WILL THERE BE A "NEW NORMAL" IN MONETARY POLICY ANY TIME SOON?

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1. **Will there be a "new normal" in monetary policy any time soon?** Firstly, one would have to be more precise what is ment by normal in this context. By "normal" we usually consider some past "average" of what we were used to or what most of us perceive as normal in behaviour or dress code. Something we can focus on and rely as a kind of benchmark. "Normal" in medecine for example means some range in blood pressure (120/90 mmHg) or cholesterol level (below 200 mg/dL) that does not harm our long term health and well being. Normal weather is the one that we are used to in a typical season in the number of years. When something deviates from that "normal", we consider it "abnormal", for examples now in summer in Europe or blood pressure above 200 mmHg, etc. In economics and in monetary policy benchmarking is more difficult than in medicine or meteorology. There are a lot of reasons why standards in economics are more difficult (to be explained later). But it does not mean we do not have views on "normality" in economy. For european economies, especially EU members (and candidates for EU), Maastricth criteria[1] are an attempt to have standards which can be considered normal macroeconomic

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[1] *They were adopted in 1991. https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/convergence-criteria-joining_en*

numbers. Yes, they are specific conditions for entering the Eurozone, but their importance is larger than the Euro itself. Before the Global Financial Crisis (GFC) most economists would agree what "normal" is. For example, most advanced economies would consider as "normal" inflation around 2%. The number was somewhat higher for emerging economies, but usually normality would be a single digit inflation. For inflation around 2% nominal interest rates around 5-6% were considered "normal"[2]. And there was a "normal way" of conducting monetary policy to achieve those values. It is called inflation targeting, which linked with central bank independence and indirect instruments of monetary policy were the standard. From the 1980-ies until 2008 a lot of central banks switched or were planning or at least aiming to achieve this standard. So normality was, for central banks, to focus only on a single goal and price stability and inflation targeting were the best ways to achieve it. Economies were growing steadily and everything seemed to be "just right". Some referred to it as "great moderation". Others considered that ideally central banking should be "boring". Flexible exchange rate, indirect instruments of monetary policy, deregulation and liberalization of financial markets were the way to run the economy and conduct monetary policy. Following dictums from the "Washington consensus" was recommended to almost all countries around the globe, from Australia to US, from Albania to Zimbabwe. But, GFC and its aftermath have destroyed this view. Central banking has changed and is still changing without clear direction how. The question therefore is what is the new normal and/or will there be a new normal if there is not one now, during rapid changes?

2. **GFC has changed central banking from 1990ties**. In May of 1996, I attended my very first Bank of International Settlements (BIS) All Governors' Meeting in Basel. I was eager to learn everything I could. The then Chairman of the BIS Board, Swedish Governor Urban Bäckström, was giving the following advice: "To be a good central banker one has to remember only four things: inflation is always too high, interest rates are always

[2] *Summers et al (2018). Episodes of very high interest rates like German of 14% in 70ties or mortgages rates of about 18% in US in 80ties were considered exceptional, not "normal".*

too low, if the economy is growing healthily it is because of the central bank, and if it has problems, blame it on the Finance Ministry." And he was not the only one with such wisdoms. The late Baron George (Eddie George, Governor of Bank of England at that time), while chain-smoking his cigarettes[3], would often say: "Central bankers have only one simple mantra to repeat and it is: "price stability". It was a simple world for central banks, back then. Today's central bankers have a more difficult task. They must take decisions in a more complex, dynamic and more uncertain world than ever. And there is no consensus on what exactly central banks should do. It may be useful to divide the history of central banking into periods as one of central banking's most prominent economists and historians, Charles Goodhart (2010) did. He distinguishes the periods of consensus and the periods of uncertainty. The periods of consensus in central banking are: 1) the Victorian era (1840s – 1914) with the main characteristic being the gold standard 2) government control (1930s – 1970s) with fiscal (Keynesian) dominance and 3) the triumph of the markets (1980s – 2007) with central bank independence and inflation targeting. He pointed out that the interregna between those periods are often confused without a clear consensus on what central banks should do. Does it sound familiar? Monetary policy and its "captains", the central banks, are changing course.

a. **Defining an appropriate target for a central bank has been questioned.** Arguably, the biggest change in central banking mandates since the 2007-GFC has been the explicit addition of the goal of maintaining financial stability. And this is very often the case, regardless of whether central banks do microprudential supervision or not. Even more so, regardless of whether their laws state it or not, central banks are expected to be the custodians of stability of the overall financial system. Systemic risks, how to measure and manage them, and the use of macroprudential tools are all relatively new games for central banks. But, every reputable central bank must publish not only its Inflation Report but a Financial Stability Report as well. Furthermore, the consensus that central banks should

[3] *Yes, it was possible to smoke at BIS in the last century, times they are 'changin'.*

aim at price stability[4] has been disputed. Some (Frankel, 2014 and Summers at al. 2018) claim that the goal of price stability (and inflation targeting as a tool to achieve it) is too narrow and central banks should target nominal GDP. Summers suggests nominal GDP growth of 5-6%. But nominal GDP is not only central banks's responsibility nor can it achieve the target by itself. This adds a new dimension; Who should define the target the government or the central bank itself? This has major implications for the governance structure of the central bank (Lybek and Morris, 2004). More central banks are adding employment/unemployment as their goal. Not long ago some were criticising the Fed for its dual mandate . However, the new PTA (Policy Target Agreement) between the Reserve Bank of New Zealand (RBNZ) and the NZ Government, mentions employment as a goal, on top of inflation. This was linked to the initiative to amend the RBNZ act accordingly. The problem with New Zealand moving in that direction is that they "invented" inflation targeting. Et tu, Brute? More and more discussions are focusing in Europe on the need to have the inflation target defined over an average period of time (say 2% over five years). This would mean that having inflation above 2% in some years is not a negative feature. Or have the target above 2%,

b. **Monetary policy should not be intentionally sectoral or have intended distributional effects.** Before GFC, it was accepted that monetary policy should not be sectoral, i.e. should not intentionally have distributional effects. In the early nineties, the Croatian National Bank still maintained the selective, sectoral loans, as they were called, from the primary emission to companies (via banks). It was considered a relic of socialism and a cause of inflation, making the quantity of money endogenous, outside central bank control. It was abolished by mid-nineties. Post GFC, ECB, considered among the most modern central banks, has not only tripled its balance sheet by buying government bonds and extending ultra cheap loans to banks, but – it is even buying corporate bonds.

[4] *Discussions on how to measure inflation, either with CPI, HICP, core or headline inflation seem small issue compared to more global goals.*

Within unorthodox monetary policy toolkit buying bonds from LVMH, Nestle or Shell is considered efficient monetary policy that will improve monetary transmission. So, Corporate Sector Purchase Program (CSPP), as it is officially called, is considered efficient and even necessary, a non-standard monetary policy invention while what the CNB did in the past was a relic of socialism that was pushing inflation up. Since 2017 ECB has been buying corporate assets on the primary market[5]. Otmar Issing (2018) warns that: "The biggest threat for independence lies in possible actions by the central bank itself. One comes from using instruments with distributional consequences, such as cheap credit to special groups, banks or companies." Only time will show if Mr. Issing, former chief economist of ECB, was right or CSPP as part of broader Asset Purchase Program by ECB has been a necessary invention, part of "whatever it takes" to save the Euro.

c. **Another change of heart post-GFC is to be seen in interest rates**. In the last century, the first lesson one would learn as a precondition for sound growth and an efficient allocation of resources was to have positive real interest rates. This is Econ 101, is it not? The ECB has nominal deposit interest rates in the negative territory for several years now. And it is not only the ECB. The central banks in Switzerland, Denmark, Japan and Sweden do the same, although not for the same reasons. Negative interest rates sound attractive to economists. So, some experts want to abolish cash so that negative deposit rates on individual's bank accounts could be a tool to fight the next crisis (and stimulate demand). With no cash, households cannot stash money, but must spend it to avoid being taxed with negative interest rates.

d. **View on capital controls has changed.** With the Washington consensus, the idea was that, after the current account liberalisation is fully done, the next step should be a complete liberalisation of the capital account. The free movement of capital around the world would lead us if not

[5] *https://www.euromoney.com/article/b12kqkczffm5dx/ecb39s-corporate-sector-purchase-programme-cspp-what-you-need-to-know*

to Utopia directly, then at least to continuation of Great Moderation, i.e. the reduction of volatility in the business cycle. Today we know better. For example, the Croatian National Bank (CNB) introduced capital controls around 2005 against the IMF advice and kept it for several years, until the GFC of course. This has understandably created a lot of criticism from the commercial banking community and (too) liberal economists. However, the CNB today is vindicated for its foresight. Capital controls are kosher again. This is a good example how each country should focus on its own specifics and not blindly follow, usually bona fide advice from multinationals or academics.

3. Why is it difficult to find the new normal?

About 10 years ago in 2008 during her first visit to LSE the Queen asked why nobody saw the financial crisis coming. Some did see the rise of risks (Ragu Rajan) but the bulk of the profession did not. Why? Because according to Nassim Taleb it was a Black Swan. And for sure there are more black swans swimming in the lake of the international financial community. How does it relate to the question of if there will be a new normal? I do not think we will son have the "new normal" as we did before the GFC because:

a. **Economies are changing rapidly, and so are central banks. In a rapidly changing world, it is difficult to say what is "normal" as normality is usually defined by steady past.** Changes in monetary policy after GFC clearly indicate that consensus of great moderation or "market dominance" (with inflation targeting and price stability) is not the "end of monetary history". As we today understand that Fukuyama's book had a short shelf life, so does a simple approach to monetary policy. We must also keep in mind changes in social attitudes. Populism is one of them. Will it put additional pressure on central bank independence? Will it influence central bank mandates, i.e. by putting more emphasis on employment in the future or subjecting banks to short-term political goals? Questions abound, but answers are few. Another, linked to it, is rising protectionism. There is no doubt that a China-US trade war will have consequences not only for those two countries but for the global economy as well. How will it affect growth, will it have an effect on the way monetary policy is conducted in the future? As discussed previously, central banks typically shy away from intentional distributional policies. But income and wealth inequalities are a hot topic. In the post-Piketty world, not even central banks can ignore these questions. One of the indications of such social changes translating into central banks mandates is the mentioned new PTA in New Zealand. Will others follow?

b. **Financial systems have became more complex and less predictable**. Other important factors to pay attention to are digitalisation of financial services in general and cryptoassests. Digitalisation is changing the landscape of the financial industry very rapidly. There is an abundance of literature on this topic, without a consensus view of the outcome for central banks. Some central banks embrace Fintech and promote their own sandboxes to allow stakeholders to play and see the consequences. Others ban outright trade in Bitcoin, for example. Some play with the idea to issue their own digital currencies, the Central Bank Digital Currency (CBDC), like Riksbank, the Reserve Bank of India, the People's Bank of China, etc. Others, like the Swiss national bank are vocal with warnings on the unmeasurable risks of issuing CBDC. All seem to agree that the distributed ledger technology (blockchain) has a lot of potential, but it is not clear when its daily use will be functional and efficient. In the meantime, Iceland can hope that not all miners will move to their island and that they are left without electricity for their daily use. Obviously, digitalisation is here to stay and expand, so the challenges are how to reap the benefits and, at the same time, adequately regulate and manage risks, especially the systemic ones. Here, I will only mention the growing issue of cybersecurity. With an increasing interdependence and interconnectivity of institutions, including central banks, the consequences of a potential cyber-attack for the stability of the financial system are growing. Artificial intelligence (AI) and machine learning will also play an important role. Will AI replace central bankers one day? Probably governors need not worry about their jobs in the short run. The other day I asked Siri over my iPhone: "Hey, Siri, should the US raise its interest rates?" Siri replied: "My web search turned something up for: US raise interest rates" and suggested five articles, all recent and relevant. I can only wonder if Bezos' Alexa would have a better response. But, I am sure that in five years from now their answers will be more sophisticated. Obviously, there are benefits as well as risks in using AI for central banks. This is well explained in Wuermeling (2018). Some central banks like the Bundesbank (and I am sure others) are using AI to monitor parts of the financial markets. Combined with big data and data analytics, and central banks have plenty of it, AI could be wisely used to increase our knowledge. But supervisors should beware as relying too much on AI can make markets less stable. We do not know, so let us be cautious. Remember the LTCM Fund? Two Nobel laureates were certain they had managed all their risks. The real world proved them wrong.

My last comment on AI is that, to the best of my understanding, AI can deal with measurable risks. As the old saying goes: "Not everything that counts can be counted, and not everything that can be counted counts.". This is the very nature of human behaviour and our economic system.

Digital currencies by central banks, cashless societies, how will it affect the traditional transmission mechanisms, we do not know yet. Are we facing secular stagnation? Monetary policy has been shaped by political influences. By taking additional tasks on their back, central banks became more vulnerable to political influences. So has their environment. And they are part of societies, so as societies values change, so will central banking. Look at Trump and its pressure on the FED, or Turkey or India. Black swans indicate that we shold not try to find a "new normal" and aim economies with monetary policies towards those standards (independend central banks, inflation targeting aiming inflation "close to but below 2%) but make them resilient.

c. **Globalization has put focus on all countries, not just advanced ones. Diversity among countries is a challenge for "new**

normal". Before GFC, it seems that globalization forces and in general convergence of countries were justifying the "one size fits all" approach. For example, Basel supervision standards are supposed to be valid for most countries, having in mind "proportionality". But I think that even before GFC those "normal" standards did not take into account diversity among countries. Benchmarks in medicine are produced by large numbers of observations (we know that people that smoke have a higher probability to get lung cancer. However some smoke their whole life and do not get one and some unfortunately have lung cancer without ever smoking a cigarette, but probabilities are high) and are averages. I doubt that in medicine there is a "one size fits all" approach in many illnesses. And variability among economies in the world is much larger than among human beings on the planet. Height and weight of humans have much less extremes or standard deviation than say GDP/per capita, inflation, population of countries and probably any other indicator of an economy. Saudi Arabia has a PPP GDP about 40 times larger than one of its border countries, Yemen. Think what would that mean for say adult height? Or even weight? Blood pressure etc... And this variability among countries has to be taken into acount when discussing a "new normal". Therefore applying averages to all countries does not sound right to me. So, one should expect not to have one "new normal" but a lot of "new normals". Similar to the concept of multiple equilibria. Or even more so. Modern trends in medicine refer to personalized medicine. One tries to tailor the treatment for a patient based on one's genome. It does not mean that each country should have its "normality", some could be grouped. Probably similar countries could have similar "normal" indicators, but comparing for example Ethiopia with USA does not make much sense. How can one even think of giving similar advice to those so diverse countries?

4. What to do?

If it will be difficult to have a simple "new normal", what should one do? It is much better to work on resilience, be prepared for rapid changes and be unorthodox. Actually a lot of measures that central banks (advanced ones) have used since GFC to save the financial world from melting down are called unorthodox. Well it seems that more than a decade since it started, now they are quite "orthodox" i.e. normal. What the future brings is anyone's guess. Therefore, let's work on buffers and resilience, be innovative and "think outside the box".

Will there be a new period of consensus within central banking or new normal in the distant future? Not possible to say, but it does not seem we will have one in the next couple of years. Therefore, my final humble advice to policy makers in any country is: think about your country and first and foremost trust yourself. Try to find the best ways on how to cope with future challenges that are appropriate for your country and to assist your people.

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