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Disciplinary Brief

VIRTUE ETHICS AND CENTRAL BANKING

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Central Bank Concerns with Price Stability and Inflation

Central banks are charged with maintaining price stability. Strictly speaking, if prices were stable, they would neither rise nor fall. In practice, prices rising slowly but predictably are less damaging to the economy than prices falling at any rate. So the practical equivalent of price stability is a rate of price inflation that falls within a target band of low inflation rates, for example, 2-3 percent per annum in the case of Australia's central bank, the Reserve Bank of Australia.

Central banks manage price inflation by influencing aggregate demand in the economy, that is, the sum of what consumers, investors, governments and foreigners seek to purchase from suppliers in the domestic economy. When aggregate demand exceeds aggregate supply, that is, the sum of what suppliers are willing to offer for sale at prevailing prices, conditions are ripe for prices to rise across the economy and for inflation to ensue, perhaps at a high rate if aggregate demand grows faster than aggregate supply and persistently so.

Balancing Interest Rates, Employment and Economic Welfare

Consumers, investors, foreigners and even governments change their demand for domestically produced goods and services when interest rates change. This is not the only factor that will induce changes in aggregate demand, but it is an important one. It is also a factor that can be changed relatively quickly unlike other influences on aggregate demand including taxes. Central banks exert a powerful influence over the level of interest rates by virtue of their monopoly in crucial parts of the financial system, including the provision of reserves of liquidity (i.e., cash) to the banking system. It is their ability to move interest rates quickly that gives central banks the power to influence aggregate demand and hence the rate of price inflation.

A dilemma in seeking to maintain a target rate of price inflation over time is that manipulating interest rates affects more than the rate of growth of prices. The rate of employment growth (and hence unemployment) is also affected. Indeed, slowing the growth of aggregate demand to match the growth of aggregate supply more closely almost inevitably involves firms losing sales and laying off workers. Laid-off workers in turn curtail their consumption as their incomes fall, causing a further reduction in sales and employment as the growth of aggregate demand slows. While keeping the rate of price inflation low and predictable is a good thing, its value, at least in the short term, is easily outweighed by the loss of economic (and social) welfare occasioned by the loss of employment. So central banks are generally enjoined to balance their focus on price stability with concern for the flow-on implications for employment.

Both objectives are given equal weight in the Act of Parliament that governs Australia's central bank. For the avoidance of doubt, the Act includes a third objective, namely, to conduct the Bank's operations in a manner that best promotes "the economic prosperity and welfare of the people of Australia". Keeping inflation within bounds is clearly welfare- enhancing but not at the expense of people's livelihood and employment.

As a member of the Board of Australia's central bank, I deliberate along with eight of my fellow Australians, including the Bank's Governor and Deputy-Governor and the Secretary to the Australian Treasury, on whether and, if so, how the Bank should change interest rates in pursuit of price stability and full employment, being mindful of the need at all times to promote the economic prosperity and welfare of Australians. The Board meets eight times each year. A decision not to change interest rates at a particular meeting is as influential as a decision to raise or lower them.

Balancing Technical Correctness with Good Judgement

To the uninitiated, calibrating interest rates to optimize the path of inflation and unemployment over time might seem like a technical problem that could be solved by a computer, especially one enhanced with access to generative AI. In practice, significant human judgement must be brought to bear, which is why the decision is delegated by Parliament to a group of nine decision-makers and not to an algorithm. Furthermore, setting aside the technical nature of the decision, whatever outcome is decided must be communicated to the public, some of whom will gain and others of whom will lose from any change in interest rates, at least in the short term. The public's willingness to accept the decision is less a matter of its technical correctness than of the public's confidence in the judgment of the decision-makers and their need to confer at some length in reaching their decision.

Practical Wisdom

As I deliberate with my colleagues at each meeting, I am struck by the need for *practical wisdom* or prudence as the key virtue required of each Board member. Only a minority of members are technical specialists and even those who are, like myself, need to apply prudence far more than technical expertise in reaching the right decision. It is not unusual for technical specialists on the Bank's staff to recommend a course of action based on predictions of one of more of the Bank's econometric models.

Board members must judge how the predictions of a technical model, based as they are on a variety of assumptions, might apply to conditions in the real economy, including whether markets might react in ways not contemplated in a formal model. Practical wisdom draws on experience but also displays caution in the face of imperfect knowledge.

Humility

Furthermore, the vicissitudes and uncertainties of the economy are such that *humility* is a second virtue much in demand. Not only is humility in the face of complexity helpful for group dynamics on the Board, it is also helpful in setting the tone for announcing decisions to the public, most especially when, with hindsight, particular decisions turn out to have been wrong. Most central banks, Australia's included, failed to foresee the sudden surge of inflation as economies emerged from the recent pandemic.

This required much sharper increases in interest rates than had been forecast just months earlier. In Australia's case, the Reserve Bank Governor was pilloried by the press and other commentators for having "promised" that interest rates would remain low only to preside over the sharpest increase in rates in living memory as inflation unexpectedly took off. He was obliged to apologise to people who had acted on the Bank's "forward guidance" and suffered financial pressure as a result.

Courage

Central banks are generally conferred significant independence from governments in their decision-making. This is to shore up confidence that their decisions are made without undue political interference. Nonetheless, central banks are public institutions whose legitimacy ultimately derives from elected representatives. The virtue of *courage* is required when political pressure mounts, most especially when the economic stakes are high, as they were during the recent pandemic, when central banks, including Australia's, opted for extreme measures in the face of potentially extreme outcomes. The discomfort is heightened when governments opt to deflect public angst onto central banks rather than initiate unpopular policies of their own. It takes courage to hold the course when governments, for their own reasons, say and do little to reassure the public in the face of unpalatable measures instigated by their central banks in the public interest.

Temperance

Having said that, in more normal circumstances, *temperance* is the virtue required to balance objectives that conflict in the short-term (keeping inflation low without raising unemployment) and only align over the longer term. Extreme circumstances demand intemperate measures; the public expects something drastic to be done. In normal times, however, the need for balance returns. Seeking to lower inflation too quickly at the expense of higher unemployment will not be tolerated when inflation is not regarded as out of control. How quickly to pursue long-term inflation targets when people's jobs might be sacrificed, at least in the short term, calls for temperance, along with prudence, courage and humility.

The Call to Virtue for a Central Banker

As a Board member, I find myself constantly seeking the virtues of practical wisdom, humility, courage and temperance in fulfilling my responsibilities as a public decision- maker. As a Christian, I find the OT command to "seek the peace and prosperity of the city” (Jer.29:7) and Jesus’ command to love my neighbour as myself (Matt.22:39) especially helpful as I look beyond the instrumental objectives of price stability and full employment towards the broader remit of promoting the economic prosperity and welfare of the Australian people.

Further Reading

Rajan, Raghuram. 2023. **Monetary Policy and its Unintended Consequences** (Cambridge MA: MIT Press) in which he calls for central banks to exhibit greater humility in the face of unknown unknowns and the inevitable unintended consequences of their actions.

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