On monetary policy and financial markets

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The recent rapid turnarounds in global markets have come on the back of attempts by central banks to combat the problems of inflation and repressed economic activity using the tool of interest rates

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Global financial markets may be exhibiting recovery following the dramatic falls in value, but the global economy is still in uncharted waters. Employment generation in the U.S. has been weaker than expected, threatening the fragile post-pandemic recovery. The Bank of Japan's decision to raise interest rates after years of keeping them low has also rattled financial markets, setting off a reversal of equity flows and a collapse in Asian markets.

These rapid turnarounds have come on the back of attempts by central banks to combat the problems of inflation and repressed economic activity using the tool of interest rates. What the current situation indicates is the difficulty in implementing monetary policy in the presence of global financial markets, where expectations display heightened volatility and large-scale drops in asset values can occur much faster than the ability of policy-makers to respond.

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Was there a threat of recession?

The current consensus regarding monetary policy is to assume a trade-off between unemployment and inflation. Central banks raise interest rates as inflation rises, reducing investment and hence slowing aggregate demand. This leads to a reduction in the demand for labour, reducing the ability of wage-earners to push for higher wages, and ease inflationary pressures.

There is, of course, a lot to debate regarding the proper conduct of monetary policy. Several have criticised the normal conduct of monetary policy, stressing that solving inflation by increasing unemployment represents an unfair burden being placed on workers everywhere, who are already grappling with a cost-of-living crisis. Instead, they argue, inflation could be better tamed by forcing companies to reduce their profit margins and by breaking monopolies.

Let us accept the current consensus regarding the conduct of monetary policy. The release of a jobs report that showed a less-than-expected increase in employment led to fears of a recession, and caused a rapid sell-off of equity stocks. This, coupled with concerns regarding the less-than-expected performance of big tech giants, led to a rout in the stock markets.

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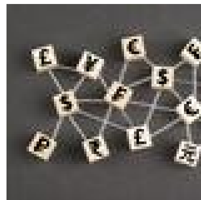

What is of note is that the economy wasn’t actually in a recession, the market just expected one to occur. The rise in unemployment rates triggered the “Sahm rule” which mandates the automatic disbursal of unemployment checks to households when the increase in unemployment rates breaches a certain threshold. This measure is not an indicator that the economy has entered recession, but is correlated with one. However, correlation does not always indicate certainty; the economy may be displaying the potential for recession, but the threat of a future recession was enough to spark fear amongst investors.

This indicates one of the problems of conducting monetary policy in the presence of a strong financial sector. The gradual reduction of inflation was being held as proof of the successful conduct of monetary policy. Less-than-expected performance in terms of employment creation in one quarter alone has caused financial markets to react and respond at a pace that is too fast for policy-makers to deal with. The market has acted on the expectation that a recession will occur without the economy ever being in one.

The carry trade

On the other side of the world, Asian markets were rattled by the increase in interest rates by the Japanese Central Bank following long periods of low rates. A long period of economic slowdown in Japan has led to central banks keeping interest rates at levels close to 0. Low Japanese interest rates have led to what is known as the “carry trade”, where foreign investors take advantage of low rates to borrow from Japan and invest in foreign markets. The increase in interest rates caused a disruption in this form of trade, leading to investors selling stocks in other markets to deal with higher borrowing costs. This, it has been said, has added to selling pressures in other markets.

This represents an added complication for policy. Low interest rates in Japan to combat a decades-long slowdown indirectly subsidised the activities of foreign capital. Domestic policy imperatives of certain economies exercise undue effects on other economies through the action of global finance.

This is not the first time the actions of global finance caused difficulties for domestic policy in other countries. Interest rates in the U.S. were low following the great recession in 2008. This led to investors borrowing at cheap rates in the U.S. and investing in other markets like India. As interest rates in the U.S. rose following a resumption of growth, capital flew out from India, leading to pressure on its external account: this was called “taper tantrum”.

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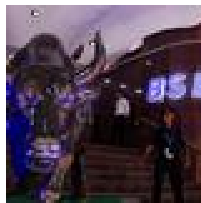

Monetary policy in financial markets

Financial markets have shown signs of recovery following these intense bouts of selling pressure, with many claiming that threats of recession are overblown, even though vulnerabilities remain. But these incidents highlight the potentially destabilising nature of finance. The speed with which financial assets can be bought and sold and the ease at which national borders can be traversed, represents burdens upon the normal conduct of monetary policy. As Keynes once said, “When the capital development of a country becomes a by-product of a casino, the job is likely to be ill-done.”

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