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Weekly Commentary

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Macro View

By Hubert Marleau

The Cornwall Consensus and Central Banks' Independence

Submitted June 13, 2021

A Snapshot of the Market for the Week Ended June 11, 2021:

Two hotly anticipated reports, one on employment and another on inflation, arrived this week and confirmed what every investor knew: job openings and inflation are rising. Both measures beat expectations by a mile.

Firstly, job openings climbed one million in April to 9.3 million, the highest since records began in 2000. Meanwhile weekly jobless claims declined by 9,000 to 376,000 and remained below 400,000 claims for a second straight week.

Secondly, over the last 12 months, headline and core inflation are up 5.0% and 3.8% respectively, and much more for used cars (29.7%), airfares (24.1%), jewelry (14.7%), bikes (10.1%), footwear (7.1%) and energy (29.0%). The 3-month annualized growth was 8.3% and 7.9% respectively.

Fortunately, these numbers did not change the market's mind.The market shares the Fed's idea that the temporary residual effect of bottlenecks and supply shocks is the cause of the inflation surge, and that the virus is the cause of the immobility of labour.

Markets did not freak out because speculators, who usually trade on noise, still believe that the employment and inflation prints were not harassing enough to flinch the Fed abruptly. In a counter-intuitive manner, bonds, stocks and the dollar jumped. Perhaps it wasn't. Jerome Powell has been very effective in selling the Fed's transitory narrative.

On the one hand, price pressures were confined to specific items that seem obviously transitory and directly associated with the reopening. As dizzying as some prices were, the exceptions prove the rule. The FT's Martin Sandu referred his readers to the Federal Reserve Bank of Cleveland. The Bank's medium inflation index, which measures inflation for the goods category, whose price rose faster than half of all goods and slower than the other

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half, hardly budged: at 2.1%, it is right on the Fed's target. Its broader trimmed index, which measures the CPI, but excludes the 8% most extreme price changes in either direction, rose 2.5%.

On the other hand, the large six per cent gap between the unprecedented amount of job openings (9.3 million) and the large number of people out of work (8.3 million) guarantees that employment growth is not about to slow down anytime soon. Actually, it's about a bonafide imbalance, which is bound to be rectified as the Unemployment Insurance expansion expires, childcare becomes easier and pandemic fear ceases. In other words, normalization will return consumption patterns to where they were in 2019.

In this connection, it looks as if investors are coming around to the Fed's view that current price gains will not last, and that the goal of full employment is achievable. The bond market is reflecting this. Over the past month, real rates have risen from -1.98% to -1.73% while inflationary expectations have declined from 2.8% to 2.5%. Additionally, under its own weight, cyclical price pressures have eased. Prices of key commodities have dropped and are off roughly 15% on average from May peaks. The University of Michigan, which runs sentiment surveys, showed on Friday that Americans are less worried about inflation now than they were in May and more optimistic about the future than at any point since the pandemic began: about as high as it was in the fall of 2019.

Because investors were not spooked, benchmark 10-year notes sank to a two-month low of 1.45%. By the end of the week, the S&P 500 notched another record high as stocks eked gains. It increased 17 points or 0.4% to finish at 4247.

Interestingly, prices received for goods and services provided by businesses have outstripped wage gains, and so have productivity gains. The dynamics are protecting profit margins and containing input costs. For example, unit labour cost is only up 1.7% from a year ago. Businesses are doing whatever they can to boost efficiencies. The U.S. is in the midst of a productivity boom. Business output per hour of work has grown in three of the last four quarters. In the recent January-to-March period, it was up 4.1% from a year ago, the fastest in a decade. The pandemic has broken the usual pattern of not investing during recessionary periods. Companies have changed their business models to intensify the use of technology to squeeze as much as they could out of existing resources. According to Jason Thomas, head of global research at Carlyle Group, industries including retailing, information, finance, construction, and professional business services accounting for a third of the job loss since the start of the pandemic, have higher output than back then. The situation has made entrepreneurs aware that the frontiers of technology are somewhat unlimited. The digital economy works night and day. As a result, companies are pouring money into software and equipment at record levels.

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Put simply, the speculators and the monetary authorities are betting that these wild economic prints are unsustainable. The gamble is based on the idea that as more and more people are vaccinated, production will ramp up and unfilled positions should get filled; and as government fiscal stimulus fades, demand ought to cool down. Meanwhile the Fed is surreptitiously preparing the terrain for a monetary policy pivot, which contrary to popular belief, is what the stock market wants. As a matter of fact, the Fed has already begun to pull back its stimulative monetary stance.

Last week, the Fed announced that it will begin to unwind its corporate bond holdings it acquired last year through an emergency lending facility. This week, it is expected to make a few technical adjustments which could sterilize excess liquidity found in the money markets. At the upcoming FOMC, the Fed will either increase the reverse repo offering rate or raise interest on excess reserves that banks have with it. Moreover, the Fed is intentionally flattening the yield curve in a bullish fashion, trusting that the operation will give it more flexibility when it comes around to discuss a tapering process. A Reuters poll of 50 economists concluded that the Fed is likely to announce in August or September an eventual abatement of its bond-purchasing program.

The Cornwall Consensus and the Independence of Central Banks

As vaccines are being rolled out, economic activity is being unlocked and the financial world is getting back to normal after 14 months of severe disruptions caused by the Coronavirus. What the economy and the financial markets have experienced may simply be a business cycle set to “fast forward” by the stimulating combination of fiscal and monetary policies. For all intents and purposes, the level of economic activity in Q/2 will be back to where it was in the last quarter of 2019. In other words, the recovery stage is over, and the expansion of the economy has just begun.

However, there are four big dissimilarities between now and then. These are the inadmissible divergence between spending and production, the intolerable out-of-whack relationship between money supply and the economy, the unendurable gap between the Fed’s policy rate and the neutral rate, and the unsupportable amount of debt held by, and budget deficits financed with, the central banks. These conspicuous differences explain why the current boom is unusually occurring at the tail end of the recovery, rather than at the tail end of an expansion. Herein lies the structural inflation risk. If these problematic issues are not going to be dealt with, inflation will become a steady process.

Leaders of the G7 met in Cornwall, England over the weekend, pledging to uphold a bunch of commitments that are academically and politically driven, which could interfere with the independence of central banks. The FT suggested that the new international cooperation, dubbed the “Cornwall Consensus”, encompassing health

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issues, corporate taxation, wealth-income inequalities, climate changes, dealings with China and global growth management opposes pro-globalization and free-market ideas of the "Washington Consensus". The latter has dominated the geopolitical landscape for the last 50 years. Should the central banks succumb to the pressure of these leaders by acquiescing to the new international zeitgeist, the disinflationary forces of the growing debt load, aging population and shrinking labour force could turn into a structural inflation problem. The "Cornwall Consensus" proposals are, however, unlikely to be adopted in the near future. Nonetheless, as Gillian Tett of the FT puts it "businesses and investors should not ignore this ritualistic display because symbols, even when they appear empty or divorced from reality, reflect and reinforce group assumptions about how the world should work". This ideological shift away from liberal capitalism to state capitalism has found adherents across the political spectrum. Think on this one thing: It was the Conservative British government that organized the advisory group that produced the "Cornwall Consensus" memorandum.

While I admit that the Fed has prioritized full employment for now, the monetary authorities have not given up their commitment to price stability and financial health. The Fed's duty is to the broad economy and not to social justice and equity. It is up to lawmakers to find solutions which will support everyone, regardless of race, ethnicity, gender or where they live. The conduct of monetary policy will always and inevitably have distributional consequences, but they are secondary to pursuing the best outcome for the whole. The tension between the general and the specifics explains why central banks ought to be independent institutions so their policies can be insulated from political pressure. The Fed is not free to set its own goals. They were set by the lawmakers, which is the pursuit of a goldilocks scenario: price stability and reasonable growth. In practice, the Fed's aim is about a two-plus-two economy: 2% for growth and 2% for inflation.

In my judgement, the Fed is fully aware that this objective can be achieved, but only if over the next two years, the growth of the money supply returns to an annual growth rate of about 5%, the policy rate closes in on the estimated neutral rate of 1.00%, and the bond-buying program is stopped. What is particularly important is the direction and that is positive. The growth of money supply is decelerating, the yield curve is narrowing and discussions on tapering off the quantitative easing program have unofficially started.

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