16

Remarks on the Future of Monetary Policy

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During the precrisis period, monetary policy appeared to be relatively predictable and straightforward. The Great Moderation saw low inflation rates around the world, with inflation targeting, either formal or informal, prevailing as the dominant framework. Interest rate policy was focused on maintaining price stability, central banks generally had almost undisputed independence in this regard, and emerging risks to financial stability from low interest rates were not generally regarded as a concern for monetary policy. In the words of Mervyn King, monetary policy had in fact reached its objective, with its indicator of success being "boring." However, since the onset of the global financial crisis, monetary policy has become anything but boring, and, as was later said, "Bring back boring!"

Little did we know at that time that, in the wake of the global financial crisis, we would be asking whether inflation targeting was enough, and if not, how should the framework be modified or augmented, and should central bank mandates be expanded. And if so, by whom and against what expectations? The global financial crisis was a salutary reminder that nothing is static, that central banks at the best of times largely deal with the unknown future, and that we have to adapt to changing and unexpected circumstances. However, there is still an intense debate about whether monetary policy should change, and if so, how it should change. My comments touch briefly on three issues: first, the challenges to central bank independence; second, the relationship between monetary policy and financial stability; and third, how to deal with spillover effects from advanced economy monetary policies, and the implications for exchange rate policies in emerging market economies (EMEs) in particular.

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Challenges to Central Bank Independence

At the previous IMF conference, "Rethinking Macro Policy II," the IMF's managing director, Christine Lagarde, suggested that central banks have emerged as the heroes of the crisis. In her view, one that is also widely held, the extraordinary actions undertaken by central banks, particularly in the advanced economies, probably saved the global economy from a far worse fate than what transpired. But this view of central banks as the heroes places inordinate pressures on them, not least because it leads to unrealistic expectations combined with an ever-expanding mandate, as well as a perception that they have become too powerful. This could ultimately lead to a backlash, with serious implications for both the independence and the mandates of central banks. While price stability remains a core objective of central banks, the persistence of the global crisis has raised expectations about what central banks can and should do and, in particular, how their expanding mandates regarding economic growth and financial stability should interact with their price stability objective. There seems to be little awareness of what central banks cannot do, as well as what they should in fact not do.

That central banks in some instances are presently regarded as the only game in town, or that they were in effect forced into taking unconventional measures, has resulted in a blurring of the boundaries between monetary and fiscal policies in some instances. Although monetary policy always has distributional effects, balance sheet policies probably have more consequences, in that choices often are made with respect to different market segments. In effect, monetary policy has become highly politicized as central bank balance sheets have expanded. This not only increases scrutiny of central banks, there is also the requirement for greater public accountability of central banks. More important, the increased scrutiny may have implications for central bank and monetary policy independence.

Eichengreen and Weder di Mauro (2015) have argued that central banks should not be concerned about incurring losses, and a paper by David Archer and Paul Moser-Boehm (2013) at the Bank for International Settlements has also argued that central banks are not profit-making organizations; they do not have a profit motive, and therefore their decisions should not be dictated by these considerations. Rather, the central

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bank balance sheet should be seen as part of the broader government budget constraint.

However, in reality, central bank balance sheets can at times take on a direct political dimension. In a number of advanced and EM economies this has come through intervention in the foreign exchange markets. Losses incurred in such instances result in potential pressure on central banks, for example the Swiss National Bank. In the United States the Fed is under increased political scrutiny with the proposed Audit the Fed bill, which, according to Janet Yellen, in her testimony to the Senate Banking Committee in February, "is a bill that would politicize monetary policy, putting short-term political pressures to bear on the Fed."

In a number of EMEs, including South Africa, losses have been incurred in undertaking sterilization activities following large inflows during the US quantitative easing. This was due to the significant interest rate differentials that exist between many EMEs and the advanced economies, which are at or close to the zero bound. How these losses are dealt with or perceived will vary from country to country and depend on accounting conventions and institutional structures. But they could result, and in some instances have resulted, in conflicts between central banks and the fiscal authorities

It does not help to try and avoid risks to independence by narrowly focusing on monetary policy. Most central bankers recognize that independence and credibility can also be undermined if they focus too narrowly on inflation. In the same way that a central bank's legitimacy may be undermined if it ignores growth and employment issues (in other words, a strict inflation targeter), it will similarly be undermined if it ignores financial stability issues. And in reality, a central bank will have responsibilities imposed on it in the event of a crisis arising from financial instability. Similarly, unconventional monetary policies (UMPs) may allow much-needed fiscal or structural reforms to be postponed, and ultimately may end up being harmful and undermine credibility.

Central banks therefore have to face the challenge of being seen to be doing too little or too much. There is a general lack of understanding of the complexity of these issues, and a key task ahead is how to broaden public knowledge and appreciation of what the challenges are. So an important role for monetary policy and central banking in general will be communicating about the role of the central bank and monetary policy,

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and its limitations. This is not new, but sustained outreach programs, not just with the markets, are increasingly important.

Relationship between Monetary Policy and Financial Stability

My second theme relates to whether financial stability should be incorporated into monetary policy frameworks. There is no doubt that a focus on financial stability is essential, although how to incorporate it into monetary policy remains a subject of debate. Should we extend the time horizon for monetary policy to account for the financial cycle, as Claudio Borio (2013) and others have suggested? In a recent speech, in answer to the question as to whether monetary policy should be responsible for financial stability *and* price stability, Christine Lagarde said, "The short answer is 'No'" (Lagarde 2015). I am of the view that the amount of monetary policy tightening that would have been needed to avoid the buildup of leverage before the crisis would have been on such a scale that it would have had severe growth repercussions. However, while I agree that in general, monetary policy should focus on price stability and macro- and microprudential policies should focus on financial stability, I am not sure that we can be dogmatic about it, or that it is an absolute. In practice, there may be instances in which monetary policy will be needed to lean against incipient asset bubbles, or it may be necessary to loosen monetary policy for financial stability reasons, as interest rates also affect financial stability and macroprudential tools may also have implications for price stability. This is particularly the case where the source of the financial stability risks relates to interest rates being too low, in which case there may be excessive leverage, or too high. Coordination will be required whatever the institutional arrangements are, as both sets of policies have an impact on each other. This will be the case whether or not macroprudential policy is located in the central bank. For coordination to work optimally, a deep understanding of both policy arenas will be required, and to allow for flexibility in the mix of policies in differing circumstances.

Furthermore, the distinction between what is monetary policy and what is macroprudential policy may not be that clear-cut. A good example is foreign exchange market intervention. The basic inflation-targeting model with a purely flexible exchange rate regime is no longer seen as

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ideal. Some form of exchange rate intervention has become increasingly acceptable. But the motivations may differ, and it is not clear whether such interventions are macroprudential policy, or monetary policy, or indeed industrial policy. Often the lines may be blurred. Are interventions in the face of strong capital inflows an attempt at leaning against possible impacts on asset or credit markets and excessive leverage, in which case they may be seen as macroprudential? Or is the concern rather that credit market implications could have an impact on inflation, or with the pass-through to inflation, in which case it is a monetary policy reaction? Or are we concerned about the impact on the country's competitiveness? Although this is an issue of particular concern to many EMEs, this is not exclusively the case. Much of the postcrisis monetary policy debates are about currency wars: the Swiss attempt to cap the Swiss franc appreciation and, some would argue, the recent quantitative easing by the ECB, which could be interpreted as competitiveness issues.

Dealing with Spillovers from Monetary Policy in Advanced Economies

The issue of spillovers from advanced economy monetary policy therefore has important implications for monetary policy going forward, particularly in EMEs, where the impact of UMPs has been felt most strongly. The sizable capital inflows to these countries, with attendant currency appreciation, misalignment, and credit and asset market booms; the volatility and reversal of capital flows when tapering began; and again the recent speculation regarding the timing and extent of US monetary policy normalization saw an appreciating dollar and significant depreciation and volatility in the currencies of many EM countries.

Some of the debate assumes that this is a temporary issue, and that once monetary policies have normalized, "normal" flows will follow. However, we have seen that UMP in the advanced economies can persist for some time; we have not seen the end of it yet, with the ECB only starting down this road and the effectiveness of such policies in Japan yet to be determined; and we have no idea how the normalization in the US economy will unfold. Furthermore, we do not know whether we are in for a period of secular stagnation, and if so, what the longer-term implications for flows to EMEs are likely to be. So we could be in for a protracted period of uncertainty and volatile capital flows.

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How should EMEs adjust to these developments? Simply responding with monetary policy in an inflation-targeting context (interest rate response and exchange rate flexibility) has been shown to be inadequate. EM countries are, and should be, concerned about financial stability and competitiveness issues. In a world where not all currencies float, currencies that do float find themselves taking on an even greater burden of adjustment. Even the IMF has moved away from the perfect capital mobility approach and now sees a place for sterilized intervention and capital flow management. However, we have noted that sterilized intervention is costly, and the efficacy of capital flow management polices differs from country to country, depending on structural features of domestic financial markets. But even so, there is much disagreement and debate on this issue. For example, did controls on inflows work in Chile in the 1990s? Did they work recently in Brazil? Despite much research on the subject, there are no definitive answers.

EM nations are often told that they can reduce their vulnerability to these flows by liberalizing and developing their financial markets. Yet it is precisely those countries with deep and liquid financial markets that are more likely to attract inflows and more likely to experience the reversals, because of ease of entry and exit. This conclusion has been confirmed in a number of studies (e.g., Eichengreen and Gupta 2014). These inflows and outflows have significant implications for monetary policy through the inflation pressures from exchange rate changes. That is not to say that financial market development should not be encouraged, but the limitations and vulnerabilities associated with it should be recognized. This is particularly the case when these countries face sizable flows in response to monetary policy actions in the advanced economies.

I agree with Raghuram Rajan, who has argued that recipient countries are not being irrational when they lament the fact that the timing and speed of implementation of and exit from unconventional policies are driven solely by conditions in the source country. As he argues, "Having become more vulnerable because of leverage and crowding, recipient countries may call for an exit whose pace and timing is responsive, at least in part, to conditions they face" (Rajan 2014).

This implies that there is a strong case for more coordinated monetary policy globally. Although it is not only the EM countries that are vulnerable to monetary policy decisions made in advanced economies,

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they are the most affected. This is a reality that they have been living with for some time, but it does not mean that there cannot or should not be more serious effort in this regard. At the very least, monetary policy in advanced economies has to be sensitive to the impact of the actions on other countries. Immediate attention should be given to the establishment of bilateral credit lines beyond those countries that have been granted them. There also needs to be clear international coordination of lender of last resort function among central banks (e.g., currency swaps among central banks) when liquidity is required. Both of these measures should be considered a priority in the appropriate forums, and preferably have a decision made in principle and when there is no immediate need or request on the table.

While recent communication by the US Fed has attempted to recognize the possible spillover effects of its actions, the ultimate test will be in the actions of the advanced economies and their willingness to go beyond talking.

The future remains uncertain, with numerous political flash points that have erupted into localized or regional conflict adding to the dangers that lie ahead. It is a time for cool heads, clear thinking, and enhanced interaction among central bankers. It is also not a time for dogmatism. Central banks have been innovative, thoughtful, and courageous in tackling the financial crisis. But significant new challenges lie ahead that will require all of our collective wisdom. We cannot underestimate the level of interconnectedness. After all, we have yet to find out what the "new normal" will be. And behind all the numbers and statistics lie the tens of millions of people whose lives have been deeply affected.

Confidence and trust matter!

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