Monetary policy: Many targets, Many instruments, Where do we stand?

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Many Targets, Many Instruments: Where Do We Stand?

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In addressing monetary policy's targets and instruments, I would like to focus on the issue of how much of the precrisis inflation targeting frameworks we should keep, going forward. There are two dimensions to the issue. The first relates to the ability of the inflation-targeting framework to ensure price stability, in particular at times of market exuberance, which may lead to the buildup of bubbles, whose burst jeopardizes financial stability and thus price stability. In light of experience, a pure inflation-target framework, which ignores financial imbalances, may not allow for a proper calibration of monetary policy. The second dimension relates to the postcrisis developments, whereby the inflation-target framework is not providing an appropriate monetary policy stance, capable of addressing the challenges that advanced economies are currently facing. The task of cleaning up the mess after the bubble burst is much more complex than what the precrisis conventional wisdom expected.

There is an increasing literature on the first issue, in particular on how to make inflation-targeting frameworks more flexible to incorporate the financial sector and on how to broaden the range of tools available to central banks to address financial stability issues so as to prevent credit bubbles. I would thus like to concentrate on the second issue, which questions the use of inflation targeting as the appropriate framework for getting out of the current crisis.

Indeed, monetary policy does not currently seem to be as effective as expected. This certainly points to the need to improve economic models that are used for policy analysis. The question is whether central banks should work in the direction of improving the existing models, or whether they need to totally change the approach.

Independently from any improvement that will be made in the understanding of monetary policy, we should not depart from a few fundamental principles, related in particular to assigning policy instruments to targets. Two principles are worth recalling in all circumstances. The first is that each instrument should be assigned to a specific target. The second principle is that the assignment should be based on efficiency; that is, each instrument should be assigned to the target it can achieve most effectively.

These two principles suggest—in my view—that there is no reason to depart in a fundamental way from inflation targeting as the basic analytical framework for monetary policy during and after the crisis. The fact that we do not understand why certain relations that were assumed to hold in the past do not hold any more is not a good reason to completely change the policy framework.

The main frustration with the inflation-targeting framework comes from the fact that monetary policy—even when pushed to the extreme of keeping very low interest rates for a prolonged period of time and implementing nonstandard measures, which have enormously increased the size of the central bank balance sheet—does not seem to be effective in raising growth, whereas inflation remains broadly in line with target. Indeed, targeting inflation is not a goal in itself, but aims at creating the conditions for sustainable growth. If keeping inflation on target is not leading to stronger growth, then what is its worth?

There are two possible reactions to this frustration. The first is to consider that if monetary policy has not been very effective so far in supporting growth, it should become even more expansionary. If the money multiplier—so to speak—is lower than expected, we need more monetary expansion, in all of its forms. The opposite reaction is to consider that maybe the way in which monetary policy has been conducted so far is not very effective in addressing the problems faced by advanced economies. Trying to push further on the string may actually make monetary policy even less effective and increase the collateral damage over time.

The two hypotheses should be tested. The problem is that we do not seem to have the right analytical model to conduct such an exercise. Indeed, the result will depend on the model that is used to compare the costs and benefits of the two alternatives. A standard neo-Keynesian model, for instance, without a sophisticated financial sector, would probably validate the first hypothesis. But we know that models that ignore the financial sector do not provide a good description of advanced economies. Their uncritical use in the past may have actually been responsible for the policies that led to the previous crisis.

The key challenge is thus to improve models with a view to provide a better understanding of monetary policies' impact on agents' behavior, in particular after a financial crisis like the one we are going through. Here, I would like to draw an analogy with the state of monetary theory before rational expectations. Standard Keynesian theory of the 1960s assumed that agents would react in a naïve way to the monetary authorities' attempt to create inflation so as to reduce the real value of debts and wages. That theory, however, could not explain why monetary policy was not capable of systematically raising employment. The reason was that the theoretical model used by the policymakers was misspecified. The old models assumed agents to be naïve, forming their expectations in a backward-looking fashion, whereas in fact they were not. Agents are much more forward looking than was thought at the time and know that when the economy slows down, the central bank will try to stimulate the economy by creating surprise inflation. They will thus rationally try to protect their income and wealth. If agents have rational expectations, monetary policy becomes less effective. Rational expectations is an extreme assumption, of course, but it is useful in explaining the limits of traditional models of monetary policy.

Back to the present, we may ask ourselves whether monetary authorities—and economists—are not making now a similar mistake of considering economic agents naïve when in fact they are not. We know in particular—and economic agents know—that there are three ways to get out from a debt overhang. The first is to save your way out, which means low growth for a protracted period of time. The second is default or debt restructuring. The third is inflation.

Economic agents want to understand what objective the central bank pursues when it embarks in exceptional nonstandard measures. The effectiveness may be very different if the aim is to repair the transmission mechanism of monetary policy, when the latter is impaired by inefficiencies or bottlenecks in the financial system, as may be the case for instance in the euro area because of the sovereign debt crisis or an undercapitalized banking system, or when the objective is to increase the amount of liquidity in the system with a view to induce investors to diversify into more risky assets so as to stimulate aggregate demand, as may be the case in Japan and the United States.

To put it in another way, it's different if monetary policy tries to address liquidity problems in specific markets rather than to stimulate aggregate demand or repair solvency problems.

In the first case, monetary policy uses instruments to try to unclog the transmission mechanism, enhancing the correlation between the policy rate and the interest rate to end users. An example is the Securities Market Program (SMP) implemented by the ECB, whose effects on the money base are sterilized, or the purchase of covered bonds, which tries to revitalize a specific segment of the banking system. The impact on inflation and wealth distribution is limited.

In the second case, the objective of monetary policy is broader, as it tries to enhance its overall effectiveness by influencing the allocation of resources across agents and within financial markets, in particular between creditors and debtors. Quantitative Easing (QE)and forward guidance are aimed at this second broader objective. This type of policy is more likely to generate reactions by economic agents, in particular creditors, which may, in turn, have repercussions for the effectiveness of the policy itself.

Inflation reduces the real value of the debt, and thus redistributes wealth from creditors to debtors. The best way to redistribute wealth ex post is to create unexpected inflation while maintaining low interest rates for a protracted period of time. This is the stock adjustment effect. By reducing the real return on safe assets, this strategy also redistributes wealth through a flow effect, as investors shift their preferences toward riskier investments, until inflation picks up and the returns on these assets turn out to be lower than anticipated.

The instruments that are currently used by central banks, such as very low interest rates for a prolonged period of time, forward guidance, and massive balance sheet expansion, are ways to try to tax creditors and subsidize borrowers, either directly by inferring capital losses and gains, or indirectly by socializing losses accumulated in central banks' balance sheets. It is another way of trying to do what central banks tried in the 1960s by reducing the real value of wages or, to put it in Milton Friedman's terms, to fool some of the people (i.e., creditors) for at least some of the time. This is why such a policy is also named "financial repression." Financial repression is actually the optimal way to get out of a debt crisis, as much as surprise inflation used to be considered as the optimal way to reduce real wages and stimulate employment.

Such a policy assumes, however, that economic agents, in particular creditors, are naïve and do not react to the policymakers' attempts to reduce the real value of their assets. This is what the models used by the policy authorities assume. And this is what makes the policy optimal.

But it is fair to ask, as some economists did 40 years ago, whether the real world really looks like the models that policymakers use, and whether agents are indeed so naïve as to accept passively financial repression. The fact that monetary policy is not as effective as we thought may suggest that it's not the economic agents who are naïve.

I would like to raise a couple of issues in this respect.

The first is that financial repression is not easy to implement in highly sophisticated financial markets, where it is the task of investors to protect themselves against risk, including—especially—the risk of being trapped into excessively low returns on investments. Our models may be too simple to capture such a behavior.

Second, even when agents are not able to protect themselves, and are pushed toward investing in highly risky assets, because of lack of alternatives, it does not mean that they are naïve and will take the loss passively when it will materialize. Sophisticated investors may know, for instance, that in current market conditions, some assets are overpriced, in particular in the fixed income market, but they may still be willing to hold them and even continue to buy them as long as they think that: 1) in the short run these assets are nevertheless relatively attractive and it may be risky to hold positions that are contrarian to the central bank's behavior; and that 2) they will be able to be the first to sell these assets when the bubble bursts and will therefore contain any loss. We know, however, that not all investors can be first out of the door, and thus some will have to bear large losses, but the rush to the door could be so disorderly that the burst of the bubble might be very damaging for economic and financial stability.

One reason why central banks may feel confident in using the old models is that inflation has remained low and inflation expectations are still anchored, in spite of the very expansionary monetary policies that have been implemented so far.

Here again, one might question whether we have the right model of inflation. In particular, our simple models may not take sufficiently into account the fact that asset prices move more quickly than do goods and service prices. In fact, asset price bubbles may build up and burst even before goods inflation starts rising. After all, isn't that what happened in 2005–2007? The bubble burst while inflation was still relatively moderate.

We could thus envision a world in which inflation remains low but the accommodative monetary policy of the central bank creates asset price bubbles that may burst even before inflation materializes. The burst itself generates deflationary pressures in the goods markets, which then requires that the central bank keeps a very accommodative monetary policy. In such a world, real interest rates that are kept low for too long generate bouts of financial instability, which negatively affects the real economy and justifies keeping rates low for even longer. The relative stability in inflation and in the (low) level of interest rates creates the conditions for instability in the financial system and in the real economy. In other words, it's not monetary conditions that adapt to real and financial conditions but the reverse. Financial and real economy become more unstable as a result of low and stable inflation, fostered by accommodative monetary conditions.

How far is this description from reality? Doesn't it look very similar to what we have observed over the last decade, with relatively low real rates of interest, and comparatively higher and more volatile real growth? The models used by central banks to implement monetary policy do not consider these effects. Maybe we just need another financial crisis for such issues to get greater attention.

I would like to make a final point, which also touches upon the structure of this conference, in which the various macro policies are treated separately. If you think about the current discussion about the role of monetary policy—and, in particular, the need for it to focus more on growth—it is partly obscured by the fact that other policy instruments are subject to severe financial and political constraints. The fact that other instruments are constrained does not justify shifting the responsibility for achieving goals other than price stability to monetary policy, without a better understanding of the potential distortions—and risks—that may be created in the short to medium term. Before abandoning the basic principle that monetary policy should primarily aim at price stability, there should be a sound and transparent analysis of the intertemporal costs that this may entail for society as a whole.

For instance, by conducting aggressive asset purchase, and maintaining the rate of interest at very low levels, the central bank undoubtedly takes away the incentive for the fiscal authorities to implement medium-term fiscal adjustment plans. We have touched this with our hands in the euro area. It is also apparent in the United States. The policy of persistently low long-term interest rates takes away the incentive from the Obama administration and the U.S.

Congress to agree on a medium-term fiscal adjustment plan, and the lack of such a plan creates uncertainty about future taxation, which may hinder firms from investing.

The question should be: Are investments more sensitive to the promise of low interest rates for a prolonged period of time, or rather to the medium-term fiscal uncertainty that such low interest rates involuntarily produce?

The low level of long-term rates produced by the bond purchase program also contributes to create the illusion—even in some prominent economists—that there is no need, nor pressure, for budgetary adjustment.

Another broad institutional issue relates to the redistributive effects of monetary policy, which are essential for its effectiveness in a post-bubble situation. It might be questioned whether such a sensitive political issue can continue to be dealt with in a semi-disguised way by the central bank only, rather than through the normal democratic decision-making process, which involves, in particular, the Parliament.

The crisis has shown how political authorities in our democracies try to postpone painful decisions and act only when they come under market pressure, as a last resort, on the verge of the cliff. By relieving market pressure, the central bank de facto can be led to play a very important political role. It can help the governments gain time for implementing their policies, but it can also help governments waste time and indefinitely postpone urgent decisions. The central bank can actually be cornered into being "the only game in town."

So, isn't it a bit naïve to assume that when monetary policy starts aiming at other goals, which should be in the realm of the political authorities, the institutional framework underlying the central bank and its independence will not be affected? Isn't it a bit naïve to assume that the distortions that are introduced in the economy—as a result of central banks entering other fields than monetary policy—can be removed through decisions that can remain of a technical nature, that is, which can be taken just by the central bank?

In other words, there is a risk that the exit strategy from a monetary policy that produces fiscal or distributional effects will not be only a monetary policy issue any more but a major political one. It is thus—in my view—disillusional to think that the debate about the exit from the current policy is about whether the central bank has the instruments to exit such a policy or not. The central bank does have the instruments, of course. Rather, the real question is whether it will have the political ability to decide the exit and the instruments to use.

To be blunt, it's clear that the independence of the central bank is at risk when the central bank enters the field of fiscal, regulatory, and distributional policies.

In my view, it is very dangerous to address such questions as *Should central banks more explicitly target activity? Should central banks target financial stability, and if so, how?* without considering what should be the role of the other policies, in particular fiscal, structural, and supervisory. Any unconditional answer to these questions—which would make the central bank the only player left in town—will lead to a time-inconsistent monetary policy, because it will create incentives among the other policymakers to act in a way that will lead monetary policy to become ineffective, and will at some point have to be reneged upon. This will inevitably lead to a loss of credibility of the central bank. Given that all the other policymakers have already lost part of their credibility, the possibility that the central bank may have lost it as well should be a concern for society as a whole, not only for the central bank. This is an issue that should be at the heart of the surveillance mandate of international institutions such as the International Monetary Fund.

Let me conclude with a few words on whether central banks should care about the exchange rate. It seems to me that central banks are actually caring too much about the exchange rate, although they will not admit it. In the current environment the exchange rate remains the most powerful channel of transmission of monetary policy. However, this is true only to the extent that the other central banks ignore it. Given that other central banks will not ignore it, and cannot ignore it in the current environment, monetary policy designed separately by the national central banks will inevitably be suboptimal and lead to excess money creation and thus fuel the next asset bubble.

This is a typical example of coordination failure. Again, this is an issue that cannot be ignored by international macroeconomic surveillance.