THE DAILY CHECK-IN WITH GOLDMAN SACHS

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Liz Bowyer: Hi Gurpreet.

Gurpreet Gill: Hey, Liz.

Liz Bowyer: You're a Macro Strategist on the Fixed Income team of our Asset Management Division. And you've written recently about the policy regime shifts at central banks around the world. Tell us what you mean by that.

Gurpreet Gill: So, what we've seen in recent years is an evolution in macro policymaking with greater regard for environmental and social issues. And the Bank of England is actually a useful case study for this change in banking. And at the turn on the country in 2000, the governor at the time, Mervyn King, said that the goal for central banks is to be boring and focus primarily on stable prices. And then if you fast forward 15 years, in 2015, the governor at the time, Mark Carney, became one of the first central bankers to really vocalize the impact of climate change and policies to mitigate climate change on central bank objectives.

And this year, the Bank of England has now included climate change in its policy remit. So, a few years ago this may have seemed quite radical. But now it's actually uncommon not to hear central bank officials talk about climate change.

And the Bank of International Settlements, for example, which is the central bank for central banks noted that back in 2018 only four central bank governors were talking about green finance. But last year, that number had increased to 13. And this is really consistent with what we're seeing in broader society in that climate change and social issues are moving up the agenda for governments on the fiscal policy fund, and but also for corporates and the private sector more broadly.

Liz Bowyer: So, what are some of the specific actions that central banks can take on issues like climate change?

Gurpreet Gill: Yeah, there's a spectrum of potential actions. And they range from protective risk management to more proactive corrections of market failures. And on the protective side, this includes mandating greater disclosure of climate risks within the financial sector. I mean, the ECB, for example, conducted a survey of 125 banks earlier this year. And it found only 3 percent of those banks could make the necessary disclosures on every climate risk category. And so, there's still progress to be made.

And another measure which central banks like the Bank of England, the Bank of Canada, but also the ECB are already engaged in is to conduct climate stress tests and scenario analyses to evaluate what's the effect of climate change and the transition to a low carbon economy on the financial sector.

And then on the more proactive side, some central banks have noted that bank capital requirements could vary according to climate risks, while others go even further to state that asset purchases as part of QE programs could vary according to the environmental profile of an issuance. So, departing from a concept know as market neutrality.

And in fact, some central banks have already acted on that front. Last year, Sweden's Riksbank stated that it will only purchase corporate bonds according to the sustainability profile of a corporate issuer. And climate change is also expected to be a prominent feature of the ECB's strategy review. The findings of which we're going to receive later this year. And so, it'll be interesting to see what actions they take.

Liz Bowyer: You also mentioned inequality. What are some of the actions that you see central banks taking in that area?

Gurpreet Gill: Yeah, and here the US appears to be leading the way. Last July, President Biden delivered a speech in which he said that the Fed should target persistent racial gaps in jobs, wages, and wealth, in addition to their maximum employment and stable prices goals. And then a month later, the Fed unveiled its new policy framework and it redefined maximum employment as a broad based and inclusive goal.

And what this means is that the Fed is now going to be taking into consideration economic outcomes from many dimensions. And that includes by race, by gender, by age, income, and educational attainment.

Liz Bowyer: And do you see any differences among the central banks in terms of their perspectives on these issues or the actions that they're willing to take?

Gurpreet Gill: Yeah, definitely. There are divided opinions both on what the role of central banks should be in addressing the climate transition and what their role is when it comes to promoting more inclusive growth. When it comes to climate change, some central bankers caution that it's not their responsibility to correct market failures. And they note that negative screens when it comes to quantitative easing could constrain an already modest investment universe. And then some also note that if you were to attach capital requirements to climate risks, and those risks don't unfold until over the longer term, that could conflict with a short-term policy stance.

And then when it comes to social issues, policy makers generally do acknowledge that easy monetary policies can help to narrow earnings gaps by pulling more people into employment. But at the same time, easy policy could widen wealth gaps. And let's take the US for example. Data shows that the median Black household does not typically have stock holdings. They do not own property. And so, the price appreciation that we tend to see in response to easy monetary policies typically bypasses the median Black household.

Liz Bowyer: And what about critics who might say that central banks, which of course are known for their independence, are veering out of their appropriate lanes when it comes to addressing issues like these?

Gurpreet Gill: That's an interesting question and it's led some policy makers to warn off mission creep. But I think it's noteworthy that in January, ECB President Christine Lagarde addressed that criticism head on. And what she said was that it is not mission creep, it's simply acknowledging reality. And it seems like she's not alone in that view. The Network for Greening the Financial System, which is a consortium of central banks that was set up to support Paris climate goals, that consortium has seen its membership double over the past two years. And in December the Fed actually joined the club.

And what we would say is that this is new territory for central banks. And this past year, we've learned that economic models could have to interact with epidemiological models, and not operate in silos. And the same is going to apply to the climate transition. Central banks are going to have to partner with climate scientists to model and to understand the economic and the financial stability consequences of climate events.

And overall, we would say that central banks are going to play a role when it comes to these challenges. But they won't be the only policy player in town. Global challenges like climate change and inequality are immense. And they, therefore, require a holistic policy approach.

Liz Bowyer: And Gurpreet, from your seat on the Fixed Income team, how do you think that this policy shift among central banks might affect the overall investment landscape?

Gurpreet Gill: When it comes to social issues, one main potential implication is dovish central bank policies for longer. Now when it comes to the Fed's new employment goal, we don't have a barometer for all of the indicators that the Fed is now monitoring. It's no longer as straightforward as looking at where is the economy-wide unemployment rate relative to an estimate of full employment. And one measure that Fed officials often quote is the gap in unemployment rates between Black workers and white workers. And in August 2019, that gap had narrowed to its lowest level on record. And it was 1.8 percent. But just for context, in March, that stood at 4.2 percent.

And then on the climate front, we think central bank focus here is just going to be an added impetus for climate-related risks being priced into the financial system. And when investing in corporate bond markets, for example, we could see that broader adoption of green quantitative easing could accentuate the valuation differences that you see based on the environmental or the sustainability profile of a corporate bond issuer. That's somewhat analogous to what we saw between QE eligible and QE ineligible bonds when central banks first embarked upon quantitative easing.

Liz Bowyer: Well, finally a question on many investors' minds is when the Fed will start to hike rates. From the perspective of the asset management division, when do you think we'll see signs that the Fed is beginning to roll back its easing policies?

Gurpreet Gill: Yeah, well, in the spirit of today's discussion, Fed Chairman Powell recently said that the pandemic downturn had had a disproportionate impact on low income and minority communities. And at the same time, he said that the recovery has been slower for those communities. And then at their latest Fed meeting, eh noted that many of the near term inflationary impulses that we're going to observe will likely be transitory. So, taken together, we think that at this juncture, Fed officials still need to see substantial progress on both the inflation and the labor market mandate. And so, we think rate hikes are a distant prospect. But we do see potential for the Fed to start talking about tapering asset purchases this summer, especially if we continue to see economic data come in positively.

And then we would expect tapered asset purchases at the turn of the year. But of course, this outlook is subject to what happens on the fiscal front and how the economic recovery evolves.

Liz Bowyer: Thanks, Gurpreet.

Gurpreet Gill: Thanks, Liz.