GLOBAL FRACTURES

Daily Note

# GLOBAL FRACTURES: MONETARY TRAPS

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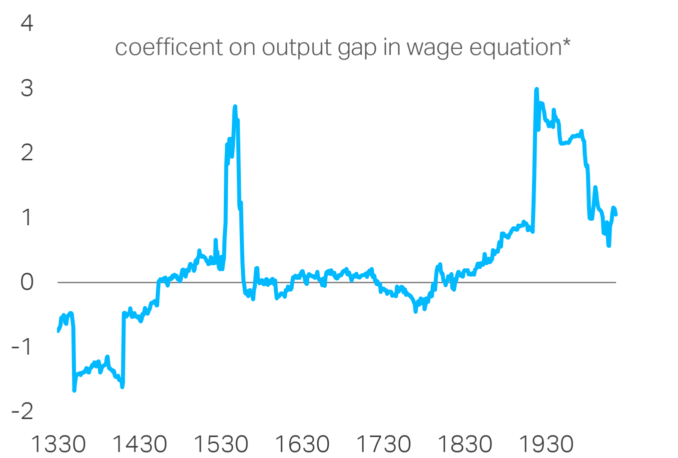
- **2019 has brought a profound shift to views about monetary policy**
- **Central banks don't believe they can hit their targets, even longer term**
- **This Daily Note is the second in our new "Global Fractures" series**

2019 has brought a profound shift in the way economists think about monetary policy. For the first time in generations, central bankers are saying – even in public – they are not sure they can hit their inflation targets, including over the long term. It is hard to overstate the significance of this revelation. For decades, the monetary authorities were seen as omnipotent and omniscient. There was supposedly no limit to what they could do, especially when it came to moving the dial on consumer prices. Inflation was 'always and everywhere a monetary phenomenon'. And in the most ironic twist, central banks are suddenly calling for fiscal stimulus. After decades in which fiscal policy had no role in macro stabilization, other than to try to minimize the harm it might do (officials always urged consolidation) another macro paradigm has been flipped on its head.

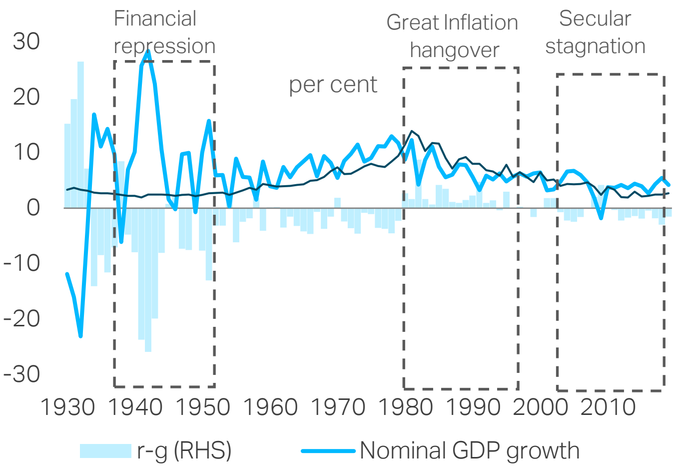
So how did we get to this point? First, it is clear the macro environment that gave rise to monetary dominance, especially the pre-1990s period of high and volatile inflation, is not the backdrop we face today. Remember, independent central banks with explicit inflation targets were a response to a unique episode in economic history – the Great Inflation of the 1970s. During the 1980s, economists convinced themselves that it was the lack of a 'nominal anchor' that had caused the inflation outbreak. Modelling themselves on the Bundesbank, arguably the only central bank to emerge from the Great Inflation with its credibility intact, policymakers applied this lesson to the rest of the world – creating the basis for the monetary institutions we

**Chart 1: UK Phillips curve back to 1330**




Source: Bank of England, TS Lombard, *50-year rolling sample

**Chart 2: The case for fiscal dominance**




Source: Macrohistory database, IMF, TS Lombard see today. This was a massive departure from the initial purpose of central banks, designed solely to provide cheap finance to governments. Yet the infamous wage-price spirals of the 1970s are now a distant memory. The Phillip's curve has flattened, returning to its historic norm.

If you wanted to be charitable to central banks, you could say they are victims of their own success. By keeping price-expectations locked down, inflation has effectively become a random walk (around a low baseline). Yet, there is no doubt powerful structural forces have also played an important role. Globalization, unionization, technology and demographics have fundamentally altered the inflation process compared to the 1970s, in ways few economists expected forty years ago. Meanwhile, policymakers have had to relearn the lessons of the Great Depression. Monetary policy is powerful at pulling inflation down, but always struggles to drive prices higher, especially in a chronically depressed economy. The popular "pushing on a string" metaphor is an obvious throwback to the 1930s, which was the last time monetary policy lost its dominance.

Beyond questioning the effectiveness of monetary policy, some are starting to wonder whether its treatment for secular stagnation is actually making the disease worse. Certainly, low interest seem to bring hysteresis effects (see this timely BIS paper). Low real rates encourage debt, which means rate sensitivity increases. Debt also leads to riskier outcomes (more extreme 'tails', as Vlieghe pointed out), which creates extra demand for safe assets, lowering the equilibrium interest rate. And then we have the potential 'zombification' problem, where easy monetary conditions harm economic efficiency and damage the return on capital, leading to – you guessed it – lower interest rates. It is easy to see how the world might find itself in a 'bad equilibrium'. The ever-quotable Larry Summers calls this 'black hole monetary economics'.

But what about helicopter money? Ultimately, if central banks just gave money away, surely their ammo would be unlimited - there could be no lower-bound. This is true, but the issue is academic since no central bank is prepared to try genuine helicopter funding. True money financing involves creating sufficient non-interest bearing currency such that there is no increase in government debt[1]. This distinction is lost because today there are various economists proposing ideas, which they call 'helicopter money', but which are actually just ways to try to get central banks to engage in fiscal policy. Central banks realize this, which is why they are pushing back. The next innovation in monetary policy could see central banks "cap" yields using QE. This is not monetary financing because 1) there is no guarantee governments will "take advantage" of low borrowing costs by ramping up their spending. They haven't done so yet, even with yields at 700-year lows. And 2) central banks will retain their independence and continue with their existing inflation mandates. Put another way, central banks will only cap yields to the extent that there is no tendency for either inflation or interest rates to break higher.

Usually we try to avoid 'normative' economics but perhaps it is worth asking whether central banks *should* be prepared to do more, via cash giveaways (tax rebates), or dual interest rates for banks. This is fiscal policy in disguise, using central banks' balance sheets to (temporarily) hide the stimulus. There might be good reasons for doing this, especially if the fiscal authorities are irrationally opposed to loosening their budgets. Yet advocates of these policies should remember that politicians are democratically elected, central bankers are not. If fiscal stimulus is really the answer, surely the public should decide the distributional aspects of these policies rather than forcing central banks to further blur the monetary-fiscal policy boundary.

[1] The critical point about 'true' helicopter money is that public debt must not increase. This will only happen if the central bank generates enough inflation such that the Treasury earns sufficient future seigniorage to offset the cost of the scheme. To do this, the bank must issue permanently-zero-interest liabilities (or commit to a zero policy rate). This way, when inflation rises and interest rates increase, there will be no offsetting impact from the central bank's liabilities.