Rewriting the Monetary-Policy Script

Mar 2, 2017 | **MICHAEL HEISE**

MUNICH – How long will major central banks blindly rely on rigid rules to control inflation and stimulate growth? Given the clear benefits of nimble monetary policy, central bankers need to open their eyes to the possibilities that flexibility affords. The rule of thumb for monetary policymakers has long been that if inflation is below official target ranges, short-term interest rates should be set at a level that spurs spending and investment. This approach has meant that once interest rates reach or approach zero, central banks have little choice but to activate large asset-purchase programs that are supposed to stimulate demand. When circumstances call for it, policymakers default to the predetermined scripts of neo-Keynesian economic models.

But in too many cases, those scripts have led us astray, because they assume that monetary policy has a measurable and foreseeable impact on demand and inflation. There is plenty of reason to question this assumption.

For starters, households have not responded to ultra-low interest rates by saving less and spending more. If savings no longer yield a return, people can't afford big-ticket items or pay for retirement down the road. Likewise, companies today are faced with so much uncertainty and so many risks that ever-lower costs of capital have not enticed them to invest more.

It's easy to see why, despite the data, predetermined formulas are attractive to monetary policymakers. The prevailing wisdom holds that in order to return the inflation rate to a preferred level, any slack in the economy must be eliminated. This requires pushing interest rates as low as possible, and when these policies have run their course (such as when rates dip toward the negative), unconventional instruments like "quantitative easing" must be deployed to revive growth and inflation. The paradigm has become so universally accepted – and the model simulations underpinning central banks' decisions have become so complex – that few are willing to question it. For individual central banks or economists, to do so would be sacrilege.

Central banks do not completely deny the economic costs that these policies imply: exuberance in financial markets, financing gaps in funded pension systems, and

deeper wealth inequality, to name just a few. But these costs are deemed an acceptable price to pay to reach the clearly defined inflation level.
Yet the policies pursued in recent years have given no room for the intangibles – unstable political environments, geopolitical tremors, or rising risks on financial markets – that can send models off course. As the 2008 financial crisis illustrated, the normal distribution of risk was useless for predictions.

Keynes never tired of arguing that monetary policy becomes ineffective if uncertainty is sufficient to destabilize the expectations of consumers and investors. Unfortunately, many central banks have forgotten this. The Bank of Japan, the Bank of England, and the European Central Bank all hone to rather rigid policy rules. If expansionary policies fail to have the desired effect of lifting inflation to the predefined level of around 2%, they do not question their models; they simply increase the policy dosage – which is just what markets expect.

For now, the US Federal Reserve has the most flexible toolkit among the major central banks. In addition to inflationary pressure, the Fed's monetary policy must also take into account employment statistics, growth data, and the stability of financial markets. But even the Fed's flexibility is under siege. Republican lawmakers are discussing how to bind the Fed to more scripted policy rules to manage inflation (using a formula known as the Taylor rule, which predetermines changes in the federal funds rate in relation to inflation and an output gap). Needless to say, such a move would be a mistake.

Central banks (not to mention lawmakers), with their strong attachment to neo-Keynesian theory, are ignoring a major lesson from decades of monetary-policy experimentation: the impact of monetary policy cannot be predicted with a high degree of certainty or accuracy. But the belief that it can is essential to the credibility of the now-standard inflation targets. If central banks keep missing these rather narrow marks ("below, but close to 2%"), they end up in an expectations trap, whereby markets expect them to dispense ever higher doses of monetary medicine in a frantic attempt to reach their target.

Clearly, such monetary policies create soaring costs and risks for the economy. And central banks themselves are coming dangerously close to looking like fiscal agents, which could undermine their legitimacy.

A new and more realistic monetary paradigm would discard overly rigid rules that embody the fallacy that monetary policy is always effective. It would give central banks more room to incorporate the risks and costs of monetary policies. With such a paradigm, central banks could move away from negative interest rates and large-scale asset purchases. They would define their inflation targets more flexibly, to avoid being forced into action whenever "uncertainties" such as declining oil prices or required wage adjustments cause inflation to move above or below 2%.

Perhaps most important, a new paradigm would acknowledge the limits of central banks' power and foresight. That would remove an alibi that governments too often hide behind to avoid introducing the structural reforms that really matter for long-term growth.

MICHAEL HEISE
Writing for PS since **2014**
14 Commentaries

Michael Heise is Chief Economist of Allianz SE and the author of *Emerging From the Euro Debt Crisis: Making the Single Currency Work*.

http://prosyn.org/LMVkmEv;