The need for a rethink by the Central Banks

The Fed, the Bank of England and some other leading Central Banks set interest rates based on the idea that if unemployment falls too far there will be inflationary pressures on wages. This requires them to put up interest rates and deter more credit being advanced, to reduce the pressure of excess demand in the economy.

In the last century it was the case that the USA, UK and other leading economies were prone to wage inflation when potential demanded exceeded potential supply and when unemployment fell to a low level. The so called Phillips curve illustrated this trade off. Whilst there were monetarist economists who preferred a money based explanation of inflation, and other economists who pointed to the role of external shocks and commodity price trends in inflation, the mainstream view based on capacity and employment was bedded into the forecasts and intellectual framework for rate setting.

I have long queried the idea of national capacity linked only to employment in an increasingly global market. We have seen how economies capable of creating many jobs and expanding capacity invite in large amounts of migrant labour, as in the USA, UK and Germany, reducing the upwards pressures on wages. We have seen how the US and UK simply import a lot more goods and services when their domestic capacity is insufficient to meet demand, tapping into vast numbers of unemployed and underemployed people elsewhere in the world capable of doing the work. There is also the option of putting more capital to work with labour saving investment.

The Governor of the Bank of England has acknowledged this in a speech which said the Phillips curve is now very flat – in other words there is not much of an inflation threat from low official unemployment figures. The Fed has recently announced a major rethink of its approach, and has stated that in the USA now the curve is also fairly flat. In the USA employment rates are still low at a stated 60.6% of the working age population, and as the economy improves more people find work who were not registered as unemployed. There are also strong migrant flows into the country to take up new jobs. Low unemployment is not a good guide to wage growth.

So what is a better guide for a Central Bank seeking to set rates? I prefer them to consider money figures more, where the figures show too much tightness in the UK and a modest rate of expansion in the USA that should not lead to an unsustainable rise in inflation. Of course they need to listen to markets and watch the trends in output and prices generally as important guides as well. The markets saved us from too much tightening in the USA late last year. What will it take for the UK authorities to follow a more pro growth policy? Given the strict fiscal squeeze, there is an even better case for a looser money policy in the UK. The US is lightening up the money supply even though the government has embarked on a big fiscal relaxation as well.