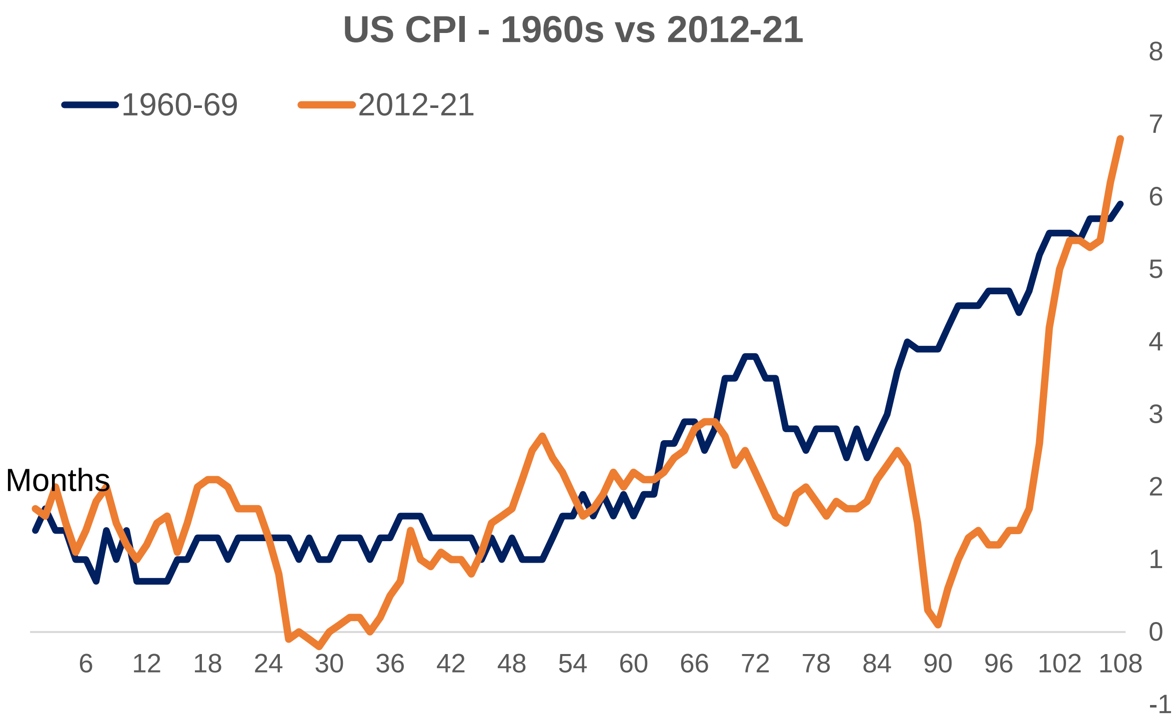
Introduction

Central banks in modern times have often been lauded for their swift and decisive actions in keeping the financial system afloat in the face of unprecedented crises. The adulation, however, has dried up in recent times as inflation has begun to bite. Some analysts, such as Allianz Chief Economic Advisor Mohamed El Erian, have gone as far suggesting that the Fed's recent characterization of inflation as "transitory" is probably the worst call in their history. Strong words indeed. There have of course been a number of unsuccessful forecasts made by Central Bankers over the years, many of which have resulted in particularly bad economic outcomes. While it is perhaps too early to tell where Powell 2021 sits in this pantheon, at the very least it is only fair to point out that he is in very good company. Below we take a look at some of the most questionable decisions made by his predecessors, many of which continue to shape the monetary landscape today.

History Rhymes: 1960s CPI vs 2012-2021



Source: Bloomberg as at 22/12/21

Ghosts of Central Banks Past

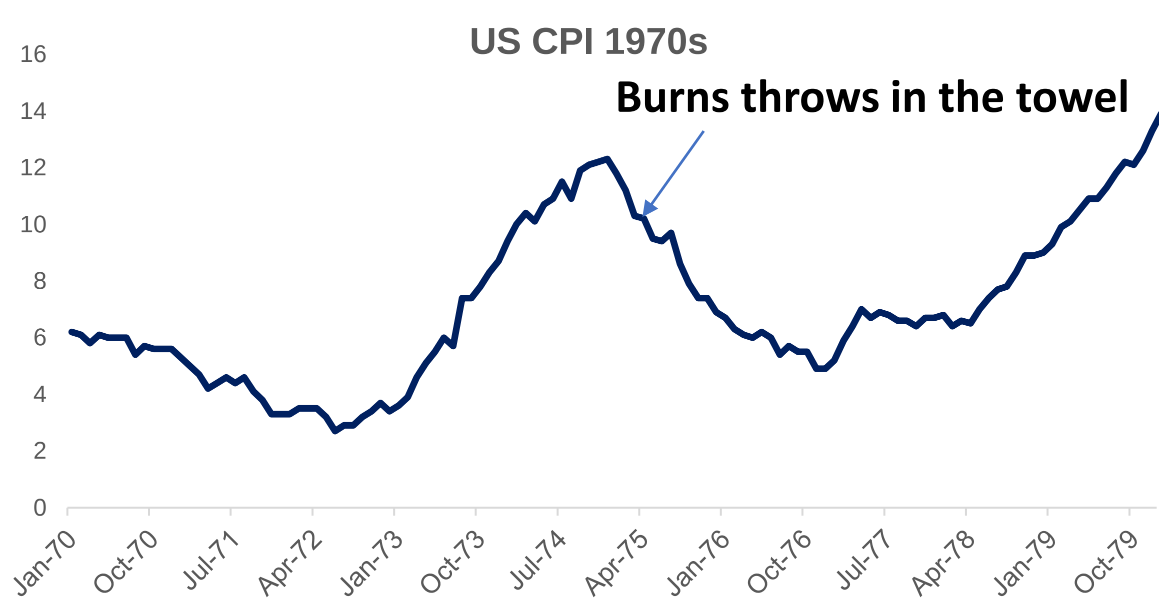
1. Arthur Burns - The Original Transitory Inflationist

After a prolonged period of steady inflation in the first half of the 1960's (sound familiar?), prices started to move higher in the latter part of the decade. The US government was starting to increase its fiscal spending considerably and that impact was filtering its way through to the economy. Additionally, demographics were beginning to have a real effect. By 1970 the sub 2% inflation of the 1960-65 period had given way to an above 5% trending CPI. The Head of the Federal Reserve at the time was Arthur Burns, an expert on the business cycle who had co-authored the definitive thesis on the ups and downs of the US economy dating back to the 19th century. Burns, who ruled with something of an iron fist, was adamant that the inflation trends witnessed in the late 1960's and early 1970's were "transitory" and best ignored. In fact, when oil prices quadrupled in the aftermath of the Yom Kippur War he argued that since they had nothing to do with Monetary Policy, the Fed should strip them out – in effect creating what we now know as Core CPI. As price pressures intensified, Burns continued on this path until in 1975 only about 35% of the original CPI basket was left[1]. However, even this heavily paired back measure was rising at a double-digit rate and it was at this point that he eventually conceded there was a problem – far too little, far too late.

1. The Ghost of Arthur Burns by Stephen S. Roach - Project Syndicate (project-syndicate.org)

As with Jerome Powell earlier this year, Burns' fixation on some of the temporary drivers of inflation meant he missed the bigger structural changes to the economy from factors like government spending, demographics and the fact that the US dollar had left the gold standard. It is hard to believe with hindsight that some of these major trends were overlooked given the subsequent impact they would have on inflation. It is probably unfair to put Powell's 'transitory' inflation forecast in the same bracket as Burns' catastrophic call in the 1970's – however there is still a long way to go before we see the true outcome of the Fed's 2021 stance.

Too Little too Late: Runaway CPI Inflation 1970s

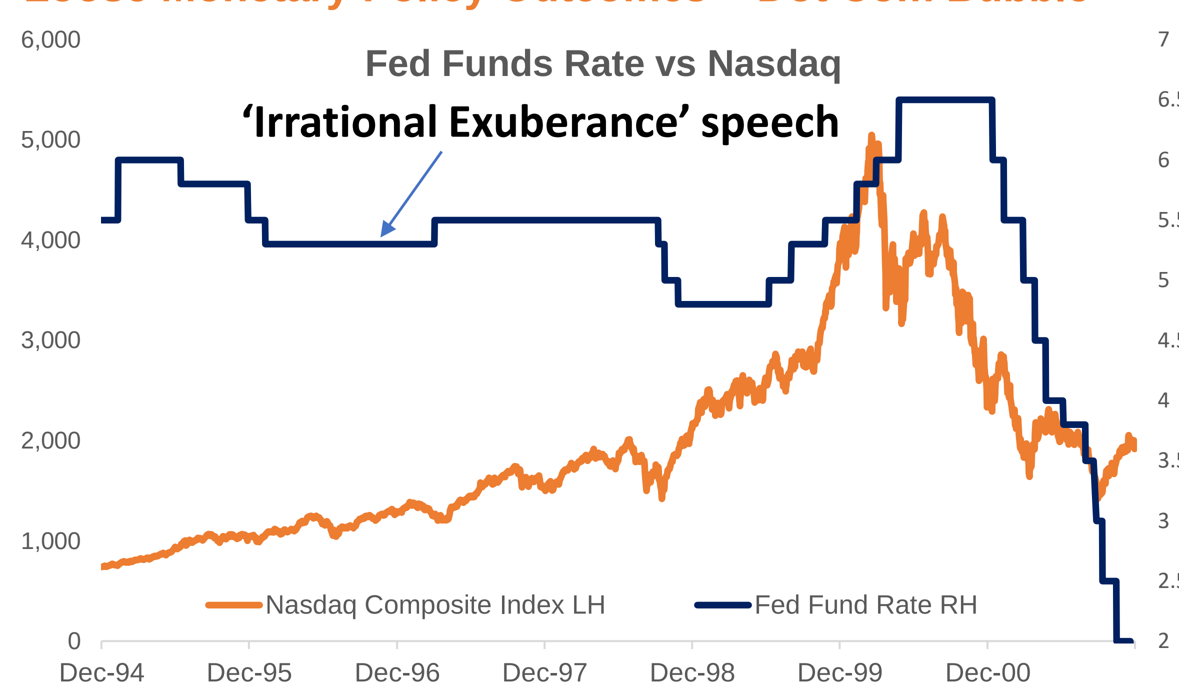


Source: Bloomberg as at 22/12/21

2. Alan Greenspan – About turn on 'Irrational Exuberance'

During the late 1990's the Federal Reserve was faced with multiple market emergencies. The Asian crisis of 1997 was swiftly followed by the both the Russian default and the collapse of LTCM in 1998. Although the US economy at that time was performing strongly, Fed Chair Alan Greenspan explained that it was his job as the Chairman of the "Global Reserve Currency" to take into consideration all relevant global factors when making monetary policy decisions. This meant that for most of the late 1990's financial conditions in the United States were far easier than they necessarily should have been given the significant productivity gains made over the period. The global savings glut and widening of external imbalances were additional factors at play over this period which, according to Greenspan himself, had the effect of keeping rates some 100bps lower than they otherwise would have been. This further increased the likelihood of an overheating economy. None of this was necessarily lost on the Fed Chair, who, in the early

Loose Monetary Policy Outcomes – Dot Com Bubble



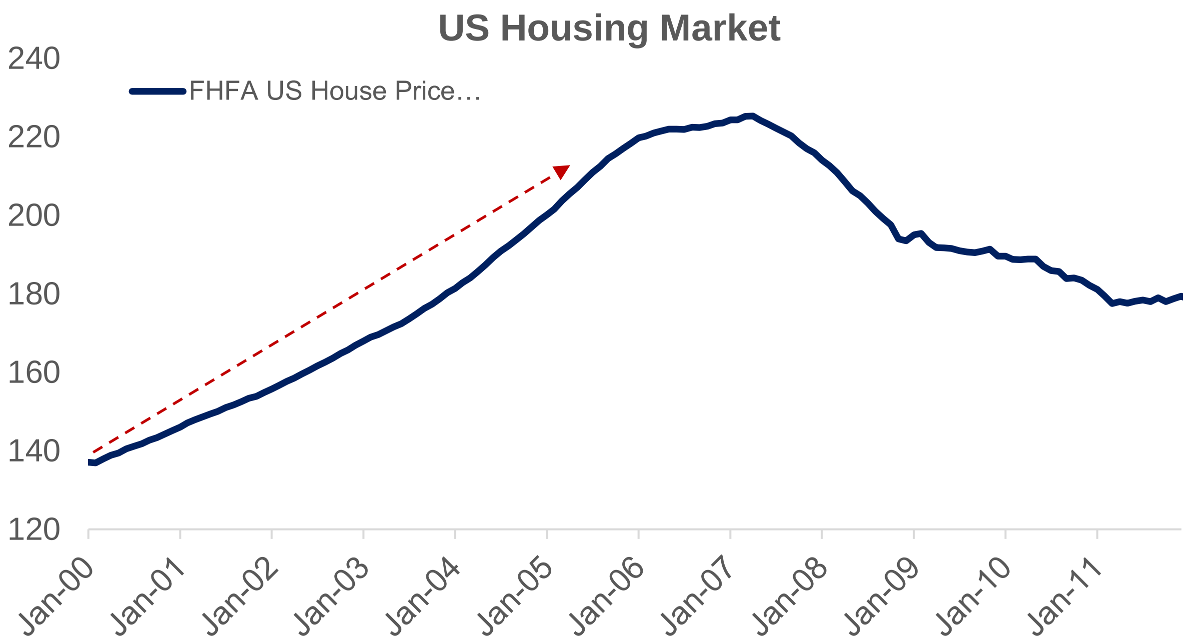
Source: Bloomberg as at 22/12/21

stages of the boom in 1996, famously described conditions in financial markets as demonstrating "irrational exuberance". However it was the fact that he would back down from this stance and continuously ignore the warning signs of excessively loose financial conditions that led many to subsequently criticise his actions. Greenspan fundamentally believed the Fed had the ability to deal with any market crisis after the fact, and in so doing could cushion any potential blow to the real economy. As he concluded in his Memoir – "in effect, investors were teaching the Fed a lesson…you can't tell when a market is overvalued, and you can't fight market forces…we never tried to rein in stock prices again"[2].

2. Master of the Universe (Rtd) | Financial Times

While the outcome of this philosophy would ultimately come home to roost in 2008, it betrayed a fundamental misunderstanding of the dangers of perpetuating asset bubbles. A recurring flaw in central bank policymaking it seems. While the Fed may indeed have had the necessary tools at their disposal to effectively deal with problems, they either ignored them or deployed them in an ultimately counterproductive way.

Housing Market Excess



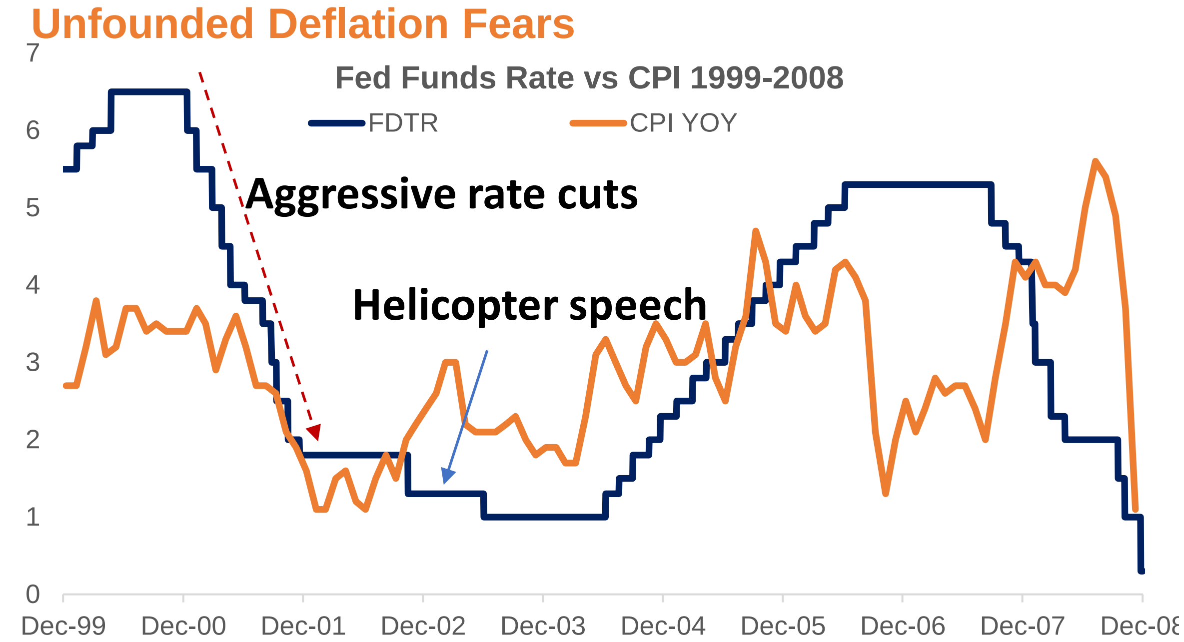
Source: Bloomberg as at 22/12/21

3. Ben Bernanke – Helicopter Money

In a famous speech to the Board of Governors of the Federal Reserve System in November 2002, Ben Bernanke outlined why deflation was only a minor risk to the United States. There were two key reasons for this; firstly because of the resilience and structural stability of the US economy itself and secondly because of the mandate handed down to the Federal Reserve and the awesome firepower at their disposal. He assured the audience that the Fed would do whatever it took to prevent deflation – a sentiment echoed by the ECB's Mario Draghi some 10 years later. Bernanke, himself an expert on the Great Depression, noted in the speech that, "a money financed tax cut is essentially equivalent to Milton Friedman's famous "helicopter drop" of money." I.e. that the Fed could start monetising fiscal deficits without directly saying so. In the footnotes of this speech Bernanke references a paper by Gauti Eggertson[3] which emphasizes the importance of a commitment from the central bank to keep money supply at a higher level in the future – something he certainly succeeded in doing. In fact he was so successful that he decided the Fed should discontinue the wider M3 money supply calculation. A questionable decision in hindsight.

Unfortunately for Bernanke global events were moving faster than the Fed's models could keep up with. On the 11th of December 2001 China became a member of the World Trade Organisation and the gates opened to cheap imports of low-cost goods into the United States. This was a seismic shift to the structure of the global economy, but Bernanke saw it as nothing more than a cyclical change and as such attempted tackle it with cyclical tools.

Unfounded Deflation Fears



Source: Bloomberg as at 22/12/21

From reading the transcripts of the FOMC in 2003 we can see that Bernanke was in fact willing to lower rates to zero. Considering the damage inflicted over this period with rates at 1%, what an additional 100bps in cuts may have done almost doesn't bear thinking about.

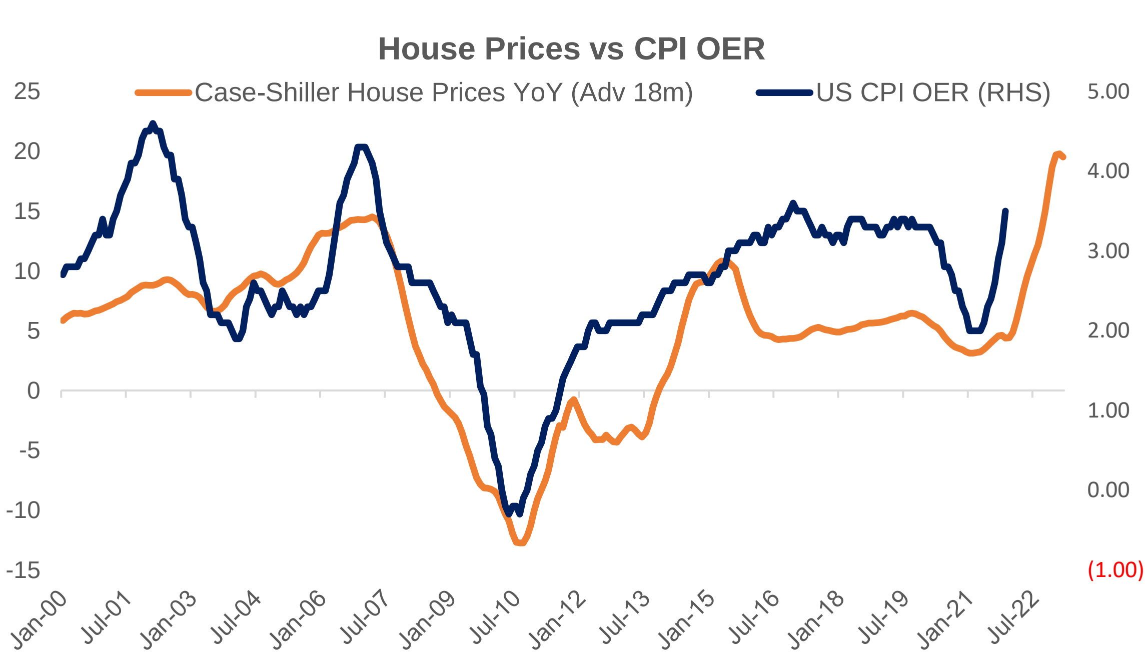
3. Serie Banca Central, Volumen 17: Fiscal Policy and Macroeconomic Performance (bcentral.cl)

In spite of the Dotcom bubble burst, US economic performance was positive and a recession was avoided. However monetary policy support remained extreme and considerably at odds with the underlying economy. As mentioned above, it was structural changes to the global economy that completely blindsided Bernanke into thinking the cyclical situation in the US was far worse than it was. As with Greenspan's disregarding of the dangers of excessively loose monetary conditions, Bernanke walked the US economy into another boom bust scenario, but this time with far more serious consequences for the global financial and economic system.

Ghosts of Central Banks Present - *Jerome Powell*

Following a 4.9% reading on the November CPI release, Jerome Powell told US lawmakers it was time to retire the word "transitory" from the lexicon of terms used to describe inflation. After months of focusing on the supply side effects of Covid and its impact on items such lumber, second-hand cars and even air fares, he had to acknowledge that inflation was becoming more entrenched in the economy than the Fed had previously anticipated.

Inflationary Outlook – House Prices and OER Inflation



Source: Bloomberg as at 22/12/21

Unsurprisingly, Powell has found himself on the back foot as regards inflation given earlier estimates of inflation overshoots were in the region of 3% not 6%+.

For some of us there was a high likelihood that inflation was going to overshoot even as things like lumber prices pared their extraordinary gains. Throughout 2021 house prices, as they did in 2008, ripped higher, except this time at a faster rate and to levels that have become even more unaffordable to many workers. The Owners Equivalent Rent (OER) measure, which depending on which inflation metric you look at occupies between 20-30% of the basket – has historically tended to follow house prices with a lag. As such higher CPI inflation was all but inevitable. It is a pity that once again the Fed was blinded to what was going on in the real world.

As fiscal spending contracts somewhat from very elevated levels and monetary policy tightens in 2022, inflation will likely retreat. However, the question that must be asked is to what extent structural changes have occurred in the economy that will mean a change to the longer-term trajectory for inflation. As we have highlighted previously, we do see a number of potential changes in the form of structurally higher fiscal spending, higher costs from climate change, strengthening in the bargaining power of labour and a more fraught geopolitical backdrop (de-globalisation?) which are already changing the post-2008 growth dynamics. While the inflationary outlook will continue to be impacted by headwinds in the form of debt deflation, mal-investment and technological trends, there is no doubt the debate is becoming more finely balanced.

As such the probabilistic nature of economic projections should also change. The fact that Powell's "new inflation framework" lasted little more than a year is a case in point. However we might add that at least it lasted longer than his "transitory" characterisation.

Ghosts of Central Banks Future – *Central Bankers for the Economy not the Markets*

What is consistent across each of these Central Banking missteps is a mischaracterisation of structural problems as cyclical complications. How could Burns not see the writing on the wall when Nixon was forced to take the Dollar off the gold standard? How could Greenspan express concern over irrational exuberance in 1996 and not shudder

Increasing Labour Costs

Source: Bloomberg as at 22/12/21

when the Nasdaq surged 85.6% in 1999, instead blaming low interest rates on excess savings in the East? How could Bernanke not see the impact China's trade was having on the dynamics of the US economy, the cheap goods and growing external imbalances? Federal Reserve Chairs have made serious blunders over the last number of decades in part because they have been incentivised to do so by their political leaders but also because they have been unable to see major turning points in the dynamics of the economies over which they preside. There is undoubtedly a human element to all of this too. Often believed to be experts in their field, there must surely be a reluctance to accept that an original view doesn't hold or requires changing. In any event the result has been an almost constant cycle of boom/bust which has delivered consistently declining benefits for the real economy.

Shifting Nature of Central Banking

As the political landscape shifts under the weight of mass inequality and a wider sense of demoralisation, so too will the nature of central banking. Politics is in transition – big capital has been winning at the expense of big population, but the tide is turning and the objectives and actions of central bankers will necessarily need to adjust.

As Greenspan to Powell reflected the times we lived in where Capital and Wall Street were king, and labour only a function to be outsourced, the new central bankers will target real economic goals over S&P performance. Some of these, like climate change, may be difficult to impact with monetary policy. Nevertheless it will be a future that reacts to employment and economic objectives as opposed to market gyrations. Powell had started on the journey in September 2019 when he announced that monetary policy had run its course, until the pandemic forced another famous Powell pivot. It was clear then, as it is now, that the old world of Wall Street over Main Street belongs in the past.

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