# The courage to normalise monetary policy

Stephen Roach | Yale University | 03 October 2017

Three cheers for central banks! That may sound strange coming from someone who has long been critical of the world's monetary authorities. But I applaud the US Federal Reserve's long-overdue commitment to the normalisation of its policy rate and balance sheet. I say the same for the Bank of England, and for the European Central Bank's grudging nod in the same direction. The risk, however, is that these moves may be too little too late.

Central banks' unconventional monetary policies – namely, zero interest rates and massive asset purchases – were put in place in the depths of the 2008-2009 financial crisis. It was an emergency operation, to say the least. With their traditional policy tools all but exhausted, the authorities had to be exceptionally creative in confronting the collapse in financial markets and a looming implosion of the real economy. Central banks, it seemed, had no choice but to opt for the massive liquidity injections known as quantitative easing.

This strategy did arrest the free-fall in markets. But it did little to spur meaningful economic recovery. The G7 economies (the United States, Japan, Canada, Germany, the United Kingdom, France, and Italy) have collectively grown at just a 1.8% average annual rate over the 2010 to 2017 post-crisis period. That is far short of the 3.2% per annum average rebound recorded over comparable eight-year intervals during the two recoveries of the 1980s and the 1990s.

Unfortunately, central bankers misread the efficacy of their post-2008 policy actions. They acted as if the strategy that helped end the crisis could achieve the same traction in fostering a cyclical rebound in the real economy. In fact, they doubled down on the cocktail of zero policy rates and balance-sheet expansion.

And what a bet it was. According to the Bank for International Settlements, central banks' combined asset holdings in the major advanced economies (the US, the eurozone, and Japan) expanded by $8.3 trillion over the past nine years, from $4.6 trillion in 2008 to $12.9 trillion in early 2017.

Yet this massive balance-sheet expansion has had little to show for it. Over the same nine-year period, nominal GDP in these economies increased by just $2.1 trillion. That implies a $6.2 trillion injection of excess liquidity – the difference between the growth in central bank assets and nominal GDP – that was not absorbed by the real economy and has, instead been sloshing around in global financial markets, distorting asset prices across the risk spectrum.

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Normalisation is all about a long-overdue unwinding of those distortions. Fully 10 years after the onset of the Great Financial Crisis, it seems more than appropriate to move the levers of monetary policy off their emergency settings. A world in recovery - no matter how anemic that recovery may be - does not require a crisis-like approach to monetary policy.

Monetary authorities have only grudgingly accepted this. Today's generation of central bankers is almost religious in its commitment to inflation targeting - even in today's inflationless world. While the pendulum has swung from squeezing out excess inflation to avoiding deflation, price stability remains the *sine qua non* in central banking circles.

Inflation fixations are not easy to break. I can personally attest to that. As a staff economist at the Fed in the 1970s, I witnessed first-hand the birth of the Great Inflation - and the role played by inept central banking in creating it. For years, if not decades, after that experience, I was convinced that renewed inflation was just around the corner.

Today's generation of central bankers has dug in its heels at the opposite end of the inflation spectrum. Wedded to a Phillips curve mentality conditioned by the presumed tradeoff between economic slack and inflation, central bankers remain steadfast in their view that an accommodative policy bias is appropriate as long as inflation falls short of their targets.

This is today's biggest risk. Normalisation should not be viewed as an inflation-dependent operation. Below-target inflation is not an excuse for a long and drawn-out normalisation. In order to rebuild the policy arsenal for the inevitable next crisis or recession, a prompt and methodical restoration of monetary policy to pre-crisis settings is far preferable.

A failure to do this was, in fact, precisely the problem during the last pre-crisis period, in the early 2000s. The Fed committed the most egregious error of all. In the aftermath of the bursting of the dotcom bubble in early 2000, and with fears of a Japan scenario weighing heavily on the policy debate, it opted for an incremental normalisation strategy - raising its policy rate 17 times in small moves of 25 basis points over a 24-month period from mid-2004 to mid-2006. Yet it was precisely during that period when increasingly frothy financial markets were sowing the seeds of the disaster that was shortly to follow.

In the current period, the Fed has outlined a strategy that does not achieve balance-sheet normalisation until 2022-2023 at the earliest, two and a half to three times as long as the ill-designed campaign of the mid-2000s. In today's frothy markets, that's asking for trouble. In the interest of financial stability, there is a compelling argument for much speedier normalisation - completing the task in as little as half the time the Fed is currently suggesting.

Independent central banks were not designed to win popularity contests. Paul Volcker knew that when he led the charge against raging inflation in the early 1980s. But the approach taken by his successors, Alan Greenspan and Ben Bernanke, was very different, allowing financial markets and an increasingly asset-dependent economy to take charge of the Fed.

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For Janet Yellen – or her successor – it will take courage to forge a different path. With more than $6 trillion of excess liquidity still sloshing around in global financial markets, that courage cannot be found soon enough.

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