The Powers and Limits of Monetary Policy

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Monetary policy is powerful when focused on what it can clearly accomplish. But negative consequences can occur when it takes on ancillary objectives. Some of its capabilities are well known, while others are still in the process of being properly understood. Hence, addressing the question of what it can and cannot do should be approached with modesty.

I would like to present my views on this issue by first discussing positive impacts expected from monetary policy. Second, I would like to examine potential negative effects. Third, I will touch on the need for time consistency to make policy reliable. Fourth, I will briefly discuss monetary challenges faced by emerging economies in the current context of the extraordinarily accommodative monetary stances of advanced nations. And finally, I will draw some conclusions.

What Positive Impacts Can Monetary Policy Have?

The most indisputable contribution monetary policy can make to the well-being of any society is price stability. As succinctly stated by

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Cato Journal, Vol. 36, No. 2 (Spring/Summer 2016).

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Milton Friedman (1963), "Inflation is always and everywhere a monetary phenomenon"; hence, monetary policy can control it.[1]

The benefits of price stability are well known. It provides a favorable framework for efficiency and economic growth. High inflation, on the other hand, breeds wasted resources, and, when unexpected, can generate consumption and investment errors. It can even fuel a loss of confidence in a country's currency.

The widespread acceptance of monetary policy to control persistent changes in the average level of prices has led central banks to establish price stability as their primary objective. In practice, central banks understand this as a minimum inflation rate, say 2 or 3 percent, consistent with factors such as innovations and consumer responses to relative price changes not properly accounted for by traditional price indexes.

In light of this definition, pursuing price stability may encompass averting the risk of deflation, a fear recently manifested by several monetary authorities in advanced nations. Regarding deflation, the following four comments are in order.

First, some deflation can theoretically be justified in terms of economic welfare. Friedman (1969) advanced the argument that one way the economy can achieve the long-run optimum quantity of money is with a rate of deflation that makes the nominal rate of interest equal to zero. Another way would be to pay interest on money balances.

Second, large time series data reveal that there is no clear negative relationship between deflation and economic growth across countries. Furthermore, in the postwar period, bouts of deflation have been milder and less persistent than before, with average growth during deflation years exceeding that of inflation years (see Borio et al. 2015, Ryska 2014).

Third, recent low inflation largely resulting from declining commodity prices, notably energy, has sparked deflation scares in several developed countries. However, these risks should be properly assessed. Falling inflation stemming from reductions in relative prices, while beneficial to consumers, may not persist, given that some of the causes behind them are necessarily transitory, such as overinvestment in the energy industry.

[1]For a recent examination of the long-run relation between money and prices, see Lucas (2014).

Fourth, as with the fight against inflation, monetary policy is well equipped to forestall unwelcome deflation. The historical international record of the ends of episodes of deflation proves this to be the case.[2]

The existence of a zero lower bound (ZLB) for policy interest rates in environments seen to be flirting with deflation has long inspired economists to conduct research. Approaches taken have engendered controversy over the power of monetary policy at the ZLB. However, recent large-scale asset purchases undertaken by central banks in advanced countries confirm that the possibilities for monetary policy do not end at the ZLB.[3]

Finally, under emergency conditions of financial market distress, central banks may perform the role of lenders of last resort. One example can be found in the extraordinary actions of the U.S. Federal Reserve during 2008. Provision of needed liquidity helps restore normal market conditions. This should always be done at a penalty rate and against sufficient collateral, following the advice of Bagehot ([1873] 1999), and as a temporary measure, to avoid moral hazard.

What Positives Is Monetary Policy Less Certain to Achieve?

While there is broad consensus on the ability of monetary policy to control inflation over time, there is less agreement on other goals it could pursue. One tendency, accentuated in the wake of the financial crisis of 2008–09, is to assign additional objectives to monetary policy.

Two goals stand out. One is the long-standing aim to boost economic activity. It is widely accepted that long-term growth depends on real factors such as investment in both physical and human capital, as well as total factor productivity. Their behavior over the long haul is independent of monetary policy, and hence, the long-term neutrality of money should hold.

Where the short term is concerned, there is controversy over the capacity of monetary policy to stimulate the economy. Under

[2]An analysis of the role of monetary policy in exiting deflation can be found in Bordo and Filardo (2005). To review the Japanese experience with deflation, see Ito and Mishkin (2006).

[3]For monetary possibilities at the ZLB, see Goodfriend (2000).

conditions of full employment, completely anticipated expansionary monetary policies are expected to produce inflation. Rational expectations models incorporating frictions such as imperfect information or price rigidities have been used to replicate short-run tradeoffs between inflation and unemployment. However, given the long and variable lags with which monetary policy acts, attempts to exploit those tradeoffs can result in output instability. International experience with high and volatile inflation during the 1970s and 1980s illustrates this danger.[4]

Under the shadow of the global crisis, many developed countries have held extremely loose monetary policies for a prolonged period of time. This has been possible, apparently, thanks to the relative stability of long-term inflation expectations. Some studies suggest that extraordinary accommodation has supported economic activity, although the degree to which this has happened is still subject to debate. Meanwhile, negative side effects may be accumulating.[5]

Another goal, which in recent years has gained prominence, is to request that monetary policy safeguard financial stability. Although financial instability is a somewhat ambiguous notion, it is generally referred to as a situation in which financial markets exhibit dislocations to the extent that their functioning is impaired, with adverse impacts on economic activity.[6]

Aside from fulfillment of the central bank's role as lender of last resort, the best monetary policy can do for financial stability is to avoid becoming a source of problems, notably, by deviating from the primary goal of price stability. For example, monetary policy can react preemptively to aggregate demand pressures that may endanger the inflation target. As a beneficial byproduct, this measure may contribute to the maintenance of financial stability by indirectly attenuating incentives for financial excesses.

Even though monetary policy may thus aid financial stability, it can hardly take the task on as an objective in itself. To begin with, such a goal cannot be translated into an unambiguous quantifiable target. Hence, the evaluation of its attainment is cumbersome.

[4]For a discussion of the stop-and-go period prior to price stabilization in the United States, see, for example, Goodfriend (2005).

[5]Martin and Milas (2012) assess the debate regarding the effect of current monetary accommodation on economic activity.

[6]A description of financial stability can be found in Tucker (2011).

Perhaps more importantly, if pursuing financial stability is meant to include identifying potential asset price bubbles, leaning against them, and trying to prick them, this may be close to an impossible task. One essential characteristic of bubbles that leads to crises is that they do not obviously look like bubbles until they implode.

The authorities have no comparative advantage in identifying financial bubbles. But even if they did have a crystal ball to tell bubbles apart from healthy growth, monetary instruments may be ill suited to the purpose. For example, higher interest rates in an emerging economy meant to deflate a bubble fed by substantial capital inflows may actually exacerbate the problem by attracting more flows.

Therefore, financial stability should be regarded as a separate objective to be tackled with nonmonetary tools. The first line of attack to reduce financial systemic risk should be to maintain a sound regulatory and supervisory framework, which includes strict capitalization and liquidity rules as well as clear resolution schemes for financial institutions.

In short, the biggest risk with additional goals, as Friedman (1968) warned almost 50 years ago, is that monetary policy may end up not accomplishing what it is most suited to do in the pursuit of what it is less suited to do.

What Negative Impacts Can Monetary Policy Produce?

As with other policies, monetary actions can produce negative effects. Although in some cases, these may be unintended, in others, likely costs are taken on because they are assumed to be outweighed by expected benefits.

A leading traumatic case occurred during the Great Depression in which the U.S. Federal Reserve did not meet an increased demand for liquidity and allowed a contraction in the money supply, resulting in widespread deflation, worsened financial panic, and plummeting economic activity. More often than not, in many economies, excessive monetary expansion has led to periods of significant inflation.

Additionally, monetary policy that is too easy may be a cause of financial problems. Specifically, it can trigger the search for yield and the undertaking of too much risk. For instance, a loose stance may have contributed to the run-up of the U.S. credit and housing

bubbles prior to the big financial crisis. Debate over the importance of this element, relative to other policies, continues to this day.[7]

Furthermore, the increasingly extraordinary monetary accommodation in advanced countries since the global turmoil, which has included massive asset purchases for a long time and, in some cases, negative policy interest rates, may be engendering financial imbalances, not only in these economies but also in other nations.

Other negative impacts may include the undertaking of quasi-fiscal operations blurring the independence of monetary policy, incentives for governments to postpone needed fiscal and structural adjustments, fewer motives for business to improve efficiency and distorted resource allocation, questionable income redistribution, and future difficulties controlling inflation (see Forbes 2015).

Some of these costs may take time to become evident, thus allowing expansionary monetary policies to claim principally benefits. However, should significant problems arise, policy could lose credibility. An objective evaluation of causes of any possible negative effects will by necessity take time.

The Need for Time Consistency

Given its capabilities and bounds, it is desirable for monetary policy to focus on price stability. Effectiveness hinges on the authorities' commitment to this goal. In addition, the strategy must be well understood by the public. Complexities are inherent in this endeavor.

One is political pressure or principal-agent problems that call for deviation from the price stability target. For instance, resistance to interest rate hikes is far stronger than to cuts, and it may sometimes come from interest groups with high stakes in the matter.

Another complication might stem from the existence of more than one goal, which may make the rationale for monetary policy decisions hard to convey. One more may come from the lack of clarity regarding the way policymakers react to available information.

As a consequence, monetary policy can easily be time inconsistent. This and dependence on high-frequency data can force economic agents to spend a great deal of time and resources second-guessing monetary policy actions.

[7]For an evaluation of the debate regarding the role of lax monetary policy in the run-up to the global financial crisis, see, for example, Cesa-Bianchi and Rebucci (2015).

One way to facilitate coherence and clarity is for central banks to express long-term guidance for their future actions in a form that may approximate a policy rule. There is evidence that periods when monetary policy is rule-like largely coincide with good economic performance (see Nikolsko-Rzhevskyy et al. 2014).

This should not be interpreted as using a rigid, mechanical rule for monetary policy, but a way to make it systematic and predictable. With long-term guidance, specifics are secondary as long as they lead to the goal and policymakers follow through. Deviations from strategy under extraordinary circumstances can be clarified when they are warranted.[8]

Challenges for Emerging Economies

Emerging economies confront their own challenges for appropriately conducting monetary policy. On the one hand, these countries need to control inflation, especially in light of long histories of significant price instability. During the postwar period, developing economies have commonly lagged advanced countries in these efforts, frequently because of fiscal dominance. To this day, some countries still suffer from high inflation and struggle to control it, within relatively weak macroeconomic policy frameworks, especially in matters related to fiscal discipline.

On the other hand, emerging-market authorities have always had to consider the decisions of major central banks and the effects on their economies. In the present context, loose monetary stances in advanced nations may have triggered spillover effects on emerging economies via capital flows, including ample foreign-currency (FX) lending, and rises in financial asset prices. Expectations for the unwinding of lax policies have started to turn the tables on these impacts, as reflected by a weakening trend for emerging market currencies, among other tendencies (see Chen et al. 2015).

In the attempt to moderate these effects, many financial authorities have responded with measures frequently justified as macroprudential policies. In particular, initially, many central banks cut policy rates. In fact, there is evidence that in recent years monetary policy in emerging economies has tended to become looser than what

[8]This idea has been put forward by John B. Taylor. See, for example, Taylor (2015).

would have been granted by their own price stability mandates. Many economies also implemented FX intervention to accumulate international reserves, while some added capital flow restrictions (see Hofmann and Bogdanova 2012, Pasricha et al. 2015).

Recently, several countries have reversed these measures. Barriers to capital flows have been relaxed and international reserves have been used, while monetary policy has frequently remained accommodative, potentially implying contradictory policy directions. In some cases, however, monetary stances have begun to be tightened. A concern in some emerging economies is high pass-through from currency depreciation to inflation.

Trying to counteract external monetary policy effects may have resulted in some costs to central banks in emerging markets. These may include possible moral hazard from investors' expectations of being protected from losses in risk positions, increased uncertainty regarding policy measures, as well as damaged progress toward the attainment of price stability.

In fact, in some cases, it has become clear that imbalances have largely resulted from misguided domestic policies, such as excessively stimulative fiscal and financial measures. Thus, blaming problems on foreign countries' lax monetary stances may have distracted countries from correcting internal fragilities in a timely way.

A challenge in the current global scenario is for central banks to pursue price stability in the face of upcoming monetary normalization in the United States, while at the same time taking into consideration possible spillovers to the extent that they may have some bearing on achievement of their inflation targets.

Conclusion

The recent global financial crisis has generated increasing demands on monetary policy. The top risk of overburdening monetary policy with possibly incompatible objectives is diminished credibility. Hence, setting realistic expectations of what it can and cannot do is all the more important.

The greatest contribution monetary policy can make to society is price stability. Given the long-term neutrality of money, any attempt to use it to boost growth is by nature limited. With respect to financial stability, the best monetary policy can do is to avoid provoking problems, notably, by neglecting inflation control.

Monetary policy can obviously engender adverse impacts. Some may take time to surface. But if significant problems arise, policy can lose effectiveness. Furthermore, monetary policy can be time-inconsistent, and to avoid difficulties from this issue, the intentions of decision makers must be transparent. An explicit long-term strategy goes a long way to facilitate coherence and clarity.

Emerging economies confront specific challenges in the wise use of monetary policy. Many of these countries have histories of high inflation and are struggling to leave it behind. Also, they must act within the world scenario in such a way that they do not deviate from the objective of price stability.

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