FINANCIAL REVIEW IN ASSOCIATION WITH Deloitte.
Retail Summit 1–2 November 2017 Intercontinental Sydney
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Global markets complacent over inflation risks: Stevens

Former RBA governor Glenn Stevens. **Louie Douvis**

by **Jonathan Shapiro**

Former Reserve Bank of Australia governor Glenn Stevens says global investors have become complacent about the risks of a sharp rise in inflation that would have "considerable implications" for financial markets.

An unexpected pick-up in inflation measures could see "markets flip from their current scepticism" that central banks couldn't hit their targets "to worries about them being exceeded", Mr Stevens said, his first major comments on financial markets and the global economy since retiring from the central bank a year ago,

In commentary published this week for Ellerston Capital, the hedge fund he advises, Mr Stevens said while inflation would not return to the "bad old days" of the 1970s, it was remarkable "how little compensation" investors were accepting for the risk of inflation being much higher.

The former governor's comments come as the major global economies are experiencing a synchronised growth upswing while jobless rates have fallen to historically low levels.

In Australia, the unemployment rate fell yesterday to 5.5 per cent from 5.6 per cent in August, marking the longest run of consecutive monthly job gains since 1994. Investors downplayed prospects of any near term interest rate hike by the Reserve

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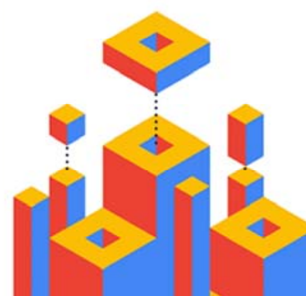

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Bank of Australia, despite the fact that the jobless rate is closing on the 5 per cent level it counts as "full employment".

At present, traders don't anticipate the RBA will lift interest rates until the second half of 2018.

The US appears to be "more or less fully employed" while jobless claims are at their lowest levels since the 1970s in absolute terms, Mr Stevens said.

Chinese economy

The Chinese economy has also continued to defy the sceptics. The world's second largest economy grew by 6.8 per cent in the year to the September quarter, according to figures released yesterday, as industrial profits showed their strongest growth in nearly five years.

Mr Stevens noted that the "upswing in the US economy had now lasted more than 100 months, and is the longest since business cycle records have been kept.

Yet despite a sustained global recovery and job creation measures inflation had remained stubbornly low, perplexing and frustrating policymakers that have responded by maintaining "accommodative policies".

"Central bankers, for their part, would welcome a bit more inflation – that has been their avowed aim. Thus far, however, market pricing seems to embody doubts that they will be successful."

Central banks, Mr Stevens said, would be in a "rather difficult position" if there was an unexpected pick up in prices. Their dilemma, he said, would be deciding whether to "tighten faster to 'catch up'" to retain hard-fought credibility as inflation fighters, or cede to "market-led tightening in financial conditions slowing growth".

Mr Stevens said that even though central banks, mindful of the vulnerabilities of higher debt, would attempt to raise interest rates gradually, tightening episodes tended to result in "upsets and volatility".

There was also the possibility that some borrowers "would get into trouble as financing costs rise, even if gradually".

Mr Stevens' comments are broadly consistent with Ellerston Capital's macro hedge fund which is positioned for a rise in global bond rates. In September, it revealed that Mr Stevens had taken an advisory role at the fund, which was set up by former Tudor Investments trader Brett Gillespie.

The RBA also appears concerned about investor complacency, as measured by low risk premia. The central bank wrote in its Financial Stability Review this month that "some investors may be underestimating the downside risks they face".

"This could lead to a further build-up of risks and could also increase the likelihood that an adverse shock would lead to a sharp and disruptive correction in asset prices."

The Reserve Bank referred in a chart to the negative "term premium" of the US 10 year bond, which implies bond investors were demanding no additional return for the risk of higher than expected moves in bond rates over a decade.

The causes of low inflation have been the subject of confusion and intense debate. Some prominent economists have argued that structural changes such as globalisation, new technology and even new business models such as Amazon's push for retail ubiquity, had contributed to persistently low inflation.

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Cyclical spare capacity

These were "important points" Mr Stevens said, but he said a "moderate upswing" after the deep downturn of the financial crisis meant that "good old-fashioned cyclical spare capacity" has been at work, even if it had been an unusually long period. And he said that while there was "fashionable talk" about a broken Philips Curve (which posits that inflation rises as unemployment falls), "those relationships were never that tight."

Mr Stevens also argued that "policy regimes matter" and in an age where governments and central banks have taken a bigger role in managing economies, the prospect of deflation was politically unpalatable. Even if structural forces, such as Amazon, would force prices lower, central banks still controlled the money supply.

"We are still in a fiat money world, and in a world of democratic politics that would find it excruciatingly difficult to deal with a situation in which nominal incomes persistently fell."

"If one thinks that institutional arrangements and so on matter, then it is hard to believe that we have seen the death of inflation."

It was possible that "financial excesses will ultimately cause the demise of the current expansion, and that is the direction in which most official radars are trained" Mr Stevens said.

But he said as the global economy moves out of the shadows of the crisis, "conventional cyclical factors" could come into play, particularly if US President Donald Trump can persuade Congress to enact his proposed widespread tax cuts..

"Expansionary US fiscal policy, tightening US monetary policy: that would be something we have seen before, with considerable implications for interest rates and currencies."

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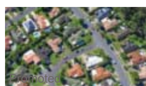
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