A Central Question

Policy Exchange

Central Banks and The World Economy in 2021

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This year it is fifty years since August 1971 when Richard Nixon closed the gold window by unilaterally ending the international convertibility of the dollar into gold and set in train a series of international monetary events that dismantled the post-war Bretton Woods fixed parity regime. It provided domestic policy makers the scope to manage macro-economic policy and monetary policy without the complications and constraints of international commitments. It ushered in several decades of instability and inflation where central banks found it difficult to control inflation and maintain a disciplined financial environment.

Over a quarter of a century policy makers learnt to control monetary conditions and enjoyed the gloss that came with low inflation and steady growth. Yet it is not clear that the satisfaction that policy makers took from this period of great moderation overlooked the structural changes to the international economy that were remote from central bank decisions and the inflation targeting regimes. The growth of international markets and trade, the dismantling of the former socialist and command economies in central and eastern Europe, as well as in China along with technological innovation created a benign environment for central banks to operate it in.

There was an extraordinary fall in interest rates, and inflation was consistently below central bank targets despite every monetary endeavour to ensure that policy makers achieved their stated objective. This suggests that the inflation targeting regime had run out of road long before it was clear over the last decade that monetary policy had lost traction as a source of effective macro-economic stimulus. The supply disruptions created by the Covid-19 public health crisis and the return in recent months of consumer price inflation above the central banks' targets suggests that policy makers now need to return to thinking about macro-economic policy and its monetary component from first principles.

"Policy makers now need to return to thinking about macro-economic policy and its monetary component from first principles."

The character of debate that is required would go far beyond the finer points of symmetric inflation targets, the timing of trimming central banks balance sheets by tapering and the role of monetary policy in shaping inequality. Central bankers need to step beyond the agenda that has occupied them in recent years at events, such as the annual Jackson Hole Economic Symposium hosted by the Federal Reserve Bank of Kansas. In short it would suggest asking how central banks can contribute to maintaining stable prices within a policy framework that ensures sufficient demand and identifying the full range of instruments and tools that could be used.

The Good News

The financial crisis in 2008 and the public health crisis that started in 2020 have demonstrated that a combination of the inherent self-righting properties of the private sector and appropriate macro-economic measures – fiscal and monetary policy – can stabilise advanced economies

subject to huge malign shocks. The manner in which advanced market economies have adjusted, adapted and begun to recover demonstrates again the extraordinary capacity that market economies exhibit in adapting to changed circumstances, whether it is a bank strike (Ireland 1970), a three day working week during an industrial relations emergency in the UK in 1974, interruptions in electrical power through inclement weather in communities such as Quebec and New Zealand or war and revolution: market economies adjust and hold up surprisingly well. The good news is that once again macro-economic policy has risen to the challenge of avoiding the economic and social damage of an event such as the Great Depression in the 1930s. Moreover, compared to the macro-economic policy response to the crisis in 2009, in 2020 policy makers made full use of fiscal policy - and on a scale that matched the challenge of the shock.

"This mismatch between demand and supply is happening in a context of a reallocation of assets and economic activity within economies as a result of the Covid crisis."

There is now a strong recovery taking place among advanced economies lead by the US and evident in the UK and other advanced OECD economies. The potential economic scarring appears to have been significantly mitigated by the active labour market measures and business support measures that were put in place. Household balance sheets are strong, and the banking system is well placed to lend. The crisis requiring stabilisation and emergency measures of stimulus and liquidity is now over. Policy makers must now return to the difficult questions of how to maintain monetary stability; anchor inflationary expectations; keep high levels of employment; and return to a rough approximation of the 2.5 per cent or so trend rates of economic growth that advanced economies enjoyed in the last decades of the 20th century after the oil shock in 1973.

The Two Big Questions that Central Banks Need to Address

There are two big immediate difficult questions. The first relates to the fact that there may now be too much demand in the international economy at a time of constrained supply. This mismatch between demand and supply is happening in a context of a reallocation of assets and economic activity within economies as a result of the Covid crisis. It is creating powerful relative price effects – such as the exacerbated costs of timber, shipping, second-hand cars – together with statistical base effects arising from the rebound in energy prices.

Will all this, combined with a synchronised international commodity price cycle, lead to only a *transitory* increase in the rate of consumer price inflation? Or will it ignite a *sustained* increase in prices that will disprove inflationary expectations? This development would damage market economies that rely on price signals for information in allocating resources and will complicate decisions about consumption, investment and saving.

The second and related question stems from the disruption and shock of the pandemic, the new ways we have learned to use existing technology, and the extraordinary fiscal measures that policy makers have taken to

stabilise demand. Has the combination of these three factors shocked advanced economies out of the slow growth, secular stagnation and potential stationary state[1] conditions that they have appeared to exhibit since 2010?

Immediate inflation pressures

Financial markets, economists in general and central bank policy makers believe that any increase in inflation this year and next will be a temporary phenomenon caused by Covid-induced economic 'bottlenecks' which will clear as things return to normal.

But it remains very difficult to interpret present economic data, make sense of it and obtain a confident purchase on what is happening. There are plainly a series of market disruptions to supply chains, that reflect the immediate consequences of both the pandemic – such as a lack of lorry drivers, a dearth of chips affecting motor vehicle production and shortage of timber and building supplies. These are likely to be temporary. Will there be a rapid wage price spiral in response to them as the economy opens further and will mismatches of labour result in reported increases in earnings? There is likely to be some upward pay pressure as specific labour markets[2] respond to labour shortages.

Modern Economies are not distorted by pay and price controls and labour-market institutions that cannot clear

Yet an aggravated wage price spiral appears unlikely. Labour market institutions are much more flexible in the North America and in the UK than they were forty years ago, notions of the going rate play little part in individual and workplace pay negotiations and organised labour has little scope to extract a pay premium or 'union mark-up' outside the public sector.

A less commented on feature of the present economy that distinguishes it from the 1970s is that present prices reflect market demand and supply. They have not been repressed and distorted by a series of pay and price controls over a decade or more. Furthermore, there are no aggravating macro-economy pay policy factors such as the escalator clauses of the Conservative Government's incomes policy in the 1970s that had a huge amplifying effect on pay inflation in the mid-1970s. In many respects powerful upward price signals may offer beneficial guidance on resource allocation in the present circumstances.

Has the pandemic and the policy response shocked the advanced economies from stagnation?

Whether the advanced economies will continue to be stuck in a state that approximates a permanent stagnation – in which productivity and economic growth will remain very low by the standards that we got used to in the second half of the 20th century – is unclear. The combination of very low real interest rates, glut of savings and financial flows desperately seeking positive real returns was increasingly apparent in the decade that

1. Secular stagnation is the notion that mature economies may have run out of opportunities to invest and deploy capital to generate results that are worthwhile for private investors, resulting in little scope for economic growth in advanced market economies. It was a question that worried the great classical economists – they referred to it as a 'stationary state' and it became a concern of economists in the 1930s during the Great Depression. Given the low interest rates, huge flows of saving and demand for safe financial rather than risk assets, economists have begun to wonder since the Great Recession whether we have entered some form of secular stagnation.
2. For example, in sectors dependent on public-facing employees who are afraid of returning to jobs in hospitality, or in labour markets that depend on a flow of trained people whose training has been disrupted.

followed the Great Recession.

It is possible that the combination of: disrupted supply chains, novel deployment of existing technologies, a huge pent up consumer demand, financial markets and company balance sheets fuelled by debt finance – may shock advanced economies out of the torpor of the last twenty years. Given the scale of the liquidity in financial markets, the access that large firms have to finance from bond markets and the elevated levels of financial assets and housing markets, it is possible that this monetary liquidity could be translated into transaction balances and spent generating a monetary transmission mechanism that ultimately results in higher prices. Several US Federal Reserve Regional Bank Presidents, for example, have noted that higher rents may now be sufficiently high to raise the Federal Reserve's chosen measure of inflation.

"Has the pandemic and the policy response shocked the advanced economies from stagnation?"

If a return to higher real growth did take place, with some upward inflation pressures requiring a genuine tightening in monetary conditions, that would probably be a good thing. This is because the very low levels of nominal and real interest rates - and the unorthodox measures such as quantitative easing and credit and interest rate guidance implemented since 2010 - have become part of the problem rather than part of the solution to slow growth and stagnating economies. Very low interest rates that have emerged from deep structural changes in the international economy have been compounded by the monetary policy measures taken by central banks in relation directly to interest rates and their open market operation such as QE.

There is one market where prices have been repressed and distorted: the money market

While contemporary market economies enjoy the advantage that prices in product market and wages in labour markets have not been distorted by being artificially repressed by direct controls, an important set of prices in one particular sector have suffered from precisely that form of distortion. Money, credit, and bond markets have prices that have been lowered by the sustained actions of central banks over more than a decade through very low interest rate polices and QE. As well as a potential inflation risk, this price distortion also creates a set of incentives that contribute to the very real deflationary stagnation that the policies are supposed to address. To make monetary policy effective in a context where it had lost all traction because interest rates were close to zero, central banks continued to try to breathe life into a dead policy when other macro-economic policy tools were needed.

"Central banks continued to try to breathe life into a dead policy."

The opportunity to return to a better balanced macro-economic policy

There is now an opportunity to return to a better balance between monetary and fiscal policy with the emphasis on tighter and more normal interest rate and monetary conditions. Policy makers should start by recognising that, instead of being a source of stimulus, the very low rates of policy interest rates and QE have been of limited use as a stimulus outside of the immediate emergency liquidity crisis in 2008. Central banks have been left by governments to take on too many burdens within macro-economic policy and have hugely expanded their own balance sheets with liabilities that should lie directly on governments' books.

"There is now an opportunity to return to a better balance between monetary and fiscal policy."

These policies have led to an effective fusion of fiscal and monetary policy – which is inevitable in a crisis - and neither central banks nor finance ministries should be shy of acknowledging it. What enabled governments and central banks to stabilise economies in the crises of 2009 and 2020 was that the national balance sheet of the countries involved could collectively take on and mitigate risks that the private sector could not manage. This was only made possible by governments' finance ministries such as the US Treasury Department and the UK Treasury agreeing to indemnify their central banks – that was the real fusion of monetary and fiscal policy, and so it remains.

As well as being disappointing in its macro-economic objectives – meeting inflation targets and raising GDP growth rates - the low interest rates policy had distributional consequences. Different categories of people experienced different effects: savers versus borrowers, the rich rentier class versus the rest of society, older versus younger households, mortgage borrowers versus people who rent and rely on incomes from savings accounts.

Central banks being invited to do too much and having the conceit to accept the invitation

This has resulted in central bankers being increasingly interested in equality and distributional questions, something that the Bank for International Settlements (BIS) has noticed. But central bankers do not actually have the policy tools to affect the distribution of income and wealth. Those instruments – taxation and transfer payments and the provision of services such as education and health in kind lie with governments. It helps to explain the novel interest that central bankers are taking in running their economies hot to create the conditions where groups with weak attachments to the labour market can emerge and participate.

Central banks are now also being invited to take on an active role in supporting the green agenda to decarbonise the economy. This role would be beyond the remit of a central bank in the prudential regulation of the banking and financial system, regulation that would have to take account of risks – particularly in relation to insurance risks – that would arise.

Yet the principal tools to manage climate change and decarbonisation – regulation, taxation, and the pricing of carbon – lie outside the scope of a central bank's toolbox. The reason for this is similar to the way in which measures to manage the distribution of wealth are contentious and should therefore be taken in an explicitly political arena rather in a technocratic context –such as a central bank – that is significantly removed from direct political accountability..

More normal monetary conditions would contribute to overcoming recent economic stagnation

There is now an opportunity to rebalance monetary policy. The very low rates of interest and the protracted unorthodox measures of monetary policy such as quantitative easing, credit guidance and the communication of assurance that central banks will keep interest rates permanently at very low levels have achieved little traction in terms of stimulus. Yet tighter monetary conditions are likely to retain their tract in terms of slowing the economy if it is overheating. Given that low interest rates and QE have become part of the problem of secular stagnation and given the inflationary pressure that is building the time has come to systematically tighten policy and return to a structure of interest rates and a yield curve where risk is realistically benchmarked.

> *"Low interest rates and QE have become part of the problem of secular stagnation."*

Has the inflation targeting regime of the last three decades had its day?

Central banks should also be examining their approach to monetary control. For a quarter of a century this has effectively been a focus on a *de jure*, or in some cases a *de facto* inflation target achieved by a wholly discretionary policy that has focused on management of inflationary expectations rather than intermediate targets or direct controls. For much of this period there was an asymmetric approach to inflation and above-trend growth to ensure full employment and no lost growth opportunities.

This was the central monetary policy failure in the run up to the credit crisis in 2007: much of the inflationary impetus was disguised by an inflation of asset prices that was not captured in the price measures used by central banks for their inflation targets. The warning signs of asset price bubbles, inflated bond, equity, and housing markets were wrongly ignored.

The creation of an international financial cycle that amplifies the normal business cycle

This compounded a growing feature of advanced economies that began to emerge about forty years ago after the end of the Bretton Woods system, i.e. the gradual emergence of a financial cycle that overlies the general business and economic cycle and amplifies it. It is exemplified by huge amounts of international liquidity chasing a limited range of safe and

sensible risk assets. Its stability has little to do with the stock of assets or liquidity; instead, it relies on the recurrent financing of transactions that are rolled over without interruption.

This a central part of the explanation of the very low interest environment that has emerged in the last twenty years. The central bank at the heart of this liquidity is the Federal Reserve Board in the USA, but its practices have been closely followed by other central banks such as the ECB and the Bank of England. The novel tool of balance sheet expansion and quantitative easing was in fact pioneered by the Bank of Japan, although it should be acknowledged that the Japanese authorities were under intense international pressure, not least from the US Treasury Department, to stimulate its economy and end the deflationary cycle it encountered in the 1990s.

"[There are] huge amounts of international liquidity chasing a limited range of safe and sensible risk assets."

Yet the principal driver of this financial cycle and its liquidity has been low interest rates and a monetary policy that was attempting to do too much in the absence of effective fiscal policies. This dynamic was in play a decade or more before the credit crises and the Great Recession that took place between 2007 and 2010.

Federal Reserve and ECB review their operating practices – an opportunity missed?

Both the Federal Reserve Board and the ECB have conducted reviews of their approaches to monetary policy. The Federal Reserve announced its new policy approach in the Autumn of 2020. Essentially it is a move towards an average inflation target where periods of above-target inflation can make up for periods when inflation has been recorded below its target.

In addition, Federal Reserve officials emphasised the institution's commitment to the employment dimension of its mandate under the 1978 Humphrey Hawkins legislation – essentially promising to take some risks with inflation to ensure very high levels of employment particularly for minority communities and only tightening when there were clear inflationary risks. This has been perceived by some commentors as a significant relaxation of the previous approach developed by Ben Bernanke, but it is not clear that it makes such a difference to the central bank's actual practice.

Dropping the Bundesbank's intellectual legacy

The ECB published its own review of monetary policy in July 2021 – the first since 2003. The document signals ECB's move to a symmetric inflation target. Technically this represents a relaxation of the policy target which, since the creation of the ECB in 1998, has been expressed as 2 per cent or less.

The review also introduces a green dimension to ECB monetary policy decisions and abandons the monetary pillar of the ECB approach inherited

from the intellectual legacy of the Bundesbank.[3]

In the 1970s, when the Bretton Woods system collapsed, central banks and policy makers had a significant constraint on their behaviour removed. In most advanced economies they went for growth released from the balance of payments constraint of a fixed parity exchange rate regime. In practice they inflated what were already overheating economies that exhibited inadequate domestic monetary control.

The distinguished exception to this inflationary episode on the mid 1970s was West Germany. The central bank that most swiftly and effectively absorbed the policy implications of the monetary analysis of Milton Friedman and Anna Schwartz and the monetarist critique of the post-war Keynesian economic consensus was the Bundesbank. German academic economists had played little or no role in this monetary counterreformation, but the German central bank officials grasped its policy imperative sooner and better than those of any other central bank.

The Bundesbank did not just set monetary targets but established operational tools to give effect to them. The central innovation was a framework of minimum reserves that directly controlled the creation of money and credit rather than relying solely on the price of money to control demand for it. In the inflationary upheavals of the 1970s and 1980s West Germany fared much better than other advanced economies such as France, Italy, the UK, and USA.

It was an analogous approach that was adopted by the Federal Reserve under Paul Volcker's leadership in October 1979 that targeted the supply of non-borrowed reserves to the banking system rather than a specific rate of interest in the Federal Funds Market. This decisively brought US monetary conditions under control between 1979 and 1982 and broke the inflationary spiral that was the economic hallmark of the Nixon and Carter administrations.

Financial innovation in the 1970s and 1980s – not least the development of interest-bearing chequing accounts and the disintermediation in financial systems – fundamentally changed the demand for money and made the task of identifying transaction balances in reported monetary measures more difficult. This resulted in most central banks abandoning monetary targeting. Yet the Bundesbank never gave up on the difficult and necessary task of trying to understand monetary growth and how it should be controlled.

A distinctive feature of the last year has been the growth in monetary aggregates in the USA. Discarding the final legacy on monetary analysis in a contemporary central bank is probably a mistake at a time when there is an inflationary impulse that needs to be understood. Part of that understanding should include a willingness to pay attention to some potentially unpalatable monetary analysis and the consequences of huge liquidity balances that could be transformed into money that will be spent and the monetary transmission mechanism that would result.

3. That legacy was laid out fully in *Fifty Years of the Deutsche Mark: Central Bank and the Currency in Germany since 1948*, a book edited by the Bundesbank and published by OUP in 1998 to 'give future European monetary policy-makers the invaluable benefit of the German experience. The book combines chronological articles with others which follow the developments of a specific issue over the entire 50-year period. On June 20th, 1998, the Deutsche Mark will be 50 years old: this book will ensure that its legacy lives on.' Ending the monetary pillar in the ECB's policy analysis ends the distinctive legacy of the Bundesbank.

The Reticence of the UK Monetary Authorities and the Bank of England

In this discussion of the future of monetary policy challenges the contribution of the Bank of England and HM Treasury that sets the central bank's target has been oblique if not silent. This point was made powerfully by the House of Lords Economic Affairs Committee's report on Quantitative Easing[4].

The report marshals the principal issues well, although its concentration on QE means that is does not get to the nub of the challenges facing central banks. For example: where are we in relation to secular stagnation? Have very low interest rates and other monetary measures been an aggravating cause of our problems? Has inflation targeting run out of road? And what monetary measures should be taken to control an unexpected and serious bout of inflation, and how should active monetary and fiscal policies be used in managing the economy?

"Discarding the final legacy on monetary analysis in a contemporary central bank is probably a mistake."

The report looked at the role of bank reserves deposited at the central bank as the counterparty to gilt purchased as part of the Bank of England's QE operations, and at the extent that these reserves may result in an effective decline in the maturity of the stock of debt exposing the Treasury to an increase in debt service charges. Yet this is a wholly myopic consideration: the question can be easily resolved by ending the payment of interest rates on commercial bank deposits held at the Bank.

The renumeration of such deposits is a relatively recent innovation following the credit crisis both in the UK and in the USA. There are good reasons for ending it. The big question about such deposits is whether there may be circumstances relating to monetary control when the central bank should compel deposits as part of a policy to control directly the supply of money and liquidity to the banking system and economy.

But the report's focus was instead on the sustainability of UK debt service charges. It ignored any analysis of the international demand for risk-free – in credit terms – financial assets issued by sovereign borrowers and the obvious scope for issuing more longer maturity debt and exploring the market appetite for permanent irredeemable debt like consols.

"Debt service charges are not an issue when sovereign borrowers can borrow at negative real interest rates for ten and fifty years."

Debt service charges are not an issue when sovereign borrowers can borrow at negative real interest rates for ten and fifty years. Moreover, as the Director of the National Institute said in evidence to the Committee, the real prize in a fiscal stimulus is economic growth that generates buoyant tax receipts and that more than makes up for any debt service charges.

The challenge for central banks is to end the amplified financial cycle that lays the seeds of the next asset price bubble and liquidity crisis and therefore to return monetary policy to a focus on more normal interest rates and bond markets. Central banks should examine how monetary policy

4. House of Lords, *Quantitative easing: a dangerous addiction?* 1st Report of Session 2019-21 - published 16 July 2021 - HL Paper 42. Available at: https://publications.parliament.uk/pa/ld5802/ldselect/ldeconaf/42/42.pdf

should be framed when the gloss of inflation targeting has been exposed as mere cover for completely discretionary policies where tensions and policy challenges are obfuscated.

Central banks should also prepare decisive measures to control inflation if that is necessary, and recognise the limitations of monetary policy in relation to fiscal policy. Furthermore, they should resile from over-burdening their role with functions related to the distribution of income and wealth, to the functioning of labour markets and participation of hard-to-reach groups, and to the regulation of environmental externalities.

Governments and finance ministries must recognise that the tools that they have in relation to taxation, borrowing and regulation have a direct and unavoidable role in demand management and in framing economic incentives, supply side performance and economic growth. These things cannot be contracted out to central banks, either technically or politically, given that they inevitably involve contested decisions about the future of the economy.

"Framing economic incentives, supply side performance and economic growth [...] cannot be contracted out to central banks."

Over the last twelve years, central banks have tried to make monetary policy work in circumstances where it cannot. In the process, their ultra-loose monetary policies have created micro-economic distortions to the pricing of money and credit, the functioning of debt and asset markets and contributed to the phenomenon of the zombie firm.

The Federal Reserve and the ECB have reviewed their operating procedures and have determined their conclusions on the assumption that secular stagnation and deflation remains the principal immediate challenge and that the solution requires very low interest rates to stimulate the economy below the so-called 'zero-rate boundary' by engineering an increase in inflation to lower the real rate of interest.

Both the Federal Reserve and ECB have done this when there is a question about whether this deflationary secular stagnation may have now ended, and at a time when mismatches between supply and demand may be about to set off an episode of higher inflation that may not be transitory.

Uncertainty and the scope for error

Central bankers, financial markets and economists in general do not think that the sharp rise in prices currently being recorded in the US and UK is anything other than transitory. Yet over the last thirty years that same galaxy of opinion has been surprised by a series of unexpected phenomena and adverse shocks: very low inflation, very low interest rates, a surprisingly strong spurt of productivity growth in North America in the 1990s, followed by very weak productivity growth in the US and other advanced economies, protracted slow economic growth in the 21st century, the banking and credit crises between 2007 and 2009, the resulting Great Recession and the adverse economic shock generated by the Covid-19 public health emergency. In this context of uncertainty,

central banks should be preparing for being mistaken about both inflation and secular stagnation.

At a time of unexpected inflation and elevated accumulations of liquidity monetary analysis is complicated but necessary

It is bizarre that in their analytical frameworks central banks have no room for explicit monetary analysis and that the only major central bank that had retained a distinctive monetary dimension to its policy assessment, the ECB, should be dropping it at a time when an effort should be made to try and map money, liquidity, transaction balances, the demand for money, and the extent to which there is an identifiable monetary transmission mechanism in play.

It is also odd that the policy-makers charged with supervising the money and banking system do not have a monetary analysis as part of their policy assessment. This is not in any way to suggest that there should be a return to the framework of mechanical monetary targets that were prominent in the US and UK in the early 1980s, but to recognise that monetary analysis has a role to play in understanding the economy and macro-economic policy. It would also help policy makers to recognise the limits on monetary policy: by artificially attempting to use it when it cannot work it creates effects that are both more complicated and potentially worse than the problem they were trying to solve.

"Ultra-loose monetary policies have created micro-economic distortions to the pricing of money and credit."

If there is a serious monetary mistake that must be corrected it would be helpful if central banks were to consider the tools available to manage such an event. Janet Yellen, the US Treasury Secretary has expressed confidence that central banks have all the tools they need to do so but it would be helpful if they could be explained.

Would central bankers simply rely on working on the demand for money through higher interest rates? What consequences would higher interest rates have on the expanded central bank balance sheets? Would they turn to direct measures that work on the supply of money, such as overfunding, or minimum reserve requirements?

The major central bank that has recent experience of direct controls is the People's Bank of China. There may be modern lessons to be gleaned from it and from other emerging market central banks that have had to deal with circumstances that are, normally, quite unlike those potentially challenging monetary authorities in advanced economies.

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