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Monetary Policy Between Stability and Growth

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Abstract: The global financial crisis and the coronavirus pandemic were marked by expansionary policies of key central banks in an attempt to stop the recession. The degree of expansiveness of monetary policy was unprecedented. As a result of expansionary policies, global inflation has been present since 2021. The change in the macroeconomic environment has led to a turnaround in monetary policy pursuits and a rapid rise in reference interest rates. The FED reacted much faster than the ECB and that is why inflation was lower in the USA compared to the euro area. All announcements for 2023 point to the continuation of contractionary policies.

The subject of the paper's analysis is the monetary policy of key central banks, as well as expectations for the next period. The paper raises the question of whether central banks have gone from one extreme of overly expansionary monetary policy to the other extreme of overly contractionary monetary policy and whether such policies carry the risk of reoccurrence of recession. The paper also contains recommendations for improving existing monetary policy regimes, as well as for creating a completely new monetary policy regime which will be based on two nominal anchors.

Keywords: Monetary Policy, FED, ECB, Inflation, Two Nominal Anchors.

JEL Classification: E50, E52 and E58

1. Introductory remarks

The relationship between inflation and economic growth has changed over time. If you had asked an economist or central banker in the 1960s what the most important objective of monetary policy was, you would probably have received the answer that it was to achieve the optimal trade-off between inflation and reducing unemployment. At that time, it was believed that economic growth could be “bought” with a slightly higher inflation rate, that is, the ruling paradigm was that fiscal and monetary policy should be coordinated and that coordination is easier to achieve if the government can control both of these policies.

Keynesians did not consider moderate inflation to be a problem and they believed it contributed to taxing idle money and thereby stimulating growth. They used the Phillips curve, as analytical tool, which allowed for a trade-off between inflation and unemployment (economic growth). However, expansionary policies led to global inflation in the late 1960s and early 1970s (Dimitrijević & Fabris, 2009). The monetarist counterrevolution showed that a settlement between inflation and unemployment is only possible in the short-term if inflation is unanticipated.

Today, there is no longer either theoretical or empirical evidence that there is a long-term “trade-off” between inflation and economic growth. Potentially using a short-term “trade-off” can only bring more uncertainty about the rate of inflation in the future. Namely, there is a consensus in economic theory nowadays that in the long-term, after the completion of the process of harmonizing changes in the money supply, there will be changes in the price level, but not permanent changes in the level of production and employment. The principle in question is that of long-term neutrality of money, which is taken from monetarist theory. This was also confirmed by Barro (1996) on the example of 100 countries observed over the thirty-year period from 1960-1990 where he concluded that the unexpected inflation would affect growth negatively through decreasing the performance of households and firms. Ghosh and Phillips (1998) are of a similar opinion and they showed that even moderate inflation has a negative effect on economic growth.

The answer to the previous question posed above is that the goal of monetary policy is to preserve price stability. As Duisenberg (1997) points out, *price stability obtains when the public no longer takes account of actual or prospective inflation in its decision-making*. The more reliable the information on relative prices, both nationally and across borders, the more efficient allocation of scarce resources and the ability of a market economy to function properly is promoted. Brash (1994) points out that *even die hard believers in the myth would probably admit*

that more inflation isn't costless and that at some point more inflation would do more harm than good.

High inflation damages the economy in more ways than one, influencing decisions on savings and consumption, borrowing and investment, cross-border cooperation, and the like. In the conditions of price stability and a predictable environment, companies are more willing to enter into long-term contracts; otherwise they prefer short-term projects or projects with a promise of quick return on investment. Also, real returns must be higher because due to inflation, companies are faced with higher real costs of borrowing as interest in such circumstances also includes inflation premium as a protection against unexpected changes in the price level.¹ In such circumstances, instead of investing in production, companies often decide to invest in real estate in order to preserve the real value of their property, and it is not possible to determine with certainty whether price changes are the result of real or monetary factors. High inflation can be associated with high inflation volatility and thus, the problem of predicting real returns and, consequently, a rapid decline in banks' lending activity to support investment and economic activities (Dhal, 2011). Price stability makes it easier to recognize changes in relative prices. This allows firms and consumers to make better informed investment and consumption decisions, which in turn allows the market to allocate resources more efficiently. By allowing the market to direct resources where they can be most productively used, price stability increases the production potential of an economy. Maintaining price stability protects against large and unjustified redistribution of income, which occurs both in inflationary and deflationary circumstances. An environment in which there are stable prices helps to maintain social and political stability. Also, in today's business globalization environment, capital tends to flee from unstable countries with high inflation.

It is a misconception that only central banks should have responsibility for price stability, even though it is the essence of their mandate. A sound fiscal policy must also be responsible for price stability, as well as the movement of wages in line with productivity growth. As the OECD (2014) determined, monetary and fiscal policy settings aimed at low and stable inflation and sound public finances are conducive to long-term growth. And in most cases, maintaining sound public finances and anchoring expectations will also help to contain shocks.

¹ The traditional view is that a higher inflation rate means higher interest rates, which leads to lower economic growth. However, it is interesting that during the last two years, interest rates did not rise in line with inflation, but with the expectations of an increase in the reference interest rates by the ECB and the FED.

However, the dilemma that remains is whether monetary policy should only take care of price stability or whether its instruments should also support other goals such as employment and economic growth. Namely, if the goal were only a low inflation rate, then the goal defined in this way could be achieved through a relatively high interest rate, but it could have a negative impact on employment and economic growth. In the legislation of most central banks, this dilemma is resolved so that the main goal of the central bank is price stability, and other goals such as support for government economic policies and employment are achieved if they do not threaten the main goal of price stability. The exception is the FED, which includes employment in its goals. However, in the practice of central banks, especially during the Global financial crisis and the coronavirus pandemic, key central banks pursued policies aimed at encouraging the real economy and employment.

The aim of this paper is to analyse the monetary policy of key central banks, primarily the FED and the European Central Bank from the aspect of its impact on price stability and economic growth, as well as to offer some recommendations for the necessary improvements of monetary policy in the coming period. The paper contains recommendations for improving the monetary policy framework and the inflation targeting regime, as well as a proposal for a potentially completely new monetary policy regime which would be based on two nominal anchors.

The paper consists of four parts. After the introductory remarks, the current monetary policies of the FED and the ECB are analysed together with their implications for inflation trends and economic growth. In the third part of the paper, recommendations are given for monetary policy improvements or modifications and/or the introduction of a new monetary policy regime. The paper ends with concluding considerations.

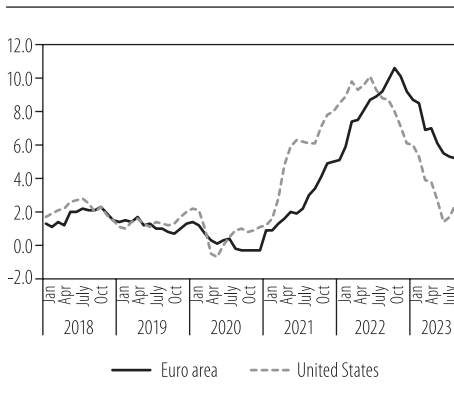
2. Changed monetary policy focus

Unfortunately, the issue of inflation has become relevant again these days. Inflation at the global level began to rise in mid-2021 as a result of monetary overabundance created first in the fight against the Global financial crisis, and then the pandemic. The balance sheets of the FED, the ECB and other leading central banks have grown to the levels unheard of and unimaginable before the global financial crisis, and some reference interest rates have gone negative, which was considered impossible. This is a classic example of what Friedman talked about more than half a century ago, and that was that monetary expansion of a large

country can create global inflation. The rapid development of globalization in recent decades has only facilitated the transmission of inflation to the global level.

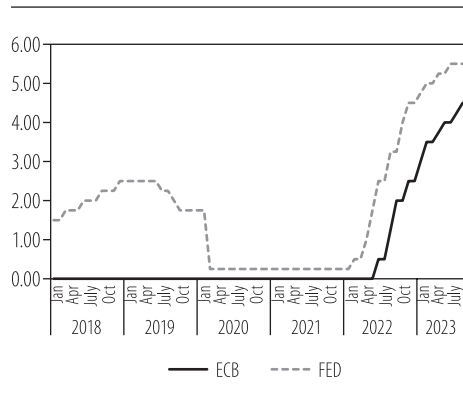
It was clear that with the revival of economic activity at the moment when there was an increase in demand for money and a consequent change in the velocity of circulation, that a large amount of circulated money would generate an inflationary effect. Therefore, the assessments of most leading central banks from mid-2021 that inflation is of temporary nature and the expectation that it will decrease significantly from the second half of 2022 are simply baffling. On the contrary, inflation only accelerated and the Ukrainian crisis and the interruptions of a large number of global supply chains that came afterwards only built up on this, with the result being the highest inflation at the global level since the 1970s and the oil shocks. The trend of inflation in the euro area and the USA is shown in the Figure 1.

Figure 1: Inflation in the euro area and the USA



Source: Author's calculation

Figure 2: Benchmark interest rates in the euro area and the USA (in %)



Source: Author's calculation

The graph clearly shows that inflation is higher in the euro area than in the U.S., which is the result of the fact that the ECB started raising the benchmark interest rates much later, as can be clearly seen in Figure 2.

During the Global financial crisis, the ECB, the FED and other leading central banks initially focused their attention on the preservation of financial stability in order to mitigate and limit the consequences of mass bankruptcy of financial institutions. QE episode was characterized by a sharp increase in the size of the balance sheet of central banks, together with an increase in money aggregates

(Mulaahmetović, 2022). Then, in the second phase of the Global financial crisis, when the crisis spilled over from the financial to the real sector, the focus shifted to supporting the real economy, and even public finances, primarily of certain over-indebted euro area countries. Until the coronavirus pandemic, the banking sector had strengthened, so this crisis did not lead to a financial crisis. Therefore, during the pandemic, the continuation of expansionary policies was aimed at supporting the real economy. It is obvious that during these two periods, the focus of monetary policy was the stimulus to growth rather than price stability. This is understandable in the FED's case as one of its goals is the support for price stability and economic growth (employment).

It is clear that too long a period of expansionary monetary policies that focused on growth sooner or later had to lead to a violation of what is the basic goal of monetary policy, which is price stability. Many studies found that in the long term, the correlation between inflation and the growth rate of money supply is almost one (Walsh, 2010). It simply confirmed once again that time lags in the case of monetary policy were long and unpredictable and that is why inflation appeared with a certain time lag.

However, now one gets the impression that this has gone to the other extreme, which is too aggressively raising reference interest rates. The ECB was late with this measure, and one gets the impression that it has been too aggressive recently in raising the rates in the desire to bring back inflation down again as soon as possible, but time delays, which are quite long, are being ignored again. This means that changes in monetary policy implemented today will affect the price level after several quarters or years. That is why monetary policy must always be forward-looking. This means that in order to curb inflation, it is necessary to apply a contractionary monetary policy even before inflation appears.² Therefore, we can conclude without a dilemma that the leading central banks were late with their measures aimed at reducing inflation.

Raising interest rates too aggressively can jeopardize economic growth. As Sutherland and Hoeller (2014) point out, monetary policy set too narrowly to maintain low and stable inflation in the near term can be associated with rising vulnerabilities. The problem is not if, for the sake of price stability, a short-term decline in production and employment must be achieved, but the problem can be if a long-term decline is created, and that is difficult to determine in advance. In

² However, in such circumstances, it is very difficult to explain to the public why restrictive measures are necessary when there is no inflation so the central bank may find itself under great public pressure.

its forecasts, the ECB continuously underestimated the inflation rate in the previous period, and the Managing Director of the IMF warned that raising interest rates too quickly leads to the risk of recession. We are also witnessing that an increasing number of companies in the EU are entering bankruptcy, not a small number of which are renowned companies with a long history of business.

Also, this example clearly shows how part of the burden of resolving the crisis in the euro area and the USA has been shifted to the rest of the world, that is, to all those entities that have euros and dollars in their portfolios. The excessive expansion of the euro and the U.S. dollar by the ECB and the FED has led to global inflation that devalued these currencies and thus shifted a part of the burden of resolving internal crises to the rest of the world in such a way that the value of their assets held in these currencies or securities denominated in these currencies have significantly declined.

3. New monetary policy framework

Apart from the policy of negative interest rates of the ECB and some other central banks, there have been no significant innovations in the field of monetary policy since the emergence of inflation targeting in 1989. Even in the latest theoretical innovation in inflation targeting, the practice went ahead of the theory because contrary to the theory, most central banks have led active exchange rate policies in this regime. Also, practice has shown that the zero nominal bound is not the lower threshold of interest rates.

The Global financial crisis and the coronavirus pandemic have created a new reality to which the traditional monetary policy cannot adequately respond. Therefore, the only dilemma at this point may be whether a completely new monetary policy framework is needed or only modifications to the existing one.

Regimes with two nominal anchors? Most economists believe that nominal anchors can strengthen the credibility of monetary policy, that is, as Mishkin (2011) points out: "The inability of monetary policy to boost employment in the long run, the importance of expectations, the benefits of price stability, and the time-inconsistency problem are the reasons that a credible commitment to a nominal anchor--i.e., stabilization of a nominal variable such as the inflation rate, the money supply, or an exchange rate--is crucial to successful monetary policy outcomes." Adopting a nominal anchor helps to stabilize expectations, which promotes economic efficiency and growth. However, we should take into account the

fact that not all central banks apply a nominal anchor in their monetary policy as the FED.

However, the dilemma that arises is whether it would be possible to pursue monetary policy regimes with two nominal anchors. If we were to read all the theoretical literature, the unequivocal answer would be that this is not possible. However, one gets the impression that the existing literature is outdated and that a new both practical and theoretical frameworks are needed.

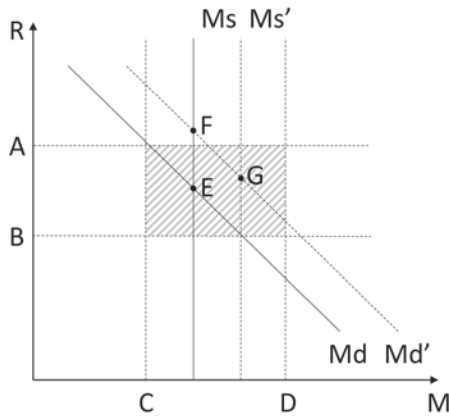
In the inflation targeting regime, the initial theoretical assumption is that the central bank must not have any other goal besides the inflation target, as this would lead to conflicting goals and a potential threat to price stability. Therefore, the initial assumption is that the policy of free-floating exchange rate is pursued in this regime. However, a large number of empirical studies have indisputably shown that some countries in this regime also have some exchange rate target which is not publicly announced, and occasionally intervene on the foreign exchange market (Lazić, 2021; Adler, Lama and Medina, 2019; Fabris, 2018; Airaud, Buffie, and Zanna, 2016; O'Connell, 2008; Stone, 2003; Svenson, 2000.)³. Basically, this is the result of a fear of free floating exchange rate, so interventions are aimed at preventing unwanted movement of the exchange rate. If central banks already had their own implicit exchange rate target, then this regime would probably be further strengthened with the public announcement of the exchange rate target. This would essentially only make public the existing practice of central banks, and the credibility of both the central bank and the monetary regime could be strengthened with two nominal anchors. Of course, it is of crucial importance that the inflation target and the exchange rate target are compatible, that is, that their values do not become conflicting objectives.

Another possibility for pursuing a policy with two nominal anchors is to simultaneously target the money supply and the interest rate. There is a clear assumption in the existing literature that a central bank may target either money supply, and then the demand would determine what the interest rate will be for the given supply, or the interest rate, and then the demand would determine the amount of money demanded for the given interest. Figure 3 explains how this mode, which I have called quadrilateral targeting, could work.⁴

³ The term inflation targeting lite or flexible inflation targeting is often used for countries that, in addition to inflation targeting, also have a policy of intervention on the foreign exchange market (foreign exchange target).

⁴ Quadrilateral targeting is related to the fact that essentially the targeted zone is the quadrilateral shaded as shown in Figure 3.

Figure 3: Quadrilateral targeting



Source: Author

The targeted level of interest rates is the zone from point A to point B, and the targeted level of money supply is the zone from point C to point D. Essentially, the targeted zone is a shaded square. The initial equilibrium exists at point E, at the point of intersection of the supply and demand for money and it is located in the targeted zone. As a result of the increase in money demand, the new equilibrium is now at point F, outside the targeted zone. As a result of the increase in the interest rate, an expansive monetary policy is implemented with the aim of returning the interest rate to the targeted framework and a new balance is established at point G, which is again in the targeted zone.

It is important that the money supply and interest rate targets are set at compatible levels, and historical data on interest rate and money supply movements can be useful. The quadrilateral targeting regime is obviously not suitable for all banks and all situations. It will be more adequate for central banks of developed countries with significant credibility. Also, it will not be suitable in countries where there are significant changes in the demand for money. It is probably more fitting in both stable conditions and recession. With these two nominal anchors, central banks could balance between inflation and economic growth, but in the event of their conflict, a clear priority would have to be given to price stability. In the end, this is just a starting assumption that requires a lot more research before this regime would be either accepted or rejected.

New inflation target? The first dilemma that arises is the adequacy of the traditional inflation targeting. Today, an inflation rate of around 2% is considered a synonym for stability, which largely coincides with the ECB target. However, during the Global financial crisis, it was shown that this target leaves insufficient room for pursuing an active monetary policy and the ECB was forced to enter the zone of negative interest rates. Namely, increasing the inflation target would create additional space for monetary policy to intervene, without the risk of entering negative interest rates and deflation. This dilemma is not new and has been around for some time. Back in 1998, Krugman suggested increasing the inflation

target to 4%. A little later Summers (1991) made a similar proposal, but with a slightly lower target inflation rate of 3%.

Sutherland and Hoeller (2014) indicate that *raising the inflation target could create additional room for monetary policy to react to a severe downturn, but the transition to a new target will involve costs and lead to efficiency losses*. Blanchard, Dell’Ariccia & Mauro (2010) are of a similar opinion and they point out that *a somewhat higher inflation target provides central banks more ammunition when facing large adverse shocks and reduces the frequency of hitting the zero nominal bound*.

In the past, this proposal was often subject to criticism, starting from the negative reactions of the public accustomed to decades of low interest rates to advocating that raising the inflation target in conditions of low inflation would be expensive and entail costs. Also, there are arguments that raising the inflation target could increase uncertainty and that it would take a lot of time for the new targets to gain credibility, as well as pointing to the danger of high transition costs of switching to a new target. Also, the frequently reiterated argument is that it would carry the risk of losing control over monetary policy and that it could lead to the growth of inflationary expectations.

Although it is completely understandable that it was difficult to implement this innovation in monetary policy in the past because it would mean an increase in inflation, one gets the impression that now could be the right moment to seriously consider such an alternative. The current inflation is high and setting a new inflation target 1 to 2 percentage points higher than the existing one would not have an impact on stability at this moment because it would lead to lower inflation than the current one, and essentially all the previously presented counterarguments would be refuted and this would leave a much higher room for monetary policy to intervene in the long term. Postponing this decision and/or reconsidering it when inflation returns to the traditional target of 2% would make this change very difficult.

A formal framework for international monetary policy coordination? – The last two crises have clearly shown that monetary policy of the largest central banks crosses national borders and particularly affects small countries. This was particularly influenced by the changed environment, the increased degree of globalization, the emergence of financial innovations and cryptocurrencies (Vučinić and Luburić, 2022). Central banks now operate in the era of digital transformation (Mičić and Mastilo, 2022).

Friedman's argument about the monetary expansion of a large country that creates global inflation has proved to be completely valid. On the other hand, financial globalization has simultaneously led to an increase in the frequency of financial crises, i.e. to their transmission from abroad. Now, in addition to keeping track of the domestic financial market, central banks must pay special attention to its interaction with international financial markets. Thus, the first disturbances that announced the Global financial crisis started in the USA in early 2007. In the beginning, it was not treated as anything serious, the FED did not share relevant information with other central banks, and most central banks outside the USA were not aware of the problems until the midsummer of 2007. Even then the disturbances were not taken seriously (Fabris, 2018).

However, if the FED had warned other central banks in a timely manner, they would have had a year to further strengthen their banking systems and the consequences of the crisis would probably have been less devastating. If a formal mechanism of coordination and/or exchange of opinions had been in place, the benefits would be evident.

Therefore, it would be useful to form a new international institution as a kind of a forum where representatives of central banks would meet on regular basis. It would be extremely beneficial for the most important central banks to participate in the forum, with the possibility of involving representatives of all central banks in the world. The goal of the forum would be to discuss current macroeconomic trends, expectations of central banks, and possible future directions of monetary policy. It would be ideal if the forum could also achieve some kind of international coordination of monetary policy, but at the moment this seems unlikely considering different economic and monetary situation in individual countries, as well as different economic policy goals. Certainly, the forum would provide access to a greater number of inputs for central banks in the formulation of national monetary policies, enable an easier fight against inflation and better adaptation to the effects of international transmission of negative shocks.

New forecasting framework – In the past, central banks largely relied on econometric models when formulating monetary policy. This was particularly pronounced in countries that had the inflation targeting regime in place, which relied almost exclusively on the model-forecasted inflation rate. However, classical econometric models suffer from a number of weaknesses. Perhaps the best confirmation of this is that no macroeconomic model predicted the Global financial crisis. Even more, as the IMF stated in its Global Financial Stability Report (2006), less than a year before the Global financial crisis outbreak, the world economy was experiencing one of the longest expansion periods and a stable banking sys-

tem largely contributed to that. So far, the economists have not agreed either on a specific model or on a specific econometric technique to be used.

Traditional macroeconomic models suffer from numerous weaknesses such as:

- Varying time lags,
- Difficulties in estimating exogenous variables,
- The relations between certain variables that can be changed very frequently (more frequently than it is possible to adjust the model),
- A large number of models that come from main postulates of some macroeconomic theory (e.g. Keynesian models, classical models, neoclassical models, and the like), and no macroeconomics consensus has been reached yet on the prevailing macroeconomic theory.
- The dilemma whether all complexities of the modern world can be shown through macroeconomic equations.

Therefore, a dilemma at hand is if macroeconomic models should be abolished or more macroeconomic models should be used. However, it is almost impossible to evaluate the impact of change in monetary instruments without a macroeconomic model. Bearing in mind all their restrictions, econometric models should not be the main decision-making instrument, but an additional or corrective instrument. This is also supported by the Blinder's (1998) hypothesis which he applied while being a member of the FED Board – “use a large number of econometric models and do not trust any of them too much”. Almost the same view has Issing (2003), who points out that mathematical models are useful for the economy as they enable creating conclusions that could not be otherwise created, but the models can never lead us to make a conclusion that they represent the real world.

From all the above we can conclude that it is difficult to implement monetary policy without econometric models, yet on the other hand, they suffer from numerous weaknesses. Therefore, it would be useful to introduce a new multidimensional approach to forecasting. In addition to traditional econometric models that need to be further improved, central banks would have to take into consideration several other dimensions, i.e. forecasts. These could first be international forecasts for the observed country given, for example, by the International Monetary Fund, the World Bank or some similar institution. The third dimension would be a panel of experts who would give their forecasts based on their expert opinion. And the last dimension would be the expectations of the financial sector, the real economy, and the household sector, which would be regularly monitored and collected. If these four dimensions had similar forecasts, it would be a sign that the central bank is on the right track. In case of significant deviations among these, it

would be a signal for the existence of potential risks and additional analysis and data collection would be needed.

4. Concluding remarks

Today, the prevailing view is that the main goal of central banks is price stability. That is, as Brash (1994) pointed out, more inflation ends up doing more harm than good or higher inflation is likely to hinder long-term growth. However, the last two crises (Global financial crisis and Coronavirus pandemic) have shown that a new reality has emerged and that the traditional framework of monetary policy - one instrument - one goal - is no longer suitable.

The key goal of central banks now is the balancing of three strategic goals: price stability, financial stability, and stability of real economic growth. Although price stability is the key objective of monetary policy and a large number of empirical studies suggest that a stable environment with low inflation is associated with economic growth and better macroeconomic performance, this begs the question of what a central bank should do when the real economy is hit by a shock. In such circumstances, the issue is whether a central bank should temporarily deviate from the inflation target and “relax” its monetary policy in order to facilitate the adjustment of the real economy. The challenge is to find the right balance.

It is obvious that during the previous two crises, the focus of the central banks was not on price stability. During the Global financial crisis, expansionary monetary policies were aimed at preserving financial stability and stimulating economic growth. During the coronavirus pandemic, expansionary policies aimed at stimulating economic growth continued. The consequence of such policies is high inflation that has been present for two years. Now central banks are trying to curb inflation by aggressively raising interest rates, but there is a risk that it is this too aggressive raising of interest rates that will jeopardize growth, and monetary incentives to economic growth will be needed again in some future period. In the author's opinion, such cyclical changes in goals are the consequence of inadequacy of the existing monetary regimes.

Therefore, the paper presents proposals for improving the existing monetary frameworks. In order to increase the effectiveness of monetary policy, it would be useful to increase the traditional inflation targets. That measure is now enforceable because inflation targets of 1 to 2 percentage points higher than the traditional ones would basically mean significantly lower inflation than the current one. Given that the existing forecasting models have proven to be ineffective,

it is proposed to introduce a new four-dimensional approach to forecasting. In order to reduce the consequences of spillover of negative shocks from individual countries and to increase the degree of international coordination of monetary policies, it is proposed to establish a permanent forum of central banks for the exchange of information and coordination of policies.

Finally, it is proposed to introduce a regime with two nominal anchors that would make it easier for central banks to balance between multiple goals. Albeit not being an explicit regime, inflation targeting with two nominal anchors has been functioning as an implicit regime for many years in a large number of countries where they do not publicly announce the exchange rate target. Contrary to theoretical assumptions, the paper also discusses the possibility of simultaneous targeting of the interest rate and the money supply. This is an idea that is still in its infancy and it will require a lot more research before being definitively accepted or rejected.

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