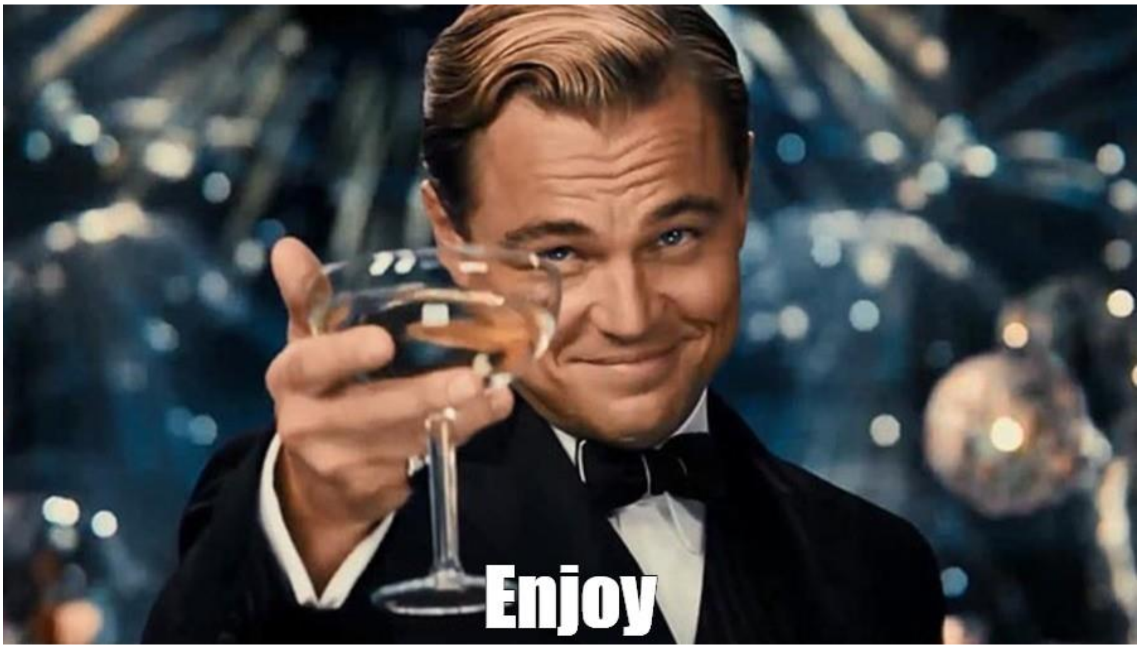
Foam-flecked at the mouth

> *"[T]here is no sight in the world more awful than that of an old-time economist, foam-flecked at the mouth and hell-bent to cure inflation by monetary discipline. God willing, we shan't soon see his like again."*

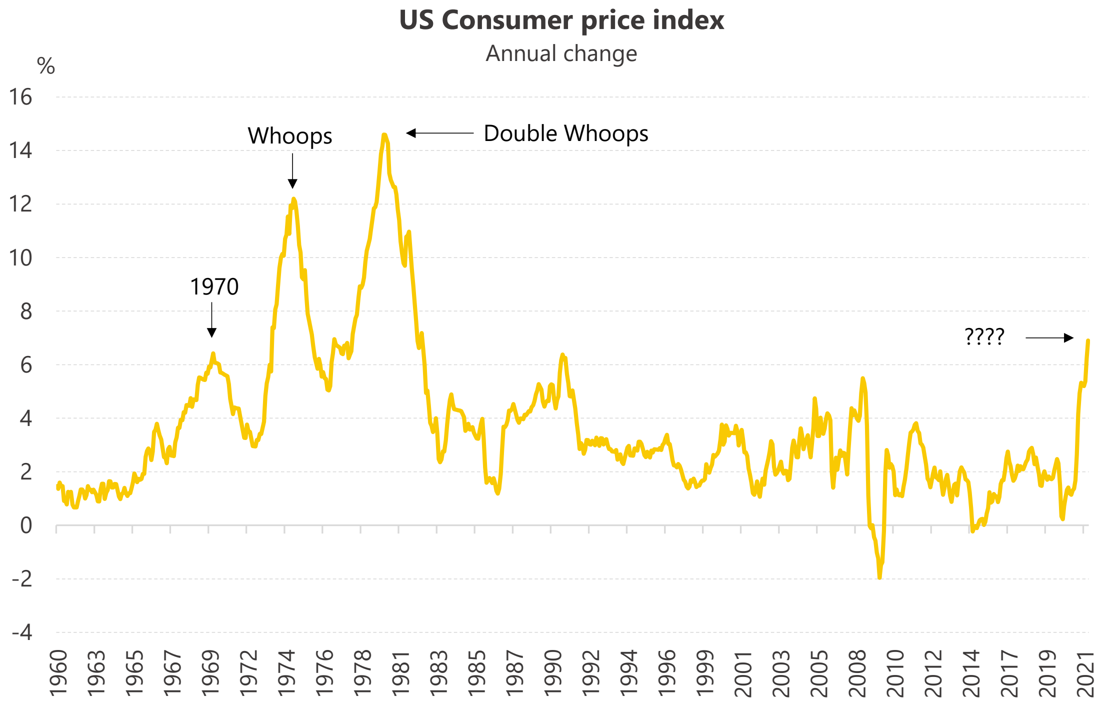
- Paul Samuelson (1969)

Welcome to the first ever *Unwrapped*, our exclusive monthly newsletter where we dive a little deeper on the most popular topic from recent issues, as judged by reader metrics (views, opens, clicks – that kind of stuff).



Samuelson was wrong

The quote from Nobel prize winning economist Paul Samuelson at the top of this page was penned in 1969 and, at least initially, looked prescient: the rate of growth in consumer prices peaked at 6.4% in February 1970 and then started to fall for a couple of years. But after that it all went oh so very wrong.



Contra Samuelson, it wasn't until an "old-time economist" called Paul Volcker took charge at the Fed in 1979 with a policy of "monetary discipline" that inflation was eventually cured. The "real danger" the entire time, [argued Volker](), came not from the old-time economists derided by Samuelson but from central bankers:

> *"...encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking, in effect standing by while bubbles and excesses threaten financial markets."*

Extreme speculation and risk taking are something that should be familiar to those Down Under – have you seen property prices lately?

Australia's central bank, the Reserve Bank of Australia (RBA), has tended to be dismissive of such risks. Governor Lowe has repeatedly argued that inflation and its "close cousin" asset price bubbles can be safely ignored so long as total employment and wages remain below its target.

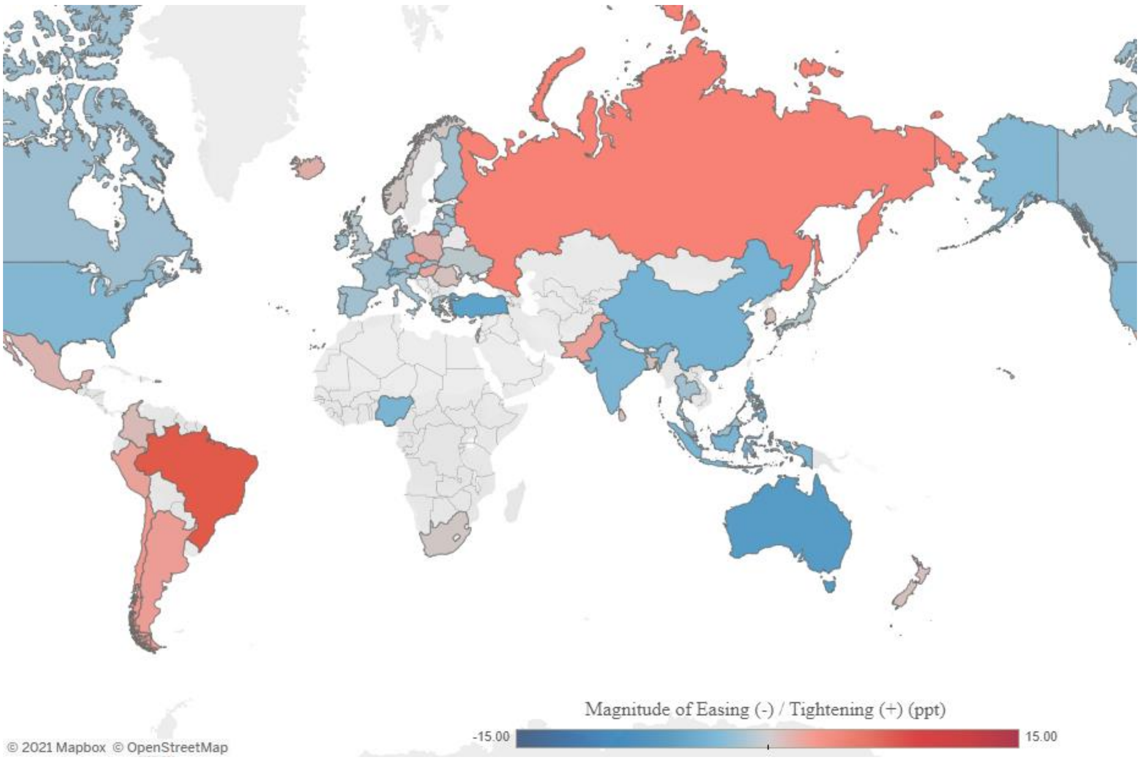
We were warned

But by not heeding Volcker's warning because of a dogmatic belief in its Samuelson-inspired New Keynesian models of the economy, the RBA is falling into a trap that another Nobel prize winner, Friedreich Hayek, called the pretence of knowledge. Hayek was warning policymakers – *especially* those armed with huge teams of experts (the RBA employs 1,400 people) – against assuming they possess enough knowledge to successfully engineer parts of society.

Hayek specifically called out Lowe's "assertion that there exists a simple positive correlation between total employment and the size of the aggregate demand for goods and services", warning that unlike the physical sciences, in an economy "the aspects of the events to be accounted for about which we can get quantitative data are necessarily limited and may not include the important ones".

That's the thing about economic models. They tend to work well until they don't, as what's important changes over time. Certainly, in the United States, United Kingdom, Canada… it's a long list now, central bankers consistently underestimated inflation, fell behind the proverbial eight-ball and are now having to play catch-up.

The countries in red below are currently tightening monetary policy, while those in blue are keeping things easy (as of November 2021). Note that Australia is now the darkest blue country in the world, i.e. proud owner of the world's loosest monetary policy (Erdogan's Turkey is at #2).[1] A word of caution – it's not even close to a perfect metric but does offer *some* insight into the relative dovishness that presently exists at the RBA.



In terms of inflation Down Under, we haven't had a data release since October so we're flying somewhat blind. Mark 25 January in your calendars because there could be some

[1] https://www.cfr.org/global/global-monetary-policy-tracker/p37726

pre-Australia day fireworks when consumer prices for the December quarter are finally revealed.

The outlook

With any luck the pandemic will gradually fade out in 2022, as Omicron takes over and perhaps even mutates into something less deadly with its own Greek letter, such as Pi or Rho. That doesn't mean restrictions won't continue long past the point when they stop making sense – many politicians and bureaucrats have found themselves empowered by the pandemic and they'll fight tooth and nail to keep that status permanently.

Perhaps that's a bigger risk than inflation but for now it'll have to wait, because inflation and more importantly how central bankers react to it could well be the new headline-grabber of the year. Most of Team Transitory has retired (Philip Lowe excluded) and that means central bankers will eventually start using their tools to bring inflation back into line. But the big uncertainty is whether they'll have the cojones to persist with monetary discipline when the screams of anguish begin to permeate their halls.

In the United States, a five-percentage point increase in interest rates would raise the government's interest payments by a cool $US1 trillion (~5% of GDP) a year.[2] Plenty of those in the private sector would also feel the burn, especially at the top end of town – asset prices have risen to unprecedented levels on the back of near-zero interest rates, and who knows what kind of highly-levered mischief the financial sector has conjured up this time around.

Fed chair Jerome Powell may have just secured himself a fresh five years but if he suddenly becomes an inflation-fighting hawk, you can be sure he'll encounter significant pushback. And if central bankers find it politically impossible to invoke monetary discipline then prices will be manipulated using other means, such as financial repression[3], price controls or even antitrust, all in the name of fighting greedy "giant corporations", as if that's somehow a new development causing all of our ills.

None of those options will reduce inflation (declining purchasing power), temper demand or fix global supply chains but will simply replace them with shortages, rationing and economic stagnation (prices signal the relative value of goods and services in an economy and are essential for economic coordination).

But when have bad, long-since discredited ideas ever stopped politicians acting on them in the past?

Thanks for reading, please feel free to forward this to friends and colleagues!

[2] Australia's gross debt is rapidly approaching $A1 trillion, meaning a similar interest rate increase Down Under would add nearly $A50 billion a year to the government's debt repayments (~2.5% of GDP).

[3] For example, forcing firms to hold government bonds yielding less than the rate of inflation.

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