

Time for Change

It's time to rethink the foundation and framework of monetary policy

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In 2008, Queen Elizabeth II famously asked professors at the London School of Economics (LSE) about the global financial crisis: “Why did no one see it coming?” If Charles III were following in the footsteps of his late mother, he would surely ask a similar question today, but about high inflation.

This question is more compelling for two reasons. First, before the recent inflation spike to levels not seen in 40 years, many central banks in advanced economies were overwhelmingly concerned about low inflation. Second, they confidently contended that inflation was transitory and failed to restrain it even as prices rose rapidly. The triggering events, notably trade and production disruption owing to the pandemic and the war in Ukraine, were supply-side events. These were considered outside

the remit of monetary policy. But the impact of triggering events on inflation varies according to preexisting financial conditions, which are in turn shaped by monetary policy. Central bankers, therefore, are not entirely blameless.

Just as when the queen posed her question to LSE professors, it is again time for deep soul-searching by academics and central bankers about the prevailing monetary policy framework and, more fundamentally, its supporting intellectual model.

Unfounded fear

The conventional fear of deflation and interest rates falling to their lowest level possible (the so-called zero lower bound) was well articulated in a speech by Jay Powell, Federal Reserve chairman, at the August 2020 Jackson Hole conference: “[I]f inflation expectations fall below our 2 percent objective, interest rates would decline in tandem. In turn, we would have less scope to cut interest rates to boost employment during an economic downturn, diminishing our capacity to stabilize the economy through cutting interest rates. We have seen this adverse dynamic play out in other major economies around the world and have learned that once it sets in, it can be very difficult to overcome. We want to do what we can to prevent such a dynamic from happening here.”

This is the crux of the argument deployed by central banks to justify aggressive monetary easing in response to declining inflation. It sounds plausible, but must be substantiated by facts. And the experiences of the “other major economies,” by which Powell obviously meant Japan, cast doubts on the validity of the narrative.

Japan indeed reached the zero lower bound on interest rates long before other economies. But if this had been a serious constraint on policy, Japan’s growth rate should have been lower than that of its Group of Seven (G7) peers. Yet growth of Japanese GDP per person was in line with the G7 average from 2000 (about the time the Bank of Japan’s interest rates reached zero and the central bank began unconventional monetary policy) to

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2012 (just before the central bank's balance sheet started to balloon). Growth of Japan's GDP per working-age person was the highest among the G7 during the same period.

The Bank of Japan's "great monetary experiment" in the years following 2013, during which the central bank's balance sheet expanded from 30 percent to 120 percent of GDP, is again telling. On the inflation front, the impact was modest. And on the growth front, its effect was modest too. This was the case not only in Japan but also in many other countries that followed it by adopting unconventional policy after 2008.

This does not mean that unconventional monetary policy never has any effect. It can become extremely potent—depending on timing. A case in point is forward guidance, the central bank's strong signal to markets of the intended path of its policy interest rate in order to influence long-term interest rates. When the economy is weak, forward guidance is not very effective because market participants expect interest rates to remain low anyway. But when the economy is hit by a surprise shock to demand or supply, forward guidance of continuing low interest rates can suddenly become too expansionary and inflationary. This may partly explain what we are seeing now.

Political naïveté

The widespread adoption of flexible average inflation targeting—which explicitly allowed inflation to overshoot the target—also fed into central bankers' failure to tighten policy sooner. When they decided to allow overshooting, central bankers forgot the inherent difficulty of taking away the monetary punch bowl—even though their predecessors had encountered similar difficulties

many years earlier. Just ask yourself a question: Is it possible in a democratic society for unelected central bankers to ask the government and legislators to trim the inflationary spending plans on which they were elected?

Perhaps central bankers simply had it too easy during the "Great Moderation," the 20 or so years of steady growth and stable inflation that began in the mid-1980s. The prevalent narrative of successful monetary policy conducted by independent central banks during that period may have come down to good luck and fortuitous circumstances. The global economy benefited from favorable supply-side factors, such as the entry of developing and former socialist economies into the global market economy, rapid advances in information technology, and a relatively stable geopolitical environment. These factors enabled low inflation and relatively high growth to coexist. Central banks' job did not require much of a political mandate.

After experiencing those peaceful times, when central bank independence came to be widely accepted, central banks started to deploy unconventional monetary policy. There was a somewhat naïve assumption that the policy could be unwound easily enough when necessary. Unfortunately, the world has changed. The environment that fostered benign supply-side factors is under attack from many directions: heightened geopolitical risk, rising populism, and the pandemic have disrupted global supply chains. Central banks now face a trade-off between inflation and employment, which makes unwinding very challenging.

Rethinking the framework

As we reflect on why central bankers missed the wave of inflation, we must reconsider the intellectual

model we have relied on—and update our monetary policy framework accordingly. I highlight three issues that should be taken into account.

First, we must reassess whether we should continue to focus on the perils of deflation and the zero lower bound on interest rates. This needs urgent consideration because it affects the end point of the current tightening cycle. As US inflation shows signs of passing its peak, some economists are already calling for a higher inflation target and thus less additional tightening to maintain an ample margin of safety and not risk deflation.

I am skeptical of this argument. Even if we had entered the global financial crisis with a higher inflation target and additional room for interest rate cuts, the global economy would not have taken a materially different course. I agree with Paul Volcker, the former Federal Reserve chairman credited with ending the high US inflation of the 1970s and early 1980s: “deflation is a threat posed by a critical breakdown of the financial system.” That is exactly what happened in the 1930s and did not happen in 2008, although we came to the brink. The key difference was that efforts at preventing a breakdown of the financial system were more effective in 2008.

Additional room for rate cuts would not offer any comfort if financial imbalances were to manifest as debt-fueled asset bubbles and financial crises. Accordingly, central banks cannot be attentive only to macroeconomic developments such as inflation and the output gap. They must also pay attention to what is happening in financial institutions and financial markets.

Second, we must reflect on why central banks were forced into prolonged monetary easing and what the consequences were. A case in point is Japan, where stagnant growth due to structural factors—notably a rapidly aging and shrinking population—was misconstrued as cyclical weakness. This resulted in decades of monetary easing. This is not the same as saying that a decline in interest rate is a response to a decline in the natural rate of interest. Rather, monetary policy became a quick fix for structural problems that required more radical reform.

Oddly enough, debates about monetary policy often assume that monetary easing and tightening arrive alternately in a relatively short space of time. If this were so, it would justify the traditional view

that monetary easing affects only the demand side. But if monetary easing takes place over a longer period of, say, 10 years or more, then the adverse effects on productivity growth through resource misallocation become serious. Monetary policy should not be guided by supply-side considerations, but it shouldn't ignore them either.

National differences

Finally, we must pay attention to national differences in the way each country designs its framework for monetary policy. Different employment practices, for example, generate different wage dynamics and for that matter different inflation dynamics. In Japan, consumer inflation is accelerating but at a much slower pace than in other advanced economies. This is mainly because of the unique practice of “long-term employment”: Japanese workers, especially at large firms, are protected by an implicit contract under which bosses try to avoid layoffs at all costs. This makes them cautious about offering permanent wage increases unless they are truly confident about future growth. It translates into lower inflation.

Even in a globalized economy, differences in the social contract or in economic structure matter. This undermines the case for a one-number-fits-all inflation-targeting strategy. We must remember why we cannot find a good alternative to the system of flexible exchange rates: countries have different macroeconomic preferences, and the resulting differences between countries are reflected in the rise and fall of their currencies. The anchor for a currency (if there ever is one) can be established only through a firm commitment by the central bank to restrain inflation by monetary tightening and to be the lender of last resort—not by a simple act of setting an inflation target.

Inflation targeting itself was an innovation that came about in response to the stagflation of the 1970s and early 1980s. There is no reason to believe it is set in stone. Now that we know its limitations, the time is ripe to reconsider the intellectual foundation on which we have relied for the past 30 years and renew our framework for monetary policy. **FD**

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