A Shift In Monetary Policy Won’t Work Miracles

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A nominal GDP target for central banks isn’t without merit, but a monetary fix won’t be a cure-all for our economic problems.

Given these chaotic days of unorthodox monetary policy practice, such as ultra-low interest rates and quantitative easing, talk about reforming the way central banks manage the monetary system is seemingly at an all-time high.

Bursting from the academic literature into the blogosphere, and from international economic bloggers into the Australian public policy discourse, comes an idea that the Reserve Bank’s longstanding policy to target price inflation at least ought to change.

That the RBA must forgo its effort to keep increases in consumer prices between 2 and 3 per cent, on average and over the business cycle, comes from an unlikely source: protectionist South Australian senator Nick Xenophon.

In collaborative work with economist Danny Pearce, Xenophon says that inflation targeting as a basis for monetary policy has passed its use-by date, especially in a low-growth world in which the inflation scourge appears well and truly vanquished (at least for now).

Xenophon and Price call for the RBA's inflation target to be swapped with a "nominal GDP growth target" of 5.5 per cent per annum for Australia, which they claim will deliver a more stable macroeconomic environment.

The call to refurbish this country's monetary policy settings in favour of a NGDP target, which incorporates both prices and real GDP, is something that has gained significant traction among economists irrespective of their ideological leanings.

Classical liberal economists Scott Sumner, Lars Christensen and Tyler Cowen are proponents of an NGDP objective for monetary policy, and these sentiments are broadly shared by progressive economists including Paul Krugman and Australian John Quiggin.

Before discussing the merits and limitations of changing the ground rules for how monetary policy is conducted in Australia, it may be beneficial to rekindle memories as to how and why the RBA came to earn its modern reputation as an "inflation fighter".

During the 1970s and early '80s, Australia and most other advanced economies confronted high rates of price inflation, oftentimes with bouts of high unemployment, as oil prices peaked, wage costs escalated, and discretionary fiscal and monetary policies boosted prices but failed to sustainably raise output.

We briefly flirted with directly targeting money supply growth to control inflation, in line with first-wave monetarist precepts about price inflation always and everywhere representing a monetary problem, but with targets proving a touch too tricky for the RBA to reliably pin down.

Price inflation remained particularly troublesome during the 1980s, continuing to erode the real wages earned by Australian workers, and measures of inflationary expectations stayed in double-digit figures.

It was only following the severe recession of 1990-91 that inflationary expectations were finally subdued, and the opportunity to lay out a basis for a new monetary policy framework arose.

Determined to ensure general price increases remained modest, the Keating government entered an agreement with the RBA setting the price inflation target as a monetary policy objective.

Australia's rate of price inflation has since been kept to an average 2.5 per cent, which has been largely attributed to the role of monetary policy anchoring price-inflationary expectations, although falling trade barriers and other microeconomic reforms have also contributed.

With price inflation still seemingly nipped in the bud, the argument is that central bankers must now do something different in an attempt to wake the economy up from its post-GFC coma.

If the RBA adopted a NGDP target of 5.5 per cent, as recommended by Xenophon and Price, then the presently “easy” monetary policy stance under the price inflation targeting regime might be reinterpreted as “tight”, given our current NGDP growth rate is only 2 per cent.

A new monetary policy regime in these circumstances would imply further reductions in our already-low cash-rate interest rate or, worse still, a green light to dabble with unorthodox policies that have side-tracked the US, Europe and Japan firmly onto a slow-growth path.

It is not clear that additional easing would be beneficial, given the dismal international track record for monetary policy exotica and the non-monetary problems constraining our growth potential.

In fairness, from a theoretical perspective, there are certainly some potential upsides to pursuing a style of monetary policy that engages in NGDP targeting.

The new-wave “market monetarists” such as Sumner and Christensen argue that a specified NGDP objective would serve as an improvement over price inflation targeting, because the former places fewer informational requirements upon central bankers.

Under NGDP targeting the RBA would not have to undergo the fatigue of trying to determine whether a change in average prices in the economy is primarily attributable to developments in the supply or demand side of the economy, and whether change should warrant a monetary policy response.

Consider the example of a positive supply shock resulting from microeconomic reforms, which would generally be seen as a beneficial development.

Under the price inflation targeting regime for monetary policy, the central bank would feel obliged to impose expansionary monetary policy to counter the falling generalised prices threatening the achievement of the target, but with the potential side-effect of exacerbating asset price bubbles.

But under an NGDP target there is no need for a policy response from the central bank because the declining price level is offset by increases in actual, and potential, output in the wake of supply-side economic reform.

Nick Xenophon has indicated that he prefers the government to abolish the price inflation framework when it sits down with the incoming RBA governor Philip Lowe to strike a new agreement on the framework for monetary policy.

It is best to consider any change to monetary policy frameworks soberly and carefully.

After all, the current inflation-oriented approach has helped focus monetary policy on a clear objective (that is, price stability) where arguably none existed beforehand, and Australians have benefited immensely from lower rates of price inflation.

And there is plenty of other reform business for the new Parliament to contend with, such as reducing red tape burdens, cutting taxes, and repairing the budget, all of which would improve our productive capacity if implemented.

NGDP targeting isn't the worst reform idea going around, but let's not think that changing monetary policy would magically resolve our economic issues.

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