The Other Side January 3, 2013

Monetary Policy: The Only Game in town?

Last week, Japan had a general election which has brought the Liberal Democrats back in power, with Shinzo Abe as the party leader and Prime Minister. As part of the party agenda, Mr. Abe has already announced that he would ask the Bank of Japan to:

⇒ weaken the yen, if necessary by increasing its holdings of foreign bonds (in other words active intervention in the market): the yen has weakened sharply in the last couple of weeks even before any central bank action;

⇒ underwrite government bonds issued to finance construction projects; and

⇒ increase its inflation target from 1% to 2%, adopting unlimited monetary easing until the target is achieved.

Mr. Abe has also threatened that, if necessary, he would enact a law allowing the government to issue directives to the central bank on these issues.

Across the Pacific, the US Federal Reserve has formally announced recently that it would continue the low interest rate policy until unemployment falls below 6.5%, the first time such an explicit target has been publicly announced. (This is quite a change from the good old NAIRU – the Non-Accelerating Inflation Rate of Unemployment; at one time, the Federal Reserve used to be worried if unemployment falls below the so-called NAIRU.) In the euro zone, the European Central Bank has undertaken a program to buy government bonds of member countries. Nearer home, there is considerable pressure, from Delhi and business lobbies, on the Reserve Bank of India to reduce interest rates to help economic growth, despite the fact that real (i.e. inflation adjusted) rates cannot be considered high.

The reality in today's world is that, whatever their formal mandates, monetary policymakers need to balance two objectives – inflation and output/employment creation. The US Federal Reserve has an explicit dual mandate – price stability and employment. The European Central Bank is supposed to have a single point agenda, namely price stability: in practice, through its Outright Monetary Transactions ("OMT") it is clearly helping the weaker governments keep their cost of borrowing low.

Another myth that has been exposed is the ban on monetization of fiscal deficits. This disallows central banks to buy government paper in the primary market – but this is circumvented through operations in the secondary market as all the three major economies' central banks, as also the Reserve Bank, are doing (the Reserve Bank's own holdings of government securities have gone up from Rs. 60,000 crores in 2006 to Rs. 6,50,000 crores at present.) The Japanese Prime Minister is going one step ahead, asking the Bank of Japan to buy construction bonds in primary issues: in other words, monetization of public debt is fine so long as it has been incurred for investment and not to finance revenue deficits. All major central banks have sharply increased their assets in the last 5 years: the Fed by more than 3 times; the Bank of England 4 times, the ECB 2.5 times; the BoJ has been in the game now for more than two decades!

There are many other areas in which the accepted relationships between different variables are proving to be empirical busts. Take the relationship between fiscal deficits and interest rates: in the US, the fiscal deficit is very high, but the benchmark 10-year bond yields are at an all time low; as low as in parts of Europe despite the fact that the latter countries are following fiscal austerity. Consider, again, the accepted relationship between money supply, inflation and interest rates. (To be sure, that arch-monetarist of the Chicago school, Milton Friedman, had debunked the relationship between money supply and interest rates, as far back as his 1967 presidential address to the American Economic Association.) Despite extremely loose fiscal and monetary policies in the US and Japan, there are few signs of inflation taking off: in fact, after 15 years of fiscal and monetary easing, the Japanese economy is in deflation, i.e. prices are falling. The low rates hurt savers; benefit hedge funds and banks indulging in carry trades; and monetary transmission to the real economy is hardly taking place: overall, the low interest rates have benefitted the middlemen far more than the end-users of the monetary system. (In our case, of course, quite apart from the unreliability of the macro economic statistics, we have different measures of inflation -- WPI, CPI, GDP deflator, etc. often moving in opposite directions.) Most central banks have abandoned the good old Taylor rule (1993) linking short term interest rates to deviations from the target inflation rate and output gap.

The fact is that the conclusions of the deductive logic used in econometric models depend on the assumptions made. These are often unrealistic, and too many times leave out many material variables. In the real economy, the most important variable is of course the “animal spirits” of the investor and the consumer (both of whom often have less than rational expectations), which cannot be quantified in any case. Perhaps the reliability of the dynamic stochastic general equilibrium model and other econometric models used by policymakers, need a review in the light of empirical evidence.

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