The US, Europe and China: Different Tools, Different Realities
By William R White

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Unpleasant Facts and the Response of Central Banks

Over the last year or so, most of the world’s central banks have been confronted to varying degrees with three unpleasant facts. This has severely complicated the task of making monetary policy since these different facts often seem to call for conflicting monetary responses. Broadly put, we have been witnessing the sharp reversal of all the remarkably positive economic and financial trends seen in some countries over previous years, and even over decades in others.1

The first unpleasant fact is that inflation has risen to higher levels almost everywhere, but particularly so in a number of important emerging market economies (EME’s). The second unpleasant fact is that growth estimates are being marked down sharply, but particularly so in a number of the advanced market economies (AME’s). And the third unpleasant fact, affecting particularly the AME’s with well developed capital markets, is that these markets are now dysfunctional in many respects. Further, asset prices in many economies are declining, losses are being recorded at financial institutions, and the adequacy of banks’ capital is being increasingly questioned. With capital becoming ever more expensive, the result is that lending conditions are already tightening and this has the potential to feed back further on asset prices and on global growth in turn.

Against this background, the response of different central banks has varied widely. At one end of the spectrum we have countries like Australia and Sweden. There, policy rates have been raised significantly and talk of a turning point has only just begun. In the Euro area and China, policy rates have also tightened, but only marginally, while in Japan they have hardly moved at all. And at the other end of the spectrum, we have the United States, where the policy rate has been lowered more aggressively than at any other time in the post war period.

Given that all these central banks are responding to the same unpleasant facts, this diversity of response needs explanation. It will be suggested here that the different degrees of exposure to individual unpleasant facts is a significant part of the explanation, but that a number of other key differences also need consideration. In spite of the growing focus on

11 The last two decades in the United States have been characterized as „The Great Moderation“. Both the level and volatility of inflation were low. As for output growth, while its level was high, its volatility was also low. Further, there were recurrent financial shocks but the financial system showed itself remarkably resilient. While other crisis ridden countries in the emerging market economies exhibited a much worse overall performance, over a similarly long period, this decade has until recently been characterized by outstanding economic performance in most EME’s.
keeping inflation under control, central banks still differ in their history, theoretical paradigms and their assessment of actual and prospective exposures. However, before turning to these differences, it is worth speculating a bit about the role that past central bank policies have played in creating the current set of global economic challenges. This might provide some guidance as to how different central banks should best respond now, as well as to what institutional changes might help minimize the costs of such problems in the future.

While this paper is essentially positive rather than normative, one introductory comment is worth making. Beginning in the 1970’s, an increasing number of central banks extended their policy horizon to allow them to capture the costly inflationary implications of the real growth which they were trying to stimulate with their monetary policies. The big question today, on which central banks still differ widely in their views, is whether the policy horizon should be extended still further to capture other undesirable side effects (here called “imbalances”) of expansionary policies. In the limit, as credit boom turns to bust, such imbalances can lead to deflation rather than inflation. Historical experience over the centuries indicates that this is likely to be an even more costly threat to price stability.

Common causes for broadly common problems

It is not hard to tell a story in which easy financial conditions over many years lie at the heart of current global difficulties. With inflation kept down by positive supply shocks, particularly due to the reintegration of many EME’s back into the global economy, real interest rates (measured ex post) in most of the world’s major regions have been very low for many years. In effect, there seemed no reason to raise policy rates, even though growth rates of GDP were high. And, by the same token, there seemed no reason not to lower rates when growth slowed or financial disturbances threatened such an outcome in the future. The story began with the easing of monetary policies in the major industrial countries, particularly Japan and the United States in response to their respective “busts” in the early 1990’s and at the beginning of this decade. However, as this eventually put upward pressure on the currency of the major EME’s, these countries responded with massive exchange rate intervention and easier monetary policies as well. The former helped lower global bond rates, as foreign exchange reserves were invested in the major financial centres, and the latter encouraged more spending domestically.

This phenomena can be put in a more Wicksellian perspective by noting that the aggregate global real 10 year bond rate (using TIPs rates where available) fell below the IMF’s estimate of potential global growth in 1997. The former has continued to fall since, and the latter has continued to rise. The gap between the “natural” rate of interest and the “financial rate” is thus of very long standing and has now reached almost 4 percent. Real policy rates are still zero in many regions and often significantly negative in others. In China, given its very high rate of potential growth, the gap could be as high as 8 to 10 percentage points.

Closely related, growth rates of money and credit aggregates have been high in all major regions (except Japan) for many years, with such figures exceeding 20 percent in many EME’s in recent years. Moreover, such measures underestimate the degree of monetary and financial stimulus at work in the global economy. This is due to the process of innovation in the financial sector (in particular the processes of securitisation, globalisation and consolidation) which have had the effect of making credit available to many who were previously denied it. This would of course include less than prime mortgage borrowers in the United States (and to lesser degree in some other countries), but also the recently urbanized poor in many EME’s.

For a very useful overview of this history, see Reinhart C and Rogoff K „This time is different; a panoramic view of eight centuries of financial crises“ NBER Working Paper 13882, March 2008
Low policy rates may themselves have encouraged this process of financial innovation. For example, tranched products like CDO’s and CLO’s are designed to make the senior tranches effectively look risk free. As is now clear, the process did not reduce expected losses, but rather reduced the probability of loss while increasing the size of the loss should the event materialize. Similarly, low policy rates could also have encouraged the expansion of markets in which the receipts come up front, but the prospective losses materialize only sporadically (if at all) and only in the future. Such behaviour would include the massive expansion in the writing of out-of-the-money options, credit default swaps and related instruments, and the pervasive use of carry trade strategies funded with low yielding currencies. Perhaps the most dangerous version of this latter trade has been the growing recourse to mortgages denominated in lower yielding foreign currencies by household borrowers in Central and Eastern Europe.

One need not be a “monetarist” to worry that monetary and financial expansion of this duration and magnitude would eventually result in inflation. The record global growth rates of the last few years seem to have raised global demand to a level that now matches the global economies near term supply potential, and inflationary pressures are clearly on the rise. Recent commodity price increases have been the cutting edge for these pressures, reflecting high income elasticity of demand, particularly in EME’s, and a relatively low price elasticity of supply, particularly for metals and energy products. However, wages and prices are rising more broadly, particularly in EME’s. Evidently, measured inflation in those countries has risen, but this is also raising inflationary pressures in the AIE’s as well. Higher import prices have been the first manifestation, but there are numerous other channels as well

Moreover, countries like the United States and the United Kingdom, which have large current account deficits, could well face further inflationary pressures arising from exchange rate depreciation. In an environment of diminished global excess capacity and shrinking margins, the pass through from such currency depreciation might well be greater than what has been seen hitherto.

Nor does one need to be an “Austrian” to have worries that the prolonged and significant gap between the financial and natural rates of interest might also have had other unwelcome effects. For many years, the BIS has raised concerns about four sets of interrelated “imbalance” emerging in the global economy; where imbalances can be broadly defined as sustained and significant deviations from historical norms. The first concern were asset prices that seemed very high by historical standards. These would include house prices almost everywhere, the price of high risk and sovereign bonds (ie low risk spreads) as well as antiques, fine art, wine and even stamps. In contrast, the price of buying insurance against risks of all sort was until recently unusually low. A second manifestation, which has received wide attention, has been unprecedented global trade imbalances.

Evidently, the concerns raised by these imbalances was that normalcy might be restored through a reversals of earlier price trends, including the possibility of a disorderly change in the value of currencies as creditor countries became less willing to finance the current account deficits of debtors. To some degree this process of adjustment has already begun. House prices are falling in a number of countries and risk spreads everywhere are up significantly in the context of the current credit crunch, which began with a “Minsky moment”

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4 See Galati G and Mellick W R “The evolving inflation process: an overview” BIS Working Paper 196. They document that exchange rate pass through has declined in most countries in recent years. If, however, this was largely because positive supply shocks were masking the effects of depreciation, this need not continue. Indeed, the positive shocks seem increasingly to be turning negative.
5 Minsky warned of the dangers of increasingly imprudent lending, leading in the end to what are effectively Ponzi finance schemes as loans wind up being used to service previous loans. At a moment in time, people
in July of 2007. Both influences will act to slow spending going forward, just as they spurred spending and growth earlier. Housing starts and employment in construction are already falling sharply in many countries. However, lower asset prices and tighter credit conditions should be considered as only the first stage of the unwinding.

A third and fourth set of identified imbalances could have even more serious effects looking forward. The third imbalance observed is that of unusual and potentially unsustainable spending patterns, similar in some respects to what the Austrian school refers to as “malinvestments”. While very low interest rates constitute the basic driver everywhere, the particular effects in different countries seem very much related to their respective stage of financial development. In this regard, the United States is at one end of the spectrum (largely market driven lending criteria) and China is at the other (largely politically driven lending criteria). Moreover, the fact that different kinds of “malinvestments” have occurred in different countries also seems to bear some responsibility for the global trade imbalances as well. In the United States and other countries, too much consumption has driven up imports whereas in China too much investment has driven up exports. Finally, the fourth imbalance had to do with the build up of risk exposures in the financial and particularly the banking system. These third and fourth issues can be treated in turn.

In the United States and a number of other countries (many English-speaking), the “malinvestment” associated with very low interest rates has been a secular and likely unsustainable reduction in household saving rates to zero or even less than zero. As asset prices rose, so did the collateral available for borrowing, and the perception of increased wealth also seems to have discouraged saving. In turn, as the demand for credit by households rose, banking systems refocused and made lending to households an integral part of their new business strategies. This change in orientation was further supported by the fact that lending to corporations was increasingly being done through markets. Associated with this lack of household saving was a steady increase in household debt levels, and a marked increase in the US trade deficit due to the high import content of consumer expenditures. This latter trend has pushed up the net external debt of the United States to unprecedented levels.

The evident concern with respect to this decline in household saving rates was that they might rebound with material and lasting effects on growth. This process has only just begun and will be further encouraged both by the interaction of lower asset prices (particularly for houses) and the tightening of credit conditions. In the United States, the sharp reduction in policy rates has been met with an increase in mortgage risk premia, such that mortgage rates have risen not fallen. Moreover, in the United States and to a lesser degree elsewhere, a further exposure has been generated by new instruments (like “teaser” rates on subprime

suddenly recognize what has been happening and further lending stops. At this “Minsky moment”, the problem appears to be a shortage of liquidity, but the underlying concern is that of counterparty risk. See Kindelberger CP and Aliber RZ (2005) "Manias, panics and Crashes" Palgrave Macmillian. They use Minsky’s model as their central analytical tool. See Chapter 2 of the Fifth Edition.

On the relative importance of collateral vs wealth effects, see Muellbauer J (2007) “Housing and consumer behaviour” in Housing, Housing Finance and Monetary policy Federal Reserve Bank of Kansas City. See also White W R (2007) “Measured wealth, real wealth and the illusion of saving” in Measuring the financial position of the household sector IFC Bulletin July. Both White and Mullbauer contend that the increase in “wealth” resulting from higher house prices is not in fact an increase in wealth, if wealth is correctly defined as the capacity to enjoy a higher standard of living in the future. The fundamental reason is that higher house prices imply an identical (once discounted) increase in the cost of housing services in the future. Living standards remain the same. However, because the price effect is up front, and the related costs distributed over the future, householders could well have the “perception” of being wealthier. This is similar to the bias towards short term results, and the tendency to ignore longer term risks, that often characterizes financial markets.
loans) which were designed to be serviceable over time only if house prices kept rising. Now that prices have fallen sharply, a significant proportion of householders cannot refinance and have debts greater than the value of the house. This could well lead to another round of foreclosures since the capacity for negotiated workouts currently seems very limited.

In China the “malinvestment” arising from the especially wide gap between the natural and financial rates of interest is of a more traditional sort. The ratio of investment to GDP has risen to over 45 percent of GDP, a level not approached even at the height of the Japanese bubble of the 1980’s. Much of this investment has been conducted by enterprises which are still state owned or heavily influenced by the state. Local and regional political authorities have also exerted an important influence, with similar investments in fashionable industries threatening overcapacity. In both cases, the availability of low cost finance from state owned banks has played an important facilitating role. Against this background, it is not difficult to imagine that many of these investments will in the end prove unprofitable or (for state sponsored infrastructure) unproductive. Further, their has been a particular focus on heavy industry, ultimately directed to support production for export markets, which has been extremely polluting and a particularly heavy user of commodities. These externalities make the social rationality of these investments even more suspect.

The first concern in the Chinese case is that this unusually high level of investment might be cut back significantly. If this occurred before domestic consumption, which has been falling as a percentage of GDP, could rise to offset it then domestic growth overall would suffer. However, this should not be an imminent worry. The Chinese authorities have both the political and financial capacity to keep up investment demand as long as is required. However, this also implies that the underlying problems will grow steadily worse. A second and related source of concern is the extent to which investments have been made in support of export orientated industries. A slowdown in growth elsewhere in the world would have a material effect on China, and perhaps an even greater effect on those who export parts to China for assembly there. The ultimate intertemporal imbalance, at the global level, would emerge if the recent build up of export capacity in Asia (and also Central and Eastern Europe) came on line just as a significant number of countries in the industrial world began to raise household saving rates in response to their past over-consumption.

The fourth imbalance arising from this long period of easy credit conditions is the increased risk exposure of the global banking system and the financial system more generally. So much has been written on this, that one can be brief. What is clear is that lending standards in many countries declined over a wide range of markets; think not only subprime, but also near-prime, home equity, commercial property, credit card debt, cov-lite and well beyond. What is not clear is how big the ultimate losses will be, or who will bear them, though the

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7 Giving mortgages to people incapable of servicing them from income sources generated fees for the mortgage originators up front. In many cases it was clear from the start that the borrower would not be able to service the loan after the “reset”. In such cases, it was intended that the mortgage would by refinanced against the presumed higher value of the house, and with a second set of fees being charged. As for the longer term risks of this strategy, there were none since the mortgage was then sold to a bank (generally to be securitized subsequently) and the originator generally had no personal exposure.

8 Limited but not non-existent. HSBC has made a determined effort in this regard, but has a certain room for manoeuvre not shared by all other lenders. Many sub-prime loans made by others were granted subject to a second mortgage (granted ba still another firm) being used to make the down payment. Even though house price declines may effectively have wiped out the value of the second mortgage, the owner of that mortgage can still try to get value by interfering in the workout process between the debtor and the first mortgagor.

9 In just the last few days it has been rumored that the Chinese authorities intend to both ease monetary policy and provide a substantial fiscal package to maintain high growth rates.
suspicion is that US and European institutions will bear the greatest burden. This is the fundamental issue behind current dysfunctional financial markets. Ultimately, and unfortunately, this must also be unknowable. The final outcomes will be dependent on the unwinding of the other imbalances identified above, and these will in turn be dependent on the extent to which credit conditions tighten. In the end, everything is endogenous.

To summarize: the current simultaneous emergence of rising inflation, slowing growth and financial turbulence is the by product of a long period of excessive credit expansion driven by easy monetary conditions and financial innovation. We are at the tipping point which heralds the ending of the "boom" phase, with its inherently inflationary implications, and the beginning of the "bust" phase, driven by the reversing of accumulated imbalances. This process could well culminate in still more inflation, should inflationary expectations be allowed to rise without resistance. Conversely, it could culminate in outright deflation, made more dangerous by the magnitude of the nominal debts accumulated during the boom years. The question that now faces policymakers is this. Which enemy to fight first?

Why Have Different Central Banks Responded Differently?

Treating the global economy as a whole, it is clear that inflation is on the rise. While food and energy are important components, at the global level these price movements must be treated as endogenous, rather than exogenous, and subject to influence by monetary policy. Moreover, the history of the industrial countries in the 1970s indicates that inflationary expectations can lead to second round affects that can be very difficult to reverse. Against this background, and with global growth still predicted by the IMF to be in 2008, maintaining real policy rates at zero (or even less) indicates big risks to the inflation outlook. Moreover, the maintenance of growth orientated strategies of this sort threatens to make the imbalances identified above even worse. For both reasons, since imbalances must eventually reverse and higher inflation must eventually be resisted, stimulating higher growth today seems sure to imply much lower growth at some time in the future. These arguments would imply that global monetary policy, in aggregate, should be much more restrictive than it currently is.

This said, major central banks have reacted differently to date and there are many reasons to explain such differences. Moreover, there are often reasons to justify such differences as well; one size need not fit all. Four sets of considerations would seem to account for different central banks having done what they have done. Different central banks have different objectives, different worries today (including different realities), different degrees of worry about tomorrow, and different tool sets to help them deal with conflicting objectives.

Consistent with the assigned title of this paper, the focus is on central banks in some of the largest countries.

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10. Nor is it the case that more inflation will sustainably spur more growth since the long run Phillips curve is flat. The Austrians, in light of the experience of central Europe in the 1920's also worried that "imbalances" would eventually culminate in much higher inflation. And think too of the experience of many countries in Latin America over decades.

11. This is a prescription rather than a forecast. Like financial markets and households, as noted above, governments and central banks can also be short sighted and discount the future too much. Further, Asia in particular has very little historical experience of high inflation and their authorities might underestimate its negative effects. Moreover, for countries with high debt levels and relatively fixed servicing charges, higher inflation might seem a relatively costless way to reduce the real burden of real debt service. The United States faces an additional temptation, in that much of its external debt is denominated in US dollars. If the effective nominal value of the dollar falls as inflation rises, then it is foreigner that take the losses. As John Connolly once famously said "Our dollar, your problem."
As for having different objectives, there is little doubt that central banks globally have converged on a model that gives more emphasis to inflation control while remaining cognisant of the costs of real output deviating from potential. The remarkable spread of explicit “inflation targeting regimes” is one indication of this trend, though the differences in both approach and results between implicit and explicit inflation targeters seems to be less than many believe\textsuperscript{12}. The central banks of all the largest currency areas do not in fact consider themselves to be explicit inflation targeters, and this gives considerable scope for differentiation.

The Federal Reserve has a dual mandate concerning the maintenance of both growth and price stability, and might have an historical bias towards the former. After all, the “Great Depression” was the defining economic event for the US in the twentieth century. The ECB must put price stability first, but can then exploit whatever leeway this provides to pursue other objectives. This is also consistent with their history, since the defining economic event for them in the twentieth century was the hyperinflation in middle Europe in the 1920’s. In China, for all practical purposes, it is the objectives of the State Council that govern the conduct of monetary policy. Moreover, these could change quite quickly depending upon the assessment of whether, at any moment, slowing growth or rising inflation posed the greater threat to social stability. The mandate of the Bank of Japan is not in fact clear, and they operate as well under immense pressure from the government via the Ministry of Finance. Such pressures might be expected to be especially potent in a society traditionally driven by consensus.

As for having different worries today, the major central banks face the same unpleasant facts but in quite different measures. The Federal Reserve and the European Central Bank have reacted quite differently to date. In the United States, the household spending (balance sheet) imbalances seem very large by the standards of Europe, house prices have fallen more, and the potential for a serious recession seems that much greater. This remains true in spite of the setback to European GDP in the second quarter. As well, and closely related, the US financial system currently seems more exposed, and the evidence indicates that US credit conditions are already tightening sharply. Such considerations would support the relatively greater degree of easing in the United States. As further support, it could also be argued that inflationary expectations may be more stable in the United States, and that the relative absence of unionisation and wage indexation also works in the same direction\textsuperscript{13}. Inflation then is thought to be less of a problem. Finally, another argument supporting the need for the European Central Bank to be relatively cautious is that it is relatively new institution and its credibility is more open to question.

Since the crisis began, neither the Bank of Japan nor the Peoples Bank of China have changed their policy rate substantially. Both seem to be caught in a tug of war between different concerns leading to inaction. On the one hand, the Bank of Japan for the moment faces rising inflation, and has also said repeatedly that it wishes to “renormalize” rates. On the other hand, it is already observing the effects on exports of the slowdown in the US, and real GDP has weakened measurably. In China, they face a similar dilemma though with both the rate of growth and the rate of inflation being very much higher than in Japan. For completeness, it should also be noted that the Chinese have other monetary tools (of which more below) that they have been using to resist inflationary pressures.

\textsuperscript{12} See White (2008) Closing comments at a conference on „The future of Inflation targeting“ Bank of Canada July

\textsuperscript{13} Union membership in the US has fallen to around 7 percent of the workforce, and most of this is in seriously troubled industries (automobiles, airlines, construction etc.) In Europe union members make up around 25 of the workforce.
What about the influence on current policies of different worries about the future? Again, there seems to be something of a trans-oceanic divide. The approach of the Federal Reserve is to focus almost wholly on setting policy to have the desired effect on growth and inflation over a relatively short policy horizon, say two or three years. In this one period context, the domestic output “gap” plays a dominant role in assessing the prospects for inflation. Very little concern is given to the possibility that such policies might, even though they work effectively in that period, create “imbalances” which would make policy making more difficult in subsequent periods.

The European Central Bank seems somewhat more open to such considerations, though perhaps still not totally convinced. Europeans have traditionally worried more about “moral hazard”, and in recent years some Europeans have raised concerns that the vigorous easing of monetary policy in downturns (the Greenspan Put) had created “serial bubbles” in the United States and elsewhere. The ECB also has its second “pillar”, which lets policy be influenced by the presumed longer run relationship between money and inflation. It is actually the Bank of Japan that seems most worried about the longer run side effects of policies that seem perfectly sensible in a short term context. Indeed, the second “perspective” guiding the policy of the Bank of Japan is an implicit vow to conduct policy such that the mistakes made in Japan in the 1980’s are never repeated. Note, however, that this provides a sharp contrast to the second “pillar” of the ECB in that the Japanese worry that excessive monetary and credit creation might well lead to deflation (after the bubble bursts) rather than inflation. Such concerns presumably underlie the Bank of Japan’s continuing frustration in not being able to “normalize” the level of policy rates.

Central banks also differ in other regards that can have a material influence on what they actually do with their policy rate. For the purposes of this presentation, these influences are referred to as “differences” in their respective tool kits. The first of these has to do with the choice of price index to indicate inflationary pressures. In particular, measures which exclude food, energy and housing services, when these prices are constantly going up, will lead to easier setting for the policy rate than otherwise. Second, there are differences of view about the effectiveness of policies to resist the implications of credit bubbles, even should it be accepted that such imbalances can have nasty, longer run side effects. The Federal Reserve has long argued that “leaning against the wind” is ineffective and has concluded that “cleaning up afterwards” is the only feasible alternative. Other central banks have questioned both of these propositions, and might therefore be more willing to take pre-emptive action in upswings.

Third, there are disagreements as to what the policy instrument should be. While most central banks focus on the overnight rate, the Swiss National Bank seeks to stabilize the three month LIBOR rate. Given the current dysfunctional state of the interbank market, this implies a more vigorous easing on the overnight rate than otherwise. Finally, central banks countries with less advanced financial markets can exploit remaining inefficiencies in various ways. For example, since market sources of credit are not freely available, the Peoples Bank of China, the Reserve Bank of India and many other central banks in EME’s have used increased bank reserve requirements to lessen the overall availability of credit.

Should There be More Convergence in Policy Settings?

If, as noted at the beginning of the previous section, global monetary policy needs to be tighter than it is, then some coordinating mechanism is needed to encourage this to happen. At the moment, global inflation is rising because countries with slowing growth are resisting

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14 From the perspective of the history of economic thought, this divide reminds one of the difference between the “Keynesians”, whose views are essentially summarized in the one period IS/LM model, and the Austrians who have a much more dynamic story. See Laidler D “Fabricating the Keynesian Revolution”
this tendency more aggressively than countries whose growth rates are outstripping potential. Indeed, with their exchange rates more or less pegged to the depreciating US dollar, many countries with rising inflation rates are not (indeed can not) resisting inflation at all. One solution would be more flexible exchange rates. Another would be for countries (like the US) who wish to ease policy to take into account the inflationary and other externalities arising for others due to the exchange rate regime. In practice, neither outcome seems very likely.

In the previous section, four sets of explanations were given for why central banks might decide to do different things with their policy rates. However, to explain differences is not to validate them. On the one hand, if different countries find themselves in different objective circumstances in an assumed one period model (described above as “different worries about today”) then it would seem appropriate to have different policy settings. On the other hand, all the other explanations for different policy settings (different objectives, different degrees of worry about the future, and different tool kits) raise the question of why those differences exist in the first place. One possibility is that they are justified by different economies having different structures, in which case different policies might again seem warranted. However, another possibility is that some central banks are simply in error. In this regard, the question of whether concerns about rising “imbalances” should or should not play a central role in the setting of domestic monetary policies is a crucial question. So too is the assertion that the aftermath of such imbalances (the bust after the boom) can be easily cleaned up with appropriate macroeconomic policies. If the current global slowdown intensifies, and if expansionary monetary policy in particular proves ineffective, debate on these issues will surely intensify.