

Economy

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The Nobel lesson for central banks in an age of supply shocks



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AS GOVERNMENTS AND central banks grapple with unpredictable US tariff decisions, geopolitical tensions in West Asia and renewed energy-price uncertainty, containing inflation without undermining growth has become increasingly complex. The 2026 Nobel Prize in Economic Sciences, awarded to Robert E. Hall and Michael Woodford for their contributions to the microeconomic foundations of macroeconomic stabilisation, is particularly relevant.

The central insight is that economies are not governed by fixed relationships between inflation, output and unemployment. Millions of decisions by

households and businesses, shaped by changing incentives and expectations, produce these outcomes. Understanding this behaviour is essential to designing stabilisation policies without creating new imbalances.

The intellectual foundations of stabilisation policy go back to John Maynard Keynes, who argued that aggregate demand need not automatically match productive capacity. Insufficient demand can force firms to cut production and employment, deepening a downturn, while excessive demand can generate inflation. Fiscal and monetary policy can smooth these fluctuations by supporting demand when weak and restraining it when the economy overheats.

However, the stagflation of the 1970s exposed the limitations of models built around apparently stable relationships between macroeconomic variables. Oil-price shocks combined rising inflation with weak growth and higher unemployment,

challenging the simple interpretation of the Phillips curve as a predictable trade-off between inflation and unemployment. The problem was not that the curve had become irrelevant, but that supply shocks and changing inflation expectations could fundamentally alter this relationship.

This raised a deeper question: could policymakers rely on historical relationships if households and businesses changed their behaviour in response to policy? Robert Lucas's critique highlighted the problem. Macroeconomic models needed stronger microeconomic foundations explaining how individuals made decisions and how those decisions changed with the policy environment. This shift helped shape modern New Keynesian economics, which combines forward-looking behaviour with the recognition that prices and wages do not adjust instantaneously.

Robert E. Hall's contribution addressed a fundamental ques-



tion: what determines household consumption? In his influential 1978 paper, Hall examined the implications of the life-cycle and permanent-income hypothesis, under which consumption depends on expected lifetime resources rather than current income alone. If households have already incorporated available information into their plans, an anticipated income increase need not immediately change consumption. Hall's result was

striking. Under the model's assumptions, consumption follows a random walk: changes cannot be systematically predicted using information already available. Consumption is not constant; it changes when new information alters expectations about future resources.

The policy implications are important. A tax cut or transfer payment will not necessarily increase consumption predictably. Its effect depends on

whether households view the additional income as temporary or permanent, as well as their access to credit and savings. Borrowing-constrained households may respond more strongly to current income. Hall's framework provides a benchmark for understanding these differences, not a claim that consumption is always unpredictable in practice.

Michael Woodford extended the role of expectations to monetary policy. Drawing on Knut Wicksell's distinction between the market and natural rates of interest, Woodford developed a framework in which monetary policy operates through real interest rates, spending decisions and expectations, rather than simply changes in the money supply. The crucial comparison is between the real policy rate and the natural real rate, which, in simplified terms, is consistent with sustainable output and stable inflation in the absence of economic disturbances. When the real policy rate falls below the

natural rate, demand tends to strengthen; when it rises above it, demand tends to weaken. Since the natural rate changes with economic conditions, the nominal policy rate alone cannot indicate whether monetary policy is restrictive or accommodative.

Woodford also demonstrated why central-bank communication matters. When households and businesses base decisions on expectations of future conditions, the anticipated path of interest rates can influence current consumption, investment and price-setting. Credibility and transparency are therefore not merely desirable institutional attributes; they are integral to monetary-policy transmission.

This framework is particularly relevant when supply shocks complicate the inflation-growth trade-off. Higher energy prices or tariff-induced cost increases can weaken production while raising inflation. Raising interest rates cannot reverse the original shock, but can restrain demand and

limit the risk of higher costs feeding persistently into wages, prices and inflation expectations. The appropriate response depends on the shock's persistence, demand strength and how firmly inflation expectations remain anchored. Mechanical tightening in response to every price increase could unnecessarily damage growth.

Hall and Woodford's lasting lesson is that stabilisation policy cannot be reduced to mechanically adjusting interest rates or public spending until headline indicators return to target. It requires understanding how households consume, firms set prices and expectations shape policy responses. Amid recurring supply disruptions and geopolitical uncertainty, this micro-founded approach offers central banks a more rigorous basis for balancing price stability against the costs of weakening economic activity.

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