Why is Everyone Panicking About Central Banks?

Retrieved Thursday 29th of June 2017 06:00:19 PM

The markets' **central bank** fetish is getting out of hand. The money manipulators were out in force yesterday. Their words moved markets all around the world.

Nothing else seems to matter these days, so let's delve into what's going on.

Bank of England (BoE) governor Mark Carney told markets last week that it wasn't time to raise rates yet. This week he said he'd have to remove some stimulus.

The pound surged a per cent on the change in potential policy. But then the BoE PR team was out in force telling the markets they had it wrong. Carney wasn't going to raise rates imminently.

Meanwhile the BoE's chief economist put a date on the interest rate increases – the second half of the year. That's supposedly a bit of a scandal, as it puts his boss, the governor, into a corner. If Carney does vote to raise rates in the second half of the year, his economist appears to be running the show.

Yes, office politics and PR teams now run UK monetary policy. The former BoE Monetary Policy Committee (MPC) member Kristin Forbes said so in her explanation for quitting the committee. In a speech to the London Business School she explained that the central bankers were too worried about the press to conduct proper monetary policy.

She also pointed out something fascinating

Central bankers around the world have accepted a far larger mandate than controlling inflation. They're now responsible for monetary policy, bank stability, unemployment, financial market stability, bank regulation, the stockmarket level and money itself. You can probably throw in exchange rates too. Not to mention the political issues that go with each of these.

The massive expansion in the role of central banking was supposed to make things more efficient and centralised. But it creates huge conflicts of interest and paradoxes. For example, what if meeting one goal comes at the expense of another? What if combating inflation means financial instability? When the central bank is faced with tough choices that cause problems within one of its spheres of influence, it can now be framed for incompetence.

It's not just in the UK that all this is happening. There must be an enormous jobs boom going on at central bank PR teams. Each time their governors, chairpersons and presidents open their mouths, the markets move and then the PR team comes out to clarify.

It's getting downright bizarre. For example, the comments from European Central Bank (ECB) president Mario Draghi which sent markets spinning were these:

> *As the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments — not in order to tighten the policy stance, but to keep it broadly unchanged.*

That gave investors a fright. The euro had its biggest move all year. The ECB's vice president promptly showed up on CNN to say the market had misunderstood the comments. They implied no change in policy.

But what did Draghi's comments mean?

Draghi is arguing that a change in monetary policy is not necessarily a change in monetary policy. Doing something can actually mean doing nothing.

Don't you see?

If we put on our central banking hat, it might make sense. If inflation rises, then increasing interest rates at the same speed keeps the real interest rate stable. The real rate is the interest rate minus inflation.

Despite the fact that Draghi said, even if he does do something, it will still be nothing, the market reacted. In the understatement of the century, the ECB's chief economist said markets are "particularly sensitive to any perceived change in the future course of monetary policy".

Draghi may have a point though. **When the Federal Reserve increased rates**, the stockmarket reacted in the way you'd expect from a rate cut. When Goldman Sachs' chief economist tried to make sense of this, he concluded that the increase in rates was actually pushing the market higher because it wasn't big enough to count as a real increase.

Not only are the PR reps obfuscating in force, so are the economists.

How does it end?

The central bank fetish dominates markets. While it continues, it's hard to see how a drop in markets could occur. Central bankers have the powers, the mandate and the infinite budget to offset any problem I can come up with. That implies a steady boom in asset prices, which you can take advantage of.

But it also puts us in some sort of weird doldrums. It's the stability of the world described in *Atlas Shrugged*, whatever you think of the book and its philosophy.

Central bankers have destroyed financial markets as a mechanism for accountability, risk pricing, capital efficiency and anything else. Financial markets have become a government welfare system run by central bankers. Investments are just a pool of pension funds which must be kept afloat by pumping stock prices.

The question is whether this imposed stability really is stable. The economist Hyman Minsky said that stability begets instability.

Let's go back to the resigning BoE MPC member who highlighted the BoE's PR paranoia. The central bank has too many roles. Some of which can conceivably conflict. Perhaps this is where our answer lies.

At the moment, the various indicators that central bankers have to control are pulling in opposite directions. Inflation falls when the financial sector is in trouble, so the BoE can rescue and print money without worrying about inflation. Inflation rises as the financial system's health improves, so the BoE can tighten policy without fear of sabotaging the banks.

But these relationships need not persist. Perhaps the BoE will some day be forced to choose between its mandates. It will have to sacrifice inflation, the stockmarket or the banks. And then our stability ends.

Stress tests

Like some sort of circus, the authorities are keeping the markets distracted from the bigger questions. The latest act was bank stress tests in the US and an analysis of financial stability by the BoE.

Every now and then regulators around the world pretend to run a health check on their banks. Why? To look busy. And reassure everyone.

These test and reports are usually meaningless. But they've opened the door to something else less innocent.

Back when a Mr Cowperthwaite was in charge of the Hong Kong economy, he refused to collect statistics. This stopped the central planners and economic meddlers in their tracks because they didn't have the data to justify their schemes. You can't regulate what you don't know anything about. Hong Kong boomed under the unique way of imposing free markets.

The regulators' and central banks' constant analysis of banks is an example of the opposite phenomenon. They have some much information, they can't help but meddle.

In the UK, the BoE decided to call upon banks to raise more than £11 billion as a capital buffer. The idea is to put money away for a rainy day. The rain being consumer credit defaults in this case.

This is an interesting turn of events. **Central bankers are trying to run banks actively now**. And the bankers aren't happy about it. The increase in capital means they can lend less, or return less to shareholders. It also smells like backdoor monetary policy. By restricting bank lending, the BoE is reducing the economy's money supply indirectly. We await the PR team's response on this.

Over in the US, the results of the second segment of the bank stress tests are out. All but one bank passed the first test with flying colours. Their stocks reacted accordingly.

The second test focused on the banks' desire to pay profits out to shareholders. Such intentions must now be approved by the authorities as not endangering a bank's financial stability because a payout to shareholders reduces capital. Again, this is regulators running bank business decisions. More symptoms of an *Atlas Shrugged* world.

The margin for error in the stress tests was large, with banks running far more safely than regulators decided was the bare minimum. The banks promptly decided to return funds to shareholders in the immediate wake of the stress test release. The $100 billion payout of the six biggest banks is close to 100% of their profits. In other words, they only had to behave until the report card came out.

At the heart of what's going on here lies an old question. Are banks businesses or utilities? They run a public function – the money supply – by providing the debt which creates money. The central bank is just the first step in the process. Banks control most of it. Having private institutions running a public function creates the problems we have now.

The debate is that we should choose between two options. Either banks should become proper utilities and controlled as such, or **money shouldn't be a public function**.

Until next time,

Nick Hubble
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