Wrap-up lecture 2023

Half a century of central banking

(c1970 – 2023)

Some background: the early post-War consensus

- Fixed exchange rate system (Bretton Woods): 1945 – 73
- The legacy of Keynes: a focus on **demand management**
  - **a stable Phillips curve?**
- 1970s deterioration in macroeconomic performance
- Apparent contradiction between:
  - high inflation
  - high unemployment

Half a century of central banking

Decade	Economic events	Monetary policy	Financial regulation
1970s	High inflation, combined with… High unemployment	Breakdown of Bretton Woods From Keynes to Friedman Monetary targets (1976-85)	Finance sector highly regulated
1980s	Partial inflation control Credit boom (late 80s)	A period of discretion (1985-) From quantity-setting to rate-setting	Deregulation Float of AUD Basel 1 accord
1990s	Early 1990s recession Return to low inflation Tech bubble (late 90s) Asian financial crisis (1997-98)	Inflation targeting	APRA established (1998)
2000s	GFC (2007-09) European aftershocks	Near-zero interest rates Quantitative easing (QE)	Basel 2 accord Emergency GFC responses
2010s and beyond	Incomplete recovery from GFC Below-target inflation (2009-2021) Covid downturn and recovery Asset inflation Return of inflation (2022-)	QE comes to Australia Framework reviews in Europe, US, Canada, Australia Rising interest rates	Basel 3 accord Macroprudential policies to tighten credit

Pivot point 1: The mid-1970s

Economic events	Monetary policy	Financial sector
High inflation High unemployment OPEC oil shock Budget deficits	Breakdown of Bretton Woods From Keynes to Friedman Monetary targets (1976 – 85)	Remains highly regulated Interest rate controls on banks Limited foreign bank access Lending controls Banking is ‘safe but boring’

Friedman's (1968) summary of the monetarist position

- Key distinction between *nominal* and *real* variables
- Objectives of macroeconomic policy are
  - real variables (growth and employment), plus
  - inflation control
- In the long run, real and nominal variables are independent
- But, there are complex (and unpredictable) interactions between them in the short run
- Central role of expectations: excess demand is associated not with high inflation, but with **higher-than expected** inflation

Friedman: what monetary policy can and cannot do

Cannot do:

- Permanently boost output and employment above levels that would otherwise prevail

Can/should do:

- Control inflation
- Avoid misguided activism

Monetarist diagnosis of the 1970s

- High inflation is not caused by excess demand, but by entrenched inflation expectations
- This in turn can be traced back to earlier misguided activism in monetary policy
- High unemployment is caused by structural characteristics of the economy, not by lack of demand
- Short-term trade-offs still work, but are of limited use in addressing these problems

Policy prescription: monetary targeting

Pivot point 2: Financial deregulation (1980 – 85 approx.)

Economic events	Monetary policy	Financial sector
Partial inflation control Credit boom (late 1980s)	A period of discretion From quantity-setting to rate-setting	Campbell inquiry (1979 – 81) Float of AUD (1983) Deregulation of banking Licensing of foreign banks

Consequences

Instability of monetary and financial aggregates
Gradual increase in focus on interest rate stability
General goal that MP should be restrictive in some sense

Late 1980s: a period of transition

Macfarlane shipping analogy

- stop the ‘ship of monetary policy’ from leaking
- fix navigation system
- determine who is at the helm

Emerging consensus on the role of macro policies: 1980s and after

Monetary policy:

- inflation control
- to be achieved by low and stable growth in money supply

Fiscal policy:

- limited countercyclical role
- but, must have due regard for debt sustainability

Structural policies (eg labour market, trade, regulatory): promote efficiency, lower natural rate of unemployment (the NAIRU)

- generally a <u>deregulatory</u> focus

Distributional policies: valid, but separable from macro

Pivot point 3: A new target-instrument framework (1989 – 96)

Economic events	Monetary policy	Financial sector
Early 1990s recession Return to low inflation Economic recovery	Rate setting confirmed as policy instrument Numerical inflation target RBA de facto independence Framework of accountability	Regulation to be replaced by supervision

Inflation targeting in ‘normal’ times

Key elements of an inflation targeting regime:

- A measurable numerical target for inflation
- A public commitment for achieving it
- Short-term interest rate is the policy instrument
- A supporting set of accountability and reporting arrangements

The above represents the emerging consensus on best-practice monetary policy framework over (approx) 1990 - 2010

Decision-making in practice: a stylised decision procedure

- Assume that the policy rate will evolve on a path consistent with current market expectations
- Based on that assumption, and on other available information, forecast the key macroeconomic variables over the next 2-3 years
- If inflation is forecast to be on a higher trajectory than desired, consider raising the cash rate
- But, only do so if there is sufficient confidence in the assessment, compared to risks of a wrong decision
- Repeat the process in a month's time, taking into account any new information that becomes available in the meantime

Inflation targeting– the end of history? (1996 – 2006 aprox.)

<u>Key events</u>

Asian financial crisis (1997-98)

Tech bubble (late 1990s)

Deflation of Japanese ‘bubble economy’

<u>Two unanswered questions</u>

Relationship between monetary policy and financial stability roles of central bank (the <u>lean</u> vs <u>clean</u> debate)

How can Japan fight deflation when R = 0?

Inflation targeting pre-2007: the agenda

- Improve the forecasting framework
- Expand communication and transparency
- Refine the objectives and decision procedures

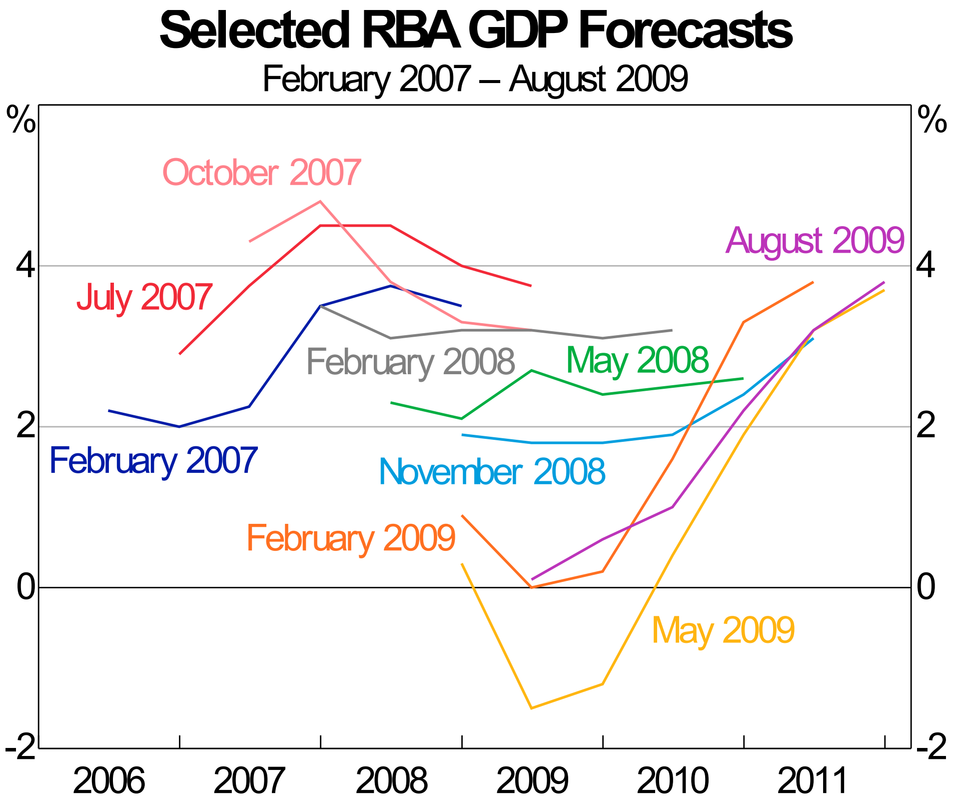
The Bernanke menu of policy options at ELB

- CB purchase of government securities (QE)
- Yield curve control
- Exchange rate intervention to depreciate the currency
- Money-financed tax cut/benefit payment (= Friedman's helicopter drop)

'Political constraints, rather than a lack of policy instruments, explain why [Japan's] deflation has persisted for as long as it has.' (Bernanke, 2002)

Pivot point 4: The GFC (2007 – 2009)

Economic events	Monetary policy	Financial sector
GFC Global recession European aftershocks Fiscal expansion	Near-zero interest rates Emergency liquidity for banks Coordinated monetary/fiscal stimulus Quantitative easing (QE)	Bank failures in multiple countries Bank rescues and emergency guarantees Regulatory responses

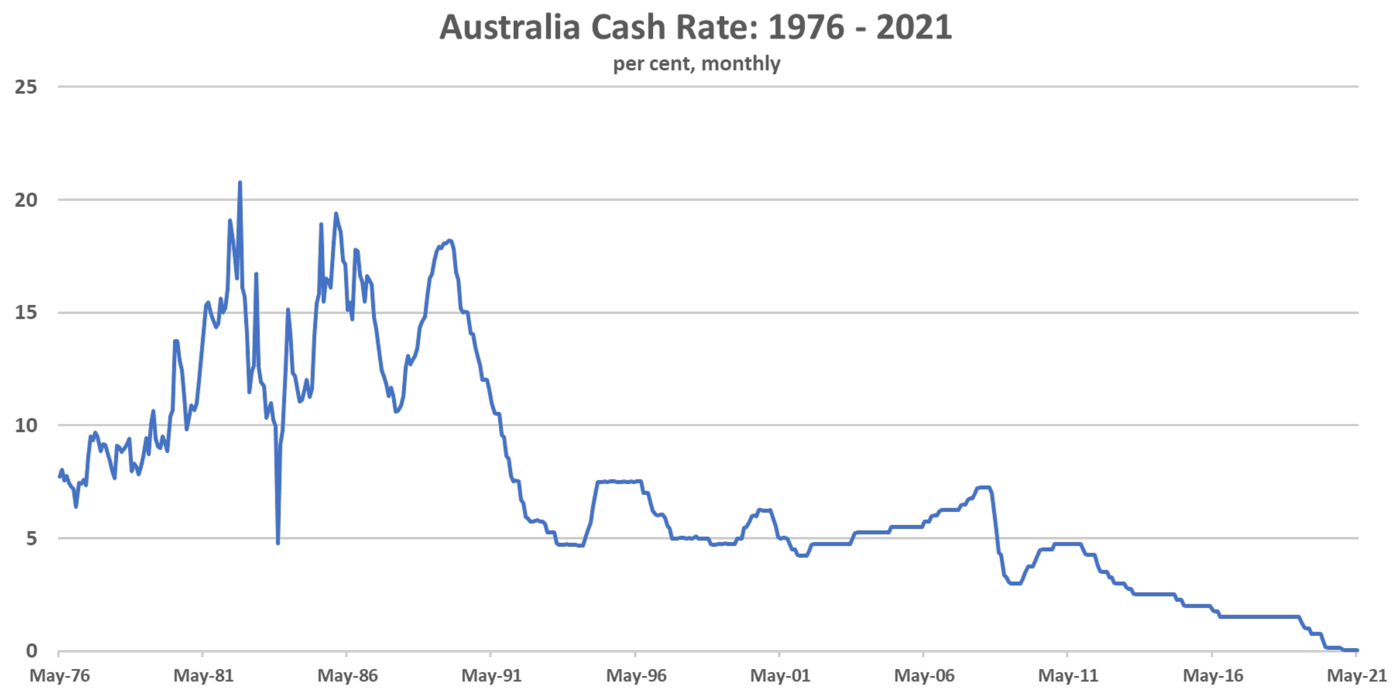


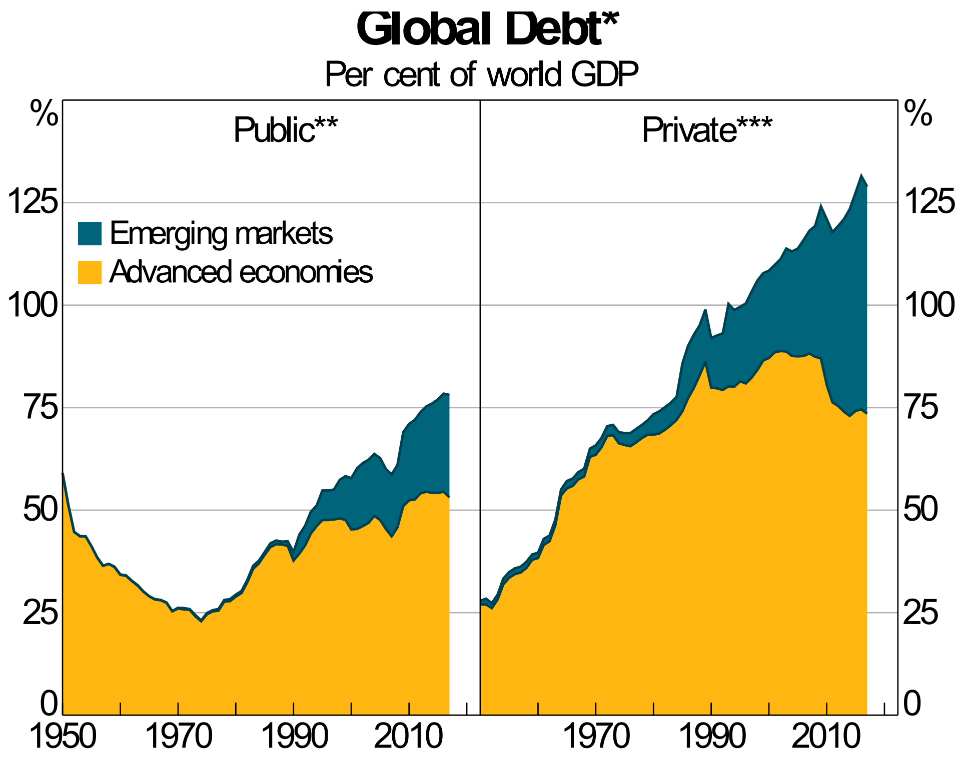
Sources: ABS; RBA

Global legacy of the GFC (2010 – 2021 approx.)

- Below target inflation
- Inflation in asset prices, but not goods and services prices
- Near zero interest rates
- QE comes into play (in Australia, later than elsewhere)
- Debt overhang
- Concern that the policy mix is adding to financial stability risk
- The <u>firepower</u> question
- Perceived need to review monetary policy frameworks
  - US, euro area, Canada, Australia

The legacy of the GFC: high debt, ultra-low interest rates





* Data for emerging markets before 1990 is limited
** General government debt
*** Debt of households and non-financial corporations
Sources: IMF; RBA

Further debate on the ZLB

After GFC, the ELB problem became generalised (not just Japan)

Key elements of the Bernanke prescription widely accepted, in a somewhat expanded form:

- quantitative easing (QE) through CB asset purchases. Aim: to flatten the yield curve, expand liquid assets of the banking system, promote bank lending
- credit easing. Purchase of non-government credit instruments to improve market liquidity and narrow risk spreads
- enhanced signalling of CB intentions. Promote confidence that interest rates would remain low
- direct CB lending to banks, and incentives for banks to lend
- interest rates below zero (slightly) in some jurisdictions
- adjust the target, to reinforce commitment not to undershoot (average targeting) (This was much discussed around 2020-2021)

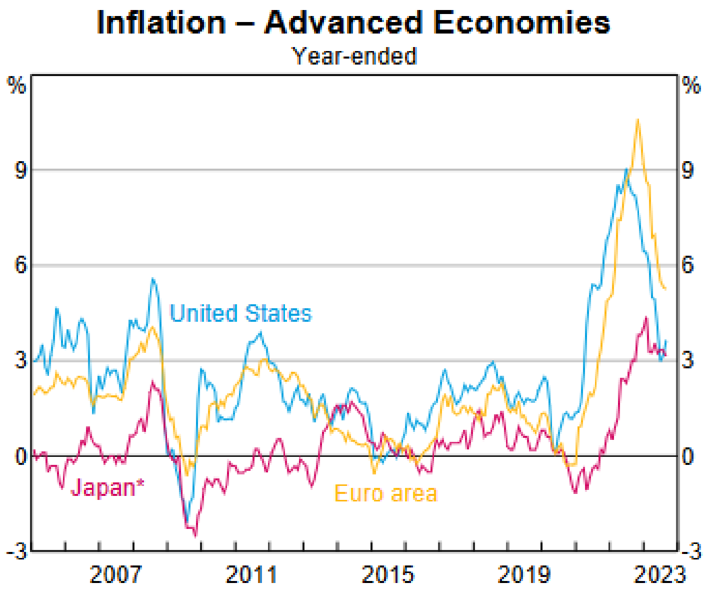
Two Bernanke recommendations <u>not</u> widely accepted

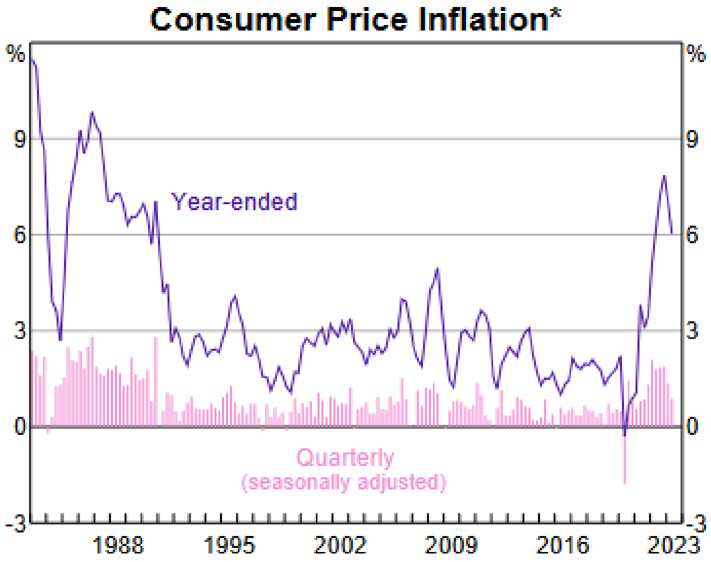
- Exchange rate intervention/depreciation
  - fear of spillovers and retaliation
  - zero-sum game at global level
- “Helicopter money”
  - weakens anti-inflation safeguards
  - often criticised as either <u>ineffective</u> or <u>dangerous</u>

A recent digression: ‘Modern Monetary Theory (MMT)’

- MMT has made its way into public debate – be aware of it
- Main characteristics:
  - Proposition that government can be directly funded by money creation until inflation is triggered
  - Often associated with political programs involving expanded government spending, eg full employment guarantee, ‘green new deal’
  - Be careful: terminology (MMT) gives misleading impression of acceptance in the policy community
  - Overlaps between MMT and orthodox concepts can cause confusion
  - <u>Not</u> the same as Friedman/Bernanke helicopter money
- MMT best seen as a headline-grabbing distraction
  - has gone out of favour with return of inflation (post Covid)

Pivot point 5: The post-Covid world (2022 -)





* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000.

Rising inflation

Rising interest rates

Criticism of RBA forward guidance

Multiple risks:

- Inflation
- Policy overkill
- Interaction of interest rates and debt

Responding to COVID – the debate in 2020-2021

- Key question at the time: are central banks out of firepower?
- This was already being debated pre-Covid
- CBs continue to try to squeeze more stimulus out of the less controversial parts of the Bernanke menu. Is this enough?
- Arguably, the combination of CB support for more fiscal spending + QE represents a form of *disguised* helicopter money
- Respectable voices (Fischer, Bernanke, Turner etc) called for a calibration/governance strategy to use this as a weapon against deflation at the ELB
- CBs cautious, due to longer-run concerns about independence and anti-inflation safeguards

2022-23: the changing landscape

- Unexpected re-emergence of inflation
- Corresponding shift in monetary policy focus
  - rising policy interest rates
  - QE begins to be phased out
- The calibration problem
  - the search for a ‘soft landing’
  - interaction between high debt and rising interest rates
  - risks are no longer uni-directional
- Framework reviews
  - governance
  - did the RBA get it wrong?
- Credibility and expectations