POLICY POINT

The false "inflation versus jobs" narrative

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Introduction

Last month, the Initiative published an essay listing six mistakes Graeme Wheeler and I argue the world's major central banks widely made in responding to COVID.

The New Zealand media interpreted this as an attack on the RBNZ. Our concern was the threat to global prosperity and financial stability. The RBNZ is not a threat to either.

However, the RBNZ has largely followed what other central banks have done. By implication, their mistakes are also its mistakes, to some degree.

The current policy note responds to narratives that have emerged in New Zealand's media in the last fortnight – narratives more sympathetic to the RBNZ's decisions. Examples include articles by Tim Hunter in the *National Business Review*, Josie Pagani in *Stuff* and Liam Dann in the *New Zealand Herald*.

The case for putting preventing high unemployment ahead of inflation

One such narrative is that the RBNZ faced a choice between unemployment and inflation – and put more weight on avoiding the former. That narrative does not fit the facts.

In fact, the RBNZ did not think that it faced that choice – until it was too late. To the contrary, in 2020 it wanted to both lift the inflation rate towards 2% p.a. and reduce the risk of unemployment. It did not see itself as facing a conflicting choice.

Figure 1 shows that as late as in November 2020 it could barely see inflation reaching 2% even by 2023. The RBNZ's inflation forecasts in successive monetary policy statements (MPSs) did not go above the 1-3% target range before August 2021. (See the table in the Appendix.)

Throughout, the RBNZ has consistently under-forecast both the rise in the all-groups CPI and its momentum. Figure 2 helps illustrates this. The 7.3% rise between June 2021 and June 2022 compares to a 0.8% forecast rise in the August 2020 MPS. Again, the August 2021 MPS shows up as the time in which the RBNZ's forecasts were showing a problem.

Remember also that the 7.3% rise is artificially low because the government cut fuel tax to keep the increase down. The pre-cut forecast rise should have been more like 7.8%.

A more sophisticated narrative is that the welfare losses from unemployment are less severe than those from inflation – justifying erring on the inflationary side. Again, this argument ignores that the RBNZ did not see itself as facing a trade-off between inflation and unemployment in its 2020 decisions.

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Figure 1: RBNZ Inflation forecasts from August 2020

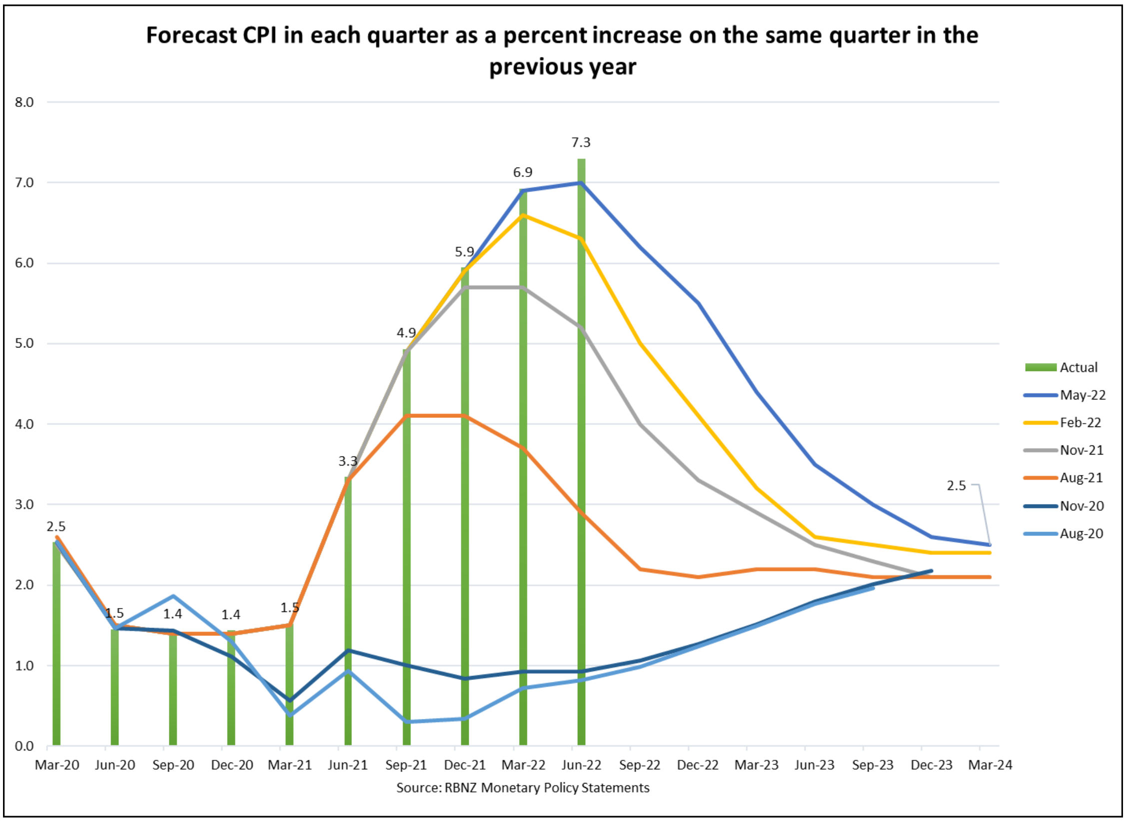
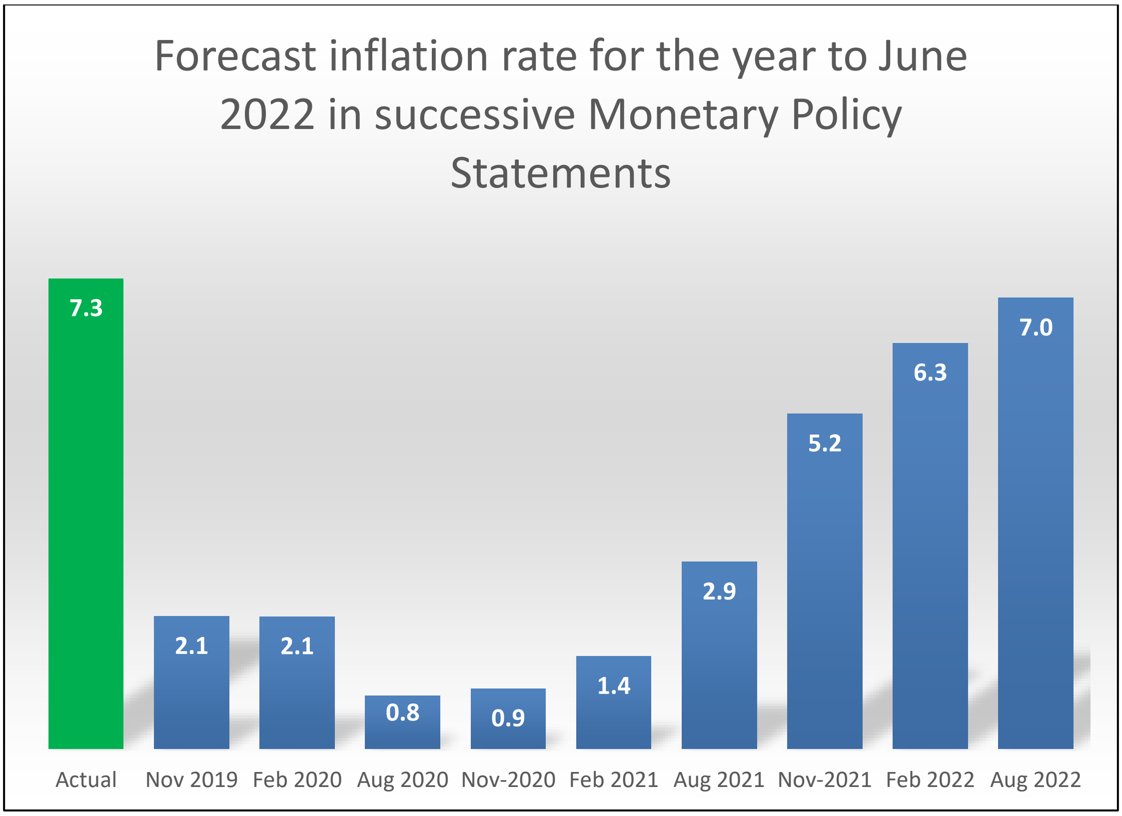


Figure 2: Errors in successive forecast CPI increases for the year to June 2022



A deeper point is that this argument presumes that allowing inflation to get away avoids unemployment. It does not. At best, inflationary monetary policy defers the days of reckoning. Those who lived through the high unemployment under Prime Minister Margaret Thatcher, President Ronald Reagan and Prime Minister David Lange's will never forget the economic pain from the need to dash entrenched inflation expectations. Monetary largesse has a horrific price.

In short, low unemployment generated by inflationary policies is likely unsustainable. Big swings in monetary policy settings have whiplash risks for investors and workers.

The case for RBNZ action in early 2020 to avert "economic collapse"

Yet another flawed argument is that a single objective (low inflation) for monetary policy means ignoring unemployment. That argument is wrong from a mainstream Keynesian perspective. High unemployment means less wage rise pressure. That allows easier monetary policy settings for an unchanged inflation target.

To the best of my knowledge no central bank with an inflation goal fails to look at labour market conditions and economic growth when reviewing its policy settings. The proposition that they would do otherwise has been called "inflation nuttery" by Mervyn King, an eminent former governor of the Bank of England.[1]

The argument that extreme RBNZ action in early 2020 was necessary to avert economic collapse also seems to confuse monetary policy and fiscal policy.

The wage subsidy was the key measure during the March 2020 lockdown. Its purpose was to sustain the employment link between locked-down workers and their employers. This was an emergency *fiscal* measure. The New Zealand Initiative strongly supported it. Indeed, it is hard to think of anyone who did not support it.

Of course, monetary policy could support such fiscal measures, and widely did across central banks worldwide. But the risks were to artificially inflate asset prices first, and wage and goods price inflation later.

Personally, I think that the 1-3% pa CPI inflation target for the RBNZ was too high for the times. Globalisation saw very low traded goods inflation for a prolonged period. That was inherently benign, but its existence masked the inflationary increases in banking system cash documented in the New Zealand Initiative's 2021 report: *Walking the Path to the Next Global Financial Crisis*.

The original 0-2% pa target range for price stability would have served New Zealand and the RBNZ better. The New Zealand Initiative made that recommendation in its 2020 report *Roadmap for Recovery: Briefing to the incoming government.*

I do not blame the RBNZ or the Treasury for the fact that the Government did not take up this recommendation. But did they give it serious consideration?

[1] Alan Blinder, "Critical Issues for Modern Major Central Banks", in *Monetary Policy-Making under Uncertainty,* Princeton University, 1999, p 67, column 2.

Concluding comment

If its forecasting experience during this period does not induce the RBNZ to re-examine its understanding of the drivers of inflation it is difficult to think what would.

For decades, I have argued that a current or former government statistician should be asked to lead a taskforce to determine what upwards drift in the CPI would be consistent with the RBNZ's statutory goal of achieving and maintaining stability in the general level of prices.

Without such an expert assessment, how can even the RBNZ know if its monetary policy is complying with its prime statutory duty?

Appendix Table of Annual CPI Increases in successive Monetary Policy Forecasts

	CPI-% change on the same quarter in the previous year										
	CPI outurn	2019	2020			2021			2022		
		Nov MPS	Feb MPS	Aug MPS	Nov-MPS	Feb MPS	Aug MPS	Nov-MPS	Feb MPS	Aug MPS	Nov-MPS
	Actual	Nov 2019	Feb 2020	Aug 2020	Nov-2020	Feb 2021	Aug 2021	Nov-2021	Feb 2022	Aug 2022	Nov-2022
Mar-20	**2.5**	2.1	2.2	2.5	2.5	2.5	2.6	2.5	2.5	2.5	
Jun-20	**1.5**	1.8	2.0	1.5	1.5	1.5	1.5	1.5	1.5	1.5	
Sep-20	**1.4**	1.9	1.9	1.9	1.4	1.4	1.4	1.4	1.4	1.4	
Dec-20	**1.4**	1.9	1.8	1.3	1.1	1.4	1.4	1.4	1.4	1.4	
Mar-21	**1.5**	1.7	1.7	0.4	0.6	1.7	1.5	1.5	1.5	1.5	
Jun-21	**3.3**	1.9	1.9	0.9	1.2	2.4	3.3	3.3	3.3	3.3	
Sep-21	**4.9**	1.9	2.0	0.3	1.0	2.5	4.1	4.9	4.9	4.9	
Dec-21	**5.9**	2.0	2.0	0.3	0.8	2.2	4.1	5.7	5.9	5.9	
Mar-22	**6.9**	2.1	2.1	0.7	0.9	1.5	3.7	5.7	6.6	6.9	
Jun-22	**7.3**	2.1	2.1	0.8	0.9	1.4	2.9	5.2	6.3	7.0	
Sep-22		1.9	2.0	1.0	1.1	1.4	2.2	4.0	5.0	6.2	
Dec-22		2.0	2.0	1.2	1.3	1.5	2.1	3.3	4.1	5.5	
Mar-23			2.0	1.5	1.5	1.7	2.2	2.9	3.2	4.4	
Jun-23				1.8	1.8	1.8	2.2	2.5	2.6	3.5	
Sep-23				2.0	2.0	2.0	2.1	2.3	2.5	3.0	
Dec-23					2.2	2.1	2.1	2.1	2.4	2.6	
Mar-24						2.1	2.1	2.1	2.4	2.5	
Jun-24							2.1	2.0	2.3	2.3	
Sep-24								2.0	2.2	2.2	
Dec-24									2.1	2.1	
Mar-25									2.0	2.0	
Jun-25										1.9	

Source: RBNZ Monetary Policy Statements

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