Rethinking Monetary Policy:
Adapting Central Bank Approaches in 2024 and Beyond

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Introduction: we are on a bad path

- Current monetary policy framework targets core CPI
- Framework prioritizes labor market over financial developments
- This framework has already produced many negative outcomes
- And poses further threats going forward

Some facts: bubbles have created 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

Some facts: bubbles have created 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”

Some facts: bubbles have created 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

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

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

Some 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

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

- Underestimation of the **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

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

- Underestimation of 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

Some observations: improving the policy framework

- Lean against the wind of credit growth and complement with changes to incentives and financial structure?
- Treat the economy as a complex, adaptive system?
- Introduce “narrow money” and solve the “boundary problem?
- But excessive debt must first be dealt with or assumed away

“If I were you, I wouldn’t start from here”