Less room for MAS to influence inflation rate

Unlike the 70s, there’s no productivity gains from catch-up growth to temper joblessness

by ROON HIAN TECK

A

LUNG with the release of its annual report, the Monetary Authority of Singapore (MAS) announced on July 24 its revised inflation forecast for 2008. It now expects the Singapore economy to experience an annual inflation rate of between 6 and 7 per cent, up from its earlier forecast of 5-6 per cent.

This is the third revision for the year, which prompts the question: how much control does the central bank actually have over the country’s inflation rate?

Much modern day thinking about a country’s control over its inflation rate is influenced by the work of two economics Nobel laureates: Robert Mundell and the late Milton Friedman, a Columbia University’s professor of economics at the time.

According to Mr Phelps and Mr Friedman, a central bank can engineer a certain level of effective demand through its monetary policy to achieve any desired rate of inflation. There are, however, two undesirable consequences for the unemployment rate in the short and long run.

For example, if the central bank wants to push the inflation rate down from 6 per cent to 3 per cent, it can do so by tightening monetary policy, which reduces effective demand and increases layoffs of workers.

The increased layoffs push up the actual unemployment rate above the “natural rate” of unemployment (which is determined by structural factors such as productivity growth, the amount of skills mismatch, and labour market institutions).

The increased slack in the labour market produced by tight monetary policy then reduces wage aspirations of workers until wage demands fall sufficiently for firms to find it profitable to re-employ all the previously retrenched workers.

In the long run, then, the economy returns to its natural rate of unemployment. In the short term, however, it suffers a period of cyclical unemployment when the actual rate of unemployment exceeds the natural rate of unemployment.

Via tight monetary policy, the central bank has the means to bring down the inflation rate. Contrariwise, via loose monetary policy, the central bank can raise the inflation rate.

In research that I have conducted with the King Wang of Nanyang Technological University, we applied an econometric method called a Structural Vector Autoregressive, or SVAR, to estimate the time path of Singapore’s natural rate of unemployment for the period 1968-2003. Just as the actual unemployment rate was below the natural rate of unemployment, it was above the natural rate of unemployment.

For the decades of the 1970s, when the world economy, like today, faced high energy prices, we found that Singapore’s cyclical unemployment was generally positive, suggesting that monetary policy was tight. The tight monetary policy helped to rein in domestic inflationary pressures arising from the quadrupling of oil prices as well as high foreign inflation rates.

Does our experience in facing off the inflationary impact from the oil shocks of the 1970s via tight monetary policy suggest that we can use a tried and trusted model to fight the current food and fuel price shocks?

My view is that the available room for maneuver by the MAS is now more limited compared to the 1970s. In the earlier era, there was high productivity growth resulting from rapid “catch-up growth”. At that time, Singapore raced towards the world technology frontier via inflows of machinery imports and foreign direct investment from technology leaders in the G-5 countries. This strategy paid off in increasing the natural rate of unemployment from over 7 per cent in 1970 to below 3 per cent in 1980.

The steady decline in the natural rate of unemployment throughout the 1970s allowed monetary policy to be very tight without causing the actual unemployment rate to rise.

Having substantially closed the technology gap, there is far less room today for catch-up growth to lower the natural rate of unemployment. Adapting a monetary stance requiring too severe an appreciation of the Singapore dollar would lead to too drastic a decline in effective demand and thus too sharp a rise in actual unemployment.

The silver lining is that, notwithstanding the energy and commodities shock, firms in Singapore have increased their pace of hiring in anticipation of a dynamic services sector that would draw tourists and other visitors.

This has helped to lower the natural rate of unemployment, thus allowing the central bank to adopt a moderately tight monetary policy without increasing joblessness. However, when the widely anticipated productivity gains in the services sector are achieved in two or three years, hiring will revert to a more normal level and the natural rate of unemployment will rise.

The economy must use the breathing room it now has, to find creative ways to launch new business ideas. This will facilitate job creation and create room for the monetary authority to offset the inflationary pressure from higher food and fuel prices as well as higher foreign inflation rates.

Workers also need to adjust their expectations to the reality of the tailing off of catch-up growth.

The writer is professor of economics at Singapore Management University. The views expressed here are his own.