Central Banks Are in The Driver's Seat

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During normal times central banks are in the backseat. Their role is to maintain price stability by monitoring inflation. Which keeps a countries currency at a fair value relative to other countries. This stability allows businesses and individuals to make long term decisions. Whether buying a house, hiring new employees, investing in a business etc. They are, under normal circumstances, observers, letting the invisible hand do its work while allowing the thousands of individual economic decisions made by the business community to play out, for good or ill.

But sometimes that invisible hand loses its grip and central banks, usually in conjunction with the Department of Finance, needs to show leadership. When the world succumbs to fear or greed and rational thought has suffered a hit and run the bank needs to step up to assume a more active, parental role. There have been many occasions in the past where this oversight has been necessary. The emerging markets debt crisis of the 1990s-culminating in the default of Russia and then Argentina, the market bubble of 2000, the Great Recession of 2008, the recent pandemic are all examples of when the central banks, the World Bank, the IMF and US Treasury helped navigate, relatively successfully, events that were beyond the control of the markets to correct on their own.

The Great Depression was the training ground for monetary policy. It demonstrated what worked and what not to do. And They have done a decent job with unprecedented wealth creation since then. So, using historical lessons as guide central banks are raising interest rates so inflation doesn't become entrenched. I have discussed this previously so won't go into details here, but the point is our current inflation is being caused by the very loose monetary and fiscal policies that were necessary during the pandemic.

What happens now? Policymakers have become increasingly hawkish about raising rates in the last few months. With expectations now being that interest rates will peak at 4.5-5 percent. This type of rapid rise means all assets need to be repriced. This has been painful with some economically sensitive companies share prices dropping 40+ percent and more speculative assets dropping even more. House prices are falling and will continue to do so. Commodities such as oil is now under 80 dollars a barrel, lumber is down 75 percent from its peak, and even natural gas is down 25 percent recently. Shipping rates from China to the US west coast are down 70 percent to more normalized levels.

Now, we need to see employment, usually a lagging indicator, come off its red-hot levels. Once that happens the central banks will be able to close the books on this episode of being in the driver's seat and let the invisible hand resume its role in business decision making. A slowing economy and rising interest rates are never pleasant but removing excesses in a timely, transparent way now will set us up for continued economic prosperity in the future. The headline news will be trumpeting negative stories for the next few months-such as falling earnings, higher unemployment- and there will be more volatility but this monetary medicine we are swallowing today will get us motoring forward again soon. Yes, we have come to a speed bump, but we will be back to open roads again.

Unless there is a nuclear war, or a malignant AI takes over, or an engineered virus is released or……