The Future of Central Banking

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The exteriors of major central banks may be solid marble and doric columns, but, inside, monetary policy remains a work in progress. The officials inside have to craft a policy framework that makes the most efficient use of instruments of varying potential effectiveness, and show responsiveness, but not subservience, to external political pressures.

Of late, the changes have come at a dizzying pace in a culture that usually measures regime shifts in terms of generations. In just a few months, we welcome a new Governor at the Bank of England, a new communications policy at the Fed, and a new determination at the Bank of Japan to hit a higher inflation target.

Not all change, though, represents progress. I am particularly concerned by the increasing desire of officials to tie monetary policy to real outcomes. This is best exemplified by the instructions handed down by the prime minster of Japan. Minister Abe held on January 11 that "We would like the BoJ to take responsibility for the real economy. I think that means jobs. I would like the BoJ to think about maximising jobs." The Fed's setting of a threshold for the unemployment rate, and the suggestion that a nominal income target be adopted in the UK, whereby real output growth and inflation get equal weights, go in the same direction.

The impetus behind this trend is understandable. Following ample and unfortunate precedent, the recovery from the financial crisis has been disappointing, and resource slack remains substantial. Worries are mounting about fiscal deficits and increases of the ratio of debt-to-income that are unprecedented in our peace-time era and that constrain the options of fiscal authorities. And if the shift of monetary policy is not too extreme, limited in duration, and accompanied by a clearly defined exit policy, I would not object.

But my observation of policy-making over the years makes me doubtful that an ad hoc entry into a new policy regime will be followed by a nimble exit when the appropriate time comes. My fear is that, once the sell-by date of these initiatives passes, central bankers will be acting contrary to everything that we learnt, painfully, in the 1970s. They will be relating monetary management to real variables on a longer-term basis. In the end, any short-term benefit will be dwarfed by the long-run pain as they push inflation higher in the vain pursuit of a real economic objective. That is, they will hit the brick wall posed by a long-run and vertical Phillips curve. Persistently higher inflation will not make inroads into resource slack and ultimately will lower, not raise, economic growth.

While there may now be a case for some further temporary monetary expansion, this can be done within the context of the present flexible inflation target.

Central bankers would be better employed by improving unconventional instruments of monetary policy. The UK's funding-for-lending scheme is a good start, as it offers a route to stimulating aggregate demand that bypasses the clogged arteries of conventional stimulus. The BoJ already has a significant portfolio of loans on its books, and the Fed would be wise to follow if the pace of the US expansion remains tepid.

Adopting a nominal income (NGDP) target is viewed as innovative only by those unfamiliar with the debate on the design of monetary policy of the past few decades. No one has yet designed a way to make it operationally workable given the lags in the transmission of monetary policy and the publication of national income and product. As yet unspecified is whether the goal is the level or change in NGDP and how misses from the target will be subsequently treated. Nor are the benefits of the regime clear if supply, instead of demand, shocks mostly predominate. Rather, a NGDP target would be perceived as a thinly disguised way of aiming for higher inflation. As such, it would unloose the anchor to inflation expectations, which could raise, not lower, interest rates by elevating uncertainty about the central bank's reaction function.

We do not know, and cannot predict, what will be the sustainable rate of real growth in our economies. Let us hope that it is well above the relative stagnation observed in recent years in the UK, US, and Japan. But it would be dangerously optimistic to believe that our economies can permanently revert to prior faster growth. In the short run, monetary expansion a l'outrance might temporarily and initially lead to a burst of growth. But the likely implications of a dash for growth and the abandonment of an inflation target would at some point unhinge the government debt market, with the risk of that greatest in the UK.

History counsels caution in assessing where that tipping point might be. While interest rates can be forcibly held down for a time by ever-more-aggressive purchases of government debt and vocal commitments to negative real policy rates, the expression of private self-interest cannot be held at bay forever. Should the view take hold that the authorities had given up on inflation in the pursuit of real variables, the extent of monetisation would be of a different magnitude from anything seen so far. It would also put central bankers at the razor's edge of high inflation on one side and renewed depression on the other. Possible, perhaps, but not a comfortable place to be.