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The challenges in using monetary policy as a countercyclical strategy

Monetary easing may have helped the global economy escape the worst effects of COVID-19 but questions remain on the ability of interest rates to influence maximum employment with price stability

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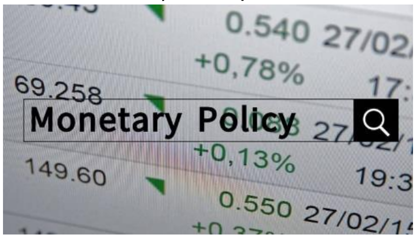

On Friday, October 8, the Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC) announced its quarterly monetary policy decision: repo rates would remain unchanged at 4 percent while ensuring that inflation remains within its target 4 percent ± 2 percent. Most financial analysts and economists seemed satisfied with the policy: no surprises, its accommodative stance, and supportive of financial market stability. With a positive outlook for GDP growth and inflation pressures receding, there is a sense that monetary policy has navigated the economy reasonably soundly through the crisis unleashed by the Covid-19 pandemic.

Globally, however, there are more fundamental questions being raised on the overall effectiveness of monetary policy – more specifically on the role of interest rates – in achieving its objective of maximum employment with price stability. With higher inflation and concerns over the robustness of aggregate demand, the possibility of stagflation is not being ruled out. It is, therefore, important to reassess the efficacy of available policy instruments to address such a situation if and when a need arises.

The first recent challenge to monetary policy came in 2019 when Rep. Alexandria Ocasio-Cortez cornered the Chairman of the US Federal Reserve (Fed), Jerome Powell into accepting the discernible irrelevance of the Phillips Curve. For decades, the Philips Curve, which argues that there exists a trade-off between unemployment and inflation, had guided monetary policy. This relationship was clearly breaking down and decreases in the unemployment rate were not accompanied by accelerating inflation. Ever since the 1990s, even as the non-accelerating inflation rate of unemployment (NAIRU) was gradually revised from about 6 percent to about 4.5 percent US inflation rates showed a secular decline. Accelerating inflation was nowhere to be seen. Powell ultimately conceded that 'the connection between slack in the economy – the level of unemployment and inflation – was very strong if you go back 50 years and it's gotten weaker and weaker and weaker to the point where it's a faint heartbeat.' He further relented that the economy could 'sustain much lower levels of unemployment than we thought without triggering troubling levels of inflation.'

This brings us to an unresolved question: are better estimates of NAIRU possible or is NAIRU itself a flawed concept? It is an important question because as and when inflation does rear its head, the Fed could revert back to raising interest rates to quell aggregate demand and thereby ease the upward pressure on wages in tightening labour markets. In fact, only last month, a growing number of Federal Reserve officials said they expected to see a rate-hike in 2022. And more recently, Larry Summers declared that US unemployment is now below its ‘natural’ rate. Rate hikes also remain a possible policy option by the RBI were inflation rates to accelerate once the economy recovers from the pandemic-induced disruptions. The Phillips Curve may not be dead after all.

The second reservation over monetary policy concerns the transmission mechanism. Even if there is general agreement that during a recession monetary policy is like pushing on a string, or in other words, incentivizing private sector investment and consumption expenditure in times of recession when uncertainty remains strong, there is greater confidence in its ability to pull on a string. By raising the cost of borrowing of firms and households for investment expenditure, higher interest rates can rein in inflation. However, what is missed out is that these costs are also simultaneously the incomes of other agents in the economy. Therefore, a rise or fall in interest rates could also mean the rise or fall of incomes respectively, making monetary policy pro rather than countercyclical. The inflection point at which monetary policy turns countercyclical may be substantially higher than expected, effectively necessitating a recession before inflation is tamed. Former Chairman of the US Fed, Paul Volcker’s high-interest rate policy may therefore have actually fuelled inflation before inducing the 1981-82 recession that subsequently brought inflation rate under control.

A stronger heterodox view contends that monetary policy is essentially about income distribution, transmitted through both income and wealth effects. While higher interest rates redistribute wealth from the working classes to the wealthier, the propensity to save increases accordingly, which consequently dampens aggregate demand and employment. On the other hand, lower interest rates not only raise the price of bonds but also generate asset bubbles. Moreover, interest rates also have implications for intra-capitalist distribution of wealth, that is between industrial and financial capital. This set of complex redistributive effects are in fact the transmission mechanism of monetary policy, not merely the cost of borrowing channel.

Finally, a recent paper by an economist at the Fed, Jeremy Rudd, argues that the use of inflation expectations as an anchor of monetary policy is unsound. The paper was not only an insider critique of monetary policy but also blatantly attacked ‘mainstream economics [which] is replete with ideas that “everyone knows” to be true, but that are actually arrant nonsense.’ Rudd claims that inflation expectations don’t shape actual future inflation rates or, in other words, inflation expectations are not a self-fulfilling prophecy as economists propose: if workers’ inflation expectations were high, they would demand higher wages that end up raising inflation. To Rudd, it is the actual inflation rate which matters in the setting of nominal wages and in determining the response of workers to the real wage. What does this mean for monetary policy? The communication agenda of central banks may be misguided: Rudd argues that ‘it is far more useful to ensure that inflation remains off of people’s radar screens than it would be to attempt to “re-anchor” expected inflation.’

While central banks will continue to play an important role as lenders of the last resort to avert financial crises, monetary policy as a countercyclical strategy remains problematic given the several pertinent theoretical and empirical shortcomings that both, mainstream and heterodox critics have raised.

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Views are personal and do not represent the stand of this publication.

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