

# Monetary Policy's *Dead End*

BY WILLIAM WHITE

*Time to kill  
inflation targeting.*

The inflation-targeting framework used by many central banks, some explicitly and others implicitly, needs to be challenged. The framework makes price stability (variously defined at about 2 percent inflation) over a relatively short horizon (around two years) the primary objective of monetary policy. That objective is to be achieved by raising policy rates whenever inflation is forecast to overshoot the inflation target, and by lowering them when the opposite is the case.

This policy framework has been supported by a highly simplified model of the economy that assumes the economy is pushed away from equilibrium (full employment and low inflation) primarily by external (exogenous) demand shocks. While the possibility of negative supply-side shocks has been increasingly recognized since the pandemic, there has still been no explicit recognition that central banks failed in the past to identify positive supply shocks, and that this error led to excessively easy monetary policy over many decades. As for the financial sector, and the possibility of positive feedback processes leading to intermittent crises over time, these continue to be almost totally ignored. Since the last three major economic downturns in the advanced market economies have had their origins in financial markets, maintaining such beliefs seems increasingly hard to justify.

These now-orthodox beliefs reflect a preference for theoretical elegance, and mathematical tractability, over empirical reality. Orthodoxy asserts that the economy can be described quite simply and is essentially linear in its relationships. It is thus understandable and controllable. In contrast, the economy is in reality a complex adaptive system subject to tipping points (crises)

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where positive feedback dynamics, particularly within the financial sector, are the principal threat to macrofinancial stability. More specifically, as described in more detail below, the financial sector in advanced economies is by nature highly “procyclical,” creating dangerous cycles of boom and bust, and inflation targeting regimes positively reinforce these procyclical tendencies. Indeed, going further, such regimes create a profound intertemporal inconsistency. Stimulating the economy through lower rates, when inflation is deemed too low, leads to more credit expansion and higher debt levels in the near term that significantly constrain demand over the medium to long term. This buildup of debt could eventually culminate in a profound economic crisis. This threat still confronts us. Former U.S. Federal Reserve Chair Paul Volcker seemed to agree when he wrote in his autobiography, “Ironically, the ‘easy money’ striving for a ‘little inflation’ as a means of forestalling deflation, could, in the end, be what brings it about.”

While it is always hard to envisage a policy framework that is different from the one that one is used to, it is a simple fact that central banks have already rotated through a number of distinctive policy regimes since the end of World War II. In each case, a failure in the previous policy regime demanded a transition. Perhaps that time has come again.

#### NATURAL PROCYCLICALITY

Since the end of World War II, macroeconomic policy has been mainly directed to smoothing out the business cycle, recurring cycles in production, employment, and inflationary pressures. Inflation targeting regimes are essentially of this sort. However, as financial regulations slowly dropped away in the post-war period, we witnessed the return of a pre-war phenomenon—the financial cycle. These cycles can be substantially longer than a business cycle

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## A Poor Policy Framework

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—W. White

and involve the gradual buildup of debt and asset prices to extreme levels, even though CPI inflation might remain quite stable.

The engine of the financial cycle is “procyclicality,” a self-reinforcing set of feedback loops involving funding conditions, the appetite for risk, and asset prices. Some piece of good news (a reduction in policy rates, an increase in productivity, a new discovery, and so forth) increases the demand for credit which a deregulated financial system is increasingly willing to supply. The growth in credit then leads to asset price appreciation which, in turn, provides more collateral for further loans and a further increase in optimism. At some point, however, the optimism is seen as unwarranted by emerging facts and the whole process goes into reverse. The “boom” is replaced by “bust.”

#### HOW INFLATION TARGETING HAS FOSTERED PROCYCLICALITY

The introduction of an inflation-targeting regime can alter people’s behavior and reinforce the procyclical process. First, putting all the focus of monetary policy on near-term inflation invites policymakers and others to ignore the possible grave harm arising from the financial cycle. Second, it can even strengthen these processes. Financial speculators are encouraged to behave even more impudently if they believe they will be bailed out by monetary easing should disinflation result from a financial bust. Similarly, governments can become inured to the risks of rising debt levels by experiencing long periods of low interest rates and debt service. Third, and paradoxically, the more credibility a central bank has and the more inflation expectations are anchored around the target rate, the longer the financial cycle could expand without meeting any monetary resistance.

These concerns are not just theoretical but are supported by the facts. Global monetary policy was eased significantly through most of the 1980s. This was first in response to the sharp global disinflation of the early 1980s,

but later in response to developments in financial markets. The Louvre Accord of 1987 required global easing to support the U.S. dollar, and then the stock market crash later in that year elicited the so-called “Greenspan put.” This caused investors to believe that the Fed would always reduce policy rates, given any material weakness in equity prices, and this belief encouraged them to successively “buy the dip.” Debt levels rose sharply through the 1980s, as did speculative investments, culminating in a global financial crisis and a shallow recession in 1991.

Through the 1990s, positive supply shocks (faster productivity growth, favorable demographics, globalization, and so forth) were increasing the potential growth rate and the neutral real interest rate. However, at the same time, they were also reducing inflationary pressures. Wrongly treating the latter as a symptom of inadequate demand, central banks failed to raise policy rates adequately and a debt-fueled investment and stock market boom then followed with technology, media, and telecommunications stocks at its core.

When this finally culminated in higher inflation, monetary resistance, global financial disruptions, and the

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contraction of 2001, monetary policy was again eased aggressively to foster recovery. This policy worked, indeed leading to “The Great Moderation,” but only at the expense of still more debt accumulation and rising financial imbalances. These culminated in the Great Financial Recession of 2008. After that, until inflation rose during the pandemic, central banks were encouraged to keep rates “low for long” by the continuation of disinflationary supply-side shocks and the growing “headwinds” of rising debt that their own policies had encouraged.

When the pandemic hit, monetary authorities failed to appreciate the joint effect on inflation of a negative supply shock along with the positive effects of massive fiscal stimulus. However, even as policy rates rose

significantly if belatedly, market optimism returned. This optimism has led in recent years to further increases in debt levels (particularly for governments), record-high stock prices, ever-narrowing credit spreads, a massive extension of credit by non-regulated sources, and a further easing of credit conditions. It seems increasingly possible that this process will end in crisis, as in all the previous cases.

### **GROWING SIDE EFFECTS AND CONSTRAINTS ON MACROECONOMIC POLICY**

Sadly, the undesirable effects of sustained periods of low real interest rates go beyond the reduced effectiveness of monetary stimulus and potential financial instability.

One such effect is reduced potential growth as low rates prioritize financial speculation and the financialization of the economy over investment in real capital. Massive increases in share buybacks in recent decades are a case in point. Low rates also encourage misallocations of capital and the survival of “zombie” companies—heavily indebted companies kept alive by cheap finance—both of which reduce productivity growth. A second effect is to increase wealth inequality as low rates increase asset prices, most of which are held by the already-wealthy. Worse, slower growth and stagnant real wages, together with a perception of growing inequality, have been a recipe for political discontent. It is not surprising that we are seeing the rise of populist movements in so many advanced economies.

The pursuit of price stability over four decades has left many economies struggling with record-high debt levels, both private and public. This debt overhang now imposes a severe constraint on the behavior of even “independent” central banks. Raising real rates to fight inflation could threaten the debt service capacity and even solvency of private sector companies. This threatens recession and perhaps even deflation. This private sector problem is often referred to as the problem of “financial dominance.” Moreover, easing policy in such a crisis could reignite the debt accumulation process, making future crises even worse.

In contrast, the problem of “fiscal dominance” occurs when it is governments that cannot bear the burden of higher debt service. In this case, the solution is likely to be much higher inflation as governments force the central bank to buy newly issued debt at acceptable rates. To forestall private holders of old government debt from selling it to the central bank, a process likely to end in hyperinflation, administrative and regulatory means will be used to increase the private demand for such debt. This combination of higher inflation and forced holdings is called “financial repression.” It successfully reduced the

government debt overhang after World War II at the expense of bond holders that received negative real returns.

These problems of financial and fiscal dominance will be exacerbated in the future by structural shifts that will reduce aggregate supply (fewer workers in an aging population, adaptation to climate change, deglobalization, and so forth) and increase aggregate demand (defense spending, increased health care, mitigation of climate change, AI investments, and more). This com-

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bination of factors would seem inherently inflationary, implying that real interest rates should rise and nominal rates should rise even more. If this cannot be allowed to happen, then the likelihood of higher inflation and eventual financial repression would be significantly increased. Arguably, markets are becoming more aware of these dangers since, very unusually, recent reductions in policy rates have been met by higher long rates. In Japan and the United States, where fiscal problems seem most severe, their currencies have recently also fallen sharply.

Some have recently expressed hope that artificial intelligence will raise productivity levels sharply, allowing the economy to grow out of these debt overhang problems. Reference is sometimes made to former Fed Chair Alan Greenspan's decision in the late 1990s to restrain interest rate increases on similar grounds. Unfortunately, Greenspan's bias towards easing can now be seen as a grave mistake. Somewhat counterintuitively, real rates should have risen to prevent current spending from increasing excessively in response to income and output gains that were only anticipated. Moreover, this period set the scene for the significant increase in debt accumulation that followed.

Lowering rates today in the face of a similar shock might be even more dangerous. First, the scale of investment spending on AI-related ventures is already massive and potentially inflationary. Second, the productivity gains today are presumed, rather than actual as they were in the late 1990s. What if they do not materialize? Third, the debt trap problem is now even more severe. With debt stocks having risen so much further in this century, the encouragement of still more debt accumulation would hardly seem optimal.

## A FINAL ASSESSMENT

To summarize, inflation targeting has led monetary policy to a dead end. Future policy choices face a major asymmetry in outcomes and dangerous potential nonlinearities. Monetary tightening in the face of inflation threatens a major downturn because of private sector debt overhang. Because of the public sector debt overhang, it might even lead to higher inflationary expectations, not less. In contrast, monetary easing might have limited effect on spending, because of the private sector debt overhang, though the potential for inflationary expectations to rise sharply should not be underestimated. Finally, these new constraints on the use of monetary policy come on top of the traditional problem posed for monetary policy by all stagflationary shocks: namely, the need to make a tradeoff between fighting inflation and supporting growth. The asymmetry between the prospective effects of monetary tightening (grave) and easing (mild) might reasonably be expected to shift the bias towards supporting growth.

It should also be noted that, with monetary policy so constrained, fiscal restraint would seem the only weapon left to deal with excessive inflation. Sadly, such

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restraint would likely face formidable political opposition. Moreover, given the overhang of public debt, fiscal expansion to deal with economic downturns would now also seem highly constrained. In short, inflation targeting has led policymakers not only to a monetary dead end but to a fiscal dead end as well. As a result, we are currently badly prepared to respond to the geopolitical, climate-related, and other shocks that are already on the horizon. Inflation targeting has clearly led us to a place where we do not wish to be. ◆