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2018 Investment Themes

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Keeping the faith: now is not the time to abandon inflation targets

There are growing calls for central banks to reduce their emphasis on inflation. However, ignoring inflation would be a mistake. To do so would lock in low interest rates for longer and make it harder to counteract economic downturns.

Monetary policy is at an inflection point. The extraordinary support from central banks is being gradually scaled back as economies improve and financial markets remain calm. Yet investors remain sceptical about how much central banks will raise interest rates by, because inflation remains stubbornly low across most of the advanced world.

Historically, declining unemployment has usually been closely followed by healthy increases in inflation. But this relationship – described by the Phillips Curve* – has weakened significantly since the financial crisis. Even in economies like the US, Germany and Japan, where the unemployment rate has fallen below estimates of its natural rate, there are few signs of rapidly building inflation pressures.

This inflation ‘puzzle’ is prompting much soul-searching. Has the Phillips Curve broken down completely? Or is it that policy needs to remain looser for longer to overcome the cyclical and structural forces weighing on inflation? The answers to these questions, which will swirl around well into next year, have major consequences for the future of monetary policy and asset pricing.

The Bank for International Settlements (BIS) is leading the charge for a rethinking of monetary policy frameworks. It argues that low inflation is mainly due to the benign effects of globalisation and technological advances. The BIS also thinks that central banks’ commitment to ultra-low interest rates is distorting the economy and amplifying financial cycles. The upshot is that central banks put less weight on their inflation targets and withdraw policy support more quickly.

The wider central-bank community is unconvinced by this line of argument. There is agreement that there are structural restraints on inflation and that wages and consumer prices have become less responsive to changes in unemployment. But most central banks also think that inflation is still low because the recovery from the crisis has been so weak and spare capacity has not been completely eliminated. They have therefore drawn a very different lesson from the era of low inflation than the BIS: policy should be kept accommodative for longer, and it will simply take time for healing from past crises and the gradual erosion of spare capacity to be felt.

These debates are far from academic. In my view, it would be dangerous for central banks to give up on their medium-term inflation objectives. Doing so would lock in low inflation and low interest rates for longer, as well as further dampening inflation expectations. It would also undermine the ability of central banks to fight future recessions and deflationary shocks. That is because there would be less room for real interest rates and real wages to adjust. That would only serve

to increase output and financial-market volatility. Moreover, if a drop in inflation has been accepted once, why not again? Meanwhile, the real value of debt obligations would come down more slowly, weighing on demand.

As for credit and asset price imbalances, the financial crisis showed just how destabilising they can be. But the crisis was mostly a failure of regulation not of monetary policy. Accordingly, the financial cycle is best managed using targeted regulation, more effective micro and macro-prudential supervision, and the maintenance of ‘flexible’ inflation mandates that ensure that monetary and financial policymakers are singing from the same hymn sheet.

Reassuringly, central banks have not yet given up on their inflation objectives. Their reaction functions are therefore unlikely to change significantly in the near term. But the challenges of conducting monetary policy in a world of less responsive inflation and lower average growth and interest rates will not go away.

As a result, further policy experimentation is inevitable, especially when the next recession hits. Among the options being debated is for central banks to purchase real assets instead of just financial ones when unconventional policies are needed, and to coordinate those purchases with governments. Ben Bernanke (former Chairman of the US Federal Reserve) recently suggested that central banks should turn to temporary price-level targeting – whereby they would commit to compensating for periods of below-target inflation with periods of above-target inflation when policy rates have reached their lower bound. They may also explore mechanisms to reduce the lower bound itself by finding safer ways to deliver negative interest rates. Of course, with experimentation always come unintended consequences. Investors may think that the last decade has been difficult to navigate. But they ain’t seen nothing yet.

* The Phillips Curve describes the theoretical and historical empirical relationship between changes in economic slack and either wage or consumer price inflation. Normally it would be expected that as unemployment rates fall toward their natural or structural rates, underlying inflation rates would increase. In practice, however, both the position and slope of this curve has tended to shift over time, as has the amount of time it takes for changes in the labour market to impact wages and prices.

2018

AT A GLANCE



1 January 10 years since Malta and Cyprus adopted the Euro and became the fourteenth and fifteenth Eurozone countries respectively

23-26 January The World Economic Forum Annual Meeting kicks off in Davos, Switzerland, on the theme of 'Acting Together in a Fractured World'

3 February Janet Yellen's term as US Federal Reserve chair ends



1 June 20 years since the European Central Bank was founded with the purpose of defining and executing the European Union's monetary policy

June California plans to allow self-driving cars to travel the state's highways without human drivers, with the new rules expected to take effect by June 2018



20 May The next Italian General Election will be held no later than 20 May 2018

6 May 10 years since then US Treasury Secretary Hank Paulson infamously claimed: "the worst is likely to be behind us" in reference to the so-called 'credit crunch'

8 & 9 June The 44th G7 Summit takes place in Quebec, Canada

14 June The FIFA World Cup gets underway in Russia



1 July Mexico holds its senate election, and will hold its Presidential election by the end of the month

16 July 100 years since revolutionary Russia executes Tsar Nicholas II, the last Emperor of Russia

100 YEARS



18 July 5 years since Detroit, Michigan, filed for bankruptcy, becoming the largest US municipal bankruptcy ever at \$18.5 billion



October Brazilian General Elections will take place this month



October European Chief Negotiator for Brexit, Michel Barnier, has said he wants all the talks with the UK to be wrapped up by October 2018, to allow ratification of the deal

10 October World Mental Health Day



6 February

Marks the final stage in India's transition onto Aadhaar, the 12 digit unique identity number issued to all Indian residents based on their biometric and demographic data



17 February

10 years since Northern Rock, one of the UK's largest banks, was nationalised

8 March

International Women's Day



16 & 17 March

10 years since the collapse of US bank Bear Stearns



20-22 April

The International Monetary Fund (IMF) and World Bank have their Spring Meeting in Washington, D.C

8 April

Bank of Japan Governor Haruhiko Kuroda's current term scheduled to end



April

Tesla's Model 3, marketed as a "smaller, simpler and more affordable electric car", enters into mass production with delivery expected in the Spring of 2018

4 April

50 years since leader of the Civil Rights movement Martin Luther King Jr was assassinated

13 March

Russian Presidential election. Incumbent, Vladimir Putin, is eligible to seek re-election for a second consecutive term

August

Central Bankers gather at Jackson Hole, Wyoming for the annual economic symposium hosted by the Kansas City Federal Reserve. 2018 will mark 40 years from when the symposium was first held



11 August

10 years since Airbnb, now the world's largest home-sharing website, is founded by Brian Chesky, Joe Gebbia and Nathan Blecharczyk

15 September

10 years ago today Lehman Brothers filed for bankruptcy, the largest in history at the time, as massive leverage overwhelms a bank with \$639bn in assets



29 September

Ten year anniversary of the Icelandic Government's announcement that it would nationalise Iceland's third-largest bank, Glitnir. The beginning of the end for the Icelandic banking system



12-14 October

The IMF and World Bank meet in Bali Nusa Dua, Indonesia for their Annual Meeting



November

Ten years on from the announcement of China's \$586 billion stimulus package. The size of the injection would amount to a sixth of the country's GDP during 2007

6 November

All 435 seats in the House of Representatives and 33 of the 100 seats in the Senate will be contested in the US mid-term elections

11 November

Singles' Day, the Chinese bonanza of consumerism. Last year Alibaba surpassed \$14 billion in revenue on Singles' Day



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