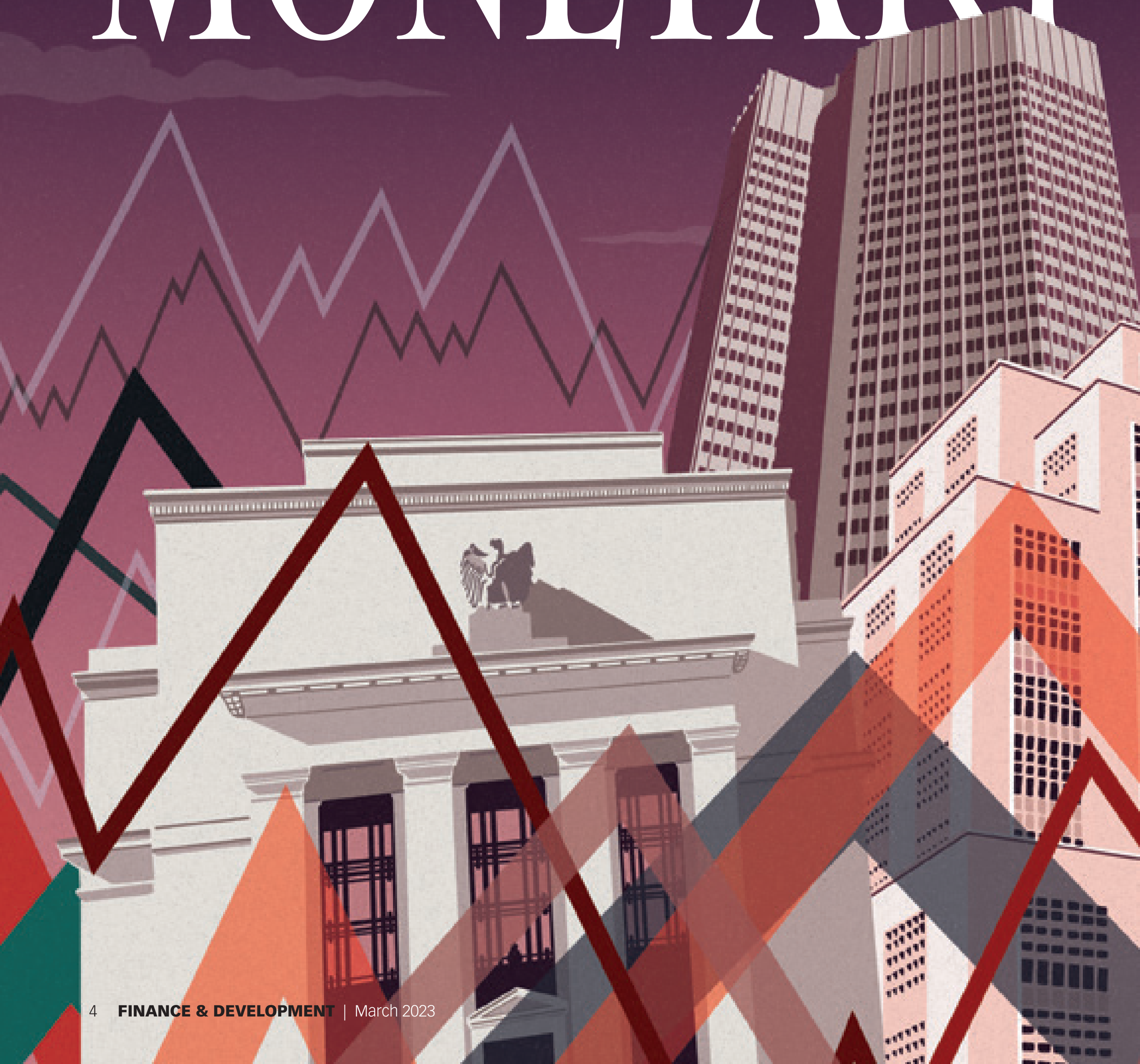
RETHINKING MONETARY



After decades of quiescence, inflation is back; to fight it central banks must change their approach

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POLICY IN A CHANGING WORLD

ART: PETER REYNOLDS

Monetary theory in economics has consisted of various schools of thought rather than a single unified model. Each of these schools emphasizes different forces that drive inflation and recommends a distinct policy response. Different times have raised different challenges—and each required its own policy approach.

Now, a resurgence of inflation requires yet another shift in emphasis in monetary policy. The predominant intellectual framework central banks have followed since the global financial crisis that began in 2008 neither stresses the most pressing looming issues nor mitigates their potential dire consequences in this new climate.

Following a lengthy period of low interest rates and low inflation, the global economy is entering a phase characterized by high inflation and high levels of both public and private debt. Fifteen years ago, central banks saw an urgent need to incorporate financial stability and deflation concerns into their traditional modeling of the economy and developed unconventional tools to deal with both.

Although financial stability remains a concern, there are important differences between the current environment and the one that followed the global financial crisis:

- Public debt is now high, so any interest rate increase to fend off inflation threats makes servicing the debt more expensive—with immediate and large adverse fiscal implications for the government. Since the beginning of the COVID-19 crisis in early 2020, it is also evident that fiscal policy can be a significant driver of inflation.
- Instead of deflationary pressures, most countries are experiencing excessive inflation. That means there is now a clear trade-off between a monetary policy that tries to reduce aggregate demand by raising interest rates and one that aims to ensure financial stability.
- The nature and frequency of shocks have changed. Historically shocks were mostly from increases or decreases in demand—with the prominent exception of the supply shocks during the so-called stagflation of the 1970s. Now there are many shocks: demand vs. supply, specific risks vs. systemic risks, transitory vs. permanent. It is difficult to identify the true nature of these shocks in time to respond. Central bankers need to be more humble.

Monetary policy requires a modified approach that is robust to sudden and unexpected changes in the macroeconomic scenario. Policies that are effective in one macroeconomic environment may have unintended consequences when conditions suddenly change. This article will discuss the main challenges central banks will face, which monetary theories will be in the limelight, and how central banks can avoid becoming complacent and end up fighting the last war.

The monetary-fiscal interaction

Central banks seem to act as the directors of modern economies, setting interest rates with the goal of stabilizing inflation and often attaining full employment as well (in developed economies). An essential cornerstone of this approach, which can be called monetary dominance, is *central bank independence.* A central bank has de jure independence if it legally has the ultimate authority to set interest rates without interference from the government. However, de facto independence is also important: when setting interest rates, the central bank should not have to worry about whether higher rates will increase government indebtedness or default risk. Indeed, as the central bank hikes interest rates and the government has to pay more for its debt, the hope is that authorities will cut back on expenditures, thereby cooling the economy and lowering inflation pressure. The ability of central banks to set monetary policy and control the economy in more fraught times hinges on independence.

The low interest rates and less extreme public debt levels that prevailed after the global crisis permitted central banks to ignore what were then relatively inconsequential interactions between monetary and fiscal policy. The period following the 2008 crisis was one of *monetary dominance*—that is, central banks could freely set interest rates and pursue their objectives independent of fiscal policy. Central banks proposed that the core problem was not rising prices, but the possibility that weak demand would lead to major deflation. As a result, they focused primarily on developing unconventional policy tools to allow them to provide additional stimulus. Central banks also felt emboldened to pursue policies that would simultaneously meet the need for further stimulus and achieve social objectives, such as hastening the green transition or promoting economic inclusion.

During the COVID-19 crisis, circumstances changed dramatically. Government spending rose sharply in most developed economies. In the United States, the federal government provided massive and highly concentrated support in the form of "stimulus checks" sent directly to households. European countries initially implemented somewhat more modest programs (largely focused on preventing workers from being let go) and on spending programs to assist the green and digital transitions. Fiscal expansion seems to have been a primary driver of inflation in the United States but has contributed to inflation in Europe as well. But as spending was increasing, countries were hit by supply shocks of unprecedented proportion, largely the result of pandemic-related problems—such as supply chain disruptions. These added to inflation pressures.

The pandemic demonstrated that monetary policy does not always control inflation on its own. Fiscal policy also plays a role. More important, the accompanying buildup of public debt raised the possibility of *fiscal dominance*—in which public deficits do not respond to monetary policy. Whereas low debt levels and the need for stimulus allowed monetary and fiscal authorities to act in tandem following the global financial crisis, the prospect of fiscal dominance now threatens to pit them against one another. Central banks would like to hike interest rates to rein in inflation, whereas governments hate higher interest expenses. They would prefer that central banks cooperate by monetizing their debt—that is, by purchasing government securities private investors won't buy.

Central banks can retain independence only if they promise not to accede to any government desires to monetize excessive debt, which would then force authorities to cut spending or increase taxes, or both—so-called fiscal consolidation.

A key question for policy is what determines the winner of any contest between fiscal and monetary dominance. Legal guarantees of central bank independence are insufficient, by themselves, to guarantee monetary dominance: legislatures can threaten to change laws and international treaties can be ignored, which could cause a central bank to hold off its preferred policy. To promote monetary dominance, the central bank must remain well capitalized: if it requires frequent recapitalization from the government, the central bank looks weak and risks losing public support. Central banks with large balance sheets that contain many risky assets and pay interest on the reserves to private banks may have large losses as interest rates rise. Those losses could result in increased pressure from fiscal authorities to refrain from raising interest rates.

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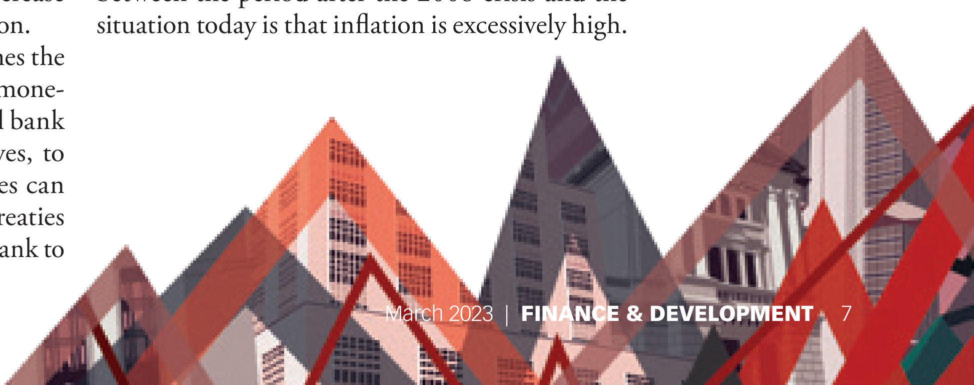
Most important, the central bank must keep public opinion on its side, because the public is the ultimate source of its power and independence. That means the central bank should effectively communicate the rationale for its actions to retain public support, especially in the face of fiscally driven inflation. A central bank ultimately maintains its dominance if it is able to credibly promise that it will not bail out the government by monetizing public debt if there is a default.

The threat of financial dominance

Central banks face new challenges in the interaction between monetary and financial stability. They now operate in an environment in which private debt is high, risk premiums on financial assets are depressed, price signals are distorted, and the private sector relies heavily on the liquidity the central bank provides in a crisis. The key difference between the period after the 2008 crisis and the situation today is that inflation is excessively high.



A decade and a half ago, central banks' twin goals of stimulating economic activity and financial stability through unconventional policies coincided. Now, there are clear trade-offs between inflation management and financial stability, because interest rate hikes to fight inflation threaten to destabilize financial markets.

After the global crisis, central banks faced the dual problem of weak demand and financial instability and committed to doing "whatever it takes" to address both. Once conventional interest rate stimulus was exhausted, they turned to unconventional quantitative easing (QE) programs, in which they purchased large amounts of risky assets from the private sector, hoping that the resulting fall in credit spreads would spur lending and real activity. These QE programs also enabled central banks to play a new significant role as market maker of last resort, buying securities when no one else would.

THERE ARE ALWAYS TRADE-OFFS BETWEEN THEIR GOALS OF PRICE STABILITY AND FINANCIAL STABILITY—EVEN IF THAT TENSION BECOMES CLEAR ONLY IN THE LONG RUN.

The large purchases of private assets caused central bank balance sheets to swell, and that expansion was not undone when the crisis ended because central banks feared that doing so quickly would cause economic damage. The willingness to maintain large balance sheets has led to a buildup of private debt, depressed credit spreads, distorted price signals, and high house prices from increased mortgage lending. The private sector has come to depend on the liquidity provided by central banks and has grown accustomed to the low-interest-rate environment. Indeed, financial markets have come to expect that central banks will always step in when asset prices fall too low. Because the private sector has become so dependent on the central bank, the contractionary effect of unwinding central bank balance sheets may be significantly more visible than the stimulus provided by QE. It is not yet clear which problems may afflict the financial sector when the monetary policy environment abruptly changes, but the potential losses faced by pension funds in the United Kingdom in 2022 provide a stark warning. Those funds used techniques that when unraveled had the potential to seriously distort long-term interest rates and trigger a larger crisis. The Bank of England had to step in to buy UK bonds to forestall a crisis after long-term rates climbed.

Now, in an environment that compels central banks to raise rates to combat inflation, their goals of inflation stability and financial stability conflict. The reliance of the private sector, especially the capital markets, on central bank liquidity has led to a situation of *financial dominance*, in which monetary policy is restricted by concerns about financial stability. In such an environment, monetary tightening could wreak havoc on the financial sector and further render the economy vulnerable to even small disturbances. The extent of financial dominance depends on whether private banks are sufficiently capitalized to withstand losses and on the smoothness of private bankruptcy proceedings. A well-functioning insolvency law would insulate the system from spillover effects from the failure of an individual institution and make it less likely that a central bank would feel compelled to bail it out. These issues make it difficult for central banks to bring down inflation without causing a recession—and somewhat undermine their de facto independence.

These problems call for rethinking how monetary policy interacts with financial stability. It is crucial that central banks aim to restore price signals smoothly in private markets in which they have intervened excessively. They should also recognize that there are always trade-offs between their goals of price stability and financial stability—even if that tension becomes clear only in the long run. The buildup of central bank balance sheets leads to financial distortions and constrains their future actions. Central banks should anticipate this tension and impose greater macroprudential oversight—that is, regulating not only with an eye to the soundness of individual institutions, as has been the aim of financial regulation historically, but also to ensure the soundness of the financial system

as a whole. Such enhanced macroprudential regulation should have a particular focus on monitoring dividend payouts and buildup of risk in the nonbank capital markets. Finally, central banks should reconsider their roles as lenders and market makers of last resort and ensure that any interventions are only temporary. Central banks should focus on *communicating* a policy framework that smooths liquidity conditions without leading to permanent asset purchases.

Inflation expectations and anchors

Today a flurry of supply and other shocks are pushing up inflation and threaten to separate inflation expectations from the central bank's inflation target, or anchor. After the so-called Great Moderation of the 1980s and 1990s—when inflation and economic growth were both favorable—inflation expectations were stable across developed economies. Following the global financial crisis, there were even fears that overall prices would fall (deflation). But the rapid inflation that followed the COVID-19 pandemic made central banks realize that the time for deflation worries had passed; the possibility that inflation will exceed central bank targets in the intermediate term is again a concern.

Central banks overlearned the lessons of the 2008 crisis, which caused them to abandon their traditional approach to inflation expectations. This intellectual shift was largely responsible for the initial misdiagnosis of the inflation threat during the pandemic. Central banks took for granted that inflation had been conquered since the 1980s, which led them to assume that inflation expectations would always remain well anchored. Under that assumption, central banks believed it was possible to run the economy hot—that is, letting unemployment fall below the so-called natural (or noninflationary) rate—without incurring much risk. They also considered it safe to make long-term policy commitments (such as forward guidance that they would keep interest rates low far into the future), because those commitments did not seem likely to have long-term inflationary consequences. But such commitments can hurt expectations if central banks in the future cannot keep them. Moreover, the fear of *deflation* led central banks to adopt a data-driven approach to policy that intentionally delayed any tightening. To ensure that economic output would not be cut off prematurely, central banks would not raise rates when they expected higher future inflation (say, because unemployment below its natural level was expected to lead to overheating). Instead, they would wait until inflation materialized before taking action.

Central banks also took a complacent approach to dealing with supply shocks. The economic models typically employed by central banks often imply that monetary policy should not fully neutralize inflation caused by supply shocks because such inflation is only temporary (ending when the supply increases) and interest rate policy is meant to control aggregate demand. Instead, the standard argument is that the central bank should weigh the benefits of cooling the temporary inflation against the costs of stifling economic growth. However, failing to react to supply shocks by taking steps to reduce demand could destabilize the inflation anchor and prevent the central bank from achieving its goals down the road. Paradoxically, the Ukraine war strengthened the inflation anchor because it gave central banks cover to explain why inflation rose so much.

The intellectual framework adopted by central banks after the 2008 crisis does not yet appear to have de-anchored inflation expectations. But it would be costly to wait until de-anchoring begins to alter the framework. Warning signals have already emerged in recent inflation expectations data. The loss of the inflation anchor, with its attendant consumer and business uncertainty, would hinder both aggregate demand and supply. That would have important consequences both for central banks—because it would hamper their ability to control inflation—and for economic activity, because consumers and firms would hesitate to buy and invest.

To address these problems, central banks should return to a monetary approach in which stabilizing inflation expectations is a central priority. Policy cannot tighten only after inflation occurs. Instead, central banks should take action as soon as warning signals flash. Central banks must incorporate both households' and financial markets' expectations of future inflation, since those expectations shape both aggregate demand conditions and asset prices. FD

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