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“We want a Goldilocks economy”

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Economic objectives of every central bank are similar: internal and external stability of the currency with an acceptable level of unemployment. Internal stability relates to maintenance of the value of domestic currency by controlling inflation. External stability is concerned with maintaining a stable exchange rate.

Central banks of countries under a fixed exchange rate regime like Fiji maintain some safe level of reserves for defending their exchange rates. If they are low, countries devalue their currencies. Pacific island countries, including Fiji aim at maintaining a level of international reserves equivalent to four to five months’ imports. Their objective is to keep annual inflation within the range of 3 to 4 percent.

Advanced countries have flexible exchange rates. They do not need any specific level of reserves. While US, UK, Eurozone and Japan target inflation rate of 2 percent, Australia aims to achieve a medium-term average rate of inflation of 2 to 3 per cent. These target rates are considered most consistent over the longer run with mandate for price stability and maximum employment.

Preoccupation with inflation

World economies in the past have suffered from inflation (continually rising price level) more number of times than with deflation (continually declining price level). As an economy grows, prices for inputs and wages also rise, reflecting the demand for them in the production of goods and services instigated by rise in income and jobs. Besides normal growth, there are other reasons as well. Expansionary policies resulting in persistent fiscal deficits or wars or domestic unrest are also reasons behind inflation. Episodes of hyperinflation include the cases of Zimbabwe during 2001-2008 , ranging from 112 percent in 2001 to 11.2 million percent in 2008; and Germany during 1921-23 with inflation at one billion percent per annum are well documented.

Central banks have learned from the experiences of these countries as well as from the peace years. The US experiences of the 1980s, when the central bank implemented tough, tightening measures to rein in inflation still guide advanced economies.

What seems difficult now is how to control deflation. The lessons learned from the Great Depression of the 1930s are not forgotten. Yet, the problem is compounded by lack of faith in fiscal policy measures. The pendulum has swung in the direction of monetarism.

Inflation hurts economic agents. It reduces value of income of fixed wage and salary earners; and hurts savers by decreasing their purchasing power. But, it encourages borrowers and investors, as the decrease in real cost of borrowing (nominal interest rate minus the expected inflation rate) acts a good incentive.

Deflation hurts economic agents in the opposite way. Falling prices are sweet news for consumers; but continually falling prices would only make consumers expect further fall in prices. They tend to postpone consumption. In economies, where consumption is 70 percent of GDP, that is disastrous. When consumption falls, production falls. Businesses and companies close, which only deepens the recession with unemployment. Investors hesitate to invest in an economy when prices are falling. That leads to no growth.

“The porridge not too hot or cold”

That is what Goldilocks would like to have in the children’s story, ***The Three Bears.***

What we need is a Goldilocks economy: the phrase was coined by David Shulman in a strategy piece he wrote in 1992 for Salomon Brothers: ***The Goldilocks Economy: Keeping the Bears at Bay.*** He referred to “an economy that was hot enough for profit growth, but cool enough to keep the Fed from hiking interest rates”.

Politicians too loved the term.

The Secretary of State Robert Reich in Clinton Administration announced in a White House news conference in 1995 that US was enjoying a Goldilocks recovery that was “not too hot, not too cold.”

Presently the world economy is going through deflation, significantly represented by falling oil and commodity prices. The UK consumer price index recorded zero percent inflation in March and the US inflation was just 0.2 percent.

The policy makers now attending the World Bank and IMF meetings in Washington D.C., want a Goldilocks economy: sustained economic growth with moderate inflation below 2 percent per annum, giving incentives to investors.

A little inflation is needed for consumption too. Businesses do not want you to postpone consumption. Better buy your semi-durables today rather than next month.

Will there be continuation of easy money policy?

Always obsessed with fear of inflation, inherited from past historical experiences of Germany, the dominant economy of the Eurozone, the European Central Bank has finally opened up by embracing what the US Fed did during last six years: quantitative easing or simply pumping in nearly US $4 trillion in the economy.

They all want a little inflation.