Monetary policy has become hard to swallow

By Catherine Macaulay

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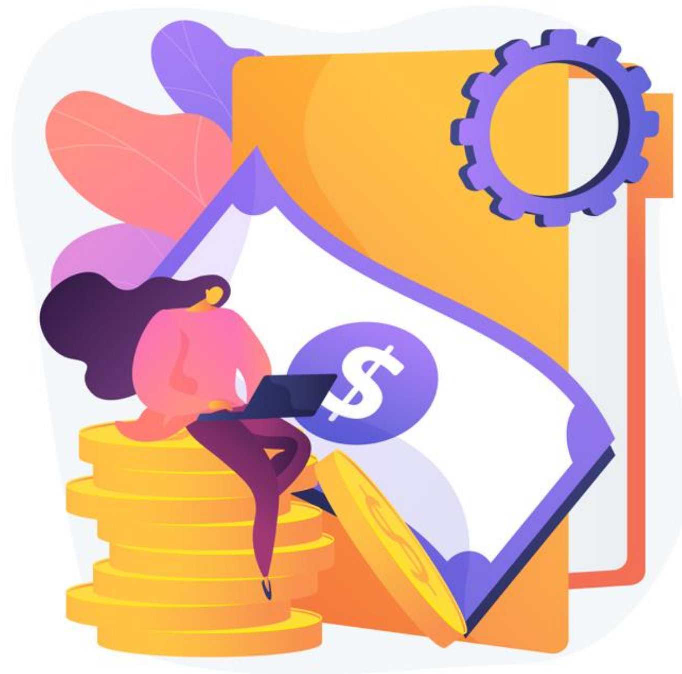
From telling lies to making cakes or setting interest rates, adding layers to solve problems can produce a sticky mess. And oh! what a tangled web we weave when we add layers to monetary policy.



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Monetary policy is changing.

Change can indicate healthy flexibility or just that nothing is settled. That's where monetary policy sits now. Central banks continue debating which inflation index is best: consumer price or personal consumption? Then, is it headline, core, sticky or flexible? And, do annual updates to the basket of goods reflect reactions to inflation, not inflation itself? QE was in, then out, as was interest rate 'forward guidance' when it proved misleading. Even the 2% inflation target, more intuitive than rigorous, is now unsettled.

Another change is central bankers' disturbing admission that unemployment is being sought as a 'solution' to inflation. In an age of wage stagnation, economists are now so afraid of inflation driven by a wage price spiral that central Bank governors in Australia, the UK and the US have all declared a need to avoid large pay rises for workers. Until recently, US Fed Chairman Volker was the hero who crushed inflation, not the banker who killed employment and the economy. If a well-functioning economy means full employment, it's clearly secondary to the goal of 2% inflation.

Are our goals sound?

Inflation may be our target, but we don't know this enemy well.

Establishing a single rate of inflation for all geographic and social groups is a generalisation as bad as homo economicus. Supply chain issues, changes in demand following technological advancement, and the loss of confidence in a currency are different economic phenomenon that can drive inflation, deflation, and hyperinflation respectively. Nuance is needed. Lumping inflation in goods and services together masks major differences and macroeconomics has until now largely overlooked the obvious problem of inflation caused by opportunistic price rises.

Chasing an inexact goal with badly measured ingredients that interact in ways we don't fully understand is analogous to making a cake using measurements in handfuls and no picture of the desired outcome. We keep changing ingredients when things don't seem right, then shoving it into the oven. If there's any indigestion, we can say we've followed recognised principles, and everyone is doing the same. But it's obvious nobody is really happy with the process.

Has anything worked better in the past?

From the mid 1970s, Germany's Bundesbank rates never reached the extreme US levels that Chairman Volker set in response to the 1978-9 oil price shocks. A temporary supply problem flowed through Germany's economy, but interest rate pressure wasn't added to that, and Germany avoided a deep recession. Moderation kept things more stable.

Economic moderation has a proven history over centuries. Debate over usury levels in 17th century England moved interest rates from 8% in 1624, to 5% in 1713, where they stayed until usury laws were abolished. The Bank of England's borrowing rate was soon fixed at 5% for a century, a policy that supported the Industrial Revolution. Entrepreneurs had the certainty they required, and a cost of capital that permitted innovation. Rate volatility only began with stock market de-regulation in 1825, which brought financial instability and the end of Britain's status as 'First Industrial Nation'. The setand-forget approach to interest rates was more stable and productive.

Could we take a new direction?

We're beginning to question the uncertain presumption that lower interest rates stimulate growth. But studies indicating the economic harm of prolonged low rates overlook changing rates as a separate problem itself, something that hasn't yet caught the attention of researchers. Has the concept of interest rate stability been ignored because it is old and simple, or because nobody believes in learning from early economic history?

Any central bank can adopt a new approach. The Reserve Bank of New Zealand originated the concept of 2% inflation targeting in the 1980s, aiming to reduce inflation to a number they 'could live with'. Why follow the Fed, especially when they doubt their own approach?

Simplifying all inflation as a matter of greater demand than supply has led to the clumsy principles of raising interest rates to supress demand and seeking economic vitality through reduced employment. With Volker's approach now clearer, economists have avoided detailing the conundrum of recessions promoted by economic theory by changing the definition of a recession. After two quarters of negative growth, satisfying the old definition, the US declared that high employment meant there was no recession. More layers and less clarity isn't great for credibility.

Instead of incrementally adding to monetary policy's tangle of definitions and measurements, it's surely time that a new generation was empowered to discard the sticky mess and start from first principles, applying more lessons from history.