Monetary Policy in the Wake of the Crisis

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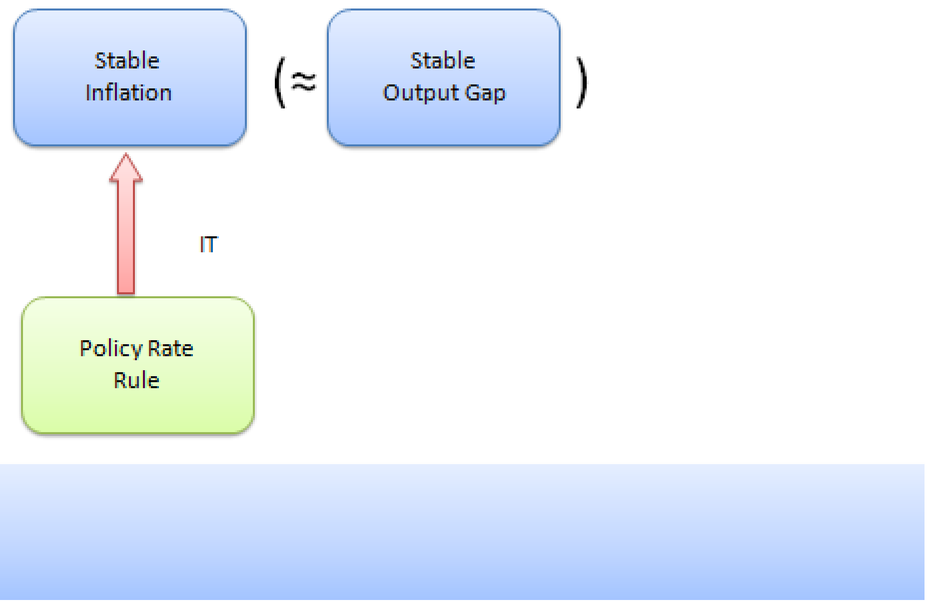
Let me start with my bottom line: Before the crisis, mainstream economists and policymakers had converged on a beautiful construction for monetary policy. To caricature just a bit: we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was basically enough to get things done.

If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments. How you map the instruments onto the targets, and how you use these instruments best is a very complicated problem. This is the problem we have to solve. Future monetary policy is likely to be much messier than the simple construction we had developed earlier.

Let me go through the argument in a bit more detail. Figure 1 is again a bit of a caricature, but not by much, of the way monetary policy was seen in advanced countries before the crisis. There was one target, stable inflation, and there was one instrument, the policy rate, or more precisely the policy rate rule, and that was basically enough. If you had the right rule for the policy rate, you would achieve low and stable inflation. The use of a rule, implicit or explicit, gave you credibility, and delivered a stable economy.

Figure 1. Pre-Crisis Orthodoxy: Inflation Targeting (IT)



The implicit assumption was that stable inflation would deliver economic stability in the larger sense, in the sense of a stable output gap. This was the case in many formal academic models, in particular in the benchmark “New Keynesian model”, which displayed a property Jordi Gali and I called the “divine coincidence”. In these models, if you maintained stable inflation you would also maintain a stable output gap. The two went together, so there was really no reason to look at the output gap separately.

Realism on the part of central bankers made them realize that this was an extreme proposition, that there could be, at least in the short run, some distance between the two, and that they had to worry also about the output gap. That led to something called “flexible inflation targeting”, in which central banks allowed for temporary deviations from the inflation target in order to stabilize what they thought was the output gap.

Now we come to the post-crisis consensus. I’ll go through one version of it, and then through another one. We learned two main lessons from the crisis:

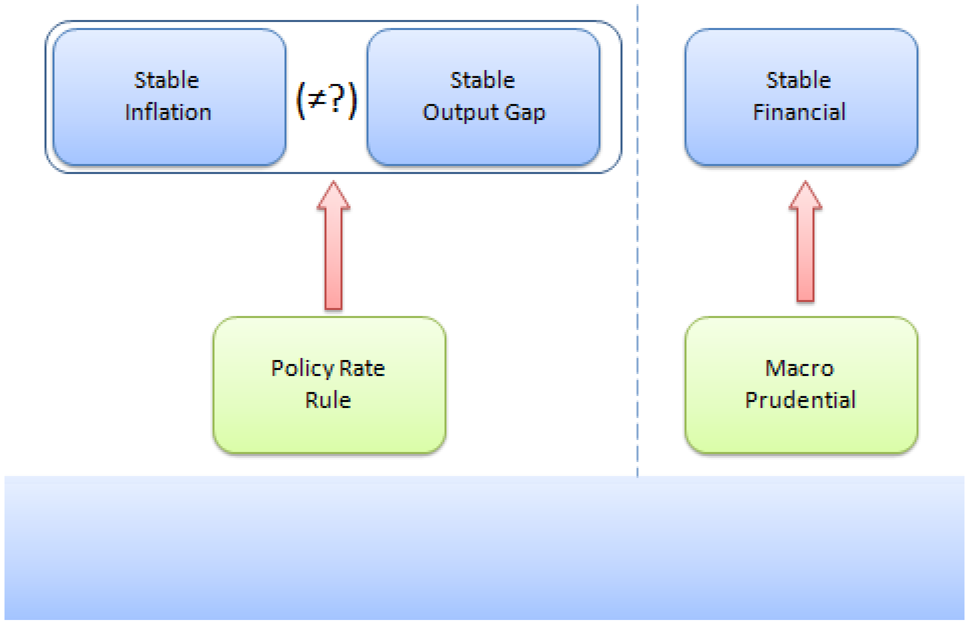
The first is that you can have stable inflation and a stable output gap, but things are not going well behind the---macroeconomic---scene. For example, tensions are building up in the financial sector, and financial instability eventually translates into major problems in terms of output and activity. This has led to a general consensus that the list of targets must now include financial stability, in addition to macroeconomic stability.

There is also agreement that the debate as it was framed pre-crisis – whether you should use the policy rate to try to achieve both macro and financial stability—was not the right debate. Basically, there is a whole set of instruments out there, not just the policy rate. There is no reason to rely only on the policy rate.

The second lesson is that the link between inflation stability and the output gap is probably much less tight than we pretended. In a number of countries, the behavior of inflation appears to have become increasingly divorced from the evolution of the output gap (This is clearly hard to prove, given that potential output and, by implication, the output gap are unobservable). If this is the case, then central bankers, when they care about macro stability, cannot be content just to keep inflation stable. They have to watch both inflation and the output gap, measured as best as they can. Nobody will watch the output gap for them.

At a conference attended by many central bankers two days ago, I got the sense that the emerging consensus among central bankers—though not necessarily among academics—was that there were now two tasks. First, to maintain macro stability, by pursuing monetary policy very much in the same way as before, using a rule for the policy rate, perhaps giving more weight to the output gap per se. Second, to maintain financial stability, using macroprudential tools. I also got the sense that they thought these two activities could be kept largely separate. Maybe one institution could be doing one and another institution doing the other. Clearly, there had to be some interaction between the two, but the two could be largely separate. This way of thinking about policy is captured in Figure 2.

Figure 2. Post-Crisis: This Way ?



I'm not sure that that view is right. It's too neat a view, two targets, each with its own instrument. First, the mapping of macroprudential policies onto the target of financial stability is a very complex one. I think macroprudential policy has to be about many aspects of the financial system, and the notion that we're going to find one sufficient statistic for systemic risk that we can then target is probably an illusion. We're going to have to look all the time at the balance sheets of the various financial institutions to identify the risks that are building up. In terms of Figure 3, there are many arrows starting from the macro prudential box, not just one. Second, there are strong interactions between macroprudential instruments and the policy rate. The empirical evidence suggests that low policy rates lead to excessive risk taking, thus requiring the use of macro prudential tools. And macro prudential tools affect not only systemic risk, but have macroeconomic effects as well: a higher loan to value ratio affects housing investment, and thus GDP. This leads me to think of policy as in Figure 3, with many arrows, going not only up but also sideways, from the policy rate to financial stability, and from macro prudential tools to macro stability.

Figure 3. Or That Way?

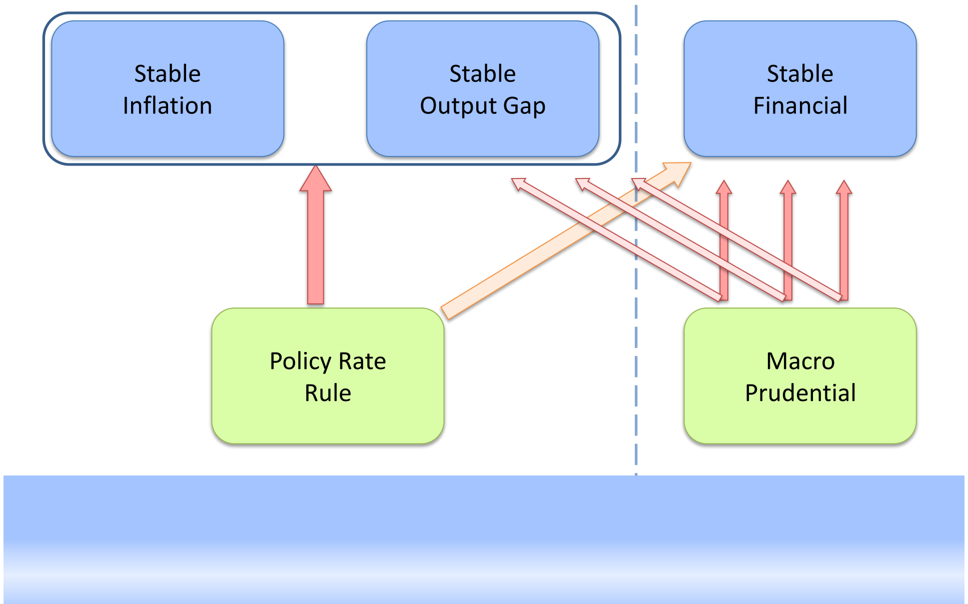


Figure 3 is much less neat than Figure 2. But, I believe it is a better description of how policy will have to operate. We need to think about monetary policy in a broad sense, as having many targets – at least three, inflation, output, and risk – and having many instruments. We can have some allocation of instruments, but we must also realize that most instruments are going to affect all three targets in some way. This raises many issues. Among them:

- How these macroprudential tools can be used is something we know relatively little about. We talk about varying the maximum loan-to-value ratio to stabilize house prices, but how such a ratio actually affects housing prices and housing investment, in a reliable way, remains very much to be worked out. The same holds for most of the other macroprudential instruments. So, we have a large amount of work to do.

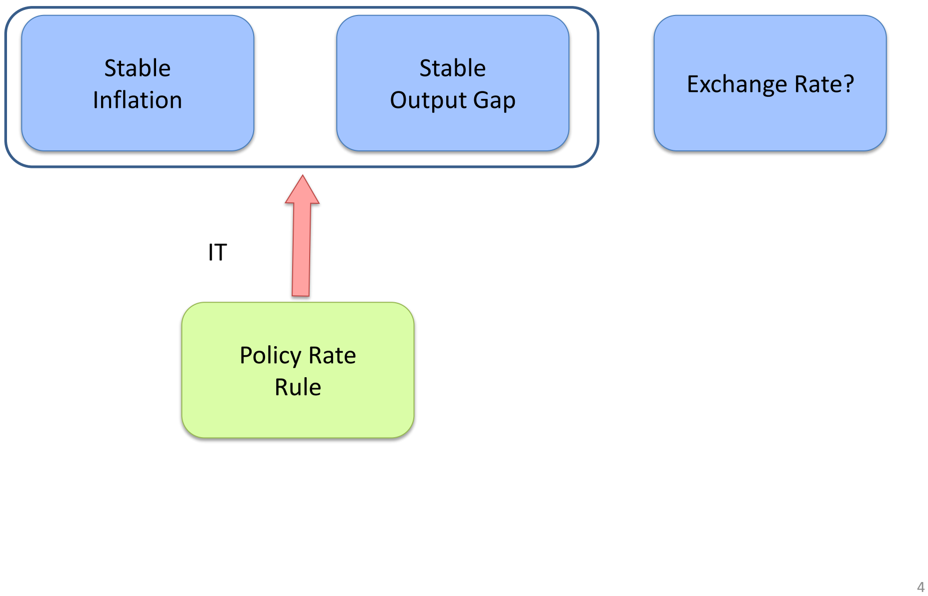
- Political economy issues loom large. So long as the main tool of monetary policy was the policy rate, monetary policy was perceived as fairly neutral with respect to sectors and particular groups. (In fact, even the policy rate is far from neutral in that way, but, somehow, nobody complains.) So, the danger that an independent central bank could target, to help or to hurt, a specific sector or group was seen as low. But if central banks start being in charge of many instruments, nearly all of them having an effect on a specific segment of the economy, then the question of independence comes up. The interactions between the various instruments and objectives argue for one decider, presumably the central bank. But now how much independence you then can give to it is an open question.

- Finally, the notion that the central bank uses many instruments reminds one of earlier monetary policies, say those of the 1950s, in which too many tools and too many interventions led to distortions, and sometimes perverse outcomes. This is a challenge. Still, we have to accept the fact that monetary policy should probably be thought of in that form – many instruments and many targets.

Let me end with a set of remarks about monetary policy in emerging market countries, countries with imperfect capital mobility. What I want to focus on is the role of the exchange rate in monetary policy.

Before the crisis, many emerging market countries had adopted inflation targeting. This was seen as state of the art monetary policy, and there was strong pressure to adopt it. These countries described themselves as floaters. They argued that they cared about the exchange rate only to the extent that it affected inflation, and so as part of inflation targeting they took into account the effect of the exchange rate on inflation. But they put no weight on the exchange rate as a target. This way of describing policy is captured in Figure 4. These were the words. The deeds, in many cases, were often quite different. Most inflation targeters in fact cared deeply about the exchange rate, beyond just its effect on inflation, and this affected monetary policy.

Figure 4. Pre-crisis: IT in Emerging Market Countries

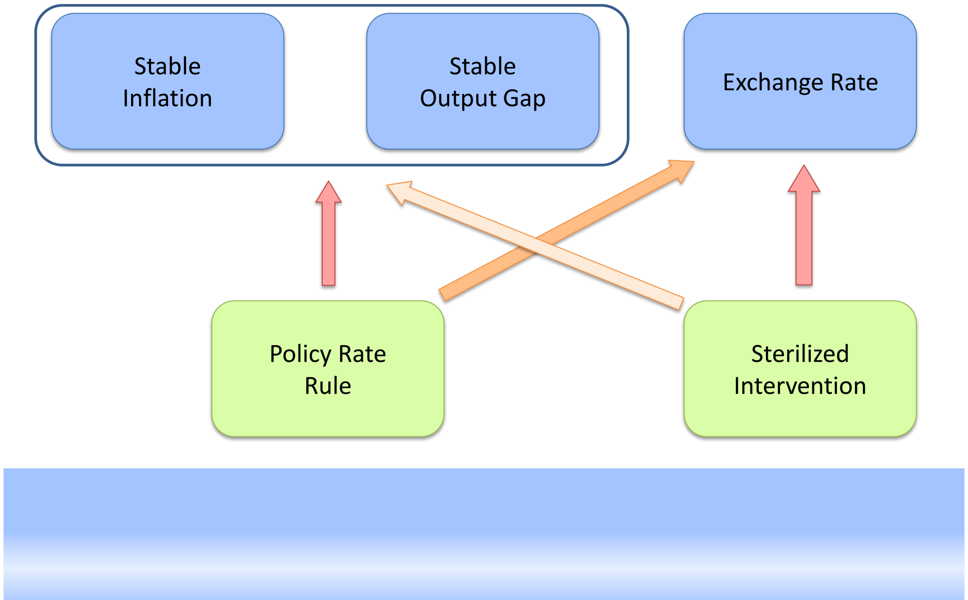


It is my sense that the deeds were right, not the words. But the discrepancy between words and deeds resulted in a rather confusing message.

My sense is that countries have reasons to care about their exchange rate. That there is such a thing as too low or too high an exchange rate, and that, to the usual targets of stable inflation and stable output gap, should be added an exchange rate target, either the level of the exchange rate or its rate of change. (Why, and which one it should be, is important but gets into issues I do not want to take up here.)

And, following the same logic as earlier, we should not think of one tool as being able to do everything, which it can't. We should think of two tools. The first one is, as usual, the policy rate, and the other is sterilized intervention, something that works when there is imperfect capital mobility. This way of thinking about policy is represented in Figure 5. How these two tools can be used, how they should be used, how this depends on the degree of financial openness, and how central banks should communicate the logic of their policies (rather than continue to pretend that they do not care about the exchange rate) is yet another challenge, both for researchers and for central bankers.

Figure 5. Post-Crisis: A More Explicit Approach?



Let me conclude by repeating my basic message. We have moved from a one target-one instrument world to one where there are many targets and many instruments. And we are just starting to explore how such a new framework may look like. It is going to be a long and difficult process.