New monetary policy guidelines: losing the anchor?

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NEW DOCTRINES OF CENTRAL BANKING?

This article deals with new doctrines of central banking. Before entering into this discussion, it is useful, even necessary, to take a look at the historical experience (Issing and Wieland, 2013).

More than almost any other field of economics, the development of monetary theory and monetary policy over the course of time reflects the influence of and interaction between political and financial systems, academic discussion, and the views and actions of central banks. In the words of Wicksell (1906, p. 3-4): "[...] the choice of a measure of value, of a monetary system, of currency and credit legislation – all are in the hands of society [...]. Here, then, the rulers of society have an opportunity of showing their economic wisdom or folly. Monetary history reveals the fact that folly has frequently been paramount; for it describes many fateful mistakes."

It is important to clarify in which environment and against what background the present discussion should be conducted. The experience of the past, both mistakes and successes, has to play a major role before dealing with the question of whether new doctrines or more modest "guidelines" should be considered.

THE HEYDAY OF THE REPUTATION OF CENTRAL BANKS

Around the turn of the last century the reputation of central banks was at a peak (Issing, 2012). There was a widespread impression that

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inflation was under permanent control and the situation for growth and employment on a global level looked better than ever before. The "Great Moderation" indicates that this was a period in which inflation had come down from rather high levels and output variability had substantially declined. The discussion as to what extent this "Goldilocks economy" was merely the result of good luck – i.e. from the policy makers' perspective due to exogenous factors – or the consequence of improved macro policies, especially monetary policy, continues to this day.

Stock and Watson (2003), for example, present empirical evidence for a decline in the size of exogenous shocks after the 1970s, whereas Romer and Romer (2002) see the trend towards greater stability primarily as a result of improvements in policy. Not surprisingly, central banks overall tend to prefer the latter explanation. And, although this debate is far from being resolved, there is reason to attribute the success to the changes in monetary policy.

After the outbreak of the financial crisis in 2007-2008 central banks acted promptly and – aided by fiscal policy – prevented the great recession from ending in a depression on the scale of the 1930s. They were seen as "saviours of the world" and their reputation reached a peak. The implicit high expectations of central banks' capabilities were further reinforced when they were charged with micro and macroprudential supervision. Taken together, these developments could lead to overloading central banks and ultimately undermining their reputation and their independence (Issing, 2017a). When considering "new guidelines" it is necessary to review these developments.

STRATEGIES REVISITED

Monetary policy strategies also have to be scrutinised.

Starting in the mid-nineteen nineties in New Zealand, most central banks adopted inflation targeting and this strategy is still seen as state of the art. While monetary policy decisions were initially based on simple forecasts of inflation, the concept of inflation targeting has undergone a substantial change, culminating in "flexible inflation targeting". After the financial crisis of 2007-2008, the leading expert in this field rendered a kind of final verdict: "In the end, my main conclusion so far from the crisis is that flexible inflation targeting, applied the right way and using all the information about financial factors that is relevant for the forecast of inflation and resource utilization at any horizon, remains the best-practice monetary policy before, during, and after the financial crisis." (Svensson, 2009). This statement still represents mainstream thinking.

Yet this assessment gives no guidance on how all the information should be organised in order to make the right decision in the context of an undefined horizon. In the final analysis it protects the concept against any criticism and amounts to a tautology (Issing, 2012). It also implies (unintentional) criticism of the policy of the central banks that had adopted inflation targeting in the years before the crisis without respecting the information on how the currency and credit were evolving – a neglect that was a major contributing factor for financial imbalances and which ultimately brought about the collapse of the financial system.

In short: no model of inflation targeting currently exists that integrates the risks from the banking system and financial markets with all their dynamics, non-linearities and overall complexity. Central banks should agree that the search for an "optimal" monetary policy regime has not yet reached a satisfactory conclusion and that inflation targeting may entail risks and shortcomings.

A monetary policy strategy should include financial stability aspects. The financial crisis has shown that "price stability is not enough". As Minsky explained, an environment of price stability can even foster destabilising risk-taking, which might ultimately lead financial markets to collapse. Is there a trade-off between price stability and financial stability? There will be cases of short-term conflict but over the medium to long-term, there can be no financial stability without price stability (Issing, 2003).

In retrospect it is astonishing to see the extent to which advocates of the inflation targeting approach have underestimated the risk implied in inflation targeting by neglecting the development of monetary and financial factors.

"The 'mop up after' strategy received a severe real world stress test in 2000-2002, when the biggest bubble in history imploded, vaporizing some $8 trillion in wealth in the process. It is noteworthy, but insufficiently noted, that the ensuing recession was tiny and that not a single sizable bank failed. In fact, and even more amazing, not a single sizable brokerage or investment bank failed either. Thus the fears that the 'mop up after' strategy might be overwhelmed by the speed and magnitude of the bursting of a giant bubble proved to be unfounded. Regarding Greenspan's legacy, then, we pose a simple rhetorical question. If the mopping-up strategy worked this well after the mega-bubble burst in 2000, shouldn't we assume that it will also work well after other, presumably smaller, bubbles burst in the future? Our suggested answer is apparent."(Blinder and Reis, 2005, pp. 67-68).

As we know today, what followed was another bubble and the subsequent collapse on a much larger scale. Have not all the arguments in the above statement been discredited by this experience?

Yet despite the fact that the collapse of financial markets in 2007-2008 brought the world to the brink of disaster, many papers came to the conclusion that a monetary policy of "leaning against the wind" could not have prevented this development or could only have done so at very high costs. Would those costs have been higher than the costs of the financial mess that led not only to the great recession but had negative economic consequences lasting a decade?

Most central banks seem to follow a strategy of reacting quickly and decisively in the case of an economic downturn, but only reluctantly and very moderately when the recovery is gaining steam. This asymmetry implied in the risk management approach to monetary policy was already suggested by Greenspan (2005) (for a criticism, see Buiter, 2008). In the course of time such an approach could be not only inflationary, but also foster the emergence of financial imbalances.

Regardless of whether they have an explicit mandate for financial stability or not, central banks risk their reputation if they are perceived to have underestimated the risk of financial instability. How should they respond to this challenge?

Can monetary policy contribute to preserving financial stability? As explained above, inflation targeting is incapable of meeting this challenge.

According to one approach, macroprudential policy should be the main tool for preserving financial stability, and financial stability should become an "explicit objective of monetary policy to be used when macroprudential policies fail as an instrument of last resort" (Smets, 2013, pp. 151-152).

However, this approach could blur the ranking of the objectives of the central bank. And relying on macroprudential policy in the first place, notwithstanding all the critical arguments against excessive expectations of this instrument, might bring monetary policy into an untenable position. If and when macroprudential policy fails in a boom phase, it might be too late for an appropriate response using monetary policy. The challenge might be close to "pricking the bubble", which would cause turmoil in financial markets, bring major economic costs, and have a negative impact on the reputation of the central bank (Issing, 2017b).

The "monetary pillar" of the ECB's strategy was an approach that aimed to implicitly take financial stability aspects into account when making monetary policy decisions. The strategy review has extended

this approach. "[...] the monetary and financial analysis examines monetary and financial indicators, with a focus on the operation of the monetary transmission mechanism and the possible risk to medium-term price stability from financial imbalances and monetary factors." (ECB, 2021). Considering financial imbalances and connected monetary developments will allow the central bank to discriminate between benign and less benign phenomena in financial markets (Fahr *et al.*, 2011). It will be interesting to observe how well the ECB succeeds in integrating this assessment into a comprehensive model (Issing, 2021).

It is striking that, despite severe deficiencies in the inflation targeting strategy, no other major central bank is even considering taking monetary developments and connected financial stability issues into account.

In this context, two further aspects should be mentioned. One is the expansion of the monetary policy toolkit. After the financial crisis, a number of "unorthodox instruments" were employed. Quantitative easing (QE) has become the key instrument. It is not easy to draw a line between "orthodox" open market policy and "unorthodox" QE. The main difference is the huge size of central bank intervention in financial markets and the public debt/deficit position, which blurs the distinction between monetary and fiscal policy. Managing the exit from the crisis mode that began with the financial crisis and continued with monetary policy in response to the Covid-19 pandemic is a huge challenge.

The ECB has to clarify that responsibility for defending the present composition of the euro area must be in the hands of governments and "whatever it takes" must not be perceived as a bail-out commitment.

The other instrument to be reviewed is forward guidance. In their communication, in which forward guidance plays a central role, central banks have gone very far in making commitments – which markets perceive more or less as unconditional – for a rather long period of time. In periods of high uncertainty, this may lead to dangerous conflicts with the objective of taking monetary policy decisions in a timely and appropriate manner (Issing, 2019).

MULTIDIMENSIONAL MANDATE?

It is the central role of a central bank to keep the currency stable. Accordingly, all central banks have a mandate to maintain price stability. (The Fed – Federal Reserve – has a dual mandate including maximum employment – the commitment to low long-term interest rates is hardly mentioned).

A clear and limited mandate is the basis for making the central bank independent. There is no democratic justification for an independent central bank to infringe on its mandate.

In the course of recent years central banks have been endowed with new areas of competence and have made their own commitments to influence income and wealth distribution and/or contribute to the fight against climate change. A number of questions arise from this self-imposed extension of their responsibilities. Can monetary policy achieve these additional goals? What about the Tinbergen rule – what are the instruments? What about conflicts with the mandate to maintain price stability?

Creating expectations and then failing to deliver on commitments will harm the reputation of the central bank and undermine its status of independence (Issing, forthcoming).

NEW GUIDELINES?

Controlling or, more modestly, guiding inflation expectations has become the key goal of monetary policy (Woodford, 2003). To meet this challenge, inflation expectations must be firmly anchored to the inflation target of the central bank. When there is a high degree of uncertainty about future economic and political developments, having a steady anchor becomes all the more important, but at the same time more difficult to establish.

As stated at the beginning, monetary theory and policy reflect developments in the economy and society. To recall Wicksell's warning, in order to avoid repeating old mistakes and making new ones, a number of guidelines can be drawn.

It remains to be seen whether the Fed's concept of average inflation targeting or the new "symmetry" approach of the ECB will be successful in providing a steady anchor.

Forward guidance, which was once called a "revolution" (Yellen, 2012), has become the main communications strategy for anchoring expectations. Theory and practice have, however, revealed major problems with this approach (Issing, 2019). It is striking that, in an environment of high uncertainty – uncertainty in the sense of Frank Knight – the Fed and the ECB have announced they will keep central bank interest rates fixed at their present low levels for quite a long period of time. Central banks, themselves facing high uncertainty, try to reduce or even eradicate uncertainty in the private domain by tying their own hands. This may cause major problems related to time inconsistency for their monetary policy. New guidelines should be drawn that thoroughly review the theory and practice of forward

guidance. This is even more necessary given that multiple goals make predicting the evolution of central bank interest rates an almost impossible task.

The theoretical underpinning of monetary policy also needs a fundamental review. Models have become more and more complex – and at the same time doubts have increased over whether they can reflect the deep changes in the structure of the economy and of financial markets. "Old" concepts like credibility issues, time inconsistency, even a straightforward aspect such as long and variable time lags have more or less disappeared from the agenda. Can inflation targeting really be seen as the final optimal monetary policy regime? Will neglecting the currency and credit become a permanent orientation?

We are still far away from fully understanding financial stability and the role for central banks. On the one hand, further research should be given priority. On the other hand, how should central banks act in an environment of extreme uncertainty? Being too ambitious might be dangerous, but what would a strategy of avoiding major mistakes look like?

The challenges for central banking have two dimensions. There is the more technical side: how should one conduct monetary policy based on research and on practical experience? On the institutional level: Independence and a clear mandate are the main pillars of existing institutional arrangements. Independence is seen as the indispensable prerequisite for sustainable price stability. Yet, in the meantime, central banks have been made responsible for wealth distribution and climate change or have themselves taken initiatives in this direction. Can central bank independence survive, should it even survive, under a new regime of this nature?

The role of central banks in society has to be reconsidered. Central bankers should not ignore the implied threat to their independence that getting involved in political issues raises.

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