Daily Note

WANNABE VOLCKERS WILL ULTIMATELY FAIL

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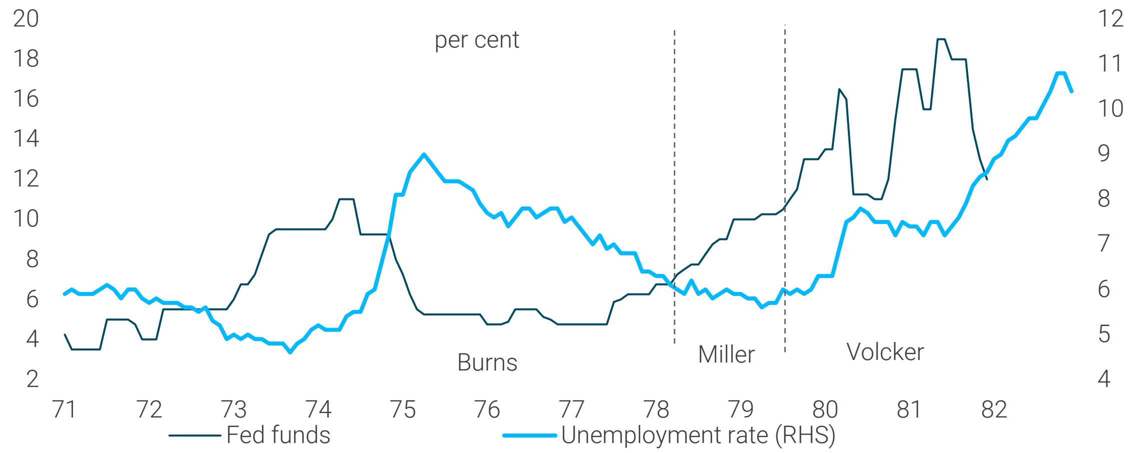
- **Central banks are willing to cause a recession to force inflation down**
- **But when the economy cracks (for real), they will quickly capitulate**
- **There is no appetite for big job losses. Fiscal policy will work against them**

After a summer of speculation about “peak inflation” and a "monetary pivot", financial pundits should have realized by now that central banks are serious in their pursuit of lower inflation. To put it bluntly: short of a full-scale financial meltdown (which the UK flirted with last week), they don't give a monkey’s about investors’ P&L. In fact, the authorities would rather see asset prices go down, which is what they mean when they use their favourite euphemism "tighter financial conditions". As I explained in a previous post, we need to think about this issue from the perspective of central bankers. In a major break from the past 20 years, their personal incentives are no longer aligned with those of Wall Street. Sure, a recession would be unfortunate, and they would prefer to avoid one; but it is not nearly as bad – in their minds – as losing control of inflation. Recessions can happen to any central banker, but total monetary failure is reserved for the unfortunate few. None of these officials want to become a “case study” in policy fiascos, the next Arthur Burns, responsible for policy blunders we will still be discussing in 40 years’ time.

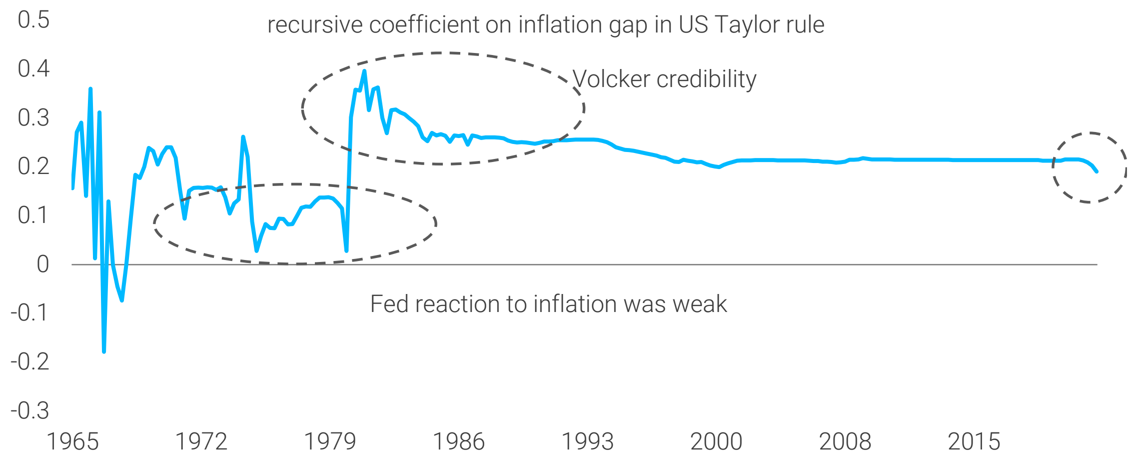
Chart 1: The Volcker shock



Sources: Federal Reserve, BLS, TS Lombard.

Now that everyone understands the central-bank perspective, there are some commentators who want to take the new “whatever it breaks” regime to extremes. According to the likes of Larry Summers, even clear evidence of a recession (not yet materialized) should not discourage central banks from continuing their big monetary squeeze. Summers compares policy tightening to antibiotics: if you stop the treatment early – as your symptoms start to improve – there is a good chance the infection will return (and, now resistant to antibiotics, perhaps become worse). He worries that central banks will back down as soon as the economy begins to deteriorate, which means inflation will not go away. Putting aside the obvious point that central banking is nothing like medicine – macroeconomics is not chemistry – the main evidence for Summers' view comes from the 1970s. There were three recessions during that decade; and with the Fed pivoting hard at the start of every downturn, inflation trended higher. Only the big recession in the early 1980s finally killed the wage-price spiral, as Volcker jacked up real rates and then held his nerve, despite an enormous amount of economic pain. It is worrying that this is a lesson that seems to resonate with central bankers today. It was one of the main takeaways from Jackson Hole, when Jerome Powell adopted his new "keeping at it" mantra (an obvious hat-tilt to Volcker's autobiography).

Chart 2: Volcker changed US monetary policy – for good

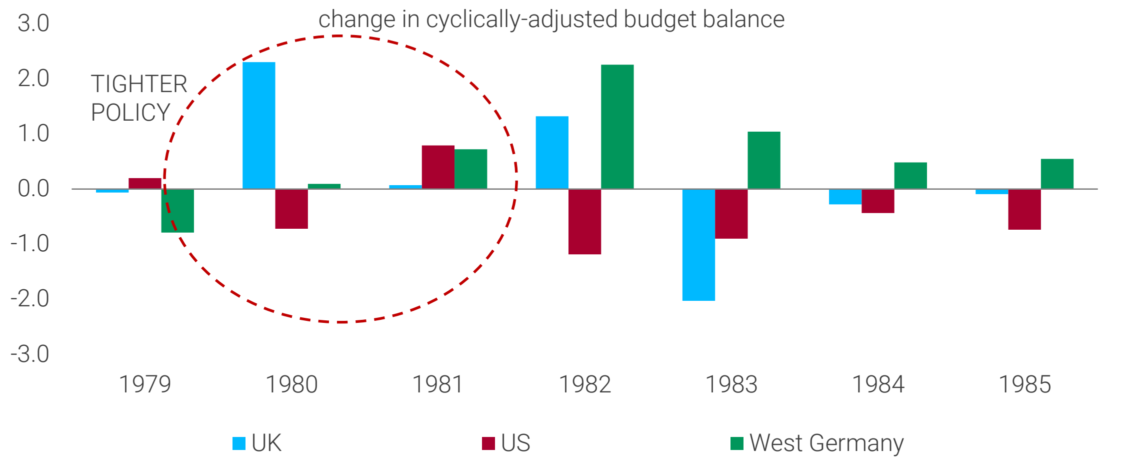


Source: TS Lombard estimates.

It is not just the Fed that is keen to learn the lessons from the 1970s. We have the ECB channelling the Bundesbank and the BoE hiking rates into what it admits will be a recession. What should we make of this hawkishness? Will these central banks seriously maintain their squeeze, even if their economies crack and unemployment starts to rise? Personally, I'm sceptical. Central banks today seem to have forgotten the political context of the 1980s: after more than a decade of stagflation, instability, uninterrupted industrial action and even a class struggle, there was a strong political desire to dismantle the post-WW2 economy. This would begin by crushing worker power. Ronald Raegan's famous battle with US air traffic controllers, and Margaret Thatcher crushing the miners, were symptoms of this deeper strategic game. While deep recessions and extreme levels of unemployment were obviously unwelcome, they helped to usher in a permanent shift in the balance of power between labour and capital, which would redefine the economy for decades to come. Over time, government reforms, deregulation and globalization would support this transition. It is doubtful the likes of Volcker, or the central bankers that followed, would have been nearly so successful without the macroeconomic supercycle shifting firmly in their favour.

Today's central bankers, despite what they themselves say, have no mandate for creating mass unemployment. And the supercycle is now moving against them, as the big secular trends of the past 40 years shift into reverse. Even if the monetary authorities can tolerate a recession, elected politicians cannot. Look at what is happening in Europe, where high inflation – aka the "cost-of-living crisis" – is already delivering (another) material easing in fiscal policy. What's happening in the UK is relevant precisely because it highlights the stark differences between the current situation and conditions in the early 1980s. Just compare "Trussonomics" with Margaret Thatcher's first budget. In 1980, Thatcher's Conservative government introduced a fiscal tightening that was so harsh the press dubbed it "the budget to produce 3 million unemployed". Even her own ministers walked out when her plans were unveiled in Parliament. The basic point is that while politicians accepted a deep recession to end the Great Inflation, there is no appetite for anything remotely similar today – especially after a decade in which most people's living standards have been going down. And if central banks try to keep policy tight, even in the face of a recession, they will soon find their political masters working against them. The "tug of war" between fiscal and monetary policy is a battle the central banks cannot win. And if they overplay their hand, they may even lose what they cherish most – their independence.

Chart 3: Fiscal policy was tight during the 1980s recession – extremely tight in the UK



Sources: OECD, TS Lombard.