Central bankers reassured after Jackson Hole, but others are not

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Central bankers left their annual conclave at Jackson Hole, Wyoming, reassuring themselves that inflation is coming down and the way is open to start cutting interest rates as demanded by financial markets.

The mood was summed up by the *Financial Times* (FT) in its report on the gathering last weekend at which "something many had considered all but impossible appeared to be in sight." It said that after the worst inflation in four decades, those in attendance were "hopeful they were close to beating the odds and achieving a soft landing for the global economy."

Their objective is a reduction in inflation to their target range of around 2 percent without inducing a recession, or what is not so often spoken of, a major financial crisis.

In an interview with the FT, the chief economist at the International Monetary Fund, Pierre-Olivier Gourinchas, said the share market sell-off at the beginning of the month was a "early taste" of a possible "risk-off" event if present slowing economic growth gave way to a more serious downturn. He said there could be "some volatility" while endorsing the move to lower interest rates.

How far and how fast interest rates might come down, especially in the US, which to a great extent sets the agenda for the rest of the world, has yet to be determined. Federal Reserve chair Jerome Powell insisted that the decisions of the US central bank will be "data dependent."

Some, both within the Fed's governing body and elsewhere, are looking for significant cuts, fearing that recessionary trends in the US may be more advanced than the present data indicate.

The president of the Chicago Fed, Austan Goolsbee, has commented that, with inflation coming down, the maintenance of the rate in the 5.25-5.5 percent range for more than a year means monetary conditions are the tightest they have been in the present cycle.

"You only want to be that tight—if you fear overheating—and this is not what overheating looks like," he told the FT.

Others have been more direct. Steven Blitz of the financial firm TS Lombard said the Fed was paying the price for what he termed its ridiculous policy of data dependence.

"When the bad data shows up, policy is already late," he told the global economics commentator for the London *Telegraph* Ambrose Evans-Pritchard.

"There is a reason sharp downward revisions occur just before or during recessions."

Blitz was referring to the downward revision last week of the growth in US non-farm payroll numbers by 818,000 in the year to last March.

Commenting on the data, Evans-Pritchard said the US economic boom had been overstated and he expected GDP numbers to be revised down as well.

A paper presented to the Jackson Hole gathering presented a different slant on the labour market. Rather than focusing attention on the unemployment rate alone, two economists, Pierpaolo Benigno of the University of Bern and Gauti Eggerston of Brown University, directed attention to the ratio of job vacancies to the number looking for work.

Their research concluded that a fall in this ratio is an indicator of recession and a rise in the jobless rate. Over the past two years the ratio has fallen from around 2 to 1.2 and appears to be on a downward trend.

"Policymakers," they wrote, "face two risks: being too slow to ease policy, potentially causing a 'hard landing' with high unemployment… or cutting rates prematurely, leaving the economy vulnerable" to higher inflation.

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Based on this analysis, they concluded "our current assessment suggests the former risk outweighs the latter."

A shift by the US into recession will have significant global consequences because recessionary trends are becoming ever more apparent internationally. There is already a manufacturing recession in Europe, centred on Germany which is continuing to stagnate.

After the 2008 crisis, China played a key role in providing support for the world economy. That is no longer possible. The growth model based on real estate and construction has collapsed and there are fears that the official target for growth of 5 percent—the lowest for 30 years—may not be met.

China was a source of demand in the years following 2008 because of government stimulus and the expansion of credit. But those measures are not going to be repeated because of government fears about the growth of debt.

Some efforts have been made to stabilise the property and construction sector, which has accounted for up to 30 percent of Chinese GDP in the past, but these are universally regarded as insufficient. According to Capital Economics: "The sums so far are still too small to make a meaningful difference."

The market turmoil at the beginning of August was the result of the combined effect of a higher unemployment rate in the US and an interest rate rise by the Bank of Japan BoJ). The BoJ move hit the so-called carry trade in which cheap yen are borrowed to finance deals in the US market.

According to Evans-Pritchard, while the "August tremor" was probably a false alarm, "there is a non-trivial risk that it may have been picking up real stress in the US economy and the world's dollarized financial system."

He noted that at one point the VIX volatility index—sometimes referred to as Wall Street's "fear gauge"—hit an intraday high of 65 on August 5, something that has only happened before in the crises of 2008 and the March 2020 crisis in the US Treasury market at the start of the Covid pandemic.

Another note of caution was sounded by Raghuram Rajan, a former governor of the Indian central banks and now a professor at the University of Chicago.

At the Jackson Hole meeting of 2005, when he was IMF chief economist, Rajan warned that the easy money policies of Fed chair Alan Greenspan could be creating dangers for the financial system.

He was set upon by all and sundry. Democratic party economics advisor Lawrence Summers led the charge because the theme of the meeting was a celebration of the "maestro" Greenspan before he handed over to Ben Bernanke.

Three years later the US financial system went to the brink of collapse, as Rajan had warned it could.

Writing in the FT on Monday, Rajan pointed to the mood in media and financial circles, saying "few would begrudge the mildly celebratory tone" in Powell's keynote address opening the way for rate cuts—given the predictions of what could have taken place.

However, the body of his comment was devoted to the build-up of debt in the US financial system. He noted that "a number of financial players tried to goose up returns by taking on additional financial risk, leveraged further with borrowing."

This had fuelled the "dash for cash" in March 2020, leading to the Fed's intervention "by expanding money-like reserves hugely and establishing extraordinary lending programs."

The result was that "explicit and implicit financial sector leverage never really came down."

He noted that if the Fed did manage to achieve a "soft landing," this would "prompt further leveraging" leading to a growth in the financial system's debt to cash ratio.

This would raise "the chances of a sharp reaction to any bad news—be it a worrisome turn in the trade wars, a troubling presidential election, or geopolitical tensions."

Consequently, he concluded, "economic stabilisation may, paradoxically, raise the chances of financial instability."

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