Inflation, Government Solvency, Unemployment or Financial Stability?

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In September I warned **inflation is making a comeback**. It's central bankers' age-old accountability mechanism. The reason **quantitative easing** (QE) never worked in the end.

It's not like we haven't tried money printing. History is littered with examples of it. And the effects are always the same. Buoyed confidence and speculation. An unsustainable government budget sustained. And derision of the demagogues. For a while.

Then inflation starts to cancel out all the benefits.

But they're like a drug. And inflation seems to solve the problem of too much debt. So even more of it seems like a good idea. Until it veers completely out of control. The currency is destroyed.

Not that every episode ends this way. Sometimes central bankers decide that ending inflation is more important than saving the economy and government. It is the **most mandated mandate**. They break the cycle at the expense of unemployment and fiscal turmoil. They're denounced by politicians and watch their effigy burned in town squares.

So the question is, which mandate is the most mandated this time around? Inflation, government solvency, unemployment or financial stability? You can't juggle them all. They're a trade-off.

That was the key theme of my speech at our conference on Friday. The DVDs are in the works already.

But the news is moving fast. Bloomberg reports that "**Bank of England** Governor Mark Carney is ready to raise interest rates from a position of economic weakness rather than strength."

The idea is that growth is still low, but a drop in the pound is pumping up inflation. And higher interest rates happen to be good at arresting the fall of a currency… in theory.

Do you see how it's a trade-off between mandates? Carney is prioritising inflation. But tackling inflation sacrifices economic growth. At least debt-financed economic growth. People have borrowed like mad during the decade of absurdly low interest rates. They'd be in trouble if rates do go back up.

And if bank customers are in trouble, so too are banks. At our conference, Akhil Patel explained how one of the best indicators of economic distress is the consumer credit market. It's an early warning system. And it's not flashing, with delinquencies at extreme lows. That's no surprise to the man who is predicting an extraordinary boom for a very simple reason.

Over in the US, they have the reverse problem. The Financial Times reports an "Inflation cloud hangs over Federal Reserve". But it's a lack of inflation, not too much of it.

And so there is growing dissent over the coming interest rate increase at the Federal Reserve. Again.

This time the rate hike was pencilled in for December. But inflation is still lagging. And it's struggled for years now. With natural disasters striking the US, a rate increase just doesn't look like a good idea for main street.

But it's Wall Street that the Federal Reserve really cares about. Economists at the Fed are worried that the constant monetary support has created a dangerous situation there. Financial stability doesn't just mean pumping up markets, but waning them back off again too.

The Fed's reversal of QE is already a big withdrawal. Adding interest rate increases could be a bit much.

Then again, there are signs that the whole central banking game doesn't actually work if you play by the rules. Because the rules are wrong.

Why central banks are failing

You know the feeling when your taxi driver doesn't know the place you're trying to go? You're about to get that same feeling about the economy.

Central bankers have started to admit they're clueless. Their models are failing, reports the Financial Times*.* Inflation, productivity, unemployment and economic growth are not behaving as they're supposed to.

Modern central banking is based on the idea that we resort to these models in order to take out the human error. But the models are wrong:

> *Janet Yellen, chair of the US Federal Reserve and the world's most important central banker, has been the most direct. "Our framework for understanding inflation dynamics could be mis-specified in some fundamental way," she said last month.*

And the **central banks**' central bank explains why:

> *Claudio Borio, chief economist of the Bank for International Settlements, which provides banking services to the world's central banks, says: "If one is completely honest, it is hard to avoid the question: how much do we really know about the inflation process?"*

The lack of knowledge is leading to constant changes of assumptions. At what level of unemployment does inflation start to creep up? What is the long-term trend of growth?

With constant updates to the way the models work, and their inputs, "sound estimation and judgment are sometimes hard to differentiate from guesswork" said one Fed governor.

In other words, these people have no clue what they're doing. They don't understand the nature of inflation, keep changing their assumptions about it and are aware there is something deeply wrong with their methods. But it gets worse.

Surprisingly, the monetary meddleomaniacs fully acknowledge the unintended consequences. Janet Yellen said so herself: "Persistently easy **monetary policy** might also eventually lead to increased leverage and other developments, with adverse implications for financial stability."

All this is horrifying given it's central bankers who steer our economy. But it's not a surprise. Every government which attempts central economic planning eventually makes the same discovery.

The other obvious answer to why all this is going off the rails is demographics. That's why the confusion for economists is greatest in Japan.

But central bankers can't solve demographic problems. They're usually too old.

Isn't it fascinating how inflation in the UK is designated a problem while the rest of the world is struggling like mad to get it? Economics and politics are very dangerous friends.

Until next time,

Nick Hubble
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