Inflation: Servicing Growth and Employment!

The central banks of our Western countries can boast of a total victory over the front of the fight against inflation in the last thirty years. If they have indeed been successful in maintaining wages well below productivity, performance in the fight against recessions over the same period, however, leaves much to be desired. This lackluster report – the result of a consciously applied strategy – thus, resulted in a heavy trend of increasing unemployment in Western societies. Firmly rooted in attitudes, conditioning the actions and reactions of almost all employees, high and endemic unemployment has been insidiously implanted in our psyche as a new “normal”. For central banks whose ultimate goal is to control inflationary pressures, admittedly, full employment is certainly not a panacea! Indeed, a low unemployment rate often leads workers and employees to play the rule of supply and demand, i.e., to demand salary increases. Hence an acceleration in inflation. Central banks will not recognize it, but that is why they naturally tend to raise their interest rates when the economy improves: to keep unemployment at a level such that wages are always under control. Why? On the one hand to be able to display their success in their mission in terms of price stability. On the other hand to preserve capital and investors who, as we know, fear inflation. And not to harm corporate profits and thus to support the stock market… Let us be clear: this is in no way a plea for inflation. However, it would have been nice if the “track record” of our central bank contained slightly less success stories on the inflation front, and a little more marked in the fight against recession and unemployment. Since the interpretation in the “strict sense” of their mission by central banks has translated over the last thirty years into a very unfortunate consequence, i.e., the “wages” portion in the economy has steadily decreased. Not all is, however, lost, since the U.S. Federal Reserve unveiled at the end of 2012 an initiative refreshing on all fronts. For the very first time in its history, it announced the continuation of its quantitative tax cuts programs until the unemployment rate in the U.S. reaches 6.5%. Indeed, the 1978 Humphrey-Hawkins Act gave it two objectives: inflation and low unemployment. However, the Fed had never mentioned its concern about unemployment in its publications and statements until 2010. It had even pointedly ignored this priority since Paul Volcker until the first years of Bernanke as chair, including during the
long reign of the very controversial Alan Greenspan. In reality, the Fed like other central banks, relatively high unemployment was the key instrument allowing them to achieve their goal of controlling inflation. As it stands, the goal of the unemployment rate to 6.5% certainly does not seem ambitious enough. After all, the significant improvement in the labor market (and growth) contributes to narrowing the deficits “mechanically”. The resolution of the U.S. Federal Reserve will nonetheless constitute a revolution in attitudes, which we hope – however without any illusions – will be followed by the ECB… A profitable business must choose where to put its profits and cash. In this respect, when a business decides to invest, or otherwise conserve cash security, monetary policy of a central bank proves decisive. In fact, the problem is far from trivial. Indeed, without getting into espousing Apple’s stunning reserves – which amount to $100 billion – and which makes some people say that this company is richer than the U.S. government! U.S. companies, to name a few, are sitting on a total cash of about 2,000 billion… The “uncertainty” factor is constantly cited by CEOs and their CFOs, who prefer to inflate their war chests or place them in in very low yield instruments, rather than commit to the future – by committing their funds. This uncertainty is nevertheless an integral part of any decision-making process and, in this regard, any self-respecting entrepreneur can handle this variable and adapt. For the entrepreneur, everything is actually uncertain: from technological evolution to consumer behavior, through tomorrow’s taxation… Corporate managers are obviously unable to predict the international environment or regulations in the years to come. This uncertainty is therefore a part of corporate daily life. Which did not prevent Google or Samsung, among others, from prospering. In fact, it is not so much this “uncertainty” factor which drives businesses to invest in low return investments and bet sparingly on the future, as it is the rate of inflation, or, at least, inflation expectations. Indeed, why would a treasurer be puzzled when he is sure that the inflation rate will not exceed 2% in the near future? The more this rate is low the more the company will actually be comfortable in this position to emphasize a very low profitability for its cash? These considerations relative to the absence of inflationary pressures go together, of course, with a pessimism – or skepticism – with respect to the prospects for growth. Strict common sense suggests indeed to refrain from any investment when the economy is sluggish or depressed, where nothing is lost in remaining liquid. In other words, it is only when prospects for growth re-emerge or there is a resurgence in inflation expectations should business be tempted to channel their cash into less secure horizons. Not until the consideration of uncertainty has disappeared from the radar. But the company may consolidate this change into asset allocation – in the direction of more aggressiveness – on a rational basis. This
“entrepreneurial” attitude thus will induce a virtuous circle because the investment itself will cause an increase in production and a revival of the inflationary trend. This is where the role of the central bank is instrumental, through its quantitative rate cuts program, i.e., its asset purchases in circulation, combined with a well-defined and tenable objective in terms of GDP. In the context of a depressed economy, only the central bank can indeed install this virtuous circle because its acquisitions and cash injections will lend credit to this growth target. Where growth prospects have improved, they, in turn, will have an optimal impact on its asset purchases. Moreover, the credibility of the central bank, as renewed confidence in future business conditions, can be further strengthened if the expansionist policy leads to a widening of the range of purchased assets by public institutions. To be reassured and heartened, businesses and consumers must be convinced that the central bank is in control, and just as energetic and determined. Indeed, it is only if the central bank orchestrates carefully this renewed optimism that confidence – which is a feeling and therefore volatile and emotional – is waiting for you. Only his unequivocal commitment to boost growth and restore jobs – even to tolerate a dose of inflation – will allow businesses to consider the future under more promising prospects. In the same vein, critics – often violent – against the U.S. Federal Reserve are unwelcome and exasperating. How indeed do you accuse this institution of contributing to the distortion of economic and financial conditions through its many programs to create money, as markets and the economy are themselves in such an upheaval? It is time to realize that our world today is nothing more than a cash trap since it has become next to impossible to reduce unemployment by reducing interest rates... which are already at zero. In such extreme circumstances, the duty of the Fed – as any other central bank – is to correct these distortions with a priority objective being restoring employment. Only its action in the sense of an increase in inflation expectations will contribute decisively to lower “real” interest rates when the nominal rate, itself, is at the bottom. The riskiest position – and certainly the least accountable and least befitting of a central bank – is to do nothing; the Fed (like the ECB in an ideal world) must engage in asset purchases to avoid liquefaction of its economy and curb unemployment. That’s why the only approach that motivates businesses to make their cash available to the real economy and for the benefit of future investment is in the hands of the central bank. Odysseus had asked to be tied to the mast of his ship to resist the song of the sirens. Today central banks find themselves in a similar situation. So much less poetic than the Odyssey, they are faced with a mission – inherently schizophrenic – which requires them to fight against inflationary pressures, while maintaining growth and economic fundamentals. How to honor a mandate to stabilize prices, which happens to be
fundamentally incompatible with the resumption of growth, reducing unemployment and redemption of government bonds and debt that nobody wants? Can central banks continue navigating this path, forcing them to adapt their monthly monetary and cash injections policy to changing economic and financial conditions, without risking the doom Ulysses faced with the sirens? For the first time in the history of central banks, the U.S. Federal Reserve has yet to cross the Rubicon committing to continue with its programs to create money (quantitative rate cuts) until the U.S. unemployment rate drops to 6.5%. This institution – under the leadership of Ben Bernanke – which certainly made us accustomed to his dynamism and pro-activity, yet is revolutionizing the profession of the central banker by correlating unequivocally printing money with the fight against unemployment. When, at the same time, the European Central Bank still displays on the main page of its website that its “primary mission is to maintain the purchasing power of the Euro, and thus price stability in the Euro Zone”. When it clings tenaciously to maintaining – on paper – the rate of inflation below 2%. While its moral obligation is to acquire Greek, Spanish and Portuguese Treasury bills to avoid a disaster in these countries and support the affected European populations. And while the very essence of this mission that it finds so hard to honor is inflationary. Very well aware of this fundamental incompatibility, the founding fathers of the ECB nevertheless focused all the vital energies of their institution on the quest (and maintenance) of the Holy Grail of stable prices. The German economist Otmar Issing, Member of the Board of the ECB, and its first President, the Dutch Wim Duisenberg, thus took the side of attaching their central bank to the mast of the sacred fight against inflation. At the expense of growth and jobs.