



THEME 02

# The future of monetary policy and central banks

DEEP  
TRANSITIONS

MACRO  
ECONOMICS

MONETARY  
POLICY

In the past months, central banks and governments have announced enormous economic aid packages to prevent their economies from freefalling after the coronavirus crisis. This crisis has accelerated macro-economic trends and, in response to this, central banks are reformulating their key objectives and common purpose. By viewing the economic issues of the twenty-first century from a perspective of long-lasting, economy-transcending developments, we will gain insight into the future of monetary policy.

## Our observations

- The Fed has recently been making a thorough analysis of the theoretical framework on which it bases its monetary policy. Last month, Jerome Powell, president of the American central bank, [announced](#) that the Fed will maintain an average inflation target of 2% as well as strive for “maximum employment”. This new approach to monetary policy means that the Fed will only raise interest rates in case of maximum employment and when inflation is higher than 2%, rather than when employment is below the level of maximum employment (which would mean wages would increase and monetary policy would have a delayed effect on the economy) as it has been the case until now. A [flatter Phillips curve](#), indicating a weaker relationship between unemployment and inflation, as well as the deflationary effects of [globalization](#) and [digitalization](#), will ensure that low inflation remains the norm for a long time. And by expanding its employment mandate, the Fed is committing itself to stimulating more inclusive economic growth.
- Christine Lagarde, president of the European Central Bank, has [promised](#) that the ECB will include sustainability goals in its operations, such as buy-back programs for corporate bonds. This makes the ECB the first large central bank to actively include sustainability goals in its monetary policy. Since her appointment in December 2019, Lagarde has announced that the ECB will begin with a “strategic review” of the ECB objectives, with [climate change](#) seen as a “mission-critical” priority, and that the ECB will take on an active role with respect to Europe’s [\(geopolitical\)](#) sustainability strategy.
- Last month, Shinzo Abe, Japan’s, longest-serving prime minister, [announced](#) that he would be stepping down because of health concerns. The new prime minister, Yoshihide Suga, [has said](#) he will continue Abenomics, Abe’s controversial economic policy since 2012 that has three pillars: i) very loose monetary policy by the Bank of Japan, ii) active fiscal policy to stimulate the Japanese economy and iii) structural reforms. The Bank of Japan buys government bonds to keep interest rates low (a strategy called “[yield curve control](#)”, because of which the Japanese government has insufficient financial means for its fiscal policy. As a consequence, Japan has the highest government debt-to-GDP ratio in the world, about [240%](#) of GDP, which will nevertheless remain fundable because of the low interest rate. Since the coronavirus crisis, more countries – either implicitly or explicitly – are following this strategy to finance economic measures. In the longer term, this strategy will become more popular as a result of green investments, ageing populations and the increasing need for investments in [resilient](#) systems (e.g. [strategic production chains](#), [global value chains](#), the [care system](#)).
- As a consequence of the coronavirus crisis and the accompanying economic monetary and fiscal measures, government debts will rise considerably (an estimated [20 percentage points](#) of global GDP). But even before the coronavirus crisis, global debt had been rising in the past decade because of the [financial crisis](#) of 2007-2008. Extending the timeline, we see that global debt has risen strongly since the 1980s due to the financialization and liberalization of world trade and capital accounts inspired by [neoliberalism](#). And yet, the [economic literature](#) provides few guidelines regarding the optimal amount of government debt. Though it was previously assumed there was a natural ceiling, [Modern Monetary Theory](#) (MMT) holds that debt ratios (for countries that issue their own currency) are irrelevant, as are budget deficits in an environment of low inflation and unemployment.

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## Connecting the dots

There are largely [three major paradigms](#) to be distinguished in macro-economic theory on monetary policy. The first began after the Great Depression of the '40s and was based on Keynesianism. This paradigm emphasized the role of contra-cyclical fiscal policy, as the market and economy are not naturally correcting mechanisms. This was institutionalized more broadly in the post-war Bretton Woods system, but after relinquishing the gold standard in 1971 (the "[Nixon shock](#)") and the problems of stagflation (high inflation combined with high unemployment) that appeared unsolvable in the Keynesian scheme, the emphasis shifted to money supply to keep inflation low. According to this "monetarism", governments were to focus on creating the right conditions for sustainable and long-term growth while monetary policy kept the business cycle in check. This paradigm was specifically inspired by the theories of Milton Friedman and his [work](#) on the role of money supply in the macro-economic problems of the Great Depression. From the '90s, a synthesis between these paradigms emerged, with independent central banks formulating an explicit inflation target for the medium and the long term, making use of short-term interest rates and monetary policy geared towards guaranteeing sufficient liquidity in financial markets. Price stability was seen as the most important condition for growth, and a crucial factor here is that the monetary instruments to achieve this are in the hands of independent, technocratic central banks, at the cost of a democratic deficit (central bankers aren't democratically elected but have enormous power), while fiscal policy is geared towards balancing government debt (expenditures) and the redistribution of wealth (taxes).

But since the financial crisis of 2007-2008, we've been seeing a number of new problems that can't be solved with this paradigm, such as persistently low inflation and unemployment (a "broken" or "flat" Phillips curve), growing inequality, both private as well as public debt, and structurally lower aggregate demand. The coronavirus crisis has accelerated many of these macro-economic trends, and reassessed the relationship between monetary and fiscal policy. Structural characteristics of a post-coronavirus economy will definitely include: i) structural micro-economic inefficiencies (e.g. restaurants and hotels with fewer guests, more safety precautions in production chains, larger reserves and supply for strategic sectors), ii) a larger role for the state in the economy, iii) higher public debt, iv) lower consumer spending and corporate investment due to high insecurity leading to lower inflation. The latter is why the growing debt remains fundable, but also why there is limited room for tightening monetary policy by, for instance, raising short-term interest rates based on predictive inflation indicators. Governments and central banks respond to this by fundamentally contemplating their common purpose and reformulating their key objectives. Some [decide](#) that monetary policy should stimulate growth and have more milder inflation targets (as in Japan), others that fiscal policy should be unrestrained when it comes to stimulating economic growth (e.g. MMT), while a radical group even advocates [negative interest rates](#) (e.g. as a redistribution mechanism and to stimulate spending and investment). Outside of these macro-economic developments, there are also broader, economy-transcending developments determining the future of monetary policy and central banks.

First, back-to-back technological revolutions (e.g. the steam engine, the automobile, IT) have led to industrial modernity with certain rules of play or "metarules" (e.g. strong productivity growth, the use of fossil fuels). Besides enormous wealth, these rules also lead to persistent

socioeconomic inequality as well as ecological degradation and climate change. To solve these problems, it will not suffice to merely double down on technology or organize individual systems more efficiently: nothing less than a [Deep Transition](#) is required to thoroughly redefine these metarules (e.g. the principle of circularity, internalizing externalities). Central banks and monetary policy can be important stimulators and coordinators by not only allocating capital where it will be most profitable in a narrow economic sense, but by playing a facilitating role in a broader system change. Reforms in the financial system, and with that, "incentive structures" are an important prerequisite for systematically changing the behavior and actions of companies, governments and consumers. In Europe, the ECB is taking the lead in this when it comes to climate change and likewise the Fed in the U.S. They could set an example for other regions.

At the same time, a more "geo-economic" outlook on economy is emerging, bringing fiscal and monetary policy with it. In the '90s, central banks became politically independent at the height of American hegemony and when the world was widely believed to be becoming "[post-historical](#)". There was a less strategic approach to technology and economic policy, as the general expectation was that countries would develop into liberal democracies with free market capitalism and mutual differences would become negligible. But now that we're on the brink of a [new hegemonic cycle](#), the role of central banks and fiscal policy in the economy is being reconsidered in regard to matters such as national security or strengthening countries' own geo-economic power as compared to their rivals'. This is also the underlying geo-economic reason why the trade war between the U.S. and China is fundamentally a [technology war](#), why [production and value chains](#) are now being evaluated more strategically (e.g. "[sensor-based technologies](#)" such as [5G, AI](#) or [quantum technology, natural resources](#), medical materials for a [coronavirus vaccine](#)). And that also means that central banks may become more politicized in order to fund fiscal and geo-economic policy (e.g. weak exchange rates for a stronger competitive position, monetary loosening for strategic industries and financing government spending such as on defense).

Finally, we're seeing that technological innovations can change the effectiveness of instruments and the core of central banks' monetary policies. Because of fintech, more and more financial transactions and interactions are taking place outside of banks and established financial institutions are disintermediating (e.g. peer-to-peer lending). In addition, digital tokens and cryptocurrencies are offering [new instruments](#) for central banks to conduct monetary policy: i) the reallocation of risk and guarantee of stability within the financial system through citizen deposits directly to central banks, ii) a more substantial grip on the effects of monetary policy as money is managed digitally more often and iii) allowing technology companies to enter the financial sector so that data can be utilized towards more financial innovations and competition, leading to higher price efficiency. This way, central banks can combat different forms of market failure (e.g. growing inequality due to the "search for yield" of capital investors), gear monetary policy more towards (geo)strategic objectives (e.g. climate change, strategic innovations), stimulate innovation (e.g. through financial inclusion based on digital credit scores, a more [decentral economy](#) with less systemic risk). Central banks and monetary policy are thus becoming important drivers of innovation and new economic models and principles.

## Implications

- The above-mentioned technological innovations make the scenario of negative interest rates even more realistic, because cash is falling into disuse, banks are further becoming disintermediated (creating more substantial effects of monetary policy instruments on the real economy), and central banks are more directly influencing consumers. But a regime of negative interest rates also entails significant macro-economic risks, such as when inflation rises (and central banks can't raise interest rates given the high debt) and further destabilizing the financial system.
- In fragile democracies and authoritarian countries, there's a high degree of "[economic populism](#)" with a strong emphasis on economic growth and income redistribution, while the risks of budget deficits, inflation and other external limitations (e.g. international market reactions to policy) are trivialized. This has always led to higher political risk in these countries, as international investors can see through this and appreciate independent central banks. Now that democratic-liberal markets are taking a more political and (geo)strategic view of central banks' monetary policy, the geopolitical will increase in capital markets, resulting in higher inefficiencies and new forms of market failure (such as the preservation of important but loss-incurring industries, i.e. zombie markets).
- Besides climate change and growing inequality, another important sociocultural system change in societies is ageing, and the accompanying changes in consumer spending, fiscal positions and pressure on the care system. Japan is a precursor in this, with a severely ageing population, and one of the reasons the central bank finances the government's fiscal policy, as it includes investing in technologies for [gray economies](#) where the average life expectancy is 100 years.