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Credit Suisse Economics

Global Money Dispatch

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We need a Volcker moment…

…a Volcker moment, where Vol stands for "vol" – as in volatility.

The FOMC has one big problem: inflation. There are two ways to slow inflation: by hiking short-term interest rates or by forcing long-term interest rates higher.

Historically, the Fed used rate hikes to engineer recessions that generated the slack needed to keep inflation in check ("opportunistic disinflation"). With the Fed's "updated dual mandate" of inclusive low unemployment and the political imperative of redistribution through firmer wage growth at the bottom of the income distribution, the Fed aiming to slow inflation via a recession is unimaginable. Hikes today then are meant to slow inflation without a recession…

…which is not something that the Fed has ever managed to achieved before.

Don't envy the Fed: the inflation picture is complex. Goods prices were a steady source of disinflation for the past two decades, which gave the Fed precious time and cover to figure out what to do with policy rates to control services inflation.

Not today. Goods inflation is now a tailwind, not a headwind. Your correspondent is no expert on goods price inflation, but he reads the papers enough to sense that with supply chain and distribution bottlenecks everywhere, goods inflation won't disappear (slow maybe; disappear no). What used to give the Fed cover now exposes it: goods price inflation is a problem *now*, and at the same time services inflation is an issue too. There is no cover; "we need to fix this yesterday".

The leadership of the FOMC knows what they can and cannot control…

They understand that they have no control over goods prices unless they curb demand through a recession – which given their updated mandate isn't an option. But they also know that they have a lot of control over services inflation – which, unlike goods inflation, is mainly a function of domestic nominal factors.

The two big components of services inflation are OER and all other services. The former is a function of house prices, the latter is a function of labor supply. Both respond to financial conditions, and financial conditions are driven by long-term interest rates (term premia) and less so by short-term interest rates.

The large number of hikes the market has priced and the Fed implicitly sanctioned has had little impact on long-term interest rates, mortgage rates, or equities to date.

Don't get us wrong – there's been *some* impact, but not enough. More is needed. To slow OER inflation, mortgage rates need to get higher and house prices flat or outright lower. To slow all other services – driven by a shortage of labor –

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we need more supply of labor, not less demand for it through a recession. Again, inclusive low unemployment is a political imperative and, by extension, so is redistribution via stronger wage growth. If we agree on that, what follows is that we need to slow services inflation by slowing, not killing, wage growth, by bringing about more supply of labor, not less demand for it via a recession.

Maybe to increase labor supply, we need lower asset prices…

Just as your correspondent is not an expert on inflation, neither is he an expert on labor matters, but growing up in Hungary, his common sense whispers that if the post-Communist government response of generous transfer payments and early retirement sapped labor force participation and hurt the real growth prospects of Hungary and other economies, the capitalist market response to low interest rates and QE through sky-high equity valuations, house prices, and the rise of Bitcoin probably does the same: if the young feeling Bitcoin-rich are less inclined to work and the old feeling mass affluent are eager to retire early, labor force participation drops to the detriment of real growth prospects. If early retirement wasn't good for Hungary, it won't be good for the U.S. either.

Maybe the path to slower services inflation – OER and all other services – is through lower asset prices. We recognize that what we are saying is extreme, but we think the Fed will soon incorporate some version of this thought process.

It wasn't tried before, but what was tried before, the Fed cannot do anymore due to the political imperatives of inclusive low unemployment and redistribution.

Hence the need for a Volcker moment.

Volatility is the best policeman of risk appetite and risk assets. To improve labor supply, the Fed might try to put volatility in its service to engineer a correction in house prices and risk assets – equities, credit, and Bitcoin too…

Legendary central bankers like Paul Volcker or Mario Draghi either sparked or tamed volatility: Draghi tamed volatility with his bumblebee-themed speech, and Volcker sparked volatility by starting to target quantities instead of rates, and he didn't talk too much about what he was doing – he kept the market guessing.

Maybe the Fed should hike 50 bps in March, put an end to press conferences, and sell $50 billion of 10-year notes the next day… Maybe FOMC members talk too much. They don't keep the market guessing. They suppress volatility…

A new Volcker moment should also mean a radical change in the Fed's strategy and involve going from targeting rates to targeting quantities once again – not the quantity of reserves in the banking system, but the quantity of duration in the market-based shadow banking system to jolt all sorts of risk premia higher.

No, lower risk assets won't kill growth. This is not a balance sheet recovery, and no, higher mortgage rates won't kill growth either – wage growth at 5% can absorb higher monthly payments. The curve is flat and borderline inverted, and delivering slope into it can come from higher term premia engineered by the Fed, not only rate cuts as the "policy-mistake-in-the-making" crowd would have it…

The Volcker moment is the eighth channel of QT (from passive to active QT), and today's Dispatch is the eleventh in a series exploring QT, and an eleventh hour appeal to market participants to start thinking about QT in a macro (active vs. passive), not just a micro (beautiful, ugly, or whiplash) sense…

The decisions of central bankers are always redistributive. For decades, redistribution went from labor to capital. Maybe it's time to go the other way next.

What to curb? Wage growth? Or stock prices? What would Paul Volcker do?

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