

Vital Signs: it's time to discuss a new framework for central banking

Written by Richard Holden, Professor of Economics and PLuS Alliance Fellow, UNSW

Vital Signs is a regular economic wrap from UNSW economics professor Richard Holden (@profholden). Vital Signs aims to contextualise weekly economic events and cut through the noise of the data affecting global economies.

In the 2017 budget lockup - when Treasurer Scott Morrison announced his [outrageous bank tax/heist](#) - I heard one well-known journo remark to another “Boy, it’s a f...ing bad day to be a banker”.

And so one might say today that it’s a bad time to be a central banker.

The big debate going on at the moment is whether the “[inflation-targeting](#)” framework followed by the United States Federal Reserve, Reserve Bank of Australia and other central banks, is up to the job in a post-2008 world.

Inflation targeting is where central banks try and keep inflation within a certain range. But they have recently been [struggling to achieve their targets](#) .

It’s pretty clear the real interest rate consistent with financial stability in advanced economies is lower than it has been in the past. This means GDP growth rates with a two in front of them are the new normal.

How should [monetary policy](#) change - if at all - in light of this?

Read more: [**Explainer: why some economists think the RBA should drop its inflation target**](#)

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Inflation targeting in both the United States and Australia dates to the (early/mid) 1990s. Central banks saw a tradeoff between inflation that was either too high or too low. The US Federal Reserve (to this day) [summarises it as follows](#) (emphasis added):

Over time a higher inflation rate would reduce the public's ability to make accurate economic and financial decisions. **On the other hand, a lower inflation rate would be associated with an elevated probability of falling into deflation...** a phenomenon associated with very weak economic conditions. Having at least a small level of inflation makes it less likely that the economy will experience harmful deflation if economic conditions weaken.

At the time the Fed settled on a [2% target](#) and the RBA on a [2-3% band](#).

The question is, are these useful targets today?

As former US Treasury Secretary and NEC Chair Larry Summers [put it when commenting on the tradeoff](#) and how it might have changed (emphasis added):

I do not see much that has changed that bears on the cost of higher inflation in making it harder for economic agents to plan. **On the other hand there are compelling reasons to believe that the risks of deflation have increased**. First, the world has seen a substantial amount of deflation or very low inflation over the last 20 years. In Japan and significant parts of Europe, deflation has taken place over several year periods. And there were moments during the financial crisis when deflation appeared a real risk for the United States. Second, deflation scenarios occur when the economy falls into the liquidity trap where short term safe nominal rates cannot be reduced any further even though there is economic slack and inflation rates are declining. On any reasonable calculation this is a much greater risk than it could have appeared in the mid-1990s.

The risk is these frameworks are beneficial precisely because they provide certainty to markets and economic actors, and anchor inflation expectations. If one changes the framework too readily or too often then disaster looms.

Changing the mandate

Having said that, there's a good case to be made for a nominal GDP target rather than the kind of inflation target we currently have. A [number of distinguished scholars](#) have advocated this position.

Whatever the new framework is - and there surely needs to be a new one - should almost surely involve nominal interest rates around 5% in normal times. This would permit monetary policy to respond to sharp economic downturns.

How that is achieved is a tactical, not a strategic question. And I say that with all due chiding.

To me, the deep and hard question is how we transition to such a framework without a large loss of credibility. That surely involves making the case - in a compelling fashion - that the world has changed.

Read more: [***Why New Zealand can't outsource employment policy to its central bank***](#)

US Federal Reserve chair Jay Powell and RBA governor Phil Lowe need to have this discussion very publicly.

Thus far the RBA has not really been on the field, but it pulled out its strongest intellectual weapon on Wednesday, with deputy governor Guy Debelle [delivering a detailed speech](#) on inflation in Brisbane.

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He offered some suggestions about why [inflation has been low](#) - perhaps unusually so - of late, and then concluded with something that sounded an awful lot like the party line (emphasis added):

Our current forecast for inflation is broadly unchanged from earlier forecasts. We did revise down our expectation for inflation in the current quarter for reasons I have just discussed. Beyond the September quarter, we continue to expect inflation to be around 2¼% over the next couple of years as above-trend GDP growth reduces spare capacity in the labour market and there is an associated pick-up in wages growth. **We expect most of these other forces that have contributed to the recent low rate of inflation to abate but there is uncertainty about how much longer they will persist. We would like to be more confident that inflation will be sustained at a rate consistent with the target**

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The RBA can call it their “house view”, and we observers can call it other things. But one thing is for sure, the RBA cannot duck the question of what the appropriate monetary-policy framework is for a [secular-stagnation](#) world much longer.

They may be able to keep the cash rate on hold, but this debate cannot be kept on hold.

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Richard Holden does not work for, consult, own shares in or receive funding from any company or organisation that would benefit from this article, and has disclosed no relevant affiliations beyond their academic appointment.

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