Ernest Gnan
Head of the Economic Analysis Division
Oesterreichische Nationalbank

Monetary Policy Crisis Management and Price Stability

The various far-reaching and unconventional steps taken by central banks since the onset of the crisis raise the question about the extent to which macroeconomic and financial system crisis management and the maintenance of price stability are compatible or in conflict. This brief introduction touches upon five issues.

1 The Short versus the Long Run: Different Agents May Weigh Different Risks to Price Stability Differently

First, risks to price stability may work in different directions over different time horizons. In a short-term perspective, most economists and policymakers would agree that the deep financial, economic and sovereign debt crisis more or less dictated the pursuit of ultra-easy, including unconventional, monetary policies. Without them, central banks would not only have put financial system and macroeconomic stability at peril; central banks would also have been in danger of substantially undershooting inflation targets (possibly driving price growth even into deflationary territory), thereby failing to fulfill their primary objective of maintaining price stability. Hence, in the short run, there was no alternative to ultra-expansionary, crisis management-oriented monetary policy to ensure price stability in the sense of low, positive inflation rates. According to various indicators of inflation expectations, financial markets, economic forecasting experts and the public at large also seem to agree that these measures did not affect central banks' short-, medium- and long-term credibility with regard to their ability to maintain low consumer price inflation (see e.g. Gnan et al., 2011). On the contrary, in a broader sense, these measures may even be seen to have supported central banks' standing as crisis managers and, thus, guardians of macroeconomic stability. One might speak of "anti-deflationary credibility" in this context.

At the same time, particularly in countries such as Germany and Austria, quite a few people seem to be deeply concerned about a possible future erosion of the value of money, as

evidenced for example by the observed flight of savers into "real assets" such as gold and real estate. Judging from media headlines and other anecdotal evidence, there seems to be a dichotomy between economists' and the public's assessment of central banks' actions in terms of inflation risks. Possible explanations might be a) different levels of understanding of economics and, possibly linked to that, higher risk aversion on the part of noneconomists ("fear for lack of knowledge"); b) different weightings of time horizons (i.e. economists, policymakers and professional investors are more short-term oriented, e.g. because they have to address immediate concerns, whereas savers are more concerned with the preservation of their savings in the long run); c) different risk attitudes (policymakers and large investors weighing short-term deflation risks very high, while savers might weigh the low-probability high impact event of high inflation quite high. Deeply-rooted negative historical experiences of hyper-inflation in the aftermath of past crises (such as wars) may contribute to such perceptions.

2 Incomplete Price Measurement, Neglected Relative Price Distortions, and Negative Welfare and Wealth Effects

Second, there are the difficult questions of how to measure inflation, how to define price stability, and whether the concept of consumer price inflation as used by most central banks eschew prices central to macroeconomic stabil-

ity but also to economic agents' welfare. Crisis management-oriented monetary policy may exert substantial influence on relative prices, across goods and various forms of real and nominal assets. For instance, while low consumer price inflation prospects in the euro area as a whole call for expansionary monetary policy, the resulting monetary stance may be regarded as too lax in some countries, such as Germany, which has been hit much less by the recent crisis. The aim to keep consumer price inflation for the euro area as a whole close to the definition of price stability may fuel sharp relative price increases in assets deemed safer in a crisis (safe-haven effects). These assets may include real assets such as precious metals, real estate, collectibles or stocks, as well as nominal assets such as German Bunds. For sure, it is commonly argued that monetary policy should not, and cannot, concern itself with relative price movements, but can only aim at price stability for the average of the whole universe of (consumer) prices. But there are also counter-arguments: First, most definitions of price stability exclude real assets typically affected by crisis-induced safe-haven purchases, so extreme movements in these prices are eschewed from monetary policy reaction functions; this may in itself entail welfare implications of monetary policy, in particular in the case of price bubbles in housing, which satisfies a basic need. Second, asset price bubbles may cause further boom-bust cycles, in turn endangering stable growth, employment and, as a consequence, also consumer price inflation. Third, overpricing of assets such as bonds, stocks but also real estate, may substantially affect the real return on investment at least in the short to medium run. The real return on nominal low-risk assets has become clearly negative over the past years. The resulting erosion of real wealth is at odds with the notion of "maintaining the purchasing power of money," which the public and indeed many economists would associate with central banks' price stability mandate.

3 Spillovers and Externalities

A third aspect concerns cross-country spillovers and externalities. The IMF and other institutions have been warning for quite some time that ultra-easy monetary policies in the U.S.A. and other industrialized countries result in capital inflows into emerging market economies (search-for-yield effects), causing an initial overheating of credit, aggregate demand and assets prices (stock markets, real estate markets) and a subsequent retrenchment once the bubbles burst.

This implies considerable risks both to macroeconomic and price stability in emerging economies (initial upward, subsequent downward pressures on inflation) but may also entail non-negligible de-stabilizing repercussions for industrialized countries (exchange rates, financial market spillovers, trade spillovers, confidence etc.).

4 Technical and Market Aspects of the Exit from Unconventional Monetary Policy Measures

It is frequently argued that central banks might find it difficult to unwind the asset purchases and other changes to their balance sheets resulting from unconventional monetary policies. This may undermine their ability to maintain price stability in the longer term. In particular, the necessary substantial sales of government bonds may not be possible without severely affecting the respective bond market segments; therefore, these sales might not take place at all, nourishing concerns about "fiscal dominance" (see e.g. Leeper, 2012).

The counter-argument is that central banks, from a technical viewpoint, can always drain liquidity from the market to ensure that a monetary stance conducive to price stability is ensured; this need not necessarily be achieved via sales of their acquired government bond portfolios but can be done for instance through the issuance of central bank paper, reverse repo operations, higher minimum reserves etc.

That being said, it may not be sufficient for central banks to technically be in a position to ensure orderly liquidity developments; they must also be able to *convince the public and markets* of this ability *and their willingness* in a timely manner to prevent negative credibility effects, which in turn might endanger their very ability to keep inflation expectations low and stable, without real economic costs.

5 New Paradigms, New Central Banks, New Tasks, New Objectives – Old Problems?

The potentially biggest challenge for central banks and their safeguarding of consumer price stability in the future are deep changes in economic thinking and the resulting changes in institutional set-ups, central bank tasks and objectives. All these changes also affect policymakers' and economic agents' incentives and expectations toward central banks.

First, the crisis is perceived by many experts to have unmasked the "Great Moderation" as a big illusion or a big policy mistake. More bluntly, macroeconomic stability, low consumer price inflation and high growth are seen to have been the result of riding financial and real economic bubbles. What conclusions can be drawn from this perception? During the Great Moderation, central banks were generally accepted to be isolated from other political tasks and influence, using their specific instrument – the short-term interest rate – to pursue a single goal: consumer price stability.[1] The simple recipes of inflation targeting – a core element of Great Moderation thinking – have also proved much less useful by the deep and long-lasting recessions in many coun-

[1] *There was indeed a long debate about the extent to which central banks should take into account asset price developments in one or the other (direct or indirect) way, but this did not substantially alter the main paradigm.*

tries: In a period of such deep and structural adjustments, reasonable estimates of potential growth and output gaps, which were at the core of New Keynesian inflation/output-gap targeting, are

impossible. Instead, arguments such as hysteresis have come to the fore, questioning the previous consensus of monetary policy's long-run neutrality. Indeed, it seems to be rather broadly accepted now that in situations of deep economic and financial system crisis, active and aggressive monetary policy is vital to limit long-lasting real damage to the economy.

Reflecting this, since the crisis, many central banks have tended to gear their monetary policies toward a broader range of macroeconomic developments, with growth and employment taking a more prominent role alongside inflation (as illustrated most recently by communication in the context of various central banks' forward guidance).

Furthermore, financial stability concerns have taken a front seat in central banks' policies. For one thing, many unconventional monetary policy measures have explicitly or implicitly aimed at solving stress in banking systems and various financial market segments, and interest rate policy too has arguably been influenced by such concerns. For another, central banks have become much more heavily involved in macroprudential surveillance and banking supervision. In many cases this has also been reflected in explicit institutional and legal changes. The interactions between monetary policy and macroprudential policies are likely to be much more intense and complex (see e.g. Blanchard et al, 2013) than some may have originally thought or hoped.

The forced close coordination with government policies, the *de facto* or *de lege* enlarged mandates and responsibilities of central banks, and the *de facto* broader monetary policy goals together have implications for central banks' role within government and economic policymaking at large. For one thing, central banks have become more important and powerful. The flip side of the coin is, however, that central banks have become far more involved in important political decisions, raising questions of democratic legitimacy and in the end potentially limiting their hard-won independence (see e.g. Borio, 2011).

Many of these issues contain interesting and potentially far-reaching political economy aspects, which might influence central banks' future ability (or incentives) to maintain price stability at levels seen during the Great Moderation. The (cautious) call for, or active consideration of, higher inflation targets put forward by some prominent economists (e.g. Blanchard et al., 2010) shows that in situations of high government (and, in some countries, private) debt levels, some still regard the old recipe of "silent" debt relief through inflation as an option that should not be discarded right away. Thus, the consensus view of the benefits of price stability (i.e. low positive inflation rates) can never be taken for granted but needs to be convincingly argued and proven to be in the best interest of our economies and societies in the long run.

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