The new abnormal in monetary policy

By Nouriel Roubini
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Financial markets are starting to get rattled by the winding down of unconventional monetary policies in many advanced economies. Soon enough, the Bank of Japan (BOJ) and the Swiss National Bank (SNB) will be the only central banks still maintaining unconventional monetary policies for the long term.

The US Federal Reserve started phasing out its asset-purchase program (quantitative easing, or QE) in 2014, and began normalizing interest rates in late 2015. And the European Central Bank is now pondering just how fast to taper its own QE policy in 2018, and when to start phasing out negative interest rates, too.

Similarly, the Bank of England (BoE) has finished its latest round of QE – which it launched after the Brexit referendum last June – and is considering hiking interest rates. And the Bank of Canada (BOC) and the Reserve Bank of Australia (RBA) have both signaled that interest-rate hikes will be forthcoming.

Still, all of these central banks will have to reintroduce unconventional monetary policies if another recession or financial crisis occurs. Consider the Fed, which is in a stronger position than any other central bank to depart from unconventional monetary policies. Even if its normalization policy is successful in bringing interest rates back to an equilibrium level, that level will be no higher than 3%.

It is worth remembering that in the Fed's previous two tightening cycles, the equilibrium rate was 6.5% and 5.25%, respectively. When the global financial crisis and ensuing recession hit in 2007-2009, the Fed cut its policy rate from 5.25% to 0%. When that still did not boost the economy, the Fed began to pursue unconventional monetary policies, by launching QE for the first time.

As the last few monetary-policy cycles have shown, even if the Fed can get the equilibrium rate back to 3% before the next recession hits, it still will not have enough room to maneuver effectively. Interest-rate cuts will run into the zero lower bound before they can have a meaningful impact on the economy. And when that happens, the Fed and other major central banks will be left with just four options, each with its own costs and benefits.

First, central banks could restore quantitative- or credit-easing policies, by purchasing long-term government bonds or private assets to increase liquidity and encourage lending. But by vastly expanding central banks' balance sheets, QE is hardly costless or risk-free.

Second, central banks could return to negative policy rates, as the ECB, BOJ, SNB, and some other central banks have done, in addition to quantitative and credit easing, in recent years. But negative interest rates impose costs on savers and banks, which are then passed on to customers.

Third, central banks could change their target rate of inflation from 2% to, say, 4%. The Fed and other central banks are informally exploring this option now, because it could increase the equilibrium interest rate to 5-6%, and reduce the risk of hitting the zero lower bound in another recession.

Yet this option is controversial for a few reasons. Central banks are already struggling to achieve a 2% inflation rate. To reach a target of 4% inflation, they might have to implement even more unconventional monetary policies over an even longer period of time. Moreover, central banks should not assume that revising inflation expectations from 2% to 4% would go smoothly. When inflation was allowed to drift from 2% to 4% in the 1970s, inflation expectations became unanchored altogether, and price growth far exceeded 4%.

The last option for central banks is to *lower* the inflation target from 2% to, say, 0%, as the Bank for International Settlements has advised. A lower inflation target would alleviate the need for unconventional policies when rates are close to 0% and inflation is still below 2%.

But most central banks have their reasons for not pursuing such a strategy. For starters, zero inflation and persistent periods of deflation – when the target is 0% and inflation is below target – may lead to debt deflation. If the real (inflation-adjusted) value of nominal debts increases, more debtors could fall into bankruptcy. Moreover, in small, open economies, a 0% target could strengthen the currency, and raise production and wage costs for domestic exporters and import-competing sectors.

Ultimately, when the next recession strikes, central banks in advanced economies will have no choice but to plumb the zero lower bound once again while they choose among four unappealing options. The choices they make will depend on how they weigh the risks of bloating their balance sheets, imposing costs on banks and consumers, pursuing possibly unattainable inflation targets, and hurting debtors and producers at home.

In other words, central banks will have to confront the same policy dilemmas that attended the global financial crisis, including the "choice" of whether to pursue unconventional monetary policies. Given that financial push is bound to come to economic shove once again, unconventional monetary policies, it would seem, are here to stay.

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