The Amplification of Transmission

Is rising government debt constraining central banks?

Introduction

The increased level of government debt has skewed how monetary policy influences capital flows and inflation.

Interest on growing government debt, which is anchored to central bank rates, amplifies the effect of a central bank rate decision. That is, should central banks raise cash rates, not only will they weaken capital flowing through private sector businesses, but they will strain fiscal policy capacity as governments are burdened with higher servicing obligations.

Further, the intermingling of central bank and government finances, where central banks now underwrite government debt through the creation of money, further limits central bank capacity to target traditional inflation goals.

Background

The manner in which monetary policy impacts economic activity and inflation, often called the transmission mechanism, is changing. Historically, as central banks lower their cash rate (interest rate) target, the cost of money decreased, and investment activities become more attractive. This led to an increased flow of capital into markets and the extra capital competed for resources. As resource constraints emerged, prices increased, creating inflation. Conversely, as central banks increased cash rate targets, demand for credit weakened, constraining capital flows and reducing inflationary pressure.

Since the global financial crisis, and now more so with COVID-19 shutdowns, governments have grown debt without constraints. Controlling government debt levels is no longer synonymous with responsible governing.

If market conditions functioned, the expansion of government debt would be funded by investors. As cash rate returns diminished, with it went investment demand for government debt. Meanwhile, supply of government debt (government bonds) continues to expand. The mismatch in demand and supply should have required governments to offer higher yields (credit spread expansion) on bonds to attract investor capital.

Instead of allowing market forces to push government bond yields higher, central banks are intervening by buying government bonds (i.e. becoming a lender to government). Central banks are funding this by printing money and increasing their balance sheet holdings of bonds.

With central banks underwriting government debt, in addition to the vast expansion of this debt, we posit central banks will be forced to alter policy settings and targets.

Central Bank Policy Changes

We think that the following central bank policy changes are likely:

1. Softening of inflation targeting.
2. Increased flexibility and nuancing of cash rate changes.
3. Rethinking how we measure inflation.

Changes explained

1. Softening of inflation targeting | It takes time for monetary policy changes to flow through the economy. Typically, rates are set to pre-emptively address inflation concerns. As former Fed Chair William Martin put it - “The Federal Reserve … is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up”.

   The impact of interest rate changes are more significant when debt levels are high. High public and private debt amplify sensitivity to interest rates and have made any central bank policy mistake more consequential. This, we think, necessitates a change in approach to inflation targeting. By broadening the inflation target window, central banks afford themselves more time to see how economic fundamentals are playing out and this reduces the risk of taking away ‘the punch’ until they can be sure everyone is having a good time!

   On the 27th of August, Jerome Powell of the Federal Reserve signalled this loosening of inflation targeting. It is expected other central banks will follow suit. The RBA, one of the more effective central banks in the world (in our opinion), already has in place a broader 2-3% inflation window (instead of the previous Fed’s target of 2%), so we do not expect any marked change in Australia.

2. More flexibility in cash rate settings | When the central bank cash rate is close to 0%, a 25-basis point lock-step approach to rate changes leaves little room for nuance. An increase from 0.25% to 0.50% represents a 100% increase in the risk-free rate. Removing the 25 basis-point cash rate paradigm provides greater flexibility for central banks to not just influence markets, but also signal to them.

   When cash rate settings are again above 1% (or some more meaningful base rate), a 25bp modal frequency is again appropriate. The Bank of England has already demonstrated this with a breaking of its lock-step approach in March this year when they went from 0.25% to 0.10%.

3. Rethink on how inflation is measured | The recent proliferation of ultra-cheap money and increased capital flows have failed to generate meaningful inflation. A subtle shift in how capital is flowing within, and through markets, has weakened the *perceived* efficacy of monetary policy.

   Businesses, in their pursuit of efficiency and competitive advantage, have increased capital investment into software and technology infrastructure. A key difference between technology capital investment, as opposed to investment in humans, factories, plant and equipment, is the lack of resource constraint and negligible marginal cost in supplying additional capacity.

   A lack of resource constraint in supplying technology means that price inflation (and broad inflation) is avoided. Technology investment, particularly when software related, may even have the capacity to be deflationary as it leads to greater economies of scale for service providers.

   The other subtle change that flows on from the shift in business investment is that productivity gains are predominately captured by business owners. As technology advances and software efficiencies have augmented the value of human capital, employee empowerment to capture a share of the productivity gains has diminished. We see this in subdued wage growth.

If governments are expanding debt, central banks creating new money and employees aren't capturing business productivity gains, where is the money going?

Money is flowing through markets into a more constrained supply of assets, bidding up asset prices to the benefit of existing asset owners. Business, equity and asset holders have seen an extraordinary inflation of wealth, creating vast inequality in the process. Central banks have no policy settings or targets directly linked to asset prices.

Asset price inflation, much like consumer price inflation, has the capacity to destabilise an economy and make it more vulnerable to economic shocks.

The broad mandate of central banks is to maintain stable economic function. This goal manifested into inflation targeting, the most effective means with which central banks use monetary policy to stabilise economic function. It is not that central bank inflation targeting is broken, but, we believe central banks have failed to adapt to the changed dynamics of business investment and destabilising impact of asset price inflation.

By Matthew Vickers

Snowgum Financial Services