The Evolution of Monetary Policy in an Age of Uncertainty

By William White

The Prudent Risk Management Approach to Price Stability

Central Bank of Armenia

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Getting monetary policy right is crucially important

- Monetary economies are complex, adaptive systems
- Such systems have breakdowns and multiple equilibria,
- Breakdowns affect nominal prices but also have real effects
- Worse, economic distress can have effects on nested systems
- Democracy and the environment already under severe stress
- Are we stumbling towards a polycrisis?

Facts: monetary policy has created ever bigger bubbles (1)

- Three major structural developments since the 1980s
- Central banks have ignored two of them
- Resulting in successive financial crises, rather than rising inflation
- With monetary policy forced to become increasingly experimental

Facts: monetary policy has created ever bigger bubbles (2)

- Embarking on the bad path: the Louvre Accord and its effects
- Followed by successive financial crises in the 1990s
- Followed by the TMT equity bubble and burst in 2000
- Followed by the false promise of an enduring “Great Moderation”

Facts: monetary policy has created ever bigger bubbles (3)

- The onset of the Great Financial Crisis (GFC)
- Followed by increasingly experimental monetary policy
- Followed by still more of the same during the covid pandemic
- Followed by rising inflation and tighter monetary policy
- Raising fears about financial stability and fiscal sustainability

Theory: how “false beliefs” led to bad policy (1)

- Central banks overestimated the **need** for easy money
- Initial deflation caused by positive supply shocks, not a problem
- But subsequent easing now threatens a Fisher “debt deflation”
- We are now caught in a “debt trap” of our own making

Theory: how “false beliefs” led to bad policy (2)

- Central banks overestimated the **effectiveness** of easy money
- Overestimated future growth and inflation for decade post GFC
- Reasons to doubt effectiveness at any moment in time
- Reasons to doubt effectiveness given repeated use over time
- Successive bubbles and the inexorable rise of debt ratios

Theory: how “false beliefs” led to bad policy (3)

- Underestimation of **unintended consequences** of easy money
- The negative effects on inequality and democracy
- The negative effects on financial stability and fiscal sustainability
- The negative effects on central bank independence
- The negative effects on potential growth
- The negative effects on emerging markets
- The shortcomings of “ample reserve” operating systems

Theory: how “false beliefs” led to bad policy (4)

- Underestimating the **difficulties of exit** from easy money
- Political economy arguments for hesitating to raise rates
- Fears of triggering financial instability and fiscal dominance
- Negative supply shocks will make future tradeoffs worse
- Exiting from Quantitative Easing faces special difficulties

Suggestions for improving the monetary policy framework

- Last Fed review (2022) now recognized to be a disaster
- Most suggestions stress the need for more humility and prudence
- As well as paying more attention to supply side developments
- **G30 Report and BIS:** stress the dangers of prolonged easy money
- **Geneva Report**: stresses easy money leads to financial instability
- **Bernanke report:** clarity needed about transmission mechanism
- Almost recommends need for alternative scenarios
- **Isabel Schnabel, Charles Goodhart:** need alternative scenarios

Prudential Risk Management responds to these suggestions

- Alternative scenarios as a response to uncertainty
- Minimizing loss functions in ENDOCRED recognizes uncertainties
- Non-linearities imply inflation more costly than deflation
- Supply shocks are given more emphasis
- Endogenous money and clarity about transmission mechanisms

Prudential Risk Management reacts against “false beliefs”

- The **need** for easy money: PRM emphasizes inflation dangers and recognizes negative supply shocks
- The **effectiveness** of easy money: assuming endogenous credibility introduces a negative feedback effect
- The **unintended consequences** of easy money: greater attention paid to distributional issues and the effects on financial variables
- The **difficulties of exit** from easy money: begins to introduce concerns about financial dominance and fiscal dominance

Credible model simulations help answer important questions

- Is it better to “lean” against a bubble or just clean up after?
- Should monetary leaning be complemented with other policies?
- Do asymmetric responses to inflation and deflation matter?
- What are the implications of different expectations formation?
- Should nominal policy rates be constrained well above zero?
- Can changes to incentives and structure improve outcomes?

Prudential Risk Management is a Significant Step Forward