



Economic Perspectives

Blowing up the box!



The Barbarians are at the gates

Peter Warburton

Assisted by Yvan Berthoux and Tom Traill

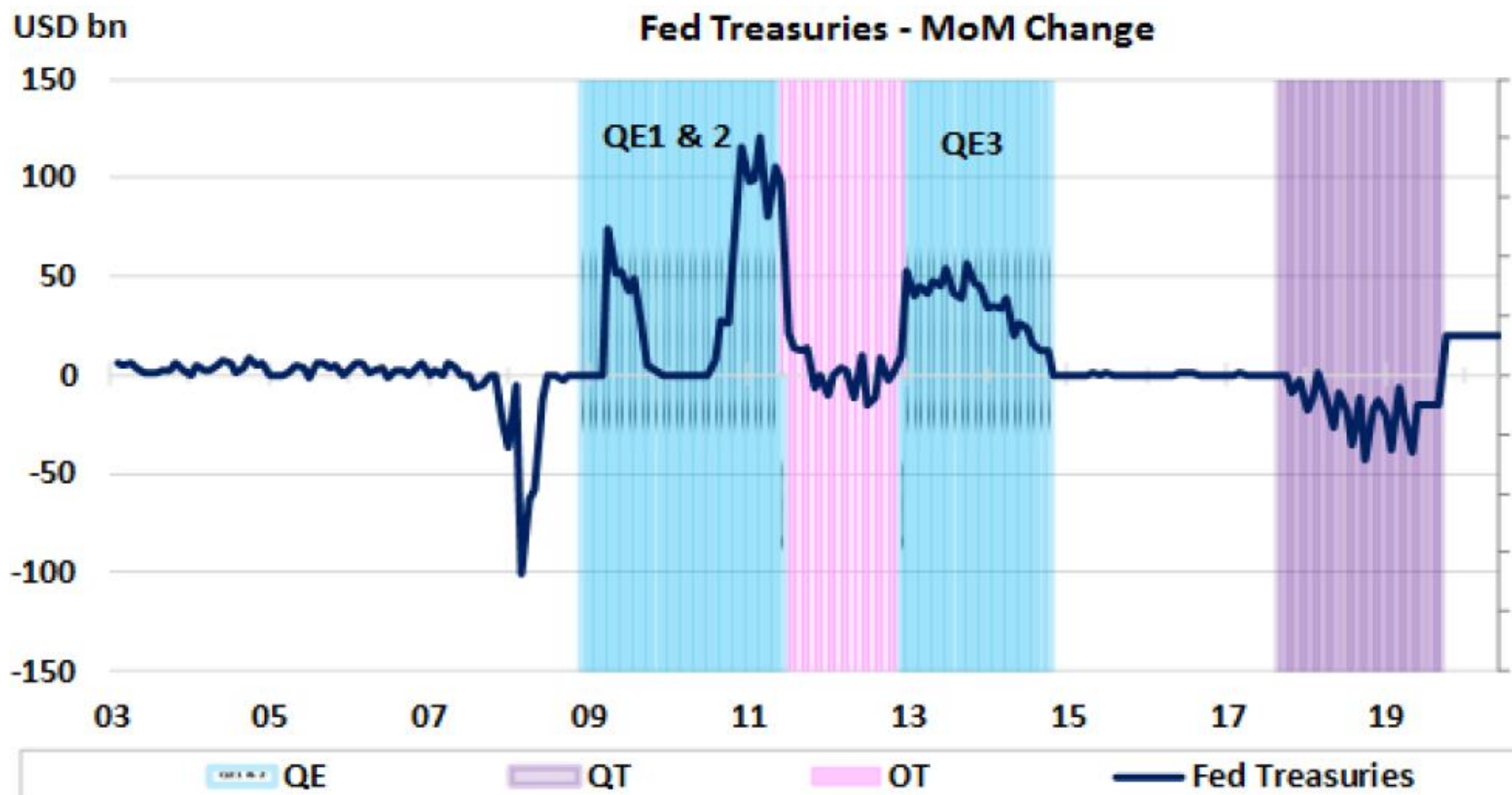
26 June 2019

Summary

- Western liberal democracies have evolved a macro-financial policy structure (the box) designed to lock in low inflation and fiscal discipline and to rebuff political interference
- The global financial crisis arbitrarily redesigned the box, skewing monetary policy easier and fiscal policy tighter, resulting in divergent real outcomes
- We stand at the threshold of a policy revolution that will blow up the box, over-riding the inflation objective and abandoning fiscal orthodoxy
- The second phase of financial repression is coming

The US Fed's lurch back to financial repression

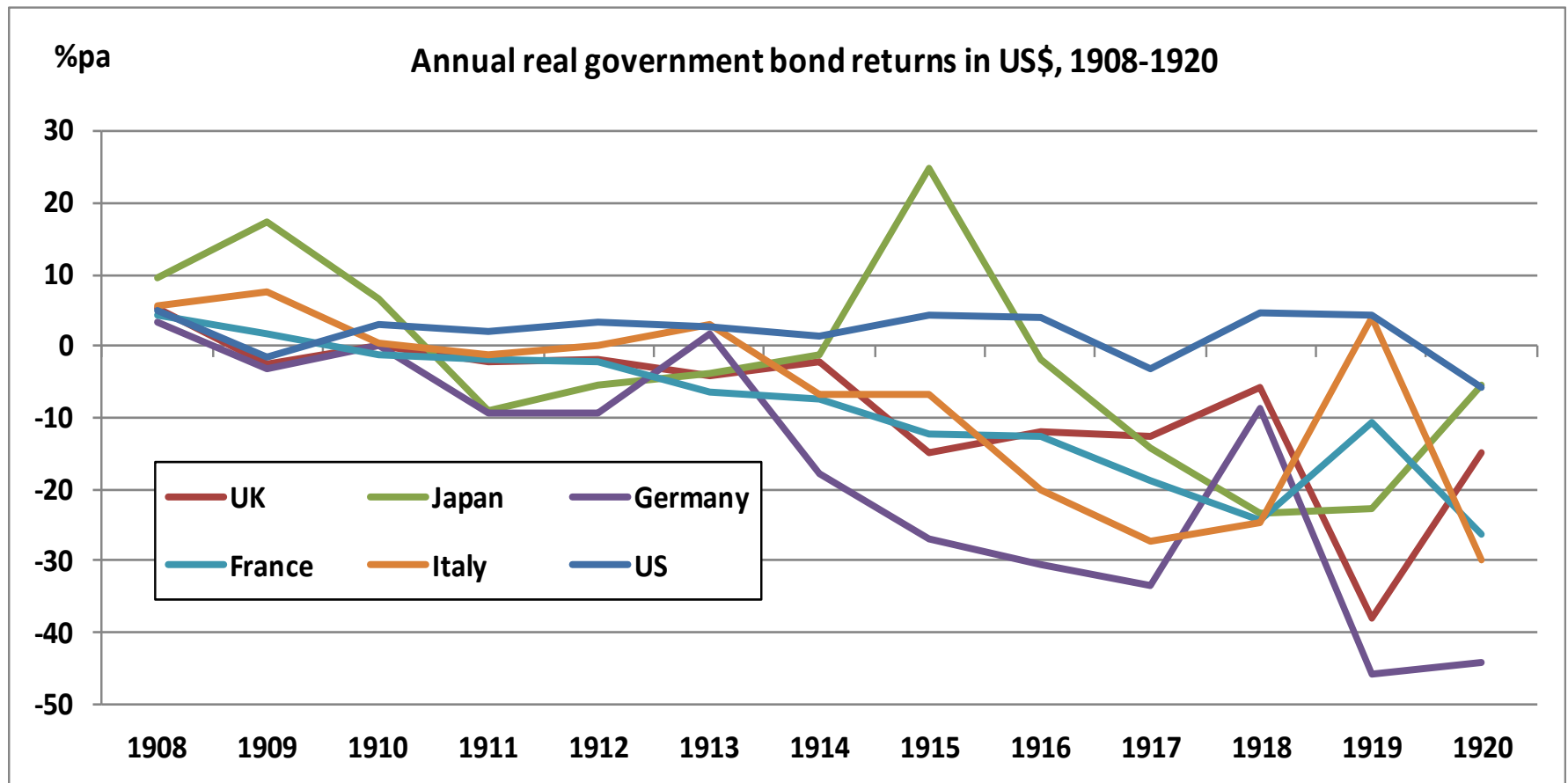
- Clarida's handbrake turn!



Data source: FRED

Financial repression 1: World War 1

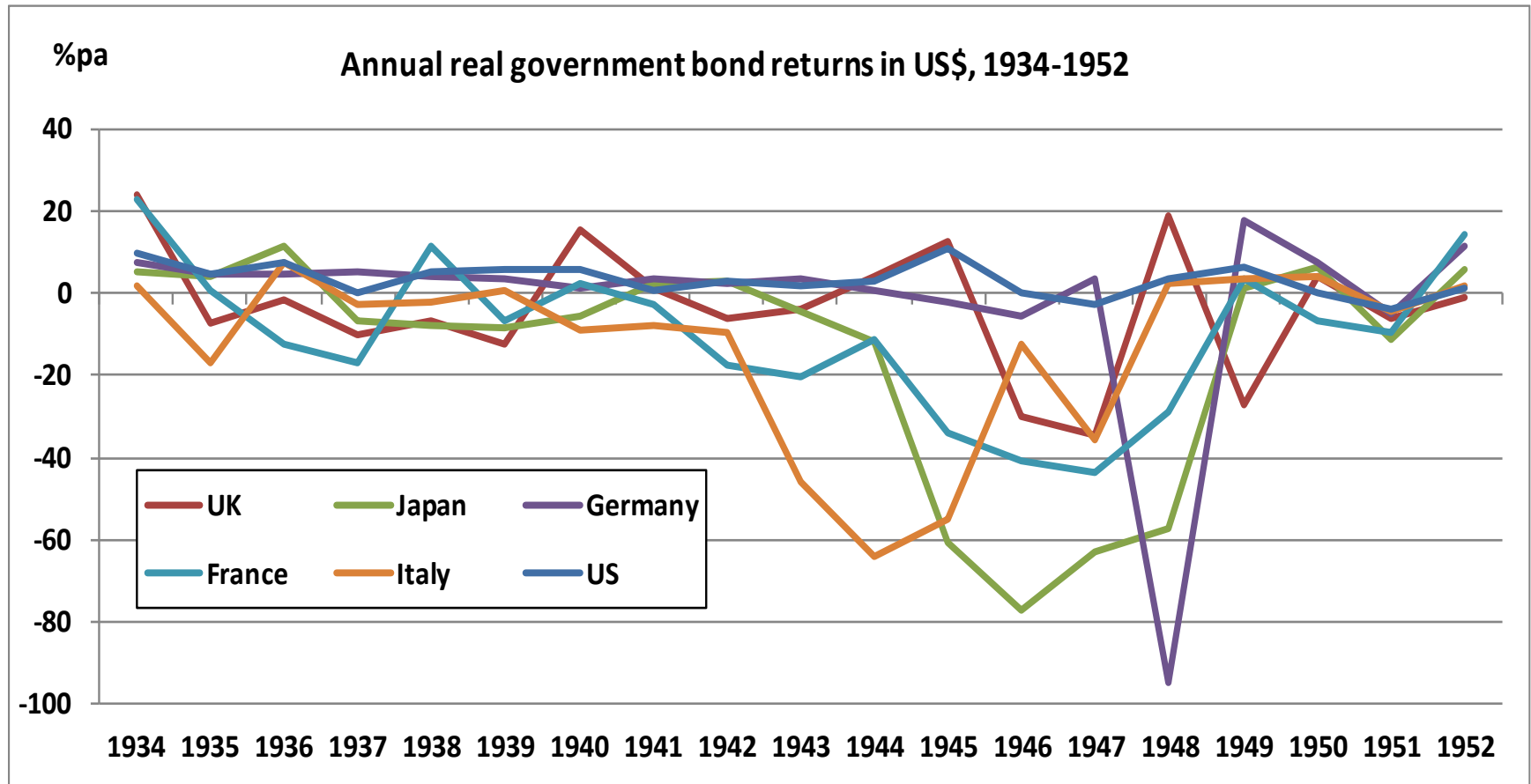
- Bonds are fine – until war breaks out



Data source: Dimson, Marsh and Staunton (2010)

Financial repression 2: World War 2

- It doesn't take long to destroy a bond market

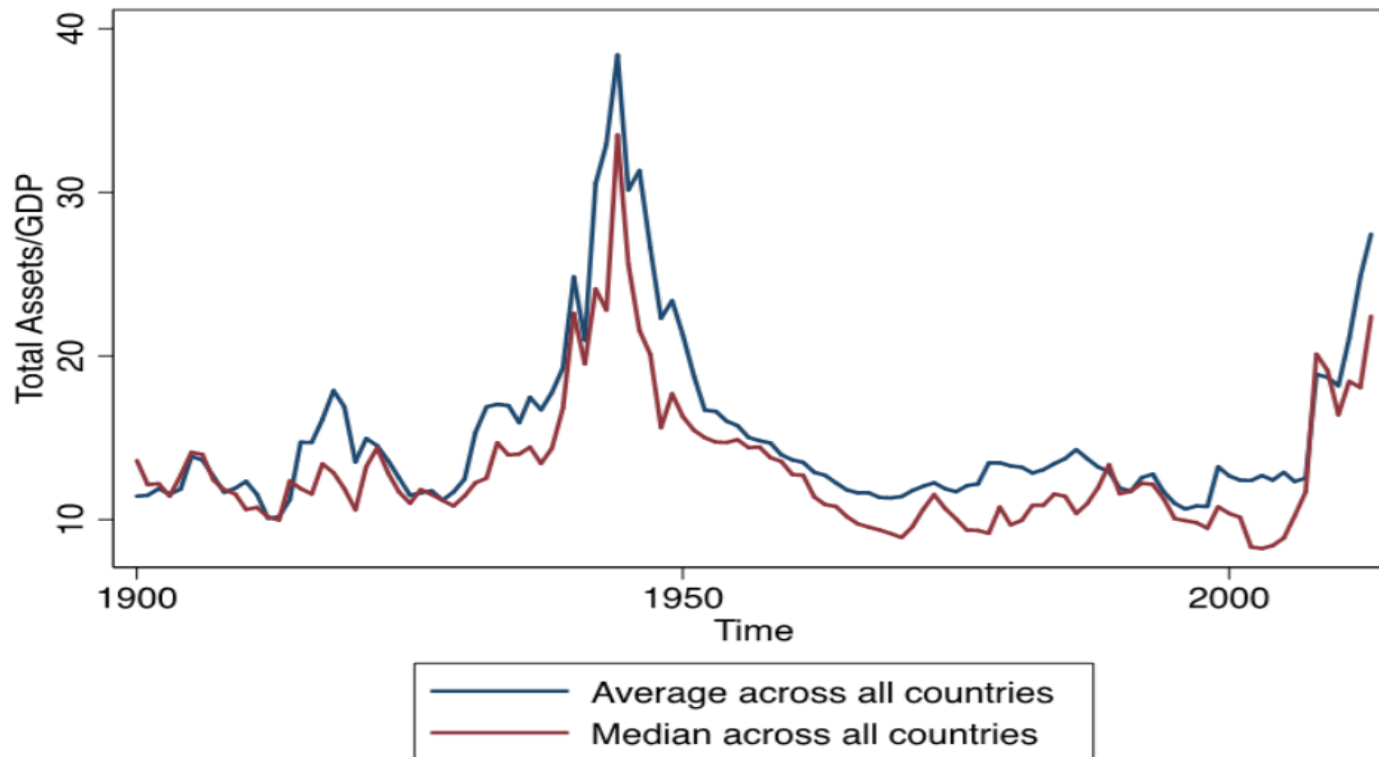


Data source: Dimson, Marsh and Staunton (2010)

Is this WW3 for bonds?

- QE has blurred the boundaries of monetary policy

Aggregated* central bank balance sheets scaled by GDP

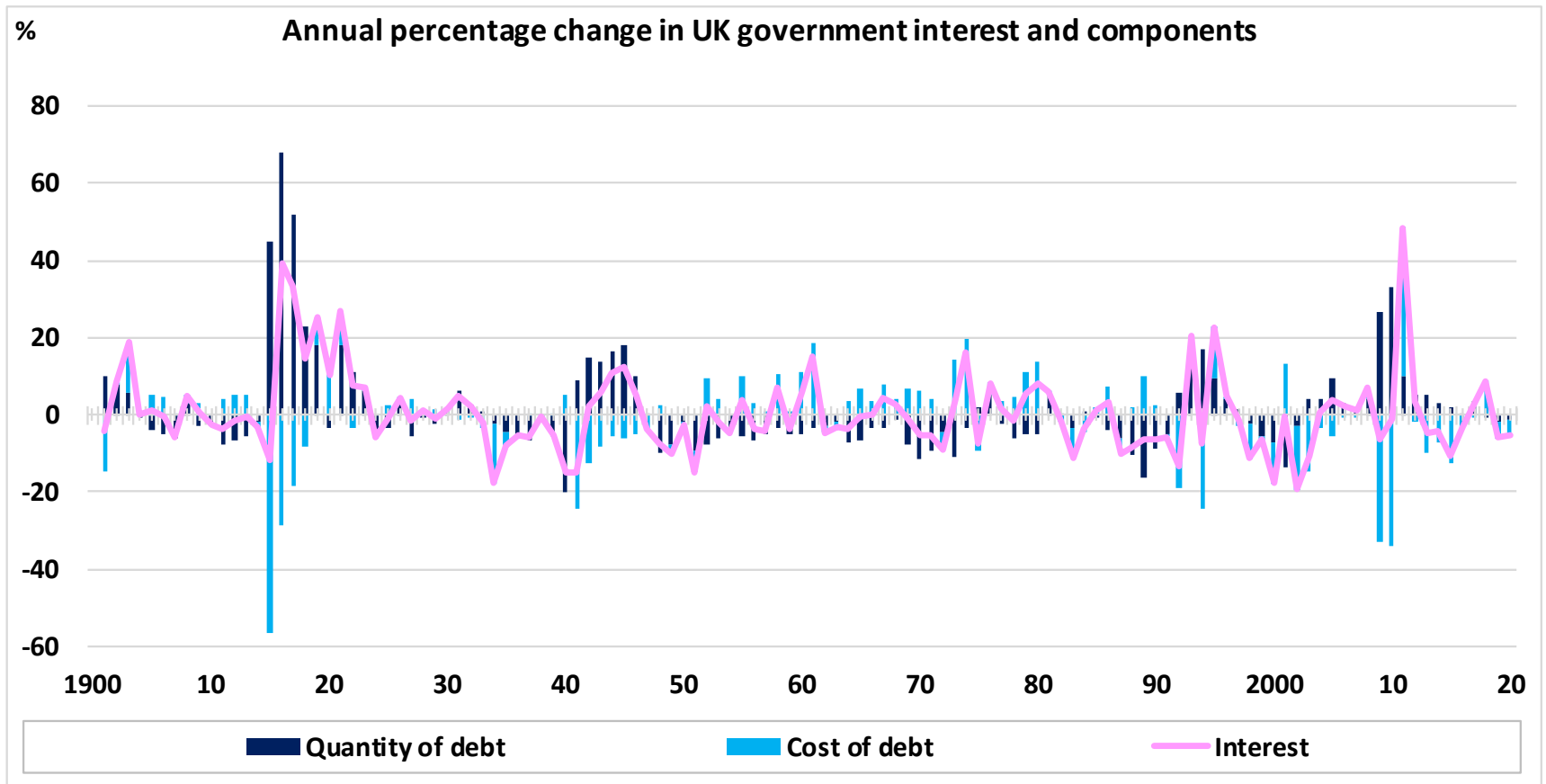


*Australia, Canada, Finland, France, Germany, Japan, Norway, Sweden, Switzerland, UK and US

Source: Ferguson, Schaab and Schularick (2014), *Central bank balance sheets: expansion and reduction since 1900*

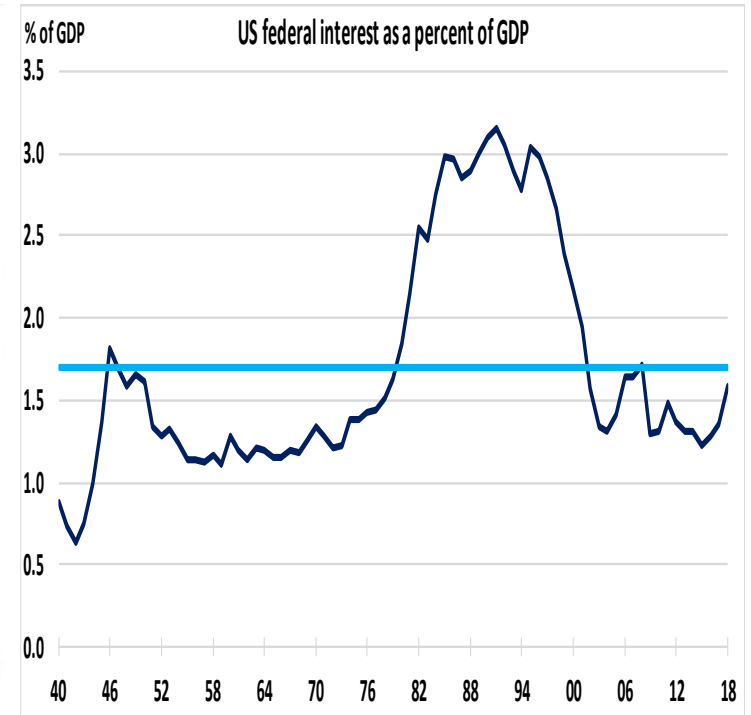
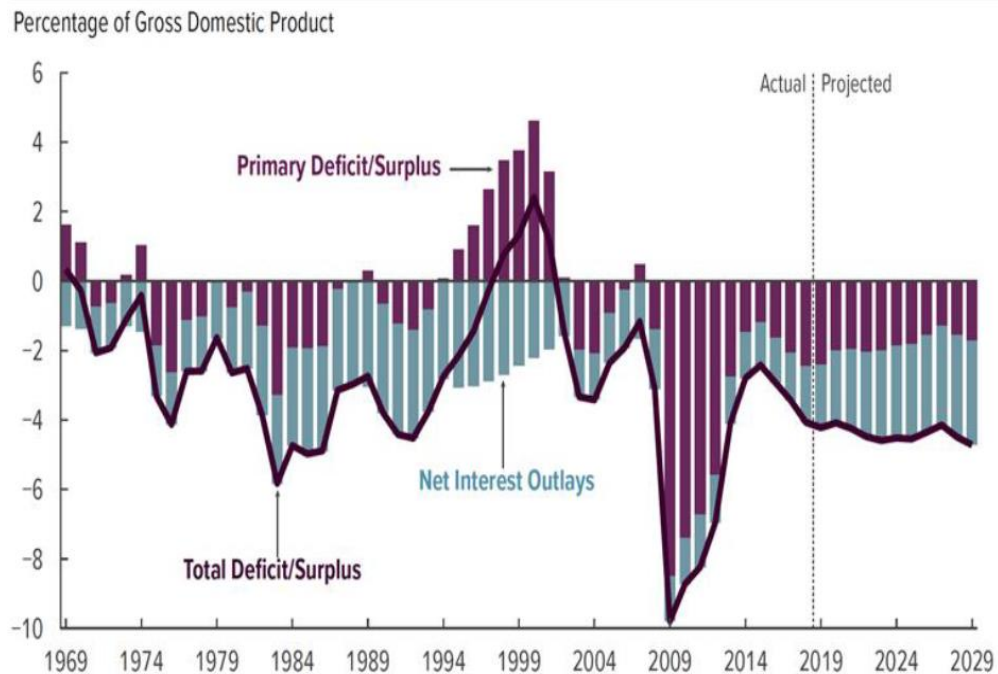
UK debt service cost ratios are well below LT averages

- Lowered cost of debt has sterilised debt surge



US debt service ratio is close to LT average ...

- ... but the debt ratio is well above average and net interest outlays are expected to swell

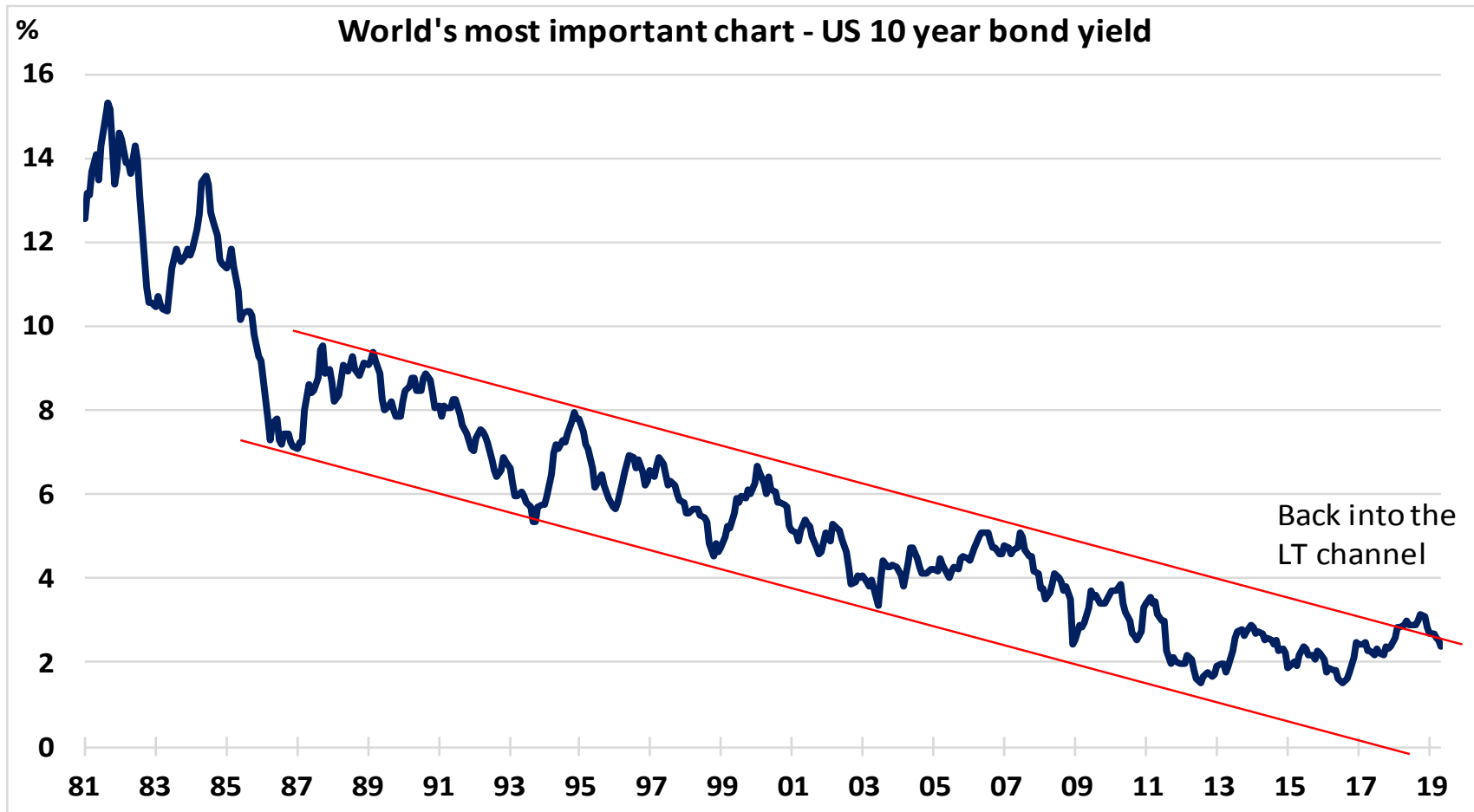


Source: Congressional Budget Office.

Primary deficits or surpluses exclude outlays for net interest.

Financial repression is a 2 act play

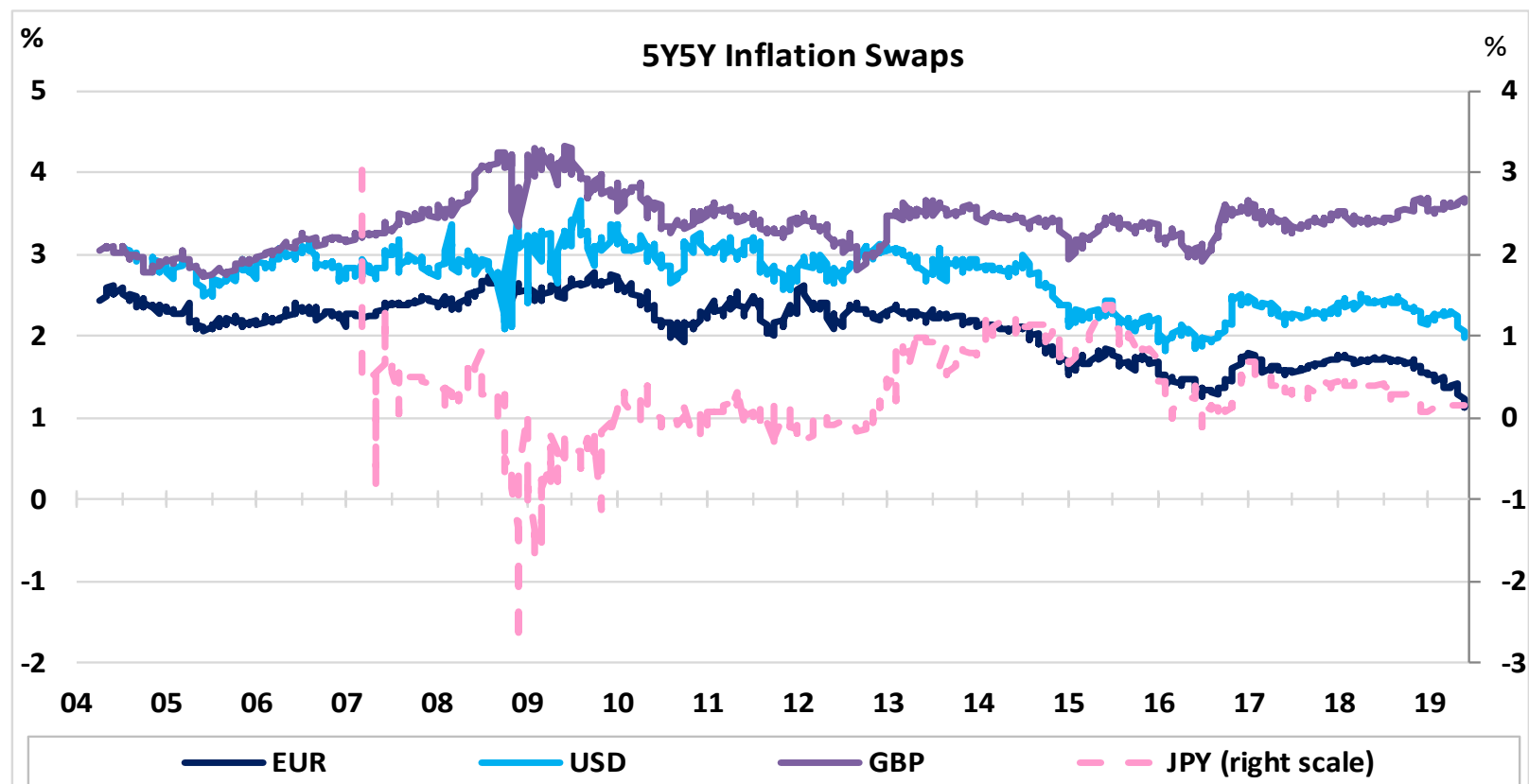
- Act 1 (interest rate repression) is **not** a settled state



Data Source: Eikon Reuters

Act 2 (unanticipated inflation) is coming!

- Financial markets are unprepared for a regime change and are unable to price such a risk



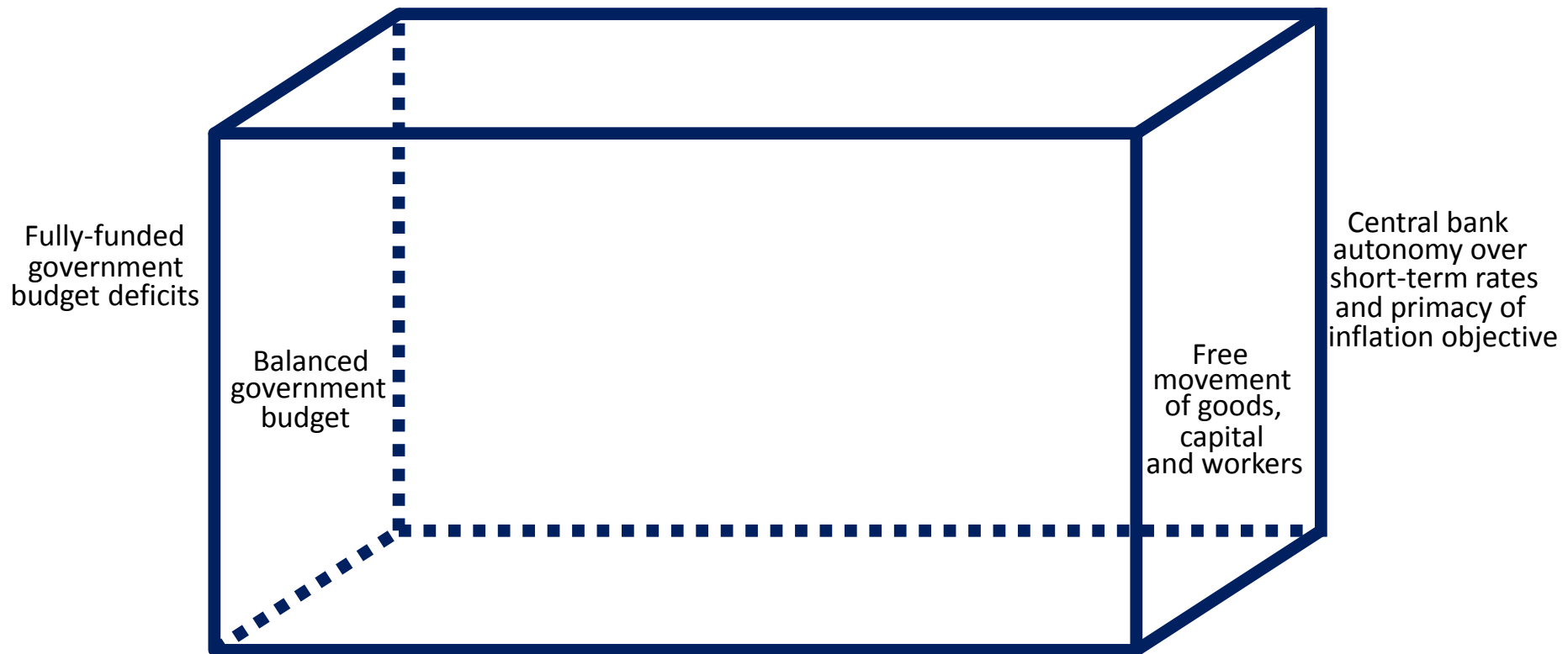
Data Source: Eikon Reuters

Defining the policy box: the four poles

- Keeping the politicians hands' out of the till!
- A Balancing the government budget over a defined time horizon, typically 5-8 years
- B Funding budget deficits fully with the issue of government debt (neutral funding)
- C Instructing the central bank to achieve a defined inflation objective over a defined time horizon, typically 2-3 years
- D Maintaining a liberal order in the markets for goods and services, labour, capital and money

The pre-GFC policy box

- Macro policy delegated to technocrats



The post-GFC policy box

- The box is hastily and arbitrarily redesigned!



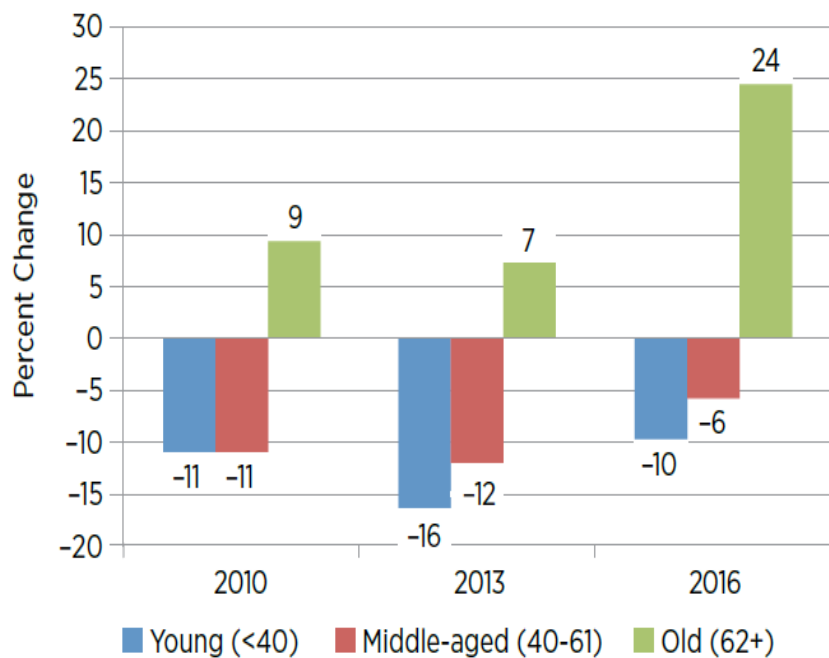
Political economy: the box as the enemy of radical change

- Capping of inflation preserves status quo and locks in high leverage ratios for 35-54 age group
- Scope for income tax redistribution is limited – compliant ‘rich’ are already paying their whack
- Fiscal constraints frustrate infrastructure plans
- Funding constraints frustrate reflation plans
- Inflation targets carry the perennial threat of central bank policy tightening
- Open markets – for goods, capital and money – allow fiscal stimulus to leak abroad

Capping of inflation locks in elders' post-GFC relative gains

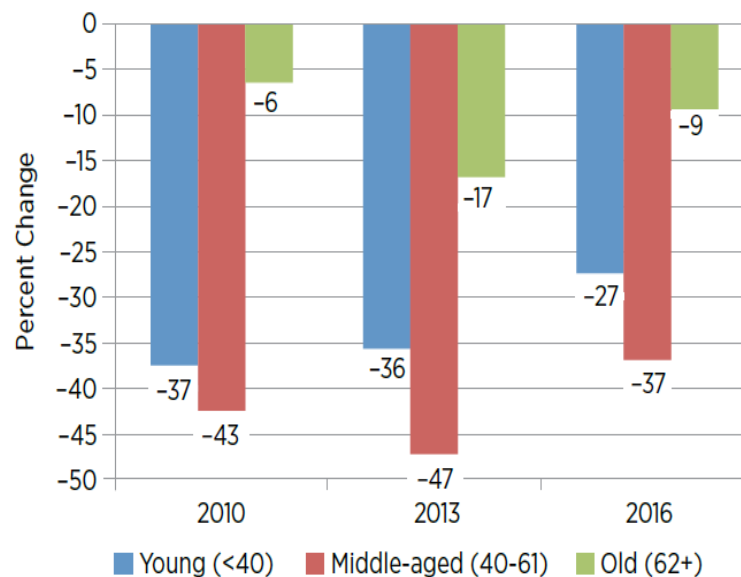
- Elders enjoy better income and wealth outcomes

Change in median income relative to 2007 Change in median net worth relative to 2007



NOTE: See note to Figure 2, replacing "net worth" with "income."

Source: St Louis Fed (2018), *The demographics of wealth*

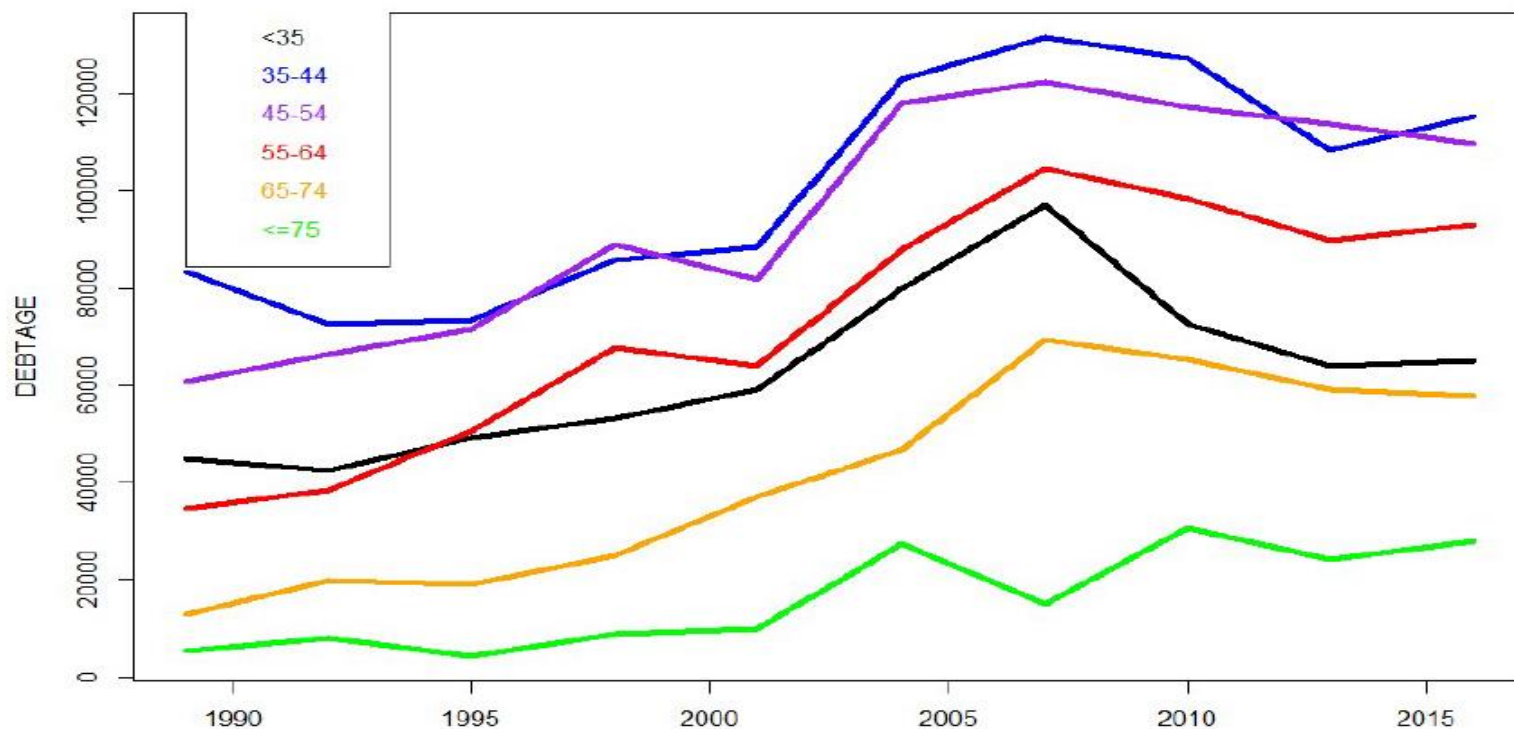


NOTE: Each age group's median net worth in 2010, 2013 and 2016 was compared to the same age group's respective level in 2007.

US household debt ratio has doubled since 1980

- Capping of inflation preserves real value of debt and obstructs deleveraging

Mean US outstanding real debt by age cohort

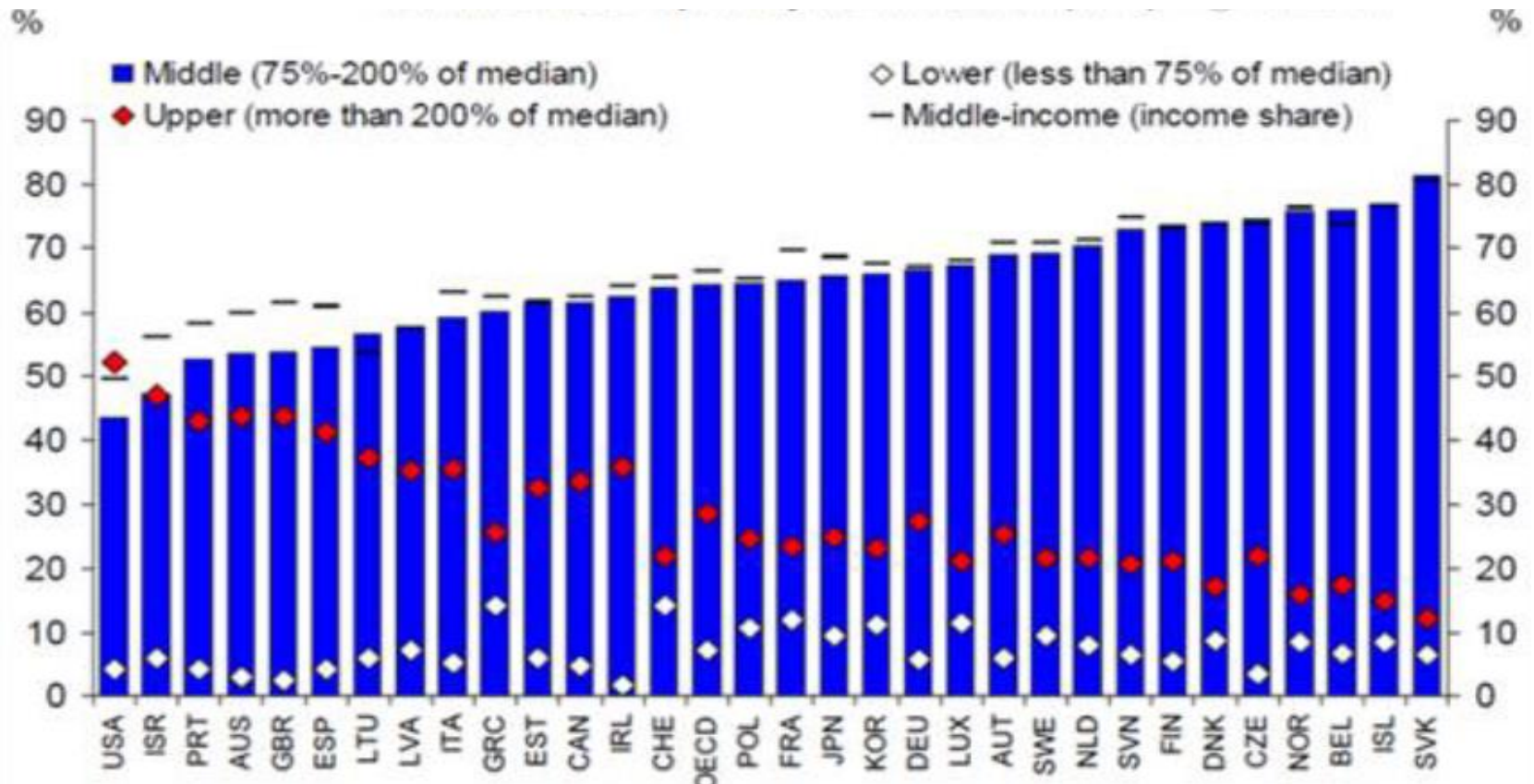


Source: Constantini (2017) *The Influence of household debt on US investment, production and growth*

Scope for income tax redistribution is limited

- Compliant 'rich' are already heavily taxed

Share of tax revenues paid by income group (in %)



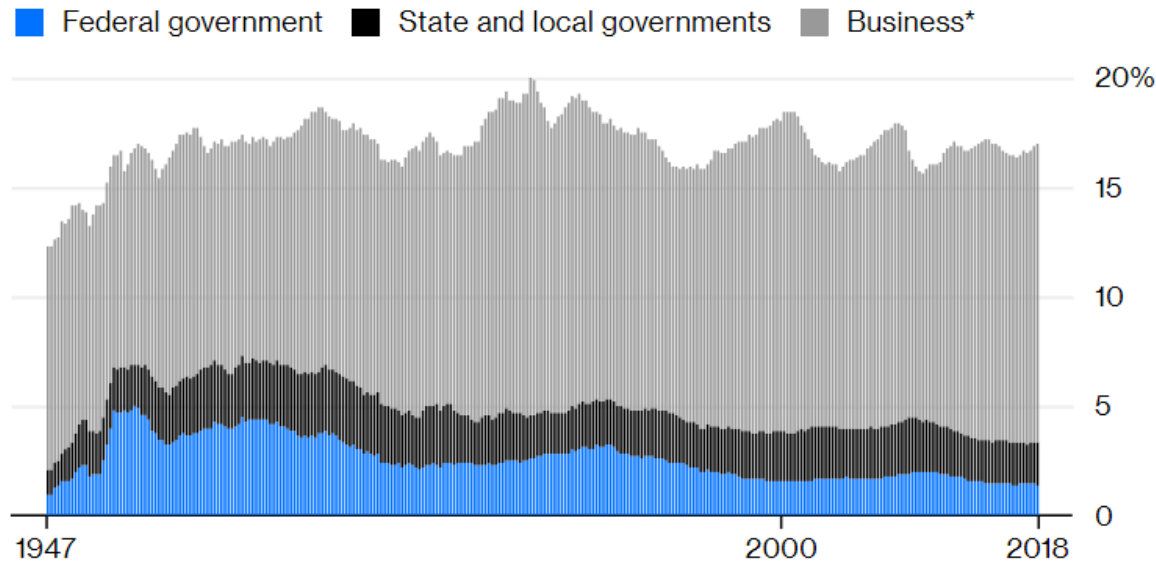
Source: OECD

Fiscal constraints frustrate infrastructure plans

- Investment spending by federal government dropped below 1.4% of GDP in 2018 for the first time since the 1940s (vs. overall 20.9% estimated)
- Investment in R&D, infrastructure has been replaced by spending on Social Security, Medicare, etc. Private sector has taken over principal responsibility for infrastructure investments and other projects that will drive future economic growth

Business to the Rescue

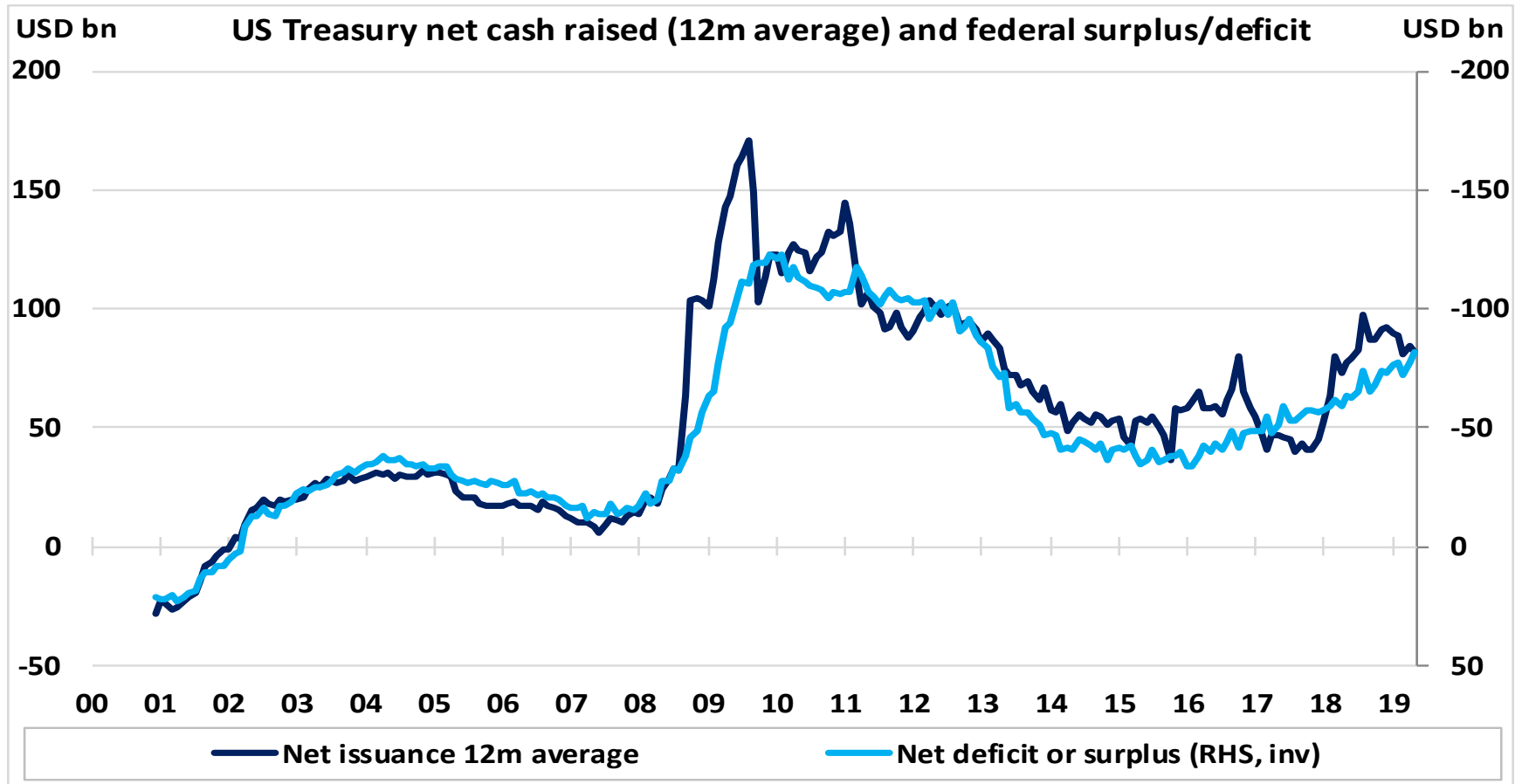
Investment as a share of gross domestic product



Data source: US BEA

Funding constraints frustrate reflation plans

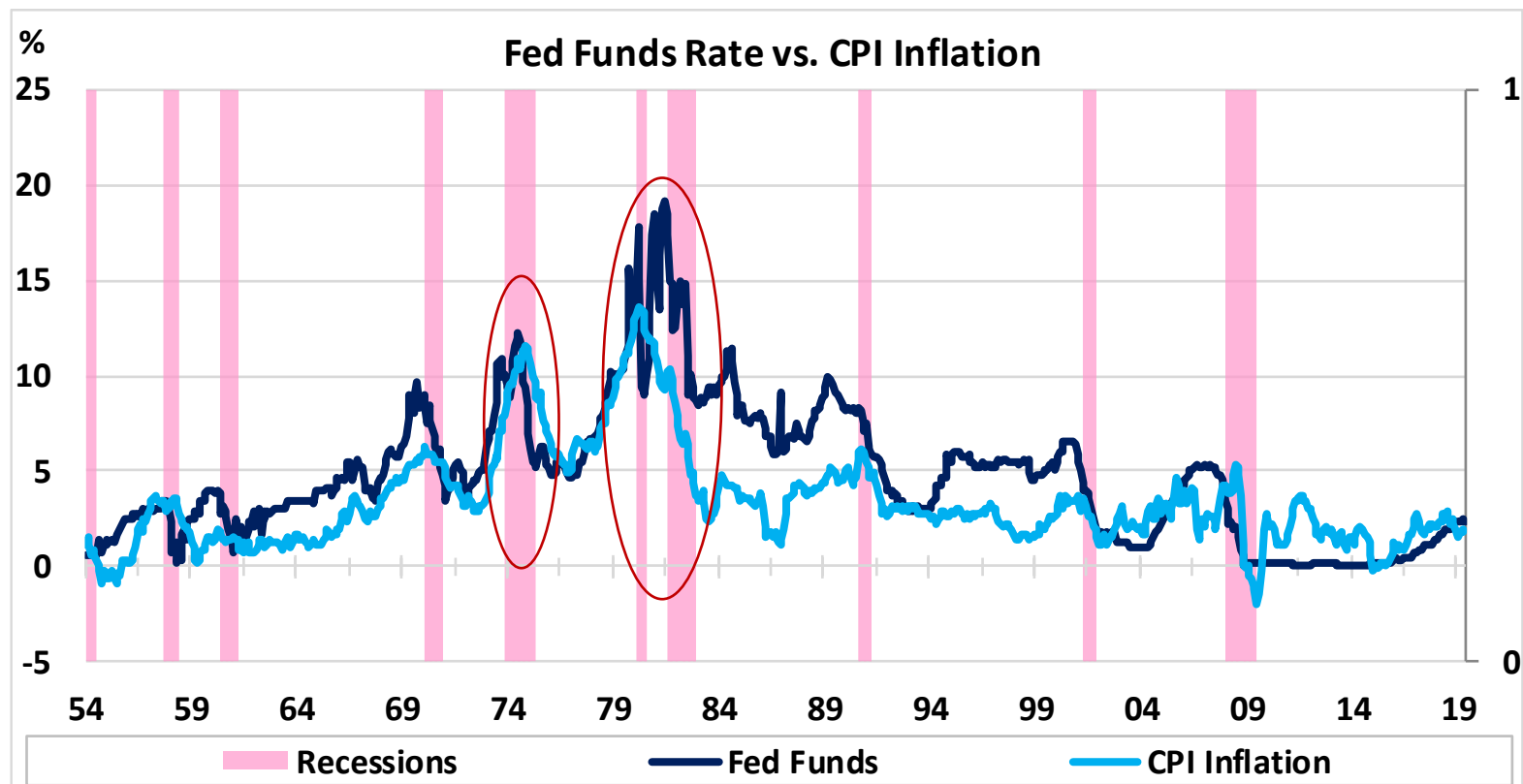
- Budget deficit expansion = higher net issuance



Data sources: Thomson Reuters Datastream and SIFMA

Compliance with inflation targets implies tightening risk

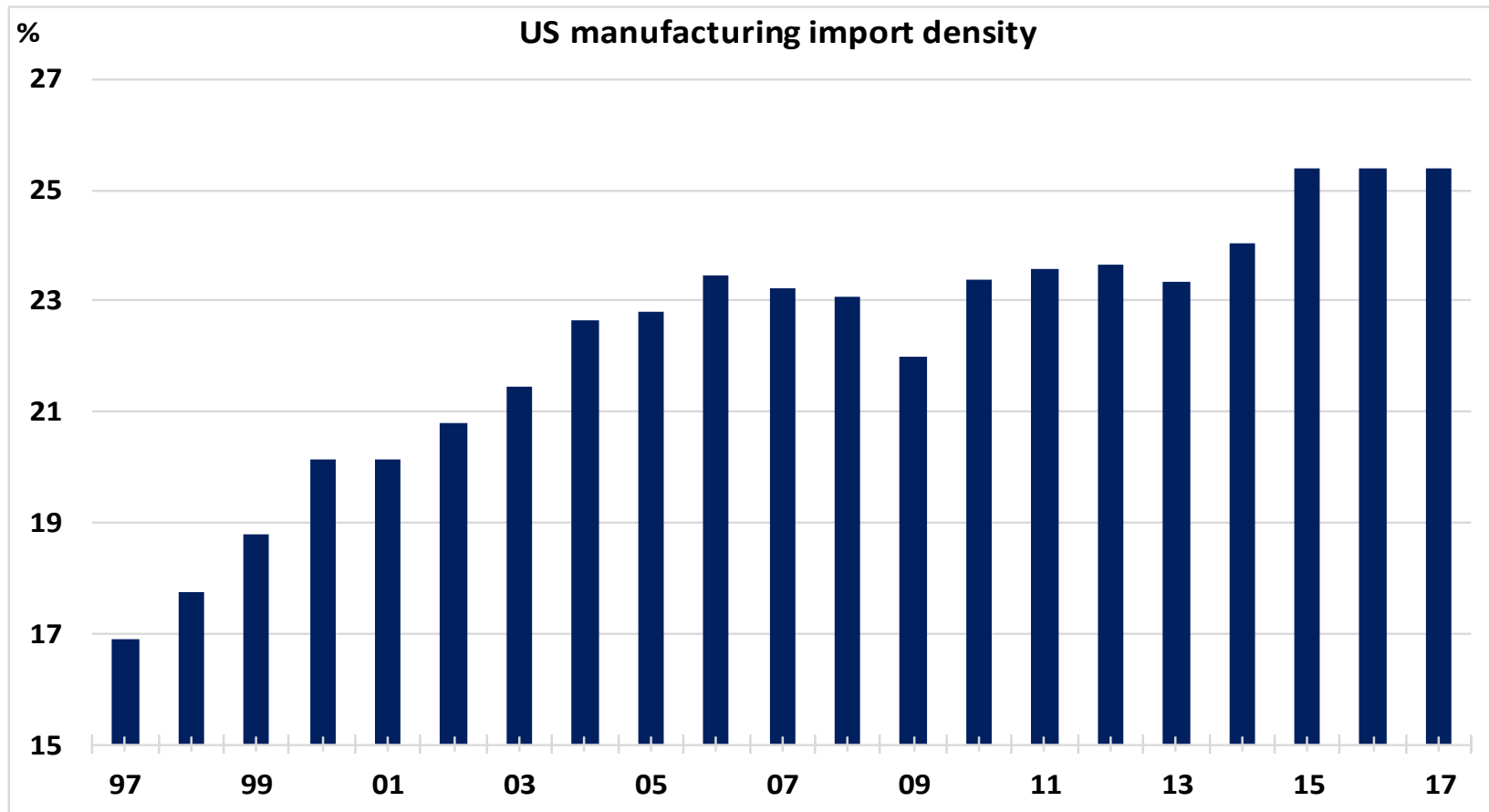
- Under an inflation target regime, policymakers may be forced to hike if inflation takes off, even though the real economy may be slowing



Data source: FRED

Free trade in goods etc. allows stimulus to leak

- Share of imports in total US product supply



Data source: US Bureau of Economic Analysis (Input-output tables)

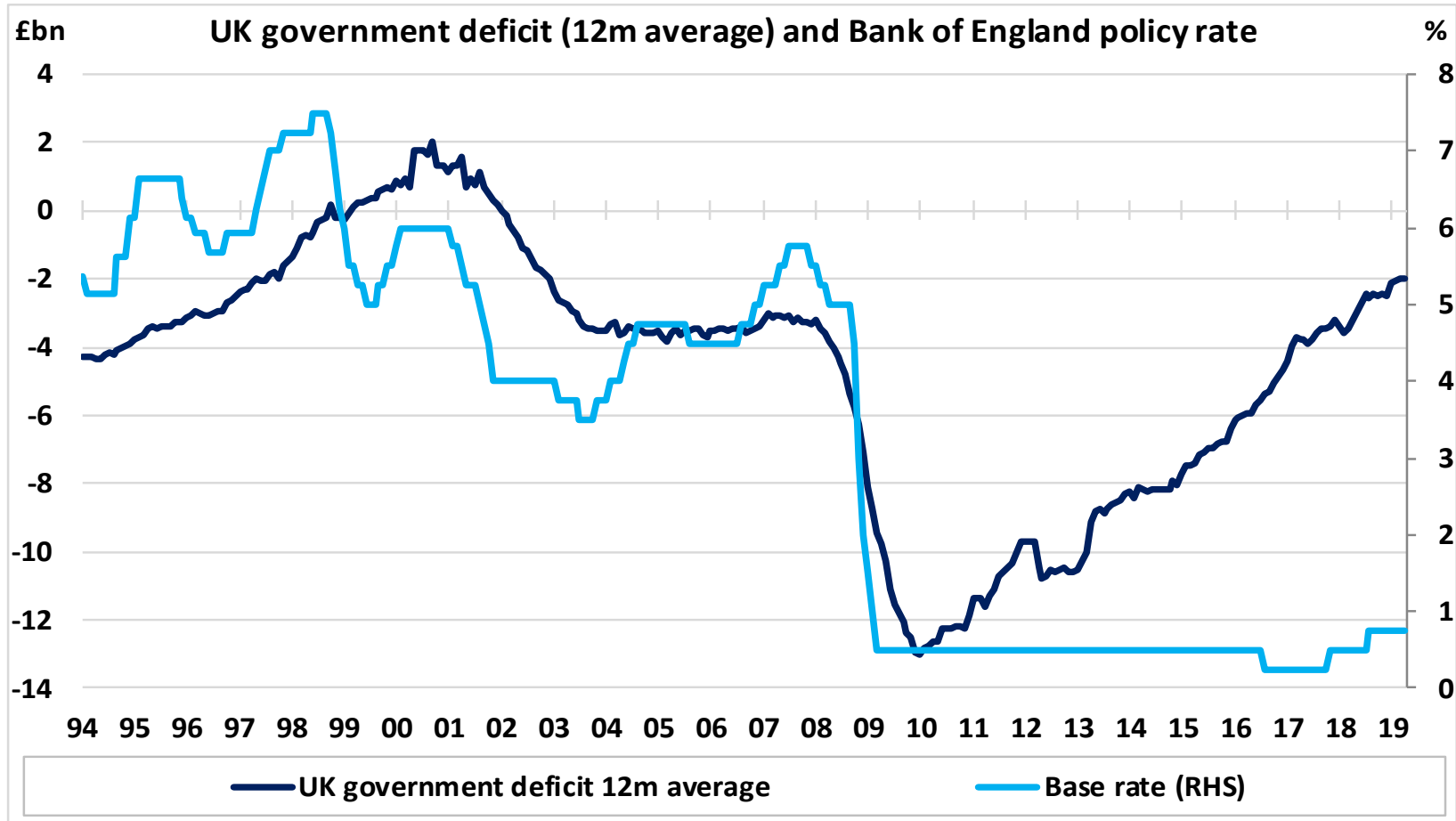
The exploded box – the destination

- 2020 presidential election is the key context



Subjugation of the central bank

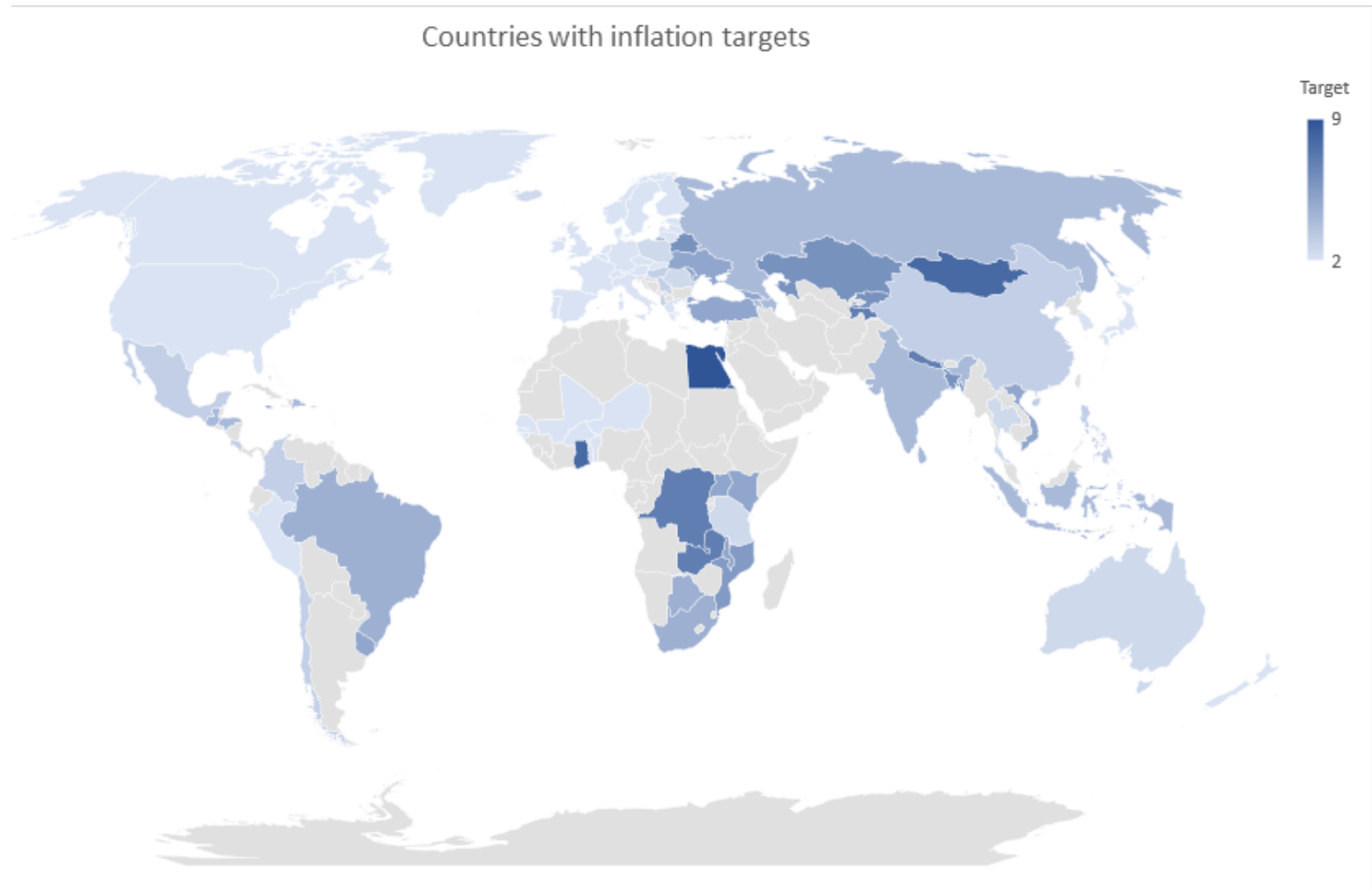
- Bank of England: prime example of timidity



Data source: Thomson Reuters Datastream

Inflation targets cover the map with false comfort

- Over 90 countries have adopted inflation targeting

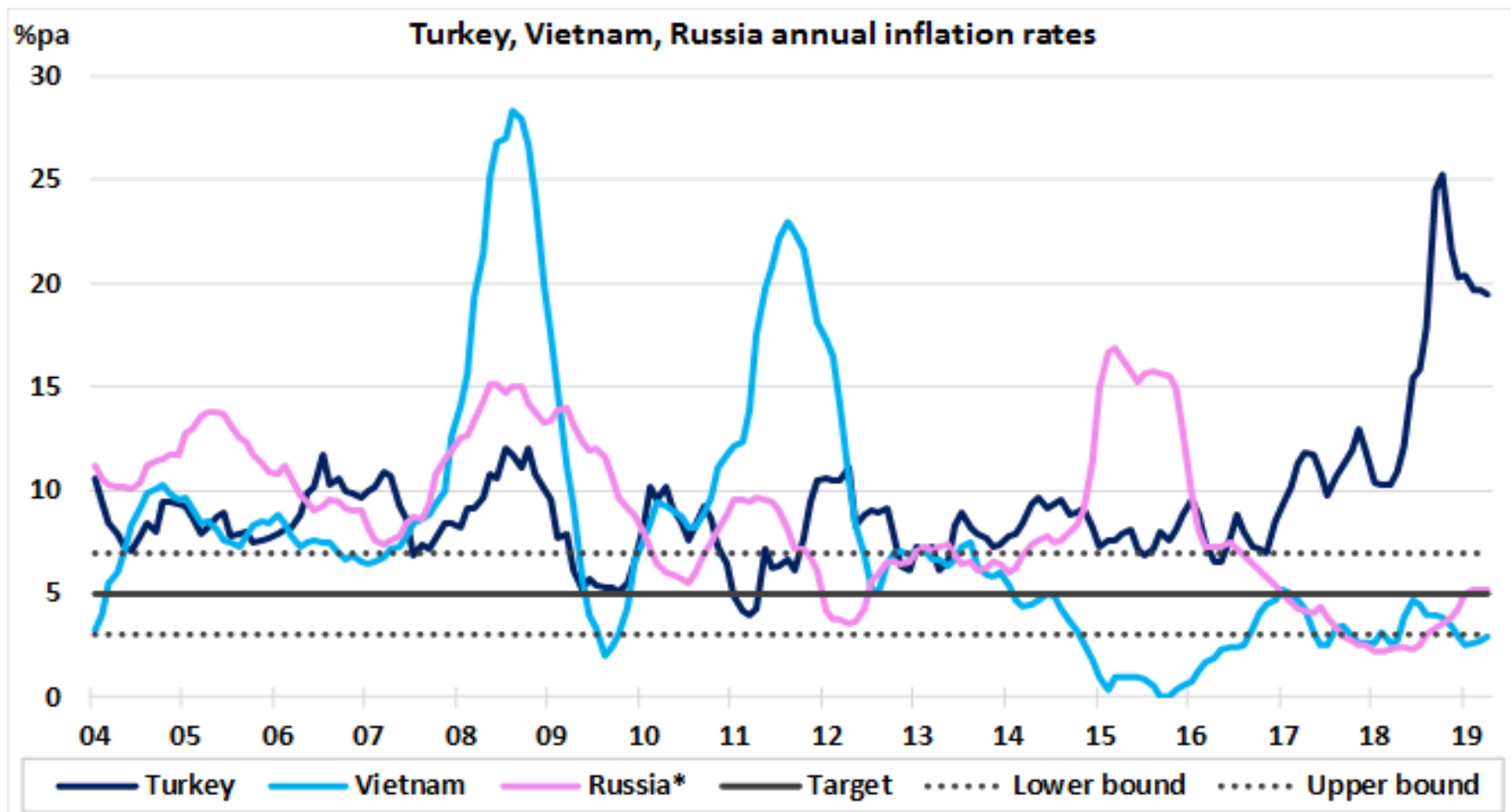


Inflation targeting (IT) regimes approach senility

- Inflation targeting was born in New Zealand in 1990. After it achieved success there, it reached developed economies such as Australia, UK, Sweden and even South America and some developing countries back then (South Africa, Turkey and Indonesia)
- The failure of exchange-rate targeting with the currency crises of the 1990s opened the door to IT
- However, the current economic crisis has questioned the sustainability of IT and its oversight of asset bubble and supply side shocks
- Leading candidate to replace IT: nominal GDP targeting. No problem of excessive tightening in response to adverse supply shocks

Force majeure: when inflation targets fail

- Central bank is reassigned to sovereign credit

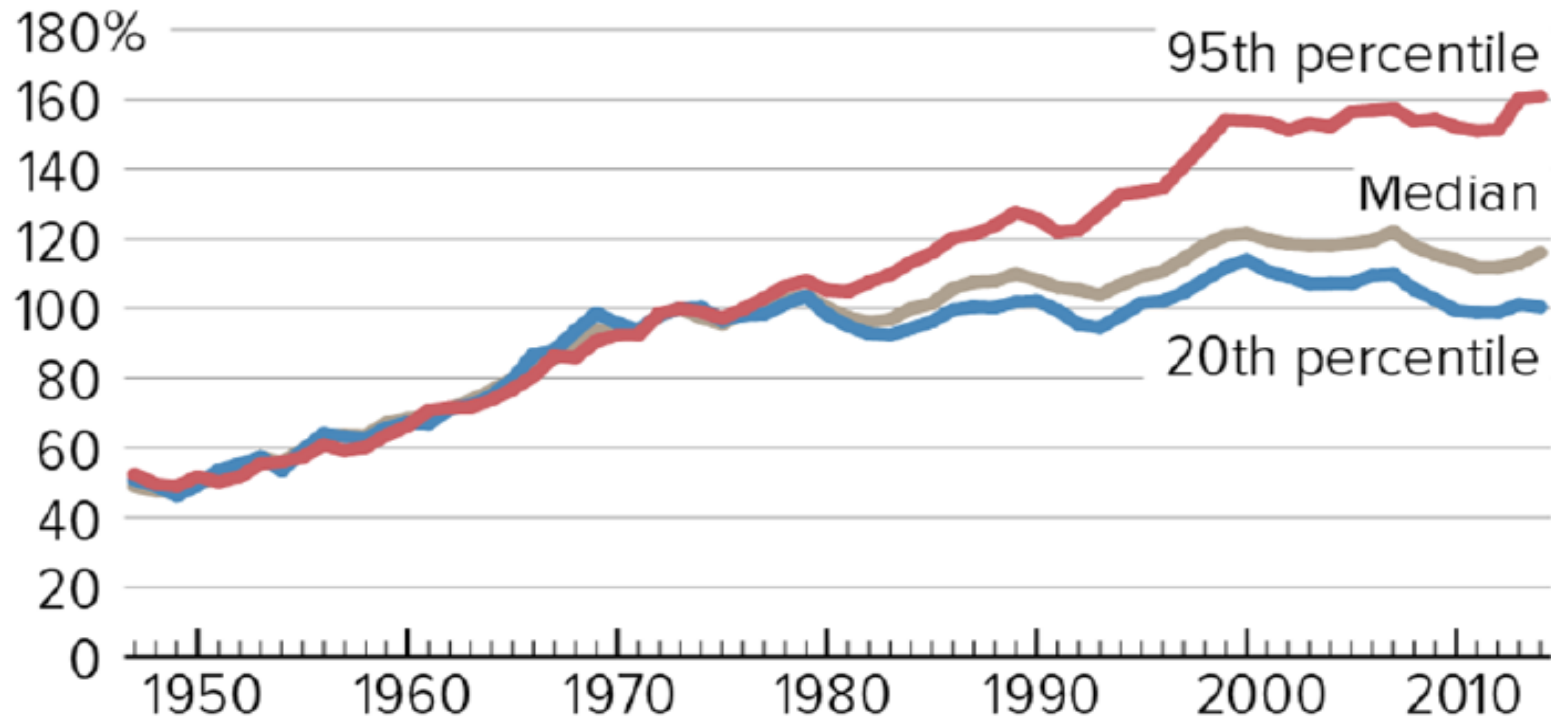


Vietnam targets 5% inflation, Turkey 5% +/-2%, and Russia 4%

Inflation as the agent of income redistribution

- Inflation surge in 1970s was not associated with income inequality

US real family income 1947-2014 (% of 1973 level)



Source: Center on Budget and Policy Priorities

Inflation as the angel of wealth redistribution

- From old to young; from rich to mid-/low income

TABLE 3
1989 WEALTH REDISTRIBUTION ACROSS HOUSEHOLDS AFTER 5 PERCENT INFLATION
EXPERIMENT RELATIVE TO AVERAGE NET WORTH IN EACH GROUP

AGE COHORT	POOR		MIDDLE CLASS		RICH	
	FS	IA	FS	IA	FS	IA
≤ 35	+14.4	+2.2	+44.9	+18.9	+5.5	+2.1
36–45	+13.3	+4.0	+12.4	+5.8	–1.5	–.9
46–55	+2.2	+2.6	+1.9	+1.4	–2.6	–1.6
56–65	–2.9	–.5	–5.5	–1.4	–6.4	–2.4
66–75	–6.9	–1.3	–9.9	–2.7	–6.6	–2.9
> 75	–10.4	–1.0	–15.0	–2.6	–10.8	–4.7

NOTE.—Gain or loss after a 5 percent inflation episode lasting 10 years as a percentage of average net worth in each group under two scenarios, full surprise and indexing ASAP, for baseline year 1989.

Source: Doepke and Schneider (2006), *Inflation and the redistribution of nominal wealth*

Conclusions: the mis-pricing of inflation risk

- Bond markets are salivating in anticipation of the next economic downturn, which is likely to bring a cyclical drop in global inflation
- But the next downturn bears an existential risk for the post-GFC policy box
- As political economy over-rides ‘the new normal’, the box explodes and priorities are re-ordered
- Fiscal conservatism will be abandoned, inflation targets disregarded and central banks will be reassigned to the defence of sovereign credit
- Act 1 is invariably followed by Act 2

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	Platinum	Gold	Silver
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North America Economic Perspective	✓	✓	
Eurozone Economic Perspective	✓	✓	
Research Digest	✓	✓	✓
Global Inflation Heatmaps	✓	✓	
GDP Heatmaps	✓	✓	
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Dr Peter Warburton

Peter@EconomicPerspectives.co.uk

+44 1582 696999

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