Central banks are facing a crisis of confidence – it's time to reinvent global monetary policy

06/10/2016

Since the financial crisis, central banks have taken on a far more significant role in economic management. But with diminishing returns of and unintended consequences from existing policies, monetary policy now faces a crisis of confidence. **Dennis Shen** *explores policy innovations that could support global central banks battling deflation and proposes a new framework to better guard against financial instability.*

Since the global financial crisis, we have been introduced to a 'new normal' in which monetary policy has taken on a dominant role in macroeconomic management, replacing what was formerly a more restricted role. We are accustomed to the vernacular of unconventional monetary policy: negative interest rates and quantitative easing. Within the G10, the Federal Reserve's balance sheet has increased to 24% of GDP, while that of the Bank of England has increased to 22% of GDP – with QE recently expanded post-Brexit. Not to be outdone, the European Central Bank's balance sheet now rests at 32% of GDP, with its Asset Purchase Programme expanded this March. The Bank of Japan comes at the front of this pack, having ballooned its books to 89% of GDP and increasing.

Although global central banks remain willing and able to act, questions about the limitations of their capabilities are now frequently debated. Confounding price stability mandates for 2% inflation, traditional inflation remains nowhere to be found. Despite historic interventions from the European Central Bank, inflation remains materially below target. And, while the economy has stabilised since the debt crisis, growth rates of 1.6% (year on year) as of the second quarter of 2016 remain inadequate to redress elevated unemployment.

Already facing issues relating to the sustainability of current policies, central bankers must also confront a dialogue focused on potential detrimental side-effects. In the months after the Bank of Japan introduced negative rates this January, the yen responded instead by strengthening, bank shares tumbled and, recently, bond yields have risen – counter-intuitive market dynamics indicating an increasing scepticism of the existing policy framework. Moreover, asset market distortions have been accelerated, with global equity indices standing at near record levels in the US and UK, and government bonds at extraordinarily low if not negative yields.

The limitations of monetary policy

In the past, European Central Bank President Mario Draghi has emphasised the limitations of the ECB, noting the interdependence between monetary policy and other policy areas. To his point, a heavy role must rest with regional governments in bolstering growth and employment objectives. This includes strengthening aggregate demand policies, including pro-growth fiscal reorientations and greater coordination between national and EU-level fiscal stances, and a revitalisation of regional structural policies, including reforms that ease the impact of a large debt overhang and work to complete the Single Market.

However, acknowledging the critical role that monetary policy must play come the next economic crisis, one might question if the existing crisis of confidence facing central banks might exacerbate such a shock due to some form of impending 'monetary impotence'. This could be because central banks become unable to respond with the requisite force using their existing toolkit, owing to existing conventional and unconventional policies facing both practical constraints in how low rates can go and what assets can be purchased, and efficacy constraints in their diminishing returns.

New innovations in monetary policy

It was during the financial crisis that modern monetary policy took shape, and it may be during the next major global shock that we see the next radical reinventions. For one, rather than the blunt use of asset purchases and liquidity-providing operations, whose funds have frequently not been channelled productively, balance sheet policies need to become more targeted. The Bank of England's 'Funding for Lending' scheme and the ECB's 'Targeted Longer-Term Refinancing Operations' represent early examples. Such schemes can be enhanced to channel low-cost financing directly to productive sectors.

Next, there has been plenty of debate on so-called 'Helicopter Drops', particularly in relation to central banks in the most pressing circumstances like the Bank of Japan and the ECB. In the version closest to Milton Friedman's 1969 thought experiment, central banks would issue new money that would be directly handed out to the private sector, without the involvement of fiscal authorities or the financial sector. This so-called 'citizen's dividend' would represent the most certain method to boost demand and inflation – because it does not depend on the marginal propensities to spend of various intermediaries, which has undermined more market-based policies like QE. It would also reduce adverse effects of QE on financial stability and income/wealth distribution.

Given the controversy surrounding Helicopter Drops, however, particularly as it relates to supervening fiscal policy, alternative 'soft' variants of Helicopter Money have been debated. The form most resembling the original concept that could be realisable in relevant horizons might involve the Bank of Japan financing large-scale tax cuts and/or cash transfers to households administered through the fiscal authority – advancing the concept of cash distribution programmes in the US and Australia during the financial crisis. This could involve the Bank of Japan monetising such operations through the purchase of perpetual government bonds.

However, if there's one thing that's clear from recent policy decisions, it's that monetary innovation will be more piecemeal prior to the next shock. The Bank of Japan's decision in September to introduce QQME with Yield Curve Control, while continuing the direction of monetary innovation in a somewhat illiberal direction of enhanced steering of markets, evinced hesitation on any near term endgame. The ECB's September decision to keep policies unchanged exhibited weariness at the burden that has been placed on it, with indications that policymakers have started to consider how eventually to exit the existing QE programme.

Asset price targeting

However, meanwhile, QE policies have manifested major distortions in financial markets, ranging from elevated stock indices to depressed credit spreads to low if not negative government bond yields. The risk is that by concentrating attention on narrow concepts of inflation, defined as the change in the cost of goods and services, central banks have forgotten the most basic intuition that inflation is ultimately a monetary phenomenon. In this case, however, inflation has been channelled predominantly toward financial prices, rather than to consumer prices. The risk of this oversight crystallises when financial price distortions eventually unwind.

In 2015, the Bank for International Settlements touched on the stronger historical link between output growth and asset price deflations, compared with the weak link between output growth and deflation in the cost of goods and services. These consequences of property and financial market busts have also been experienced first-hand recently, during the financial crisis and Europe's debt crisis. Taking into account the impact of asset price deflations, financial stability ought not to be a lateral consideration in monetary policy. To that end, we proposed in 2009 the Carson-Shen Rule to reform policy rate-setting, to link official rates to asset price evolution. This framework, and those like it, can be advanced to reimagine a framework for monetary policy that can construct a more stable and sustainable global economic and financial system.

The future of central banking

Ultimately, the moment is right for a rethink of central banking, in Europe and abroad. If policymakers rehash existing tools, such an approach could trigger complex unintended economic and financial consequences. For central banks facing a battle to stem deflation, more targeted policies and innovative concepts, like Helicopter Drops, ought to be on the table. In addition, the intricate links between monetary policy and financial stability needs to inform a framework that directly addresses financial imbalances in policy setting. A reshaped monetary policy can enhance nominal growth and better safeguard economic stability.

Please read our comments policy before commenting.

Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics. Featured image: European Central Bank president Mario Draghi at a press conference. Credits: European Central Bank (CC BY-NC-ND 2.0).

Shortened URL for this post: **http://bit.ly/2d50ceZ**

About the author

Dennis Shen graduated from the MPA in International Development from the London School of Economics in 2013, and completed undergraduate studies at Cornell University. He worked with Alliance Bernstein in New York and London, most recently in the role of European Economist. His research interests include international political economy, global governance and environmental regulation.

-