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Monetary Policy in the Wake of the Crisis

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Before the economic crisis began in 2008, 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, and one instrument, the policy rate. And that was basically enough to get things done.

One lesson to be drawn from this crisis is that this construction was not right: beauty is not always synonymous with truth. There are many targets and many instruments. How the instruments are mapped onto the targets and how these instruments are best used are complicated problems, but we need to solve them. Future monetary policy is likely to be much messier than the simple construction we developed earlier.

Figure 1.1 shows the way that 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 the central bank credibility and delivered a stable economy.

The implicit assumption was that stable inflation would deliver economic stability in the sense of a stable output gap. This was the case in many formal academic models, particularly in the benchmark new Keynesian model, which displayed a property that Jordi Gali and I have 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 no reason to look at the output gap separately.

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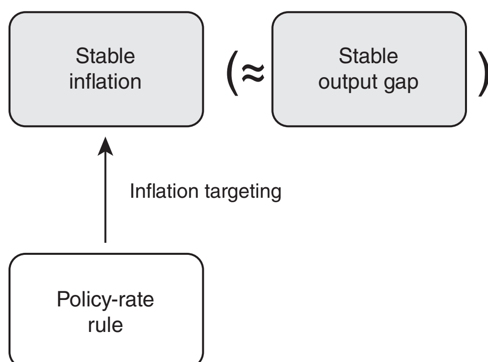

Figure 1.1
Precrisis orthodoxy: Inflation targeting.

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 also had to worry about the output gap. That led to something called *flexible inflation targeting*, in which central banks allowed for temporary deviations from the inflation target to stabilize what they thought was the output gap.

We learned two main lessons from the current crisis. The first is that even with stable inflation and a stable output gap, things might not be going well behind the—macroeconomic—scene. For example, tensions can build up in the financial sector, and financial instability eventually translates into major problems in terms of output and activity. This realization has led to a general consensus that the list of targets must now include financial stability as well as macroeconomic stability.

There is also agreement that the debate as it was framed precrisis—whether you should use the policy rate to try to achieve both macro- and financial stability—was not the right debate. There are many instruments out there, not just the policy rate, and 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 weaker than was originally thought. In a number of countries, the behavior of inflation appears to have become increasingly divorced from the evolution of the output gap. (This is hard to prove, given that potential output and, by implication, the output gap

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are unobservable.) If this is the case, then central bankers who care about macrostability 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 recently, I got the sense that the emerging consensus among central bankers (though not necessarily among academics) was that there were now two tasks—(1) to maintain macrostability by pursuing monetary policy in the same way as before, using a rule for the policy rate, and perhaps giving more weight to the output gap, and (2) 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 do one, and another institution could do the other. There had to be some interaction between the two, but they could be largely separate. This way of thinking about policy is captured in figure 1.2.

But this view might be too neat a view—two targets, each with its own instrument. First, the mapping of macroprudential policies onto the target of financial stability is complex. Macroprudential policy has to be about many aspects of the financial system, and the notion that we can find one sufficient statistic for systemic risk that we can then target is probably an illusion. We are 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 figure 1.3, many arrows (not just one) start from

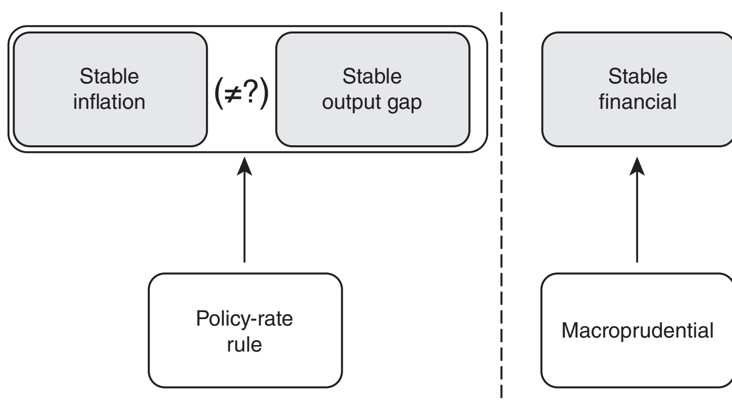

Figure 1.2
Postcrisis: This way?

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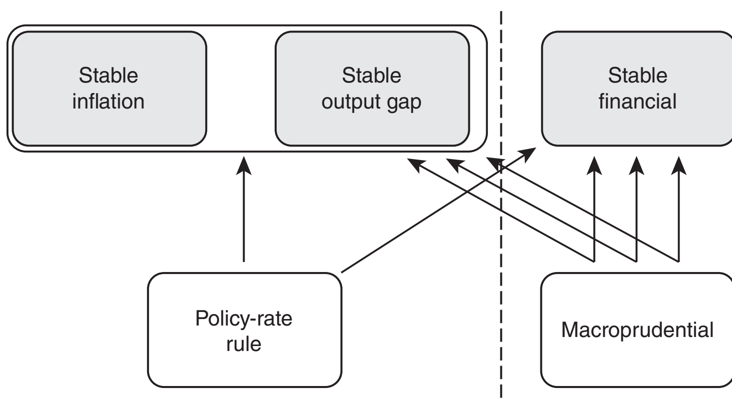

Figure 1.3
Or that way?

the macroprudential box. 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 macroprudential tools. And macroprudential tools have macroeconomic effects: a higher loan-to-value ratio affects housing investment and thus gross domestic product. This leads me to think of policy as in figure 1.3, with many arrows going up and also sideways—from the policy rate to financial stability and from macroprudential tools to macrostability.

Figure 1.3 is much less neat than figure 1.2, 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 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, including the following:

- 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 to be worked out. The same holds for most of the other macroprudential instruments. So a large amount of work remains to be done.

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- Political economy issues loom large. When the main tool of monetary policy was the policy rate, monetary policy was perceived as fairly neutral with respect to sectors and particular groups. (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 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, such as 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 remarks about monetary policy in emerging-market countries, focusing on 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 1.4. These were their words, but their deeds, in many cases, were often quite different. Most inflation targeters cared deeply about the exchange rate, beyond just its effect on inflation, and this affected monetary policy.

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

Countries have reasons to care about their exchange rate. There is such a thing as too low or too high an exchange rate, and to the

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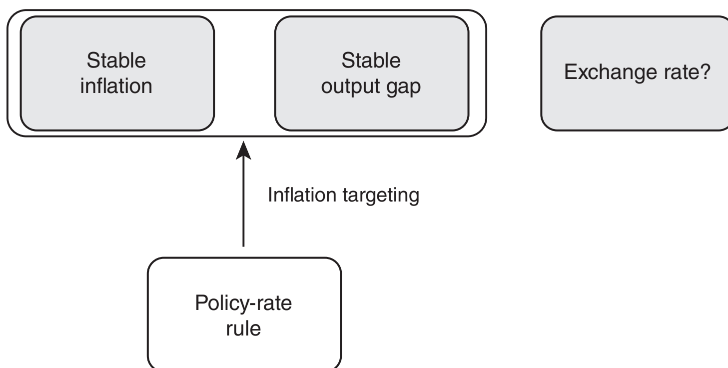

Figure 1.4
Precrisis: Inflation targeting in emerging-market countries

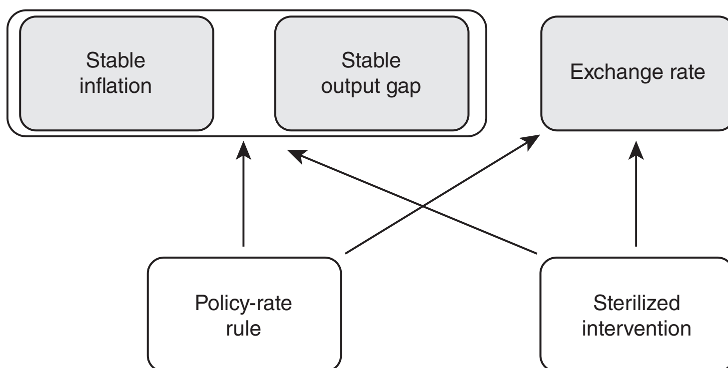

Figure 1.5
Postcrisis: A more explicit approach?

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 are important but get into issues I do not take up here.)

Following the same logic used earlier, we should not think of one tool as being able to do everything, which it cannot. We should think of two tools—the policy rate and sterilized intervention, which works when there is imperfect capital mobility. This way of thinking about policy is represented in figure 1.5. How these two tools can be used, how they should be used, how this depends on the degree of financial

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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.

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 begin the long and difficult process of exploring what such a new framework may look like.

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Citation:

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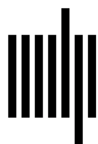
Edited by: Olivier Blanchard, David Romer, Michael Spence, Joseph E. Stiglitz
DOI: 10.7551/mitpress/9451.001.0001
ISBN (electronic): 9780262301831
Publisher: The MIT Press
Published: 2014



The MIT Press

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This book was set in Sabon by Toppan Best-set Premedia Limited. Printed and bound in the United States of America.

Library of Congress Cataloging-in-Publication Data

In the wake of the crisis : leading economists reassess economic policy / edited by Olivier Blanchard . . . [et al.].
p. cm.
Conference proceedings.
Includes bibliographical references and index.
ISBN 978-0-262-01761-9 (hardcover : alk. paper)
1. Global Financial Crisis, 2008–2009—Congresses. 2. Fiscal policy—Congresses. 3. Monetary policy—Congresses. 4. Economic development—Congresses. I. Blanchard, Olivier.
HB37172008.I6 2012
339.5—dc23

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