

Focus

The limits to monetary policy

Central banks were seen as saviors during the financial crisis.
Where does their power end?

The interaction of power and markets has always been an issue for economists. A hundred years ago, for example, they argued that, in the long run, wages should be determined by demand and supply and not by industrial relations. They realized that market distortions could lead to unemployment and falling wages. However, immediately after the financial crisis, more hopes than ever before were put on monetary policy since it had obviously managed to moderate the effects of the crisis and end recession. But it has become more and more apparent that money and capital markets react in a similar way to the labor market: policy intervention has its limits.

In 1928, the economist Ludwig von Mises postulated that excessive monetary growth led to artificially low interest rates and swelling credit¹ and that part of the borrowed money would be misallocated, leading to defaults. In his view, the world depression from 1929 to 1933 had been triggered by monetary-policy mistakes. This train of thought was revived in the wake of the financial crisis that started in 2007.

Most countries had enjoyed a high level of employment and price stability before the financial crisis. Central banks were therefore surprised by the Lehman default and the resulting chain reaction in the financial system. And just like during the Asian crisis of 1997-1998 and the New Economy crisis of 2000, central banks in the advanced economies responded to the financial crisis with official rate cuts and the provision of liquidity for their banking systems. Despite those efforts, their economies continued to deteriorate in 2008 and 2009. The belief that cyclical downswings and crises could be overcome with the help of monetary policy alone suffered a blow.

Models on trial

Some central banks had to fall back on unconventional measures such as asset-purchasing programs in order to stabilize the situation. The unexpectedness and depth of the crisis triggered intense research from 2008 onwards as to whether the central banks' economic management models were sufficient. Based on these models, central bankers had tried to align the demand and supply of goods in times of normal capacity utilization. Pivotal targets were therefore full employment and moderate inflation.

Research on these models' failings soon focused on the capital markets. In the years up to 2007, credit volumes had increased sharply. The money borrowed was invested in properties and equities so that asset prices rose accordingly. Market volatility was, moreover, reduced during this credit boom as high liquidity made investors feel safe. When the financial boom ended in 2007, credit defaults triggered additional selling pressure resulting in an increased supply of real-estate properties and equities, which in its turn sent asset prices further down. The result was an additional increase in loan defaults and a deepening of the financial crisis.

New challenge

Analysis also revealed that the credit market behaves like a rubber band: During a credit boom, the volume of credit quickly expands while it quickly contracts in times of crisis. It is therefore no surprise that the Bank for International Settlements has examined potential credit booms and asset-price bubbles in its most recent annual report.² And indeed, warning signals are already to be found in several countries. The central banks of these countries are now faced with a new challenge: They must harmonize the two targets of a balanced economy and avoiding a credit boom. But these targets may be conflicting.

So governments will have to take a more prominent role. Governments have tended to focus on the management of aggregate demand. So they borrowed money to increase economic demand. Strengthening the supply-side has proved to be a more challenging task for governments in many countries. Meanwhile, many politicians have realized that only structural reforms will help to further deregulate product and labor markets and to promote entrepreneurship and innovation. This should foster additional growth which would, in turn, allow a more restrictive monetary policy so that unhealthy credit growth could be reined in sooner.

¹ Source: Ludwig von Mises: Monetary Stabilization and Cyclical Policy; 1928

² Source: Bank for International Settlements: 85th Annual Report; June 2015

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