When Cassandra and Goldilocks wait for Godot

The Bank for International Settlements (BIS) has always played the role of Cassandra, the daughter of the Trojan king in Greek mythology, whose warnings about the fall of Troy lamentably went unheeded. The global bankers' bank has been admonishing policymakers for years about the negative effects of keeping policy rates too low, which has led to a dangerous build-up of global debt and fanned runaway asset prices, among other undesirable effects. But, both policymakers and market players have kept the party going, blithely ignoring the doomsayer's advice. The bank's latest quarterly review continues this fine old tradition.

This time, though, the BIS report agrees that the market rally has as its basis the Goldilocks scenario prevailing across the globe, where the economy is "not too hot, not too cold, but just right". The JP Morgan Global Composite Purchasing Managers' Index for August indicated that the world economy expanded at its fastest pace since early 2015. The recovery was especially strong in Europe, but the US economy has been doing pretty well too, with unemployment in July falling to levels last seen in 2001. Emerging market economies too, in general, have done their bit, with growth in China holding up better than expected.

Yet central banks in the developed economies have been reluctant to raise their policy rates and that has led to the continuation of easy liquidity conditions. Market participants too have become increasingly sceptical about central banks withdrawing the punch bowl in a hurry. That confidence is reflected in the very low volatility in the markets. It has enabled another round of risk-taking, leading to increased flows into equities and to capital flows to emerging markets.

These flows have driven up equity valuations worldwide. Yet the BIS report acknowledges that while stock valuations may appear stretched, they may not be out of line considering the exceptionally low levels of bond yields.

But what is it that is keeping bond yields so low in the developed economies? Why are their central banks so reluctant to raise their policy rates? Simply put, it's the lack of inflation. Despite the recovery in the global economy, inflation has remained remarkably subdued. The Bank of America Merrill Lynch survey of fund managers report defines Goldilocks as "above-trend growth + below-trend inflation". The key to the trajectory of the markets, therefore, lies in the behaviour of inflation.

As Claudio Borio, head of the BIS's monetary and economic committee put so admirably, "This puts a premium on understanding the 'missing inflation' because inflation is the lodestar for central banks. It feels like *Waiting for Godot*. Why has inflation remained so stubbornly low despite economies approaching or surpassing estimates of full employment and unprecedented central bank efforts to push it up? This is the trillion dollar question that will define the global economy's path in the years ahead and determine, in all probability, the future of current policy frameworks. Worryingly, no one really knows the answer."

But while no one knows for sure, there's no dearth of guesses. Economists have advanced a menu of options about what's keeping inflation low, ranging from the impact of an ageing society to technological marvels such as the rise of Amazon, to lower Chinese growth rates, with its effect on commodity prices. Lower oil prices have, of course, had a big impact on headline inflation, but core inflation too has been restrained. The BIS annual report had talked of secular disinflationary pressures associated with globalization and technological pressures, which have together sapped both the bargaining power of labour and the pricing power of firms, making the wage-price spirals of the past less likely. Lael Brainard, a member of the US Federal Reserve's Board of Governors, said in a speech earlier this month that a long period of low inflation has led to lower inflation

expectations and that is what is dragging down core inflation, which is a bit like a dog chasing its tail.

There are other guesses. Perhaps rising inequality is keeping consumption on a leash, while the higher incomes of the top 1% fuel an asset price boom? Others believe it's much ado about nothing and it's only a matter of time before inflation goes up. Recent inflation readings have generally seen upside surprises. Eurozone wage growth has improved. Commodity prices have moved up. This is benign inflation—the result of growth—and even if policy rates are raised the market will take it in its stride.

But haven't we seen this movie already? Before the financial crisis, central bankers in the developed world patted themselves on the back for ushering in The Great Moderation, when their allegedly superior monetary policy skills had banished inflation. Surely the lesson of the financial crisis was that central bankers had been lulled into a false sense of complacency because they did not see any inflation on Main Street, while rampant asset inflation on Wall Street went unnoticed? They may well be making the same error again and this time, another mistake will be catastrophic.

As the BIS annual report warned, "The main cause of the next recession will perhaps resemble more closely that of the latest one—a financial cycle bust."

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