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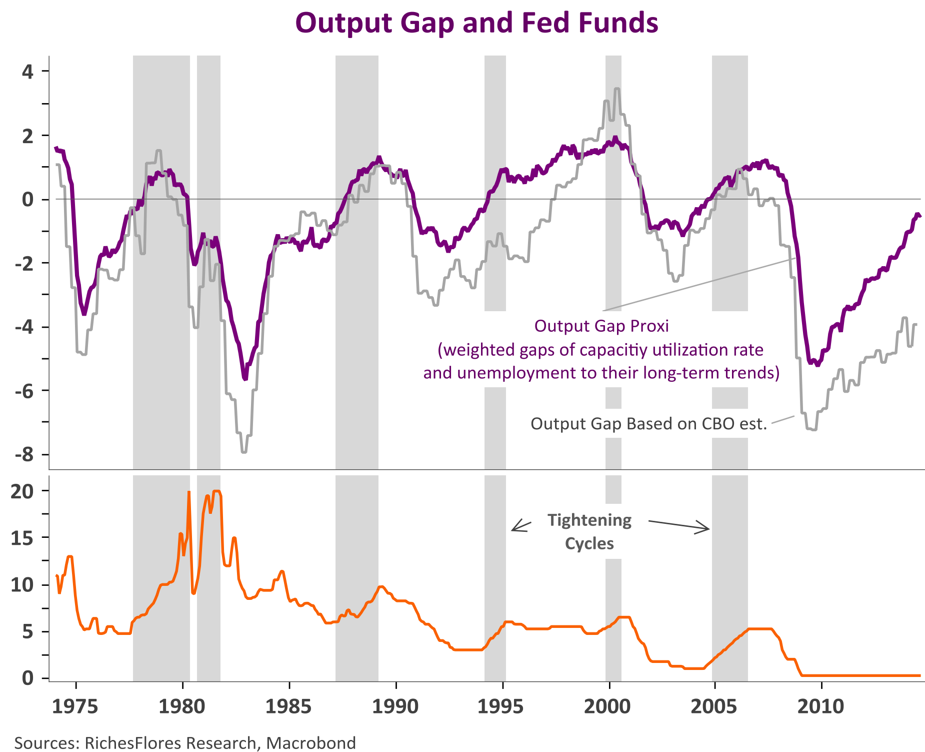
Are Ms Yellen and Mr. Draghi overstepping their boundaries?

Considering Janet Yellen's comments on poverty and inequality or Mario Draghi's talk of needing to stimulate demand, the messages from central bankers these days have shifted considerably. Against vastly different backdrops, the new posture by the monetary chiefs on both sides of the Atlantic raises a number of questions.

Is Ms. Yellen fighting the wrong fight?

Exclusion, poverty, inequality…Janet Yellen is by turns pioneering, surprising and, more often than not, befuddling. Is she out of line? Are these topics really within the remit of any central bank? Does monetary policy risk being poorly adjusted to the business cycle as a result of such inappropriate considerations?

One thing is for sure: It is hardly standard operating procedure for the Fed chairman to give such importance to the social aspects of the U.S. economy. And yet, during this week's FOMC meeting, Ms. Yellen will probably discuss these topics again in an increasingly desperate attempt to ward off investors' attempts to discern whether or not a rate hike is in the offing and to prevent long-term interest rates from soaring. If our analysis is correct and judging by the predominant sentiment on the market in recent days, many observers could be wrong-footed and could challenge the wisdom of her strategy. The "traditional" indicators do indeed point to a need to begin a rate hike cycle: With unemployment nearing 6% of the active population and an industrial capacity utilization rate very nearly at its long-term average, our synthetic indicator for the resource utilization rate has returned to levels that, in the past, have coincided with the beginning of a round of monetary tightening.



Sources: RichesFlores Research, Macrobond

Is poverty an appropriate variable to be used by central banks?

That said, given the fact that rising poverty, social exclusion and inequality erodes the U.S. economy's growth potential, Janet Yellen's approach – even if it is atypical – is fully justified:

1. Deteriorating U.S. economic growth potential means the Fed is failing to deliver on the first part of its dual mandate (i.e. full employment and inflation).

2. Her analysis of the U.S. economy's ability to cope with an increase in the cost of money is inextricably dependent on her analysis of the change in the economy's growth potential.

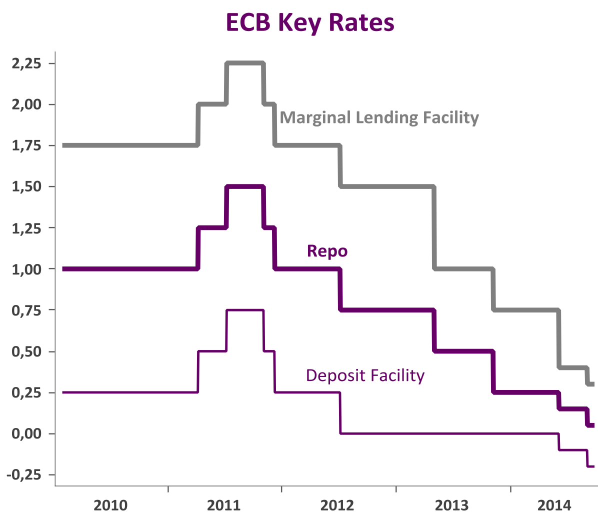
Certain findings in a paper published in September by the Fed on Changes in U.S. Family Finances from 2010 to 2013 illustrate the extent to which the widening wealth gap affected the economy's growth potential by denying large swaths of the population access to homeownership, savings and consumption. The difference between rich and poor has also shrunk jobs potential as families in the bottom income group (i.e. <50th percentile) saw the value of their business equity holdings fall by nearly 40%.

The Fed is therefore right to talk about social difficulties insofar as they determine future growth. Overlooking them would risk overplaying the strength of the current recovery and increasing rates too quickly. Given this, broadening its monetary policy dashboard to indicators that provide a clearer picture of the depth of the jobs recovery and social exclusion seems both justified and necessary.

Of course, there are pitfalls in doing so, Janet Yellen must be convincing in arguing that this approach, given that it is a break with the past, has legs to stand on. Another risk would be to under-estimate the inflationary effects should future growth increase markedly – especially since growth potential appears relatively weak at present. Weighing the current risks however, there can be no doubt: It is far riskier to raise rates too soon rather than too slowly.

Has Mr. Draghi crossed the Rubicon?

Mr. Draghi has made his shift in posture against an entirely different backdrop. Its main thrust was not to adjust the ECB's capacity to respond, which seems to have run out of means of action but to improve the coherence of the policy mix – without which ECB initiatives, even the most extreme, would be doomed to failure.



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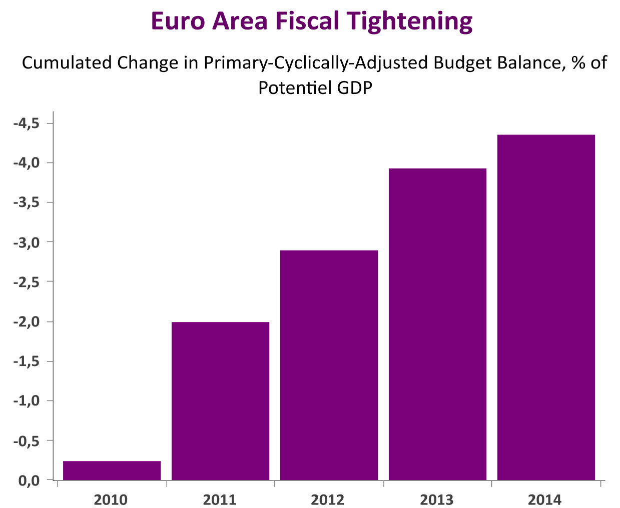

Sources: RichesFlores Research, Macrobond

By calling on governments to enact policies to stimulate demand and to use fiscal room for maneuver "whenever it exists" and to "set up a major European-wide investment program", as he outlined in his speech in Jackson Hole (see xxx) Mr. Draghi went a good deal further, delightfully stepping on the toes of countries' fiscal and tax policies as well as the European Commission's strategy. What should be made of such an intransigent statement? Was the ECB president laying the groundwork and making gains ahead of his remarks or was he prodding Europe into action? Mr. Draghi sees Europe as being too stiff but the ECB's credibility is, of course, entirely dependent on the support of currency union members. It is difficult to know what to make of the remarks given the

lack of response to them. However, accounting for the virulence of his remarks we must conclude that Mr. Draghi has indeed crossed the Rubicon. It would be complicated to turn back: all indicators point to the situation getting worse in the euro area in terms of growth and deflation.

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