The Other Side May 9, 2013

**Monetary Policy and Inflation**

For the last couple of months, I have been studying a fascinating book *Keynes Hayek: The Clash That Defined Modern Economics*, by Nicholas Wapshott. Without going into too many technicalities, the clash is between *laissez faire* capitalism and government intervention; between the invisible hand converting individual virtues into public good, and individual virtue sometimes becoming public vice. As for the latter, one example often cited is hoarding foodgrains in times of shortages; clearly, this would benefit the hoarder, “maximize his utility”, but is it necessarily good for the society as a whole? A parallel example would be excess savings in expectation of price falls in recessionary/deflationary conditions: benefits the saver, but surely not the unemployed? The point is that such “feedback loops” are rarely virtuous, carrying prices (of goods and services and, even more so, of financial assets), way above or below fundamentals. Criticizing Keynes’ *A Treatise on Money* Hayek argued that the cost of using monetary policy to increase output and employment as Keynes advocated would only lead to “roaring inflation”; that left to itself an economy would reach equilibrium at full employment; monetary/fiscal stimuli would only distort the process. Clearly, Hayek would not approve of what the major central banks are doing since 2008.

Another article of faith of monetarists namely that increased money supply is the only cause of inflation, is also coming increasingly under question. Japan has been following loose fiscal and monetary policies for a decade and the economy is still in deflation. The target now is to bring inflation up to 2% p.a. The US Federal Reserve is giving greater priority to bring unemployment down: its target is 6.5%, and it has promised to continue quantitative easing until the target is achieved. (Having lost faith in the central bank, law makers in some states in the US are likely to follow Utah, which authorized the use of gold as currency in 2011.) Interestingly, the Bank of England’s sole mandate is to target inflation, with no responsibility for growth or unemployment: inflation has been above the Bank's target for most of the last 8 years! Has the relationship between inflation and inflation expectations on the one hand, and short term interest rates and money supply on the other, broken down? Should central banks target nominal GDP rather than inflation, as the incoming Governor of the Bank of England is advocating? Or should central banks influence inflation more directly through the broad money supply numbers, rather than putting faith in quarter percent changes in short term rates?

The European Central Bank, which cut the bank rate by 0.25% last week to 0.5%, also has, in theory, a single point agenda namely inflation control. And yet, it has promised to pump in as much money as is needed in order to "save the euro". The zone remains in recession, thanks to fiscal austerity, despite the huge increase in money supply. One wonders of course whether these prima facie illogical outcomes in the advanced economies are a manifestation of a breakdown of the monetary transmission mechanism. The fact is that, while monetary easing has led to bloated central bank balance sheets, money is not reaching the 'real' economy. One wonders whether one important reason is the increase in capital charges for banks as a result of Basle III which is making them reluctant to lend money to the end-user in the real economy. What the quantitative easing, by whatever name, has done is to help improve the profitability of the banking system through the 'carry' between central bank funding and bond yields. To be sure, Nouriel Roubini, one of the few who had forecasted the mortgage market crisis of 2008, has cautioned in a recent article (Project Syndicate, March 2013) of the risk of another asset price bubble.

Like the European Central Bank, our own Reserve Bank cut the administered rate by a quarter percent last week. One hopes that our political masters, busy as they are in dealing with too many other political problems and scandals, have some time to pay attention to the following words from the monetary policy statement: *"Even as the large CAD is a risk by itself, its financing exposes the economy to the risk of sudden stop and* *reversal of capital flows … Should global liquidity conditions rapidly tighten, India could potentially face a problem of sudden stop and reversal of capital flows jeopardising our macro-financial stability."* One interesting number: the RBI forecast for real growth in fiscal 2013-14 is 5.7. The budget has calculated the fiscal numbers on the basis of a nominal GDP growth of 13.4%: this translates into a GDP deflator (another inflation measure) at 7.7%, even if the exchange rate remains steady.

Coming back to the Keynes Hayek dispute, one wonders to what extent the latter's view about inflation was the result of the fact that his own family wealth was wiped out during the hyper-inflation in Austria in the 1920s. Surely, there are many stages between very low or zero inflation to 'roaring inflation'? Surely, one should not look at merely the 'corner' end-results? The fact remains that, for the last 80 years, after every crisis, democratic governments have adopted Keynesian prescriptions. Coming back to the ideological dispute, I am reminded of an old joke about economics – that answers keep changing while the questions remain the same!

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