

Central Banks and The Things They Get Up To

Analgesics are addictive. The US Federal Reserve has cut rates to address every downturn but sows the seeds of subsequent downturns so it can never quite normalize rates before the next crisis occurs.

Analgesics are very addictive. Before 2008, the Fed used interest rates to manage the speed of the economy. It has now discovered the wonders of QE. Expect bond buying to be deployed the next time there is a crisis.

Cutting rates and QE haven't had the desired effect on real output and inflation. Asset markets, however, have done well. The result is that asset owners, especially leveraged ones, have done well while workers and people whose source of wealth and income is employment as opposed to dividends and coupons, have done poorly.

Interest rates and inflation. It is not clear that cutting rates incites inflation. Low interest rates can make capital cheaper encouraging over-investment and over-capacity leading to disinflationary pressure.

Interest rates and inflation. Low interest rates also makes it cheaper to finance the buying of factors of production relative to renting these factors. Labour is rented, fixed capital is bought. Low interest rates can therefore lead to underemployment of labour and overemployment of capital.

In a knowledge economy, labour's share of income should fall over time. Entities and companies can accumulate intellectual property without bound. A single individual, however, intelligent, can accumulate only a lifetime's intellectual property and has their intellectual capital bounded.

Unequal distribution of wealth and income complicates policy. Monetary policy faces a range of velocities of money corresponding to richer households which have a lower marginal propensity to consume (and a higher savings rate), and poorer households with a higher marginal propensity to consumer. In a highly unequal economy where the distribution is skewed, that is there are a very small number of ultra-rich, and a substantial majority of less rich, the velocity of money is lower than expected and monetary policy is blunted.

Interest rate policy impact depends on the prevailing level of interest rates. Raising rates when rates are low is not the same as raising them when they are high. When rates are low, interest rate hikes raise debt service costs significantly more than when rates are high. This can complicate central bank policy as they begin to retreat from accommodative policy.

As a reminder of the sometimes ignominious history of central banking. the world's first central bank, Riksbank, was a failed commercial bank whose founder Johan Palmstruch was condemned to death for the collapse of the bank. The world's second oldest central bank, the Bank of England, was created to monetize 1.2 million pounds of the British national debt which was raised to rebuild the navy.