Blowing up the box!

Welcome to our *Economic Perspectives* seminar – this one is number 6! Thank you all for coming. Soon, we plan to issue badges to those with a perfect attendance record! You should each have a copy of the slidepack entitled “Blowing up the box!”, to which I will refer. At this point, I want to acknowledge the contribution of my colleagues, Yvan and Tom, in creating the slidepack and Amy, for organising today’s seminar. My presentation will last about 20 minutes, allowing plenty of time for questions.

Last April, our seminar title was “The Little Inflation with the Big Bite”. A distinction was drawn between increases in inflation *within* the constraints of the prevailing policy framework (The Little Inflation) and increases in inflation associated with regime change (The Large Inflation). The upward drift of global and US inflation in the following months was sufficient to propel the US benchmark bond yield to a peak of 3.25 per cent, but not the 3.75 percent that we deemed credible, given the historical relationship of yields to prior nominal GDP growth. We noted the dangerous threshold for inflation of around 3 per cent, which has been associated with equity market de-ratings of up to 25 per cent. In June and July last year, the headline US inflation rate reached 2.9 per cent and before the end of 2018, the S&P 500 had completed a 20 per cent correction. Now, all of that seems like ancient history, with many measures of US inflation below 2 per cent again, the benchmark Treasury bond yield dipping below the 2 per cent level and the S&P 500 back to new highs.

Last April, we concluded that the “Little Inflation poses a dual threat to capital preservation: in the incremental damage that it inflicts directly and as a potential trigger for changes in the socio-political climate that could usher in a Large Inflation in due course.” We observed that the Large Inflation was neither a certain nor an imminent outcome; a prospect, not yet a reality, but that the key point was that it was a more credible prospect than 5 years before, or even 2 years before.

Today, I want to throw a spotlight on the disturbing developments of the past year or so, that threaten the integrity of the policy framework that has undergirded economic progress in western democracies on one hand, but fostered an unsustainable accumulation of debt, on the other. I will argue that the macro-financial policy structure (the box) that was designed to lock in low inflation, uphold fiscal discipline and rebuff political interference, is in mortal danger, not only, but not least in the US. We stand at the threshold of a policy revolution that will blow up the box, over-riding the primacy of the inflation objective and abandoning fiscal orthodoxy into the bargain.

The dominant market narrative of the past 6 months has been the Fed’s *volte face* – or Powell pivot, according to taste. A key feature of the policy reversal has been Richard Clarida’s handbrake turn regarding the management of the Fed’s balance sheet, announced last March (page 3). The curtailment of the Fed’s quantitative tightening programme was accompanied by a neat twist – the deployment of the proceeds of ongoing MBS sales in the purchase of additional Treasury securities. We regard this as a retrograde lurch to the policies of financial repression, pursued in various guises still, by the ECB and Bank of Japan.

As a quick reminder of what a successful financial repression looks like, please refer to pages 4 and 5. These recap the unhappy experiences of bond holders during World Wars 1 and 2. Noting the similarity of central bank balance sheet expansion in recent years with that during WW2, it is pertinent to enquire whether this is WW3 for bondholders.

Interest rate suppression (and yield curve control) artificially lowers the cost of debt service for households, non-financial companies and, of course, government. However, rate normalisation – which can be policy-led or credit market-led – implies rising debt service ratios and painful debt dynamics for those who have grown very comfortable with bargain basement borrowing costs. Moreover, rising private sector debt service ratios exert downward pressure on tax yields, depriving households of disposable income from which consumption and indirect tax revenues derive. The twofold fiscal stress of a rising public sector debt service burden and a diminished scope for tax collection creates the potential for an explosion in the budget deficit.

Financial repression is a 2-act play. Act 1 is interest rate suppression, but this is not – and can never remain – a settled state. The so-called "New Normal" is nothing of the sort: rather, it describes an interim state of disequilibrium. When Act 1 ends, perhaps there is an intermission – enough time for a quick G&T and a trip to the facilities – but very soon Act 2 begins: Act 2 is unanticipated inflation. Unanticipated inflation, by definition, is an unpriced risk, as illustrated on page 10. Act 2 is coming!

Out of the chaos of the post-Bretton Woods world, emerged an effective response to the high inflation and poor growth and unemployment outcomes of the 1970s and an increasing commitment to liberal economic policies – freer trade, abolition of capital controls, floating exchange rates and freedom of movement across national borders. In time, this would develop into a coherent – but never watertight – policy framework, which we represent by the box on page 12. The pre-GFC box had 4 supporting poles or columns, encompassing public sector budgetary discipline over a defined time horizon, a neutral funding policy, the delegation of a defined inflation objective to a central bank and an adherence to the principle of free and open markets for goods and services, labour, capital and money.

Deprived of the traditional tools (spending boosts, tax cuts and interest rate cuts) to manipulate the economic cycle for electoral gain, politicians evolved alternative strategies. While declaring their unswerving allegiance to fiscal rules and the monetary independence of the central bank, they promoted financial liberalisations that would widen and deepen access to private sector credit, moved a swathe of financing of infrastructure investment off the public sector balance sheet, failed to address mounting demographic pressures on the provision of public services and multiplied public pension entitlements and other financial promises that stretch far into the future.

When private sector debt exploded in 2007-08, the politicians endorsed rescue packages that caused the budget deficit to soar and gave their approval for the central bank to embark on large scale purchases of government bonds and other assets, while maintaining near-zero short-term interest rates. While tighter bank regulation disabled many traditional lending channels, cheap credit was mediated to the private sector through unregulated shadow banks. The private sector debt bomb has been re-engineered and repositioned in the corporate sector.

Plainly, the design of the pre-GFC policy box was not perfect: there would not have been a GFC if it were. However, the crisis brought about the arbitrary redesign of the policy framework, skewing monetary policy easier, fiscal policy tighter and blurring the boundaries between the two. This hastily and arbitrarily redesigned policy box, page 13, while retaining a commitment to the capping of inflation, would turn out to have some very different properties to the original, including some serious flaws. Specifically, the post-GFC box has locked in inter-generational gains and losses – and deepened the divergence of outcomes over time, in some cases. The capping of inflation has also preserved the real value of debt and the high leverage ratios of the 35-54 age group.

The political economy of the post-GFC box has become toxic: fiscal constraints frustrate infrastructure and environmental plans; funding constraints frustrate reflation plans, including healthcare reform, 'living wage' and job guarantees; inflation targets carry a permanent background threat of policy tightening; free trade in goods, etc. allows a national stimulus to leak and an open capital account permits capital flight. It is becoming increasingly clear that national policy agendas – of the political right or left – cannot be reconciled with the post-GFC box. A critical insight concerns the scope for fiscal redistribution: if new spending priorities are to be afforded within existing budgetary constraints, then significant new taxes must be raised. The incomes of the compliant rich – especially in the US – are already heavily taxed and wealth taxes – such as advocated by Elizabeth Warren – are much more difficult to assess and collect. It could take 3 years to bring in the revenues from a new wealth tax, which is a long time in the context of a 4-year presidential term.

The bi-partisan political consensus that has upheld the post-GFC box is dead – and clearly not only in the US, as the recent news from Italy demonstrates: MiniBots are go! Our destination is the exploded box and the 2020 US presidential election is the key context. Even before the contest begins in earnest, the US president has unleashed waves of chaotic dislocation in the policy arena. I refer to a recent tweet:

> Despite a Federal Reserve that doesn't know what it is doing - raised rates far too fast (very low inflation, other parts of world slowing, lowering & easing) & did large scale tightening, $50 Billion/month, we are on course to have one of the best Months of June in US history…

Trump is already shaking the poles, seeking the resumption of QE, unbalancing the budget, undermining not only the independence but also the legitimacy of the US Federal Reserve – by effectively labelling its actions as 'unpatriotic', erecting tariff barriers to levels unseen since the 1970s, discouraging economic migration and of course, the plans for a Mexican wall. Trump resembles a modern-day Samson in his final show of strength – shackled, blind and a source of public entertainment, yet strong enough to dislodge the pillars of the house and bring the roof down on the Philistines. If re-elected in 2020, it is reasonable to assume that he would seek to demolish what remains of the post-GFC policy box, on which so many investment strategies rest.

So, what of the Democrats, should their candidate be successful in 2020? The policy messages from the Democrats are every bit as revolutionary as those of the president. Setting aside the specifics of the policy proposals associated with advocates of Modern Monetary Theory, it is hard to find a moderate voice among the Democratic hopefuls. Joe Biden was recently quoted at a fundraiser: "When we have income inequality as large as we have in the US today, it brews and ferments political discord and basic revolution." Larry Summers, widely-tipped for a key policy role in a Democratic administration, supports the presidential clamour for immediate rate cuts: "A serious recession anytime in the next few years would encourage populism and polarization at home and reduce American influence and strength in the world, as well as damaging the global economy."

The voices of fiscal conservatism – on the right and left of the political spectrum – are mute. And the voices of economic nationalism – again, across the political spectrum – are growing louder.

In his book, *Revolution and Rebellion in the Early Modern World*, Jack Goldstone analysed periodic governance breakdowns in Europe, China and the Middle East from 1500 to 1850. He concluded that "population growth, in the context of relatively inflexible economic and social structures, led to changes in prices, shifts in resources, and increasing social demands with which agrarian-bureaucratic states could not successfully cope."

He discovered that four critical trends were at work in every episode of breakdown: government fiscal distress, intra-elite conflicts, a heightened potential for mass mobilisation and increased salience of utopian ideologies of rectification and social organisation. Significantly, population growth is associated with price inflation, and the demands of an aging population with fiscal distress. Goldstone finds that "revolution and rebellion were not due to excessively high taxation by rulers, or to a simple lack of social mobility, or chiefly to class conflict, or to general impoverishment of society. Instead we find consistently that fiscal crises were due to *under-taxation* as elites systematically evaded taxes, so that state revenues barely kept pace with inflation, and hence never kept pace with the increasing *real* wealth of their societies. We find everywhere that high social mobility – high rates of turnover and displacement – preceded crises, while *low* social mobility characterized times of stability." "We also find consistently that elites succeeded in shifting the burden of taxation to the middling classes, and that the conditions of the working classes and peasants declined while elites and commercial classes grew richer. Thus, we consistently see a *polarisation* of social wealth in the generations preceding crises."

Arguably, Goldstone's four conditions for revolution and rebellion are amply satisfied in the US today. Despite a falling unemployment trend, the US budget deficit, as a proportion of national income, has worsened in the past 2 years and the tax proportion is falling. Political polarization has increased to the point where bipartisan compromise has become extremely rare. Systematic migration between US states has also risen significantly due to diverging economic fortunes and state taxes. Mobilisation should also be understood in terms of campaigns organized on social media, in support of a living wage, Medicare for All or a Green New Deal. Finally, the endorsement of Modern Monetary Theory (MMT) by several candidates for the Democratic nomination in 2020 smacks of utopian dogma, inferring a clear repudiation of fiscal rules and norms.

There are three potential triggers of the explosion of the US macro-policy structure and its embedded inflation objective. The first is a pronounced global economic downturn that overlays cyclical and structural fiscal burdens on the existing unsustainable fiscal path. The behaviour of debt service costs is a wild card in this scenario.

The second is a global financial crisis that deflates the equity and credit markets, prompting calls for another massive rescue package. The more likely scenario is an attempt to deliver "People's QE", whereby private investors are compensated for their losses or private borrowers are given the means to settle their debts. This could be presented in an MMT framework.

The third is an old-fashioned fiscal boost that is accompanied by monetary accommodation, creating a powerful liquidity impact. This policy could be presented as a pre-emptive strike against growing disinflationary pressures and an associated concern that the public's inflation expectations had drifted unacceptably lower.

Central bank independence and the primacy of the inflation objective represent plum targets for the new revolutionaries, the new Barbarians. Without the relaxation of this policy constraint, it is doubtful that significant inroads into the reduction of income inequality are possible. While inflation targeting regimes are ubiquitous – covering over 90 countries worldwide – IT regimes have failed on numerous occasions: Turkey, Vietnam and Russia offer recent examples (page 26). It is important to note that the surge of US inflation in the 1970s did not result in a divergence of real incomes. The stagnation of real incomes in the bottom quintile of the income distribution and the surging prosperity of the top decile have occurred in the context of low inflation. Inflation, long viewed as an ancient peril to be eradicated, has been re-cast as the agent, probably the only viable agent, of income and wealth redistribution.

To summarise:

Bond markets are salivating in anticipation of the next global economic downturn and the extreme lengths to which policymakers will be driven in the search for effective remedies. However, the next economic downturn bears an existential risk for the post-GFC policy box on which so many investment strategies depend. As political economy overrides 'the New Normal', the policy box explodes and priorities are reordered. In order to redirect economic policy towards new objectives, central banks will likely be reassigned to the defence of the sovereign credit in the context of ambitious public spending programmes and the continued repression of nominal interest rates. In practice, the inflation objective will be jettisoned and the inflation rate will find a new level, opening up the path to The Large Inflation. Act 1 ultimately gives way to Act 2.

Peter Warburton

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