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# How Far Should Unconventional Central Banking Go?



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### INTRODUCTION

The world's major central banks have radically altered their strategies since 2008 as they grappled with the great financial crisis and its various consequences. One view (Issing 2016) is that they have gone too far, and that their actions will result in inflation and loss of independence. Another view is that the crisis has been at least as violent as the 1929 crash on Wall Street, but nevertheless we have not seen the decade of economic misery that followed when central banks clung to narrow dogmas (Friedman and Schwartz 1963). History did not repeat itself because we learnt from the past (Bernanke 2000).

These two views are apparently inconsistent yet each carries some truth. Unconventional monetary policies have saved the world from acute distress, but they have come with potential side effects. This article argues that we should recognize both success and risks. Central banks have been forced by the turn of events to leave their comfort zone and to adopt a more sophisticated view of their task and of how monetary policy operates. This is not a new view, just a more elaborate one.

### CENTRAL BANK MANDATES

Having adopted policies that often led to double-digit inflation rates in the 1970s, central banks have developed a consistent framework that combined two key principles. The first principle is the Tinbergen rule that policy can achieve as many objectives as it has instruments. The second principle is that inflation is a monetary phenomenon. Together, these principles have been interpreted as implying that central banks should have one objective, price stability, because they have one instrument, either the money supply or the policy interest rate. This led to clear mandates and to policy independence.

This strategy worked well as long as the world conformed to the many implicit assumptions that lie behind the principles. The world has changed,

however, and the assumptions are no longer valid, so the mandate had to evolve. The Tinbergen rule assumes certainty (Brainard 1967). This may be a reasonable approximation as long as the financial markets are stable. When major financial instability introduces massive uncertainty, however, the Tinbergen rule breaks down. In addition, central banks are the only institutions that can effectively deal with acute financial instability, when large cash injections are required in a matter of hours (Friedman and Schwartz 1963). A central bank mandate that ignores these simple facts is simply incomplete.

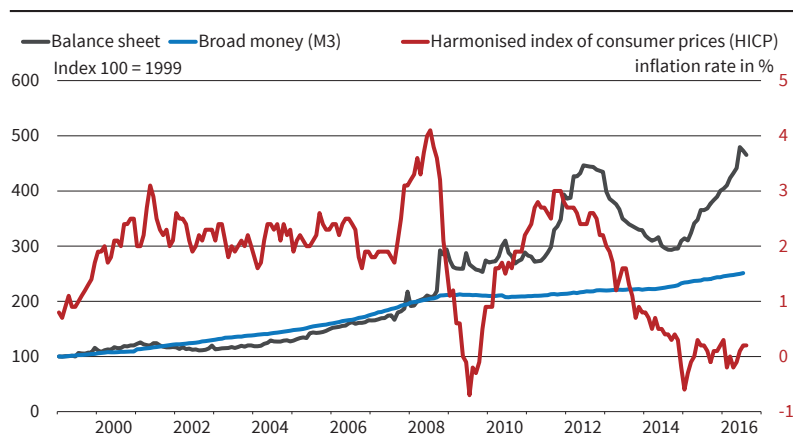
Secondly, the famed link between money and inflation has always been troublesome. Its theoretical basis is robust, but which is the relevant monetary aggregate? Over the years, views have changed, not because of theoretical innovations, but because the data were not cooperating. The financial crisis has shown that we need to think deeper about that link. Figure 1 displays two monetary aggregates of the Eurozone – the size of the ECB's balance sheet and M3 – and the inflation rate. Before the crisis, the link between the monetary aggregates was far from stable; after the crisis it completely dissolved. The reason is that banks did not “transmit” as they focused on their own difficulties and undertook to deleverage. Inflation declined for six years while the monetary aggregates rose, spectacularly so in the case of the size of the ECB's balance sheet. This breakdown of time-honored principles is probably temporary and directly related to the financial crisis. Indeed, this is the point: since 2008, monetary policy cannot be business as usual.

### FISCAL DOMINANCE

While central banks had every reason to step in and adopt policies out of the traditional box, they have been taking risks. Among them is the possibility that, for all their power and clout, they may fall victim to fiscal dominance, which means that their future actions will be constrained by concerns over public budgets. When they purchase public debts, these debts effec-

Figure 1

#### Monetary aggregates and inflation in the Eurozone



Source: ECB (2016).

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tively cease to exist since debt service paid to the central bank is rebated to the government *ceteris paribus*. Debt financing has long been recognized as the number one source of future inflation.

Central banks routinely acquire public debt instruments as they carry out their normal monetary policy operations. They even hold private stocks and bonds. This is considered normal because purchases and sales are seen as temporary and explicitly part of monetary policy. Unconventional policies are also meant to be temporary monetary policy actions, albeit in a new form because the interest rates have reached their presumed lower bounds. Why, then, all the concern with fiscal dominance?

One reason is scale. The fear is that these considerable purchases will not be reversed, or not fully. That, indeed, is the current conventional wisdom. It is believed that quantitative easing (QE) has entered the central bank toolkit and will remain there so central banks may never revert to previous lower levels of bond holdings. Yet this remains monetary policy and it does not portend inflation.

The other concern is that central banks stand to suffer large losses when the time comes to raise interest rates. Worse still, they may come under pressure from governments that fear higher debt service, which would indeed be fiscal dominance. We do not know whether this risk will materialize, but what we do know is that central banks are conscious of it. At present, however, it is far too early to draw any conclusions.

## MORAL HAZARD

When it occurs, fiscal dominance is ominous, but it can even be threatening if it is simply thought to be about to occur. If governments believe that they are on the verge of achieving fiscal dominance, they may be tempted to forego fiscal discipline. This is why central bank independence is essential, but is not a black and white issue, and is therefore quite fragile.

The proper response to this very serious risk of moral hazard is not to cry wolf when there is no such threat. The outcry – and legal proceedings – against the ECB’s Outright Monetary Transactions (OMT) is a good example of misguided reactions. After three years of a highly contagious debt crisis that governments failed to stop, just three words (“whatever it takes”) reversed the devastating trend. Instead, the proper response is to build institutions and procedures that effectively impose fiscal discipline on member governments, unlike the ill-designed Stability and Growth Pact (Wyplosz 2013). The culprit is the pact, not the ECB.

## POLICY EFFECTIVENESS

It has now become conventional wisdom that unconventional monetary policies become less and less effective as they expand. There are many plausible theoretical reasons behind this, including decreasing returns and growingly adverse side effects, but what is the evidence? Panizza and Wyplosz (2017) formally

explore the question and find limited support to back up this hypothesis. As is often the case, conventional wisdom may turn out to be an unsubstantiated guess.

Even if decreasing effectiveness sets in, it is mistaken to conclude that these policies should be discontinued as a result. Other policy responses need to be contemplated. A first option is simply to pursue more unconventional monetary policies. Another response would be for governments to step in with counter-cyclical fiscal policies. This has occurred in various countries to some degree, although not in the Eurozone. The Eurozone governments have failed to cooperate with the ECB, and thus to alleviate the need to expand its unconventional policy. This failure has many roots. One of them is that many governments already face high public debt levels and felt constrained by the pro-cyclical restrictions of the Stability and Growth Pact. Another reason is that less indebted governments happen to face better growth prospects and are quite reasonably unwilling to raise their own debts for no necessary domestic purpose.

Misguided conventional wisdom has also played a role: it has been asserted that fiscal policies do not work, or even that they work in reverse (the negative multiplier view). These views have once again been rejected formally by the data (e.g., Blanchard and Leigh 2013). At any rate, when governments do not cooperate and inflation remains far below the inflation rate implied by its own definition of price stability, the ECB has no choice: it must do its utmost to fulfill its mandate.

## CONCLUSIONS

The happy years when central banks could just aim at price stability are over. They may return, once the tailspin effects of the great financial crisis have faded, and once adequate bank regulation, supervision and resolution procedures and proper fiscal discipline institutions are in place. In the meantime, central banks have largely been left to deal single-handedly with a crisis of historical proportions. Drawing lessons from the Great Depression, they have innovated in many ways, including by adopting unconventional policies.

The results are plain to see: we have avoided another Great Depression; but the experiment is not over yet. Central banks will have to phase out their policies, normalizing interest rates and shrinking their bloated balance sheets. Mistakes may happen. At this stage, and contrary to early criticism, inflation has not reappeared, quite the contrary in fact. So far, so good.

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