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Monetary policy: past, present and future[1]

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It is a pleasure and an honour to be back at this prestigious conference, if only virtually, and to be on such a distinguished panel.

This event is about the state of monetary policy since the conference series began 40 years ago. Thus, I thought I would reflect on three monetary policy challenges, from the past, the present and the future, respectively.

I will argue that, at each step of the long journey, as monetary policy interacts with the economic environment, the way in which it tackles one challenge helps define the next. The thread underlying my presentation – the *fil rouge*, as it were – is the changing nature of the business cycle and the role that financial forces play.

The past

Where does the story begin? I would say with the change in the nature of the business cycle in the early to mid-1980s – roughly when this conference series began. It was then that, with the fuzziness that inevitably characterises any investigation of this kind, recessions started to evolve from the inflation-induced to the financial cycle-induced kind.[2,3]

More specifically, until then a rise in inflation prompted a tightening of monetary policy, which in turn triggered a recession. In the background, not much was happening to the behaviour of financial cycle indicators. Thereafter, the picture was quite different. As we know, inflation stayed relatively low and stable, so that monetary policy had little reason to tighten during business cycle upswings. By contrast, large financial expansions turned into contractions, weighing on the

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[1] The views expressed are my own and not necessarily those of the BIS.

[2] By "financial cycle" I mean the self-reinforcing interaction between credit, risk-taking and asset prices (especially property), which generates expansions (or booms) followed by contractions (or busts). See C Borio, "The financial cycle and macroeconomics: what have we learnt?", *Journal of Banking and Finance,* vol 45, pp 182–98, August 2014, also published as *BIS Working Papers*, no 395, December 2012.

[3] For an analysis of the change and the implications for leading indicators of recessions, see C Borio, M Drehmann and D Xia, "The financial cycle and recession risk", *BIS Quarterly Review,* December 2018, pp 59–71. See also *BIS Annual Economic Report*, June 2021.

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economy. I am of course excluding the Covid-19 recession which, as we know, was sui generis and entirely exogenous.

Why did this change in the nature of the business cycle take place? I would suggest that this had to do with major changes in policy regimes, which shifted the tectonic plates that shape movements in the economic landscape.

First, the shift from financially repressed to liberalised financial systems across the world. This provided much more scope for the forces behind the financial cycle to play out, both domestically and internationally.

Second, the globalisation of the real economy. This acted as a powerful tailwind, expanding the production possibilities of the economy and generating persistent disinflationary pressures.

Third, the establishment of credible monetary policy regimes focused on near-term inflation, so that little or no attention was paid to monetary and credit aggregates. This was instrumental in bringing inflation down and hardwired the gains. But it also meant that, unless inflation became a threat, there was little reason for monetary policy to tighten during economic expansions and thus to rein in the financial forces.

It is no coincidence perhaps that business cycles came to resemble more closely those during the first globalisation wave – the one that took place under the gold standard between the 1870s and the Great Depression. In that era too, liberalised financial markets and integrated global trade coexisted with relative price stability.[4]

Put differently, inflation arguably became an unreliable signal of unsustainable business cycle upswings. By the same token, it became a less reliable compass for monetary policy. Business cycle expansions could proceed for longer, but at the cost of allowing financial imbalances to build, sowing the seeds of the subsequent downturns. And, as most spectacularly illustrated by the Great Financial Crisis (GFC), financial cycle-induced recessions can be especially deep and the recoveries especially drawn out.

Hence two important, and closely related, policy implications.

The first is a progressive loss of room for policy manoeuvre. Since policy was not tightened that much during expansions but was naturally eased, aggressively and persistently, during contractions, it contributed to the decline in nominal interest rates over successive business and financial cycles. In fact, with inflation relatively stable, this was also true of real interest rates.

[4] For a comparison of the two regimes from this perspective, see C Borio and P Lowe, "Asset prices, financial and monetary stability: exploring the nexus", *BIS Working Papers*, no 114, July 2002 and for a broader analysis, see C Borio, "On money, debt, trust and central banking", *Cato Journal*, Spring/Summer 2019, also published as *BIS Working Papers*, no 763, January 2019.

The second is the unreliability of the natural rate of interest – or r-star – as a policy guide.[5] I am not referring to the well known practical measurement difficulties. Rather, I am referring to r-star being defined in terms of what happens to inflation when output is at potential. With inflation providing only an unreliable signal of unsustainable expansions, r-star inherited this property.

At the same time, this pattern in business and financial cycles, coupled with the decline in interest rates, helps explain another major long-lasting shift in the economic landscape. Debt levels, both private and public, reached historical peaks globally.[6]

In all this one can see clear elements of a "debt trap".[7] Low rates and high debt reinforce each other, making it harder to raise rates without damaging the economy – a burdensome legacy.

The present

The past challenges naturally set the stage for the present ones.

Policymakers are now facing an unprecedented economic configuration. They are tightening monetary policy to quell inflation *in the presence of* widespread financial vulnerabilities, notably high debt levels and high asset prices, especially property prices. In other words, the two types of forces that lurked behind inflation-induced and financial cycle-induced recessions are coinciding for the first time.[8]

The configuration greatly complicates the calibration of monetary policy.[9] The economy has become more sensitive to higher interest rates. But by how much? And when will this become apparent? After all, real interest rates are still firmly negative.

Moreover, will there be consequences for financial stability once again? The picture is somewhat mixed, I would say. Crucially, the banking system is much stronger than ahead of the GFC, thanks largely to the subsequent prudential reforms. But the regulation of non-bank financial

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5 See C Borio, "Navigating by r*: safe or hazardous?", keynote lecture delivered at the SUERF, BAFFI Bocconi, OeNB workshop on "How to raise r*?" 15 September 2021, also published as *BIS Working Papers*, no 982, November 2021. See C Borio, "Revisiting three intellectual pillars of monetary policy", *Cato Journal*, vol 36, no 2, pp 213–38, spring/summer 2016.

6 The corollary is that, by the time the global economy was re-emerging from the pandemic, the policy room for manoeuvre – both monetary and fiscal – had narrowed substantially. Hence the need to rebuild policy buffers, or safety margins, to deal with the inevitable future downturns as well as the unexpected. Since this was a joint task, it meant that, along the long normalisation path, the two policies would work at cross-purposes, complicating each other's task. This is all the more so since central banks' large scale asset purchases of government debt raise the sensitivity of fiscal positions to higher interest rates. What we have started to see, now that monetary policy is tightening, is just an illustration of this broader picture. For a more in-depth discussion, see C Borio and P Disyatat, "Monetary and fiscal policies: in search of a corridor of stability", *VoxEU,* November 2021 and *BIS Annual Economic Report*, June 2021.

7 See, C Borio and P Disyatat, "Low interest rates and secular stagnation: Is debt a missing link?", *VoxEU*, June 2014.

8 This is, of course, a stylised picture: it is possible to find instances of this combination in some countries (eg, some EMEs), but globally what we are seeing is indeed unique.

9 The latest *BIS Annual Economic Report,* (June 2022) provides some simulations to shed light on the orders of magnitude involved.

intermediaries (NBFIs), such as that of the asset management industry, has lagged behind.[10] Strains in the NBFI sector were already in evidence during the GFC, when banks also struggled; they were at the heart of financial stress during the Covid-19 crisis, when banks helped cushion the blow to the economy.

This still leaves open an obvious question: after having been dormant for so long, why did inflation suddenly wake up, and with such vigour, taking most observers by surprise? As discussed in detail in the latest BIS Annual Economic Report, the Covid-19 crisis no doubt played a key role. Global aggregate demand rebounded with surprising vigour. This was not just the natural sequel to its artificial suppression during the lockdowns, but it was also the result of unprecedented fiscal and monetary policy support. In addition, the pandemic-induced rotation of global demand from services to goods turned out to be unexpectedly persistent; notably, it put global supply chains under huge pressure – the so-called bottlenecks. And this major rebound and rotation in demand clashed with inelastic global supply, which proved unable to keep up. Increases in commodity prices, which individual countries tended to treat as "supply shocks" turned out to reflect, to an important extent, global demand pressures – a kind of "fallacy of composition".

An analogy may help to clarify this. Imagine you turn on a machine that has been switched off for a while. And that you do so after having kicked it hard and added high-octane fuel. The ensuing rumblings resemble those of the global economy once economic activity was no longer artificially suppressed. Less metaphorically, the initial stages of the post-pandemic inflation flare-up in some respects look like those seen in the aftermath of wars: the release of pent-up demand coupled with a massive redirection of production.

But, of course, this is not the end of the story. It never rains, but it pours. No sooner did the global economy seem to be emerging from the pandemic than the tragic Russia-Ukraine war broke out – yet another exogenous shock. The ensuing surge in commodity prices, not least those of energy and food, has greatly added to inflationary pressures.

Regardless of the specific causes, it is essential that monetary policy reacts – which it has – and that it perseveres until the job is done.[11] As also discussed in this year's BIS Annual Economic Report, transitions from low- to high-inflation regimes[12] tend to be self-reinforcing. For one,

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[10] See C Borio, M Farag and N Tarashev, "Post-crisis international financial regulatory reforms: a primer", *BIS Working Papers*, no 859, April 2020. See also BIS Quarterly Review, December 2021 and therein A Carstens, "Non-bank financial sector: systemic regulation needed".

[11] See A Carstens, "The return of inflation", speech delivered at the International Center for Monetary and Banking Studies, Geneva, 5 April 2022.

[12] The Report characterises the inflation process as comprising two regimes – a low- and a high-inflation one – with self-reinforcing transitions from the low to the high one. The two regimes are very different. The low-inflation one has certain self-equilibrating properties: inflation largely reflects sector-specific (or relative) price changes rather than their co-movement: these sector-specific price changes tend to leave only a temporary imprint on inflation itself; and wages and prices are only loosely linked. The opposite is true in a high-inflation one. Moreover, the impact of monetary policy on inflation is much weaker, which may help explain the difficulties central banks have faced in raising inflation back to target post-GFC. For a full analysis, see Chapter 2, "Inflation: a look under the hood"; for a concise treatment, see the speech by C Borio, "Inflation: a look under the hood", delivered at the Annual General Meeting, Basel, 26 June 2022, and for a more technical analysis, see C Borio, P Disyatat, D Xia and E Zakrajšek, "Monetary policy, relative prices and inflation control: flexibility born out of success", *BIS Quarterly Review*, September 2021.

during those transitions, inflation moves out of the zone of rational inattention, where it is hardly noticed by economic agents, and snaps into sharp focus. In addition, it becomes more representative: as prices increase, they become more similar and synchronised, acting as a kind of co-ordinating device for agents' decisions. This increases the likelihood of wage-price spirals, which lie at the heart of the inflation process.

One is reminded of Volcker's and, later, Greenspan's definition of price stability, ie a condition in which inflation does not materially influence economic agents' behaviour. We probably lived in such a world for a good long while.[13] We took it almost for granted and, paradoxically, did not enjoy it enough. Now, we need to make sure we return to it. Failing to act forcefully might reduce the near-term costs, but at the expense of higher ones down the road: once inflation becomes entrenched, it is all the harder to rein it in.

There is a broader lesson in all this.[14] The long low-and-stable inflation phase may have masked the economy's supply constraints. But those constraints did not go away. Until recently, they emerged in the shape of financial instability, although probably they were not recognised as such at the time. They have now showed up as inflation – a more familiar, if almost forgotten, guise. The policy levers of demand management cannot be the engine of long-term growth. We need to move away from the *de facto* debt-fuelled growth model that has brought us here. We need to rediscover the importance of the economy's supply side and of the policies designed to strengthen its resilience and vigour.

The future

So much for the past and present. What about the future? What is the next evolution of the business cycle likely to be? And what are the implications for the challenges monetary policy may face?

There are reasons to believe that the environment will become more inflationary. In some respects, a return to a high-inflation regime always threatened to be the endgame of the trajectory the global economy has followed for the past 40 years.[15] Maybe the pandemic and the war – two *exogenous* shocks – have brought the *endogenous* endgame closer.

Why such an endgame?

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13 P Volcker, "We can survive prosperity", speech to the Joint Meeting of the American Economic Association and American Finance Association, San Francisco, 28 December 1983, and A Greenspan, Meeting of the Federal Open Market Committee, 2–3 July 1996.

14 See A Carstens, "A story of tailwinds and headwinds: aggregate supply and macroeconomic stabilisation", speech delivered at the Jackson Hole Symposium on Financial Stability and Macroeconomic Policy, sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 26 August 2022.

15 See C Borio, "Secular stagnation or financial cycle drag?", *Business Economics*, vol 52, no 2, pp 87–98, April 2017. See also C Borio, "Is inflation: dead or hibernating?", *SUERF Policy Brief*, no 41, January 2021.

Many of the secular economic tailwinds that helped keep inflation low could be turning into headwinds.[16] Demographics? We know that this tailwind will become a headwind, as a scarcer labour force will see its bargaining power grow. Globalisation? There are some signs that it may be in retreat. Moreover, new headwinds are emerging. The transition to a greener economy will put strong pressure on many commodity prices – we have recently seen once more what the consequences might be. And in the background, there are also signs that the (geo)political environment is becoming less supportive of global international cooperation and free market forces. Populism seems to be on the rise.

Last but not least, the legacy of the past 40 years is still with us in the shape of historically high debt levels. This could raise the temptation to accept inflation as a deceptively attractive way of reducing debt burdens.

It is not hard to see how this environment – closer to that of the 1970s – is structurally more inflationary. But the future is not preordained. The task of central banks is to prevent inflation from materialising. In such an environment, central banks will be tested to the full, not least institutionally. As the costs of higher interest rates to public finances became more starkly visible, central bank independence is likely to come under threat.[17]

Conclusion

Let me conclude.

Monetary policy has gone on an extraordinary journey over the past 40 years. At all points, the interaction between monetary policy regimes and the economic environment has played a key role in setting the stage for the next challenge. Now, central banks face the once-but-no-longer familiar challenge of preventing a transition from a low- to a high-inflation environment. Central banks have shown their mettle, as they have forcefully pivoted to prevent that transition. Yet, tougher tests may lie ahead.

[16] See A Carstens, op cit, see note 12.

[17] See C Borio, "Central banking in challenging times", *SUERF Policy Note*, no 114, November 2019, also published as *BIS Working Papers*, no 829, December 2019.