Can central banks retain their independence?

- Higher levels of uncertainty and cyclicality are influencing central banks' strategies
- Central banks are coming under greater government scrutiny as they turn attention away from fighting inflation

JOHN BUTLER

Over the last few decades, following central bank behaviour has been a rewarding investment strategy. That is why there is now a community of people employed to analyse every word central bank officials utter, just to get an edge on their next decision, rather than seeking to understand the broader environment they operate in. However, this strategy may have run its course as monetary policy is likely to become more unpredictable.

Central banks, caught between structurally higher inflation and growing political scrutiny, may be increasingly inclined to flex their inflation targets in support of growth, employment and even fiscal considerations. Just by how much is still unclear, but I believe investors will need to adapt to higher levels of uncertainty and cyclicality, and probably nowhere more so than in Europe.

John Butler

The politics of monetary policy

Central banks are in the process of shifting their attention from fighting inflation to concerns around cyclical growth and employment. The question the market is grappling with is how many cuts will result from this change of direction, but I argue that the implications are far broader.

Central banks are easing, even though core inflation in most countries remains well above their targets; all the while unemployment rates are still near historic lows. This apparent reluctance to administer the medicine needed to bring inflation back to target makes me more confident that the global economy is in the early stages of a long-term upward trend in inflation. I see several structural reasons for this rise, but a key explanation is that the monetary policy regime in place since the mid-1990s is unravelling.

Central banks are, in effect, in a trap of their own making. In their fight to eliminate the risk of deflation, central banks effectively became fiscal entities. Purchasing government bonds and, in some instances, moving into negative interest rates are fiscal, rather than monetary, policy decisions, which have huge social implications.

These decisions by unelected officials deepened the wealth gap as asset prices surged while real growth and productivity remained stagnant. On top of that, central banks – having successfully facilitated the response to the COVID pandemic – were slow to recognise the associated rise in the cost of living and its disproportionate impact on lower-income households. When they finally acted, it was primarily through higher interest rates rather than the sale of the assets they had accumulated, creating the perception that central banks had elected to hit the average person on the street rather than the select few that had gained the most. Today, we are witnessing the political fallout of these actions across much of the developed world.

Central banks will argue that they had no choice, with the alternative being far worse. There is a lot of truth in that, but it misses the point that unelected institutions cannot step over the fiscal threshold without consequences. It changes perceptions. From now on, governments will want to be involved in central bank policy more closely as they are wary of unelected officials straying too far into fiscal territory.

Given this politically fraught background, I suspect there are few central banks that are brave enough to spell out that keeping wages and inflation down will necessitate higher unemployment. The political backlash would be significant, particularly in an election year. The implication is that central banks will be very sensitive to the first signs of rising unemployment, even if, as our work suggests, the unemployment rate required to stabilise wage growth has moved up.

When a central bank stops viewing the world as a set of probabilities and instead makes choices on competing 'costs', it stops being truly independent. We are seeing an implicit politicisation of monetary policy. This happened a long time ago in Japan and is now occurring in other countries as central banks' remits broadened. Moreover, there is natural logic for central banks to tread the path of least resistance to try to avoid further political scrutiny.

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Europe at heart of the new reality

This new challenge for central banks is perhaps the most acute in Europe. The European Central Bank (ECB) has to deal with the most complicated political backdrop of all, as it oversees the monetary policies of 20 democratically elected states. The ECB's quantitative easing (QE) may have saved the euro area but there are few voters who understand that and even fewer that directly benefited from the rise in asset prices. The ECB's QE ended up driving European savings out of the region to fund investment in other countries, notably the US. It also does not sit well with European governments that the ECB is starting to sell its bonds at a time when they have a long list of domestic spending priorities that need financing.

The recent parliamentary elections in France are the latest sign that the European political landscape is becoming increasingly fraught to navigate for monetary policymakers. Given France's deteriorating budgetary situation, markets could eventually take fright. In such a scenario, the ECB would face an untenable situation. Does it let bond yields go higher and higher or does it, after a bit of pain, intervene to lower yields for France and other affected member countries? Either choice is political. Past evidence and current political circumstances suggest that the ECB is likely to focus on credit risk at the cost of higher inflation.

Investment implications

Central banks ceased being truly independent as soon as they acted as semi-fiscal entities. I am not saying they were wrong to implement QE; they had no choice. But it means that the politics of monetary policy has changed. Getting out of the trap is politically difficult and involves hard and unpopular choices, especially if our research is right that decision makers face a more explicit trade-off between growth and inflation. It means that the monetary regime we have been used to is shifting. The fact that central banks can declare victory on inflation without any clear signs of slack building in economies is evidence of that shift. The implication is that inflation targets in most countries should instead be viewed as the lower bounds of a range.

It will take time for investors to adjust to this structural change in monetary policy, just as it took time for markets to adjust to the decisive drop in inflation during the mid-1990s. Market expectations of long-term inflation across most countries still sit around 2%. I believe this is too low. Over time, the market will need to adjust its expectations higher, with a greater margin for uncertainty. That will mean higher medium-term inflation but also bigger swings in cycles. And Europe is at the heart of this shift.

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