The defunct economics that drives US monetary policy

Raising interest rates is too blunt a tool to tackle the inflationary pressures of today

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Jerome Powell, chairman of the US Federal Reserve

Highlights

- *The New Consensus Macroeconomics paradigm underlies Jerome Powell's unrelenting hike in interest rates by almost 4.5% in less than a year*
- *This is what has led to SVB's demise*
- *Economists such as Joseph Stiglitz have argued that such sharp increases in interest rates will only add to inflation since low investment would further inhibit increases in supply*
- *Monetary policy targets the entire economy and is therefore too wide in its reach and impact*
- *Other policy instruments such as windfall profit taxes, anti-trust measures, price gouging policies and direct price stabilization may be a better alternative to tackle the kind of inflation we are witnessing now*

'The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist.'

- John Maynard Keynes

Keynes' quote can be seen in the context of the present Silicon Valley Bank (SVB) crisis with Jeremy Powell, Chairman of the US Federal Reserve (Fed) and the Federal Open Market Committee (FOMC) members having taken the place of the 'practical men' while the 'defunct economist[s]' and their economics are hidden from view in the dark shadows, obscure to most.

Who are these economists and what is their economics? To answer this question, a look at the 'best' economics departments across the world where the dominant paradigm, 'New Consensus Macroeconomics' or NCM is taught and gets the most research traction reveals the underlying basis for the Fed's hawkish monetary policies. Michael Woodford, once acknowledged by the Insider as 'the world's most influential economist', in a seminal paper categorically summarized the fundamental tenet of NCM: 'monetary policy is now widely agreed to be effective, especially as a means of inflation control. The fact that central banks can control inflation if they want to (and are allowed to) can no longer be debated after the worldwide success of disinflationary policies in the 1980s and 1990s. It is also widely accepted that it is reasonable to charge central banks with the responsibility of keeping the inflation rate within reasonable bounds.'

Ben Bernanke, who needs no introduction, is also an adherent of NCM. In his recent book, '21st Century Monetary Policy', Bernanke vehemently supports the Federal Reserve Chairman, Paul Volcker's epic war against inflation through massive interest rate hikes between the late 1970s and early 80s. He blames Volcker's predecessor, Arthur Burns' tentativeness in his decision to raise interest rates to fight inflation for the crisis at that time.

It is shocking to know how a model which assumed no role for money and banking (now sometimes brought in as an add-on) and at the same time treated inflation as a monetary and therefore macroeconomic phenomenon – to be controlled through interest rates – came to adopted as the mainstay for monetary policies of central banks. Fiscal policy, on the other hand, was downgraded, its role contained by the need for fiscal prudence and an inter-temporal balanced budget. However, the model adopted the New Keynesian premise that frictions like sticky prices and wages as well as asymmetric information, allowed interest rates to impact the real economy, at least in the short-run. Finally, central bank independence was required so that monetary policy would not come under the control of an elected government that might prioritize employment over inflation.

The NCM paradigm unequivocally underlies Jeremy Powell's unrelenting hike in interest rates by almost 4.5% in less than a year. The hawkish stand of the Fed has been criticised by some economists like Joseph Stiglitz who argue that such sharp increases will only add to inflation since low investment would further inhibit increases in supply, elevated prices in non-competitive markets where the additional costs would be passed on to consumers, worsening intergenerational inequalities in housing markets on account of costs of mortgages, and so on. Globally too, there has been a backlash from many countries, especially emerging markets and poor nations, where countries have had to face depreciating exchange rates, higher domestic interest rates that have slowed growth and also the burden of dollar-denominated debt.

Just as economists did not foresee the 2008 global financial crisis despite their (superficially) sophisticated models, it is surprising that something as glaring as the effect of interest rate hikes on the price of fixed income securities and its consequent impact on the value of 'risk-free' assets of banks could have been missed out. The rise in interest rates caused the price of securities to fall by some 30%. The consequent asset-liability mismatch in SVB's balance sheet was noticed and taken advantage by short-sellers who triggered a run on SVB to the tune of $42 billion on a single day or some 20% of its assets. The liquidity issue soon turned into a solvency issue for SVB.

While the Fed has already indicated a bail out of commercial banks heavily invested in safe securities, and not the usual risky assets, to pre-empt financial contagion and a larger real-economy crisis, this may well be the final straw in the Fed's strategy of an unabated increase in the Feds Funds Rate and more generally, the confidence in monetary policy as a tool to fight inflation.

The question, however, remains as to how inflation can be tackled. At the forefront of a new approach is economist Isabella Weber who sees inflation in the present context as being caused by 'overlapping global emergencies' including climate change, post-pandemic supply chain disruptions and the Russia-Ukraine war that have had an asymmetrical sectoral impact. These shocks in specific sectors cause a systemic rise in the general price level. Monetary policy targets the entire economy and is therefore too wide/aggregated/macroeconomic in its reach and impact. Instead, it is necessary to identify key sectors reeling from and provoking inflation at a more general level.

The set of policy instruments that could also enhance the available stabilization toolkit of state institutions would include 'windfall profit taxes, anti-trust measures, price gouging policies and direct price stabilization.' Some economists have further argued in favour of targeted credit allocation to sectors where investment and output needs to enhanced while curbing demand for non-essential goods and services.

While these policy prescriptions need debate and discussion, particularly with respect to their effect on employment, it is doubtful whether the community of NCM macroeconomists are willing to do so and relinquish their position as defunct economists.

(Sashi Sivramkrishna studies macroeconomics from a Modern Money Theory (MMT) perspective. Views are personal and do not represent the stand of this publication)