But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions, as they have in Japan over the past decade? And how do we factor that assessment into monetary policy?”

Many would correctly identify the source of the above quote as Alan Greenspan, former chairman of the US Federal Reserve. However, not many would recall what he said later on in the same speech, delivered sometime in 1996: “We should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance sheets generally, and in asset prices particularly, must be an integral part of the development of monetary policy.”

It is a revelation to know that one of the leaders of the American central bank thought of asset prices as integral to the development of monetary policy. More than 20 years after he made those remarks, it is amply clear that central banks have influence only over one sort of inflation—and that is the inflation of asset prices—and not over the inflation rate in consumer goods and services that they ostensibly are targeting, in many countries around the world. With their unconventional monetary policies, they have been remarkably successful in stoking asset price inflation and have been disasters in stoking inflation of the regular variety.

In fact, historically, central banks have had very little to show in terms of being able to influence the inflation rate in either direction. The only successful instance of a central bank getting a grip on inflation through monetary policy was in the 1980s in the US, when Paul Volcker raised the policy rate to over 15% and brought down the inflation rate, and that too at the cost of two economic recessions in quick succession. In the developing world, in recent times, we know that both Zimbabwe and Venezuela have experienced hyperinflation due to explosive growth in money supply and debasement of the currency. But, in both cases, inflation was as much a consequence of monetary policy gone rogue as it was of economic rigidities, inefficiencies and policies that struck at the heart of productive enterprise in the countries.

In India, between 2009 and 2014, the annual inflation rate was in double digits. For a portion of that period, monetary policy was somewhat too loose. But, even after it corrected and became suitably restrictive or neutral, the double-digit percentage rise in the rate of inflation persisted. That had a lot to do with a reckless fiscal policy kept too loose for too long, one which also dominated monetary policy by forcing the central bank to monetize a portion of the fiscal deficit.

In other words, monetary factors may have an adjunct role in shaping inflation trends but the main culprit has to be real factors. As a (relatively) young analyst in 1997, I wrote that rates of inflation in the developed world would remain quiescent for some time to come because of the expansion in global trade and the consequent reduction in tariffs, the decline in energy prices, import of labour from, or export of jobs to, the developing world and the decline in labour bargaining power, including the waning influence of labour unions. Most of these factors endure to this day despite the mounting rhetoric against globalization and restrictions on export of jobs to, and import of labour from, the developing world. Labour anxieties in the developed world persist.

Despite very low unemployment rates in the US, UK, Japan and in many countries in the Eurozone, wage growth remains remarkably restrained. Worker insecurity is high because technological developments facilitate displacement of labour by capital. Further, technology facilitates the development of global supply chains that neutralize the role of domestic labour and other costs in the evolution of the overall cost of production, keeping inflation rates low. In short, real factors matter more for inflation outlook than monetary factors.

Claudio Borio, chief economist of the Bank for International Settlements, has been hammering away at this theme for quite some time. Edmund Phelps, the 2006 Nobel laureate in economics, thinks that “people’s values and attitudes, and their hopes and fears about the unknown and unknowable”, have a role in the current low inflation-low unemployment combination in the developed world. The remarkable and astounding failure of a decade of low-to-zero interest rates and massive amounts of liquidity failing to lift the inflation rate even marginally means that these theories need to be considered as serious alternatives to the monetary theory of inflation that has failed empirically.

Recently, Stephen King, the author of *Grave New World: The End Of Globalization, The Return Of History* wrote in the *Financial Times* that central banks do not have any idea of what drives inflation. Monetary policy will likely be more effective in targeting asset prices. Recent experience with quantitative easing bears that out. Financial stability, banking regulation and asset price inflation should be their remit and the pretence that they can influence and control retail price inflation dynamics must be dropped. It might all be too late to stop the current asset price bubble from bursting and crashing spectacularly. But what emerges out of that wreckage must be a drastically different monetary policy framework.

Will Jerome Powell pick up the baton that Alan Greenspan dropped in 1996?

V. Anantha Nageswaran is an independent consultant based in Singapore. He blogs regularly at Thegoldstandardsite.wordpress.com. Read Anantha’s Mint *columns* ***here***

Comments are welcome at baretalk@livemint.com

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