Conundrum, Once Again

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Central bankers worldwide are once more facing a delicate situation. Determining the right monetary policy stance in a chaotic, highly uncertain, and volatile world has again become a quite complicated exercise. Leaning towards higher policy interest rates might well be the least bad option at this moment.

On June 22 of this year, **Alan Greenspan** passed away at the age of 100. Greenspan had been the second-longest-serving chairman in the history of the American central bank, the Fed, serving for 18.5 years (August 1987-January 2006)—just four months less than William McChesney Martin (April 1951-January 1970). Once treated as a god-like figure, Greenspan's reputation was significantly tainted by the **Great Financial Crisis** of 2008. Greenspan had a unique way with words, a verbal virtuosity he often used to hide his real intentions.

In February 2005, Alan Greenspan famously argued that he saw a "**conundrum**." How was it, he asked during congressional testimony, that despite the Fed increasing its short-term policy rate, the federal funds rate, by 150 basis points since June 2004, the 10-year Treasury bond interest rate remained essentially unchanged? Greenspan could not find a logical explanation for this anomaly and creatively described it as a "**conundrum**." Defining a conundrum as a confusing and difficult problem and/or a question with no easy answer, it is quite straightforward to see that central bankers today are once more confronted with such a **conundrum**.

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Waiting Game

During the last days of July, the European Central Bank (ECB) and the Fed, arguably still the two most important central banks in the world, both decided to **leave their policy interest rates unchanged**. The ECB kept its deposit facility rate at 2.25%, the main refinancing operations rate at 2.40%, and the marginal lending facility rate at 2.65% (after having hiked these rates by 25 basis points in June). The Fed decided to keep its federal funds rate unchanged at the 3.50–3.75% interval where it has been for the last six months.

Adjusted for inflation, both the Fed and the ECB are flirting with **0% real policy rates**, with the Fed just a tiny bit in positive territory. The latest US inflation number (June) came out at 3.5%, with core inflation—the general inflation rate corrected for energy and food prices—at 2.6%. The ECB was facing 2.8% annualized inflation for June, with core inflation at 2.4%. A week after the ECB council meeting, the July inflation numbers came out a fraction higher, with 2.9% for headline inflation and 2.5% for core inflation. The ECB's real policy rates are clearly in negative territory, albeit in a limited way. **Negative real interest rates tend to signal accommodative financial conditions**.

The "**wait and see**" decision was **not self-evident**, neither within the ECB nor within the Fed. ECB president Lagarde admitted that some council members "**asked themselves whether we should not consider a hike**." Such a thought is easy to understand given the fact that the ECB research department forecasts **3.4% inflation for the second half of this year and 3% inflation for next year**. Both these numbers are significantly above the ECB's inflation target of 2%. Especially worrying is the fact that inflation in the service sector of the economy remains stubbornly above 3%. Lagarde described the situation caused by the Iranian conflict as "**alarming**" for price stability. At the Fed, three members of the decision-making FOMC (Federal Open Market Committee) pleaded for a rate rise and rejected the status quo that was ultimately decided. All three of them warned of **imminent threats to price stability**, mostly as a consequence of rising energy prices.

Clouded Crystal Ball

It shouldn't come as a surprise that even amongst central bankers—a group that on average attaches great importance to internal cohesion and unanimity—different opinions circulate on what trajectory monetary policy focused on price stability should follow. Essentially, two major developments give rise to diverging opinions and policy recommendations.

First, there is the **Iranian conflict** and its impact on energy prices, with major (or not) consequences for price developments in general. **Volatility** is the order of the day, not least because of the... volatile decision-making in and around the Trump White House. The Ukraine war, the Taiwan "**conundrum**," and many other geopolitical choke points are only adding to this **tsunami of uncertainty and volatility**. It is absolutely unclear how all these issues will work out, in the short run as well as in the longer run.

Secondly, there is the **huge investment boom in AI (Artificial Intelligence)**. Google, Amazon, Microsoft, and Meta invested together $1.1 trillion in AI over the last three and a half years, and their rate of investment in AI seems to be accelerating even further. In the short run, this investment boom tends to be **inflationary** because of the huge demand for materials and energy, pushing up prices in general. In the medium and longer term, many analysts expect **major increases in productivity** due to the widespread use of AI throughout the economy. Higher productivity tends to exert **downward pressure on prices**. But the scenario of AI consequences is **highly uncertain**, both in terms of magnitudes (how substantial will short-term price hiccups be and how large a positive productivity shock is to be expected?) and in terms of timing (when will the productivity increases start to show?).

Central bankers not only have to try to see clearly through the fog of the energy market and AI uncertainties they face; they also have to deal with the implicit and sometimes even explicit pressure of heads of government most worried about the impact of higher interest rates on their budget deficits and debt outlook. A number of economists and analysts are increasingly warning of the so-called "**fiscal dominance**" of monetary policy. Heightened uncertainty with respect to economic growth prospects is further clouding central bankers' skies.

Punch Bowl

Is it then, given all the uncertainties and volatilities of the present days, not quite understandable that central bankers take a wait-and-see attitude? A "**no**" answer to this question is, in my opinion, a bit more defensible than a "yes" one. I have two reasons to underpin that opinion. First, the **anchoring of inflationary expectations** of consumers, producers, and investors is of crucial importance for price stability. Firmly anchoring inflationary expectations requires rigorous central bankers, in words but even more so in concrete actions. Rising interest rates will of course not directly affect the energy prices that presently drive inflationary pressures, but they tend to **limit the fallout of that initial inflationary outburst**.

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Secondly, **financial markets** have over the past decades been almost continually gorging on **cheap money**. Many **bubbles and disequilibria** have been the consequence thereof. The recent report of McKinsey Global Institute on the worldwide balance sheet contains impressive evidence of the **over-financialization** that has taken place during the recent past. The worldwide balance sheet of assets and liabilities (both private and public) reached at the end of last year a total number of **$1.8 quadrillion**, or $1800 trillion, or $1,800,000 billion.

The relentless increase in the worldwide balance sheet, so the bright minds of McKinsey Global Institute conclude, is recently almost entirely due to increases in **financial wealth, not real assets**: "Global wealth was driven to a greater extent by paper wealth, or nominal asset value decoupled from the real economy." Last year, it was most of all the huge increases in US equity prices and in Chinese corporate debt that fueled global "**wealth**."

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The link between the continual tendency towards **cheap money** and escalating financialization of economies and societies is complex and hard to evaluate precisely, but there can be no doubt that such a link does exist. Maybe the time has come to bring back to attention the probably most memorable… punch line of the man who until further notice remains the longest-serving Fed chairman. William McChesney Martin declared in 1955 that the Fed is "**in a position of the chaperone who has ordered the punch bowl removed when the party was really warming up**." It can be argued that both the ECB and the Fed should realize that the party is already **well beyond the "warming up" phase**.