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Baer Necessities

Is this the end of central banks' independence?

I still remember the excitement I had as an economist at the European Central Bank when the Chairman Mr. Wim Duisenberg said: "In just over 75 days, the euro will be in our pockets, and will finally become an everyday reality for all of us". It was October 17th 2001, and I had the privilege to touch-and-feel some of the first euro banknotes, before they eventually became available to the public on January 1st 2002.

At that time, the ECB's mandate was *just* to maintain low and stable inflation, endowed with independence in conducting monetary policy by the Maastricht Treaty.

Economic theory suggests that low and stable inflation favours higher levels of employment and economic growth. The academic consensus is that central banks granted with independence in conducting monetary policy are more effective in keeping inflation under control and this is the reason why they increasingly became more independent from governments. Without autonomy in conducting the monetary policy, inflation may rise above the 2% target and it would be very difficult to bring inflation back under control, once the anti-inflation credibility was lost.

Starting with the Great Financial Crisis in 2007 until the current Covid-19 pandemics, all major central banks experienced a significant expansion to their mandates and to their arsenal of monetary policy instruments.

The ECB now has responsibility for bank supervision and financial stability, and has indicated a possible involvement in combating climate change, in addition to its original mandate to keep inflation low and stable. Its toolbox now includes negative interest rate policies, plenty of new lending operations, asset purchase programs (Quantitative Easing, "QE"), and forward guidance (communication of intentions on future interest rates level).

Although a full assessment of the effects of these unconventional monetary policies will not be possible until they will have eventually been removed, a few observations about these "steps in the dark" can safely be made.

The unconventional monetary policies restored liquidity and brought stability to a financial system that would otherwise have been insolvent in the Great Financial Crisis. On the other hand, these policies created an increase in risk-taking behaviours ("reaching for yield") for investors with low-risk profiles who then migrated to instruments beyond their risk appetite, such as junk bonds, emerging market bonds, commodity ETFs and stocks. The ECB's QE measures aimed at alleviating the euro-area sovereign debt crisis effectively enhanced the credit rating of the fiscally weaker euro-area states ("periphery") at the expense of the stronger states ("core"), and removed the market discipline on the governments' budget decisions.

Markets and the public may unreasonably expect that central banks have the mandate and all the tools to manage the economy, restoring full employment, keep inflation low, safeguard financial stability and possibly also fight against climate change. Therefore, should the central banks not meet all these expectations they would lose their reputation with increasing risks to their independence.

Ken Rogoff, an economist, noticed that central banks are already gradually losing their independence, pressed by populist parties requesting more oversight powers and criticized by right parties as the balance sheets are too big and by left parties as the balance sheets are too small.

The Covid-19 pandemic has further highlighted the conflicting nature of the ECB's goals of keeping inflation low and stable, avoiding another sovereign debt crisis, supervising the banking sector and addressing the pandemic emergency with an additional QE package (the PEPP).

To be clear: the pandemic has accelerated the trend of higher public and private debt, low interest rates and diminished effectiveness of monetary policy so that it will be increasingly difficult for central banks to raise interest rates should the inflation start rising.

Add to the ultra-low interest rates, the stimulus measures taken by governments to cope with the pandemics and the disruption of some global supply chains and the case for rising inflation over the next 12 months is further reinforced.

There is a strong argument for central banks to remain independent and focus on doing what they are good at: keeping inflation under control. But with multiple and even conflicting mandates, get ready for inflation in 2021.

Hedging your portfolio against inflation

With raising inflation, clients are advised to invest in real assets, or investments traditionally thought to hold their value during times of high inflation. Many "real" assets, including inflation-linked bonds, commodifies and real estate turn out not to be that "real", in fact. Inflation linkers have almost no correlation with inflation. Among commodities, possibly only energy has some hedging against inflation. Gold has also been a poor hedge historically. Equities, which is believed to be good at hedging inflation, actually provide poor inflation hedging characteristics but strong returns above inflation over the longer term.

Investment ideas: Real estate (only if the "location! location! location!" mantra applies) is a good inflation hedge. Short-term high quality bonds, which have the highest correlation with inflation as central banks tend to rise rates when inflation goes up. And of course, equities, for their higher expected returns compared to inflation.

Dr. Francesco Mandalà, PhD
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