

In the face of inflation, policymakers are hesitant to reduce interest rates. Is this in line with economic theory?

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AUTHOR BIO

Blair Han is a 16-year-old high school student currently living in Japan with a keen interest in economics and global issues. With a passion for understanding the nitty-gritty of monetary policy and its implications for economic stability, she has undertaken this research to find out the challenges of disinflation and how central banks can manage it. As increasingly recognizing the interdependence of world economies, she hopes to add to dialogue on how policymakers can manage economic uncertainty while generating sustainable growth. This essay demonstrates her dedication to using economic theory to address current problems and further understand the underlying forces of the global economy.

ABSTRACT

The paper addresses the challenge central banks face in dealing with disinflation, particularly the "last mile" of reducing inflation to target. Drawing from recent economic circumstances, including the inflationary surge following the pandemic and the ensuing disinflationary pressures, the study examines policymakers' reluctance to lower interest rates amid falling inflation. The analysis draws on economic theories such as monetarism and New Keynesian economics centered around the money supply and the Phillips curve as the underpinnings for inflation-unemployment relations. The United States and Japanese historical case studies provide mixed successful and failed experiences in the management of disinflation, highlighting the requirement for central bank judgment and flexibility of approach. The article also considers the potential consequences of maintaining high interest rates through disinflation, including stifled economic growth and increased unemployment. Finally, it examines newer policy approaches, such as gradualism and openness in communication, as ways to maintain economic stability. The paper concludes that the conservatism of policymakers, while seemingly counterintuitive to traditional economic theory, is evidence of an acute understanding of the complexities of contemporary economies. Also, the paper concludes that central banks must trade off responsiveness to new economic data against caution, achieving both price stability and growth sustainability.

Keywords: *Disinflation; Central Banks, Interest Rates; Monetary Policy; Inflation Targeting; Phillips Curve; Economic Stability; Federal Reserve; Deflation; New Keynesian Economics; Gradualism; Unemployment.*

NAVIGATING DISINFLATION: CENTRAL BANK STRATEGIES AND ECONOMIC IMPLICATIONS

During the Covid-19 pandemic, shocks to food and energy prices, shortages caused by supply chain disruptions, and a tightening labor market led to high inflation rates. The Federal Reserve responded by cutting the interest rates to near zero for two years to save the US economy from recession (Adams, 2024). As a result, inflation hit a 40-year high, leading to a series of rate hikes to 5.5% (Adams, 2024). Countries around the world experience similar trajectories. Currently there is a global trend of disinflation, which refers to a decrease in the rate of inflation (Marks, 2023). Between March 2022 and May 2024, US inflation fell by 5.2 percentage points as measured by the Consumer Price Index (CPI) (Bensaidani, 2024). As disinflation enters the “last mile,” policymakers are reluctant to lower interest rates. The “last mile” challenge, which refers to the often difficult final stages of disinflation, requires vigilance and fine-tuning of approaches. While maintaining price stability is crucial, policymakers must manage disinflation carefully to avoid hampering economic growth.

THE ROLE OF CENTRAL BANKS IN ECONOMIC STABILITY

Central banks play an important role in the domestic and global economy. Central banks, such as the Federal Reserve, typically target a specific inflation rate (e.g., 2% annually) to maintain price stability. In many countries around the world, central banks have been entrusted with maintaining price stability as their sole or primary objective. To ensure that this objective is not compromised by short-term political pressures, these financial institutions have been granted independence from government control (Moser-Boehm, 2006).

The central bank adjusts its key interest rate to influence the money supply and achieve its inflation target. By raising rates, it can reduce the growth of the money supply and curb

inflation, while lowering rates increases the money supply to stimulate economic activity. However, during periods of disinflation, central banks must be careful not to cut rates too quickly. From a monetarist perspective, championed by Milton Friedman, the money supply is the primary determinant of inflation in the long run. Disinflation, from a monetarist perspective, could be a sign that the money supply is growing too slowly. Despite the need to accelerate the rate of growth, increasing the money supply too quickly could potentially reignite inflation.

That said, it is crucial to avoid deflation, as prolonged disinflation can have severe negative consequences. Disinflation can result in a vicious cycle where people and firms expect prices to keep falling, leading them to delay spending and investing, which further depresses prices (Beidas-Strom, 2016). Additionally, as prices and incomes decline, the real value of existing debt increases, making it more burdensome for borrowers (Szczepański, 2015). This can lead to reduced economic activity and increased financial instability.

CONSEQUENCES OF “HIGHER FOR LONGER”

A reluctance to lower interest rates during a deflationary period can have significant economic consequences, in particular by inhibiting economic growth. When borrowing costs decline, both businesses and individuals are more likely to borrow for various purposes, ranging from business expansion to home purchases (Baldwin, 2023). This increased borrowing typically leads to higher levels of investment and consumer spending, two key mechanisms of economic growth. Therefore, maintaining higher interest rates during deflation can potentially prolong economic stagnation.

New Keynesian economics posits a complex interplay between inflation and unemployment, often illustrated through the Phillips curve. This model suggests a short-term inverse relationship, where decreasing inflation -

or deflation - tends to coincide with rising unemployment (Engemann, 2020). As a result, maintaining high interest rates during deflationary periods can exacerbate joblessness, while reducing interest rates can stimulate growth and job creation. New Keynesian theory emphasizes the importance of interest rate flexibility in managing this trade-off. By allowing for lower interest rates during deflationary periods, policymakers can help balance the risks of both inflation and unemployment (Engemann, 2020).

HISTORICAL CASE STUDIES: THE U.S. AND JAPAN

The 1990s offered contrasting case studies of central bank interest rate management during disinflation and deflation. The U.S. successfully navigated a period of disinflation following the recession of the late 1980s. By strategically lowering interest rates in 1991, the Federal Reserve stimulated economic recovery without igniting inflation (Matthews, 2022). In stark contrast, Japan struggled with prolonged deflation and economic stagnation after its asset bubble burst. The Bank of Japan's aggressive interest rate cuts, culminating in near-zero interest rates in the late 1990s, failed to reignite growth (Williams, 2009).

Taken together, these examples underscore the critical role of central bank judgment in managing interest rates during periods of disinflation. While rate cuts can be effective in stimulating growth during the "last mile," their impact in a deflationary environment is less certain and thus requires fine-tuning.

STRATEGIES FOR ECONOMIC STABILITY

Recent developments have complicated traditional policy approaches. The flattening of the Phillips curve, which is the traditional trade-off between unemployment and inflation, has weakened in recent decades, challenging policymakers to reassess the relationship between these key variables (Engemann, 2020). Moreover, a cautiousness bias, or the tendency

to act less decisively due to uncertainty, can inadvertently shift private sector inflation expectations away from the central bank's target (Dupraz, 2023).

In light of these developments, policymakers have adopted a range of strategies to maintain economic stability and adapt to evolving economic relationships. Gradual interest rate adjustments, or "gradualism," entail implementing minor, incremental alterations to interest rates, thereby facilitating seamless transitions in monetary policy (Bernanke, 2004). The close monitoring of economic indicators, including employment, consumer spending, and investment levels, enables the implementation of timely policy adjustments. Transparent communication of policy objectives to the public and financial markets fosters trust and manages expectations.

CONCLUSION

A recent illustration of this adaptive approach is the Fed's response to data indicating a weak job market (Saphir, 2024). In light of the disappointing employment figures, the Fed is anticipated to reduce interest rates by half a percentage point in September. After a period of sustained high interest rates aimed at combating inflation, the Federal Reserve now considers economic weakness to be a more pressing concern.

This policy shift demonstrates the intricate relationship between economic theory and practical policymaking in the context of disinflation. While traditional economic theory might suggest lowering interest rates to stimulate growth during periods of disinflation, policymakers' reluctance to do so reflects a more nuanced approach. This cautious stance can be justified by concerns about the potential for inflation to be reignited, the necessity of maintaining central bank credibility, and the uncertainty surrounding the persistence of disinflationary pressures. Nevertheless, as evidenced by the Fed's recent decision, there is a point at which economic data requires action that is aligned with theoretical principles. This

equilibrium between caution and responsiveness exemplifies the dynamic character of monetary policy and underscores the necessity for central banks to adapt their strategies to an ever-evolving economic landscape.

In conclusion, although the initial reluctance may appear to diverge from the straightforward tenets of economic theory, it is in fact aligned with a more sophisticated comprehension of the intricate nuances inherent to the administration of contemporary economies.

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