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# A (policy) bridge over troubled water or a bridge too far?

Well, if it had not provided enough drama already, 2020 gave as a fitting full stop: abbreviated family Christmas gatherings, underwhelming Near Year's Eve celebrations and the unusual spectacle of a sparse MCG crowd on Boxing Day.

However, financial markets reflected a capacity to see a silver lining in the COVID cloud with equity markets ending the year at or close historic highs. For some that presages better times ahead for 2021. In its preview of 2021, the Economist Magazine notes that the number 21 is connected with luck, risk, taking chances and rolling the dice. While I certainly hope that the association of that number with luck is borne out, the journey poses several challenges.

Central bankers acted aggressively and early in attempting to mitigate the consequences of the pandemic. At the same time, however, it is clear that there has been an excessive reliance on monetary policy and the consequences of that excessive reliance are becoming more manifest and problematically so.

In this sense monetary policy can be thought to have built a rickety bridge. The hope is that fiscal policy can build a sturdier bridge of sufficient magnitude to take the global economy over troubled waters, from which point the widespread dissemination of a vaccine can return the global economy to some semblance of normality.

Central bankers from Powell to Lagarde to Lowe have led the charge in urging on their respective countries' elected representatives a greater role for fiscal policy.

Excessive reliance on monetary policy has led to a seeming disconnect between financial markets and the real economy (the bifurcation between Wall Street and Main Street). It was important for monetary policy to stabilise markets and encourage their smooth functioning in order to forestall rolling liquidity induced crises. And while that may have mitigated the economic fallout it is hard to escape the conclusion that monetary policy is increasingly impotent in addressing the real economic concerns that are the focus of Main Street.

Put simply, ever increasing liquidity has led to an inflation of financial asset prices without discernible increases in spending (a decline in the 'velocity of money'). One of the more obvious consequences of that approach has been an exacerbation of wealth inequality. Adverse distributional outcomes can be avoided with well-crafted fiscal policy.

There are other costs associated with extremely accommodating monetary policy. The 'moral hazard' consequences of current policy settings may manifest themselves in various guises. The most obvious is the encouragement of excessive risk-taking that ultimately engender financial stability risks.

However, there are subtler dimensions. Risk markets have become addicted to the drug of central bank liquidity. Risk market pricing is now set by virtual central bank 'liquidity fiat' rather than any 'fundamentals' reflecting the current or prospective performance of the economy (the bifurcation between Wall Street and Main Street again).

Put another way, central banks have been drawn into adopting a policy aimed at directly supporting financial markets, but not the conditions for their organic growth. Markets work only if the adverse consequences of unbridled and undisciplined risk-taking are visited on their practitioners. The 'moral hazard' consequences of the 'central bank put' and attendant easy liquidity will be difficult to shake. Easy liquidity debilitates future economic performance by allowing 'zombie' companies to persist, ultimately delaying necessary economic adjustment. In this way it might ultimately lower the economy's growth path by inhibiting its productivity, flexibility and dynamism.

Despite extremely accommodating monetary policy, markets appear to have become inured to the notion that there is any prospect of inflation on the horizon. And yes, maybe it is difficult to get worked up about inflation in the next year or two. Other challenges appear more pressing. However, inflation risk is highest precisely when low-inflation conviction is the strongest and that view has become entrenched in intellectual and policy frameworks.

The reversal of the two great structural trends that account for the deflationary tendency of the past three decades: viz; globalisation of labour supply (as well as that for goods and services) and baby boomer workforce participation, are on the cusp of reversing. Those developments accounted for a decline in wage growth and a structural deflationary trend on a global scale. That is now coming to an end. Potentially exacerbating these emerging structural inflation concerns is a process of deglobalisation and re-regulation. A 25% hike in Uber prices in Seattle on January 1 after that city's minimum wage laws illustrates the impact of regulatory imposts.

In 2020 it was clear that macro-policy in general and fiscal policy in particular have a role to play in countering sudden and severe economic dislocation. However, there needs to be caution in over-interpreting the ability of the authorities to counter-cyclically 'fine-tune' with macro policy and be mindful of its limitations. Policymakers need to pursue policies aimed at maximising the operational flexibility of goods and labour markets and resist the siren call of protectionist measures.

In the Australian context, Governor Lowe has urged movement on IR, responsible lending laws, digital initiatives in the payments area, health and government service delivery and infrastructure. In other words, micro or supply-side reforms are always important. The more dynamic and flexible an economy is, the better and quicker it recovers from negative economic shocks.

So, let us hope that the number 21 lives up to its billing as the harbinger of luck, and that the bridge is successfully crossed. However, the chances of doing so are better if markets and policymakers are mindful of the potential navigation hazards. And they are many!

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