

ECONOMIC VIEWPOINT

Less Leeway for Central Banks Is There Anything Else for Them to Do?

Many central banks have few leeway in the face of a possible worsening economic slowdown. Part of the solution to this problem is for governments to implement measures to stimulate the economy. This, however, would not be an ideal scenario, especially for countries where public debt is already very high and where concerns about long-term public finance sustainability could be questioned. Heavy pressure may therefore remain on central banks to find new ways of operating, especially in Europe and Japan. The monetary policy framework could be reviewed, entailing changes to inflation targets or alternatives to those targets. In addition, the use of unconventional tools could become even more widespread with the possible introduction of monetary financing, commonly referred to as “helicopter money.”

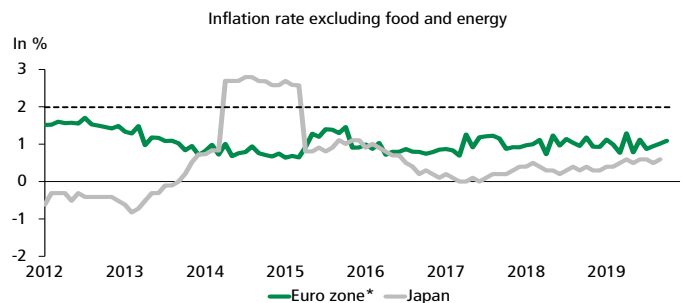
Targets More Difficult to Meet

In most advanced countries, central banks adjust their monetary policy based on the achievement of an inflation target that is generally around 2% annually. Yet, many central banks now seem to have trouble reaching their target, which means keeping interest rates low and other stimulus measures in place.

The European Central Bank (ECB) and the Bank of Japan (BoJ) are perfect examples. Both adopted negative interest rates, but that has not been enough to return to their inflation target (graphs 1 and 2). The situation might become even more complex in the coming quarters, as the global economic downturn could worsen, adding deflationary pressures.

GRAPH 2

Inflation struggles to accelerate in the euro zone and Japan



*The European Central Bank is aiming for lower inflation, but close to 2%, which is generally interpreted as an inflation rate of 1.8% or 1.9%.

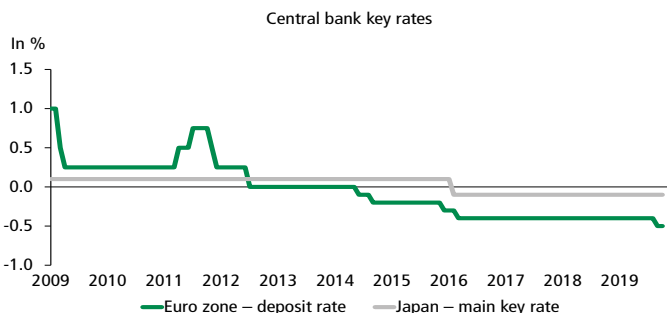
Sources: Datastream et Desjardins, Economic Studies

Other central banks in Europe have followed in the footsteps of the ECB with negative interest rates and are faced with a similar challenge. The Bank of England has more ammunition to defend its inflation target, as its key interest rate remains in positive territory at 0.75%. This rate is not very high, however. Canada and the United States appear to have more leeway, with key rates at 1.75%¹. Inflation in those countries is also already close to the target, meaning that they have no catching up to do

¹ In Canada, the target for the overnight rate is 1.75%. In the United States, the target range for the federal funds rate is between 1.50% and 1.75%.

GRAPH 1

The European Central Bank and the Bank of Japan both have negative rates



Sources: Datastream et Desjardins, Economic Studies

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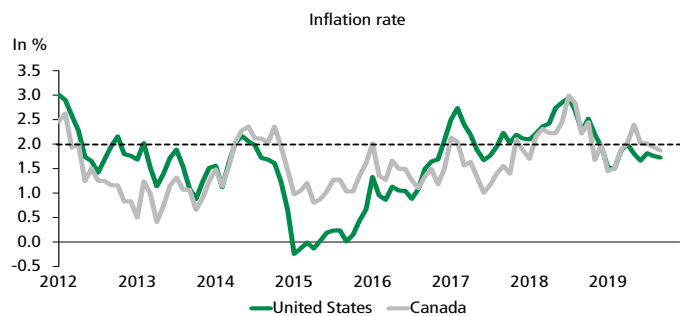
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(graph 3). Nonetheless, even the Bank of Canada (BoC) and the Federal Reserve (Fed) do not have as much intervention capacity as before. Should a major shock occur, these central banks could also struggle to defend their inflation target.

GRAPH 3
Since 2017, inflation has been hovering around 2% in Canada and the United States



Sources: Datastream et Desjardins, Economic Studies

Changing Targets

Would it not be better, then, to abandon these targets? That would mean foregoing their advantages. Low, stable and predictable inflation makes it easier to distinguish movements in the prices of various products and services. Better consumption and investment decisions can therefore be made. This also protects the purchasing power of individuals whose income does not keep pace with price increases. Financially speaking, medium- and long-term interest rates are typically lower in an inflation targeting regime given that there is less uncertainty about future price movements. Lastly, a well-controlled inflation target has the advantage of strengthening itself due to its influence on inflation expectations.

It is better to try to change inflation targets than abandon them completely. Targets lowered to around 1% would mean that most central banks would now be meeting their target. There would also be other potential advantages, particularly as concerns protecting the purchasing power of those whose income is not as well indexed.

The problem of central banks running out of ammunition would, however, be compounded with lower targets because the lower real interest rate limit would be higher. Assuming that the limit of the nominal interest rate of overnight funds on the interbank market is -0.5%, the lower limit of this rate in real terms would be -2.5%, with a well-controlled inflation target of 2%. This limit would change to only -1.5% with an inflation target of 1%, meaning that there would be reduced leeway to stimulate the economy. The chances of deflation would also be higher.

If the objective of overhauling the monetary policy framework is to increase central banks' leeway, the option of raising inflation targets appears to be more advisable. Using the previous

example, by targeting inflation at 3%, the real overnight rate could drop as far as -3.5%. We could go even lower if nominal rates can be reduced further in negative territory or by targeting higher inflation. Some studies suggest targeting up to 4%². Among advanced countries, Australia currently has the highest inflation target, ranging from 2% to 3%. South Korea used to have a median target of 3%, but that target has been 2% since 2016.

In theory, if central banks were to adopt higher inflation targets, that could also help accelerate certain macroeconomic adjustments. For example, real wages could potentially be adjusted more easily and allow the labour market to recover faster from a recession. In addition, a higher inflation rate could help reduce the debt burden if nominal income were to increase faster.

The fact remains that, with this approach, the purchasing power of some individuals could deteriorate further. Tolerating higher inflation might also make inflation more unstable over time and more difficult to predict. Inflation expectations could become not as well-anchored, which could complicate the work of central banks. There is an adage in economics that if you start flirting with inflation, you will have to marry it!

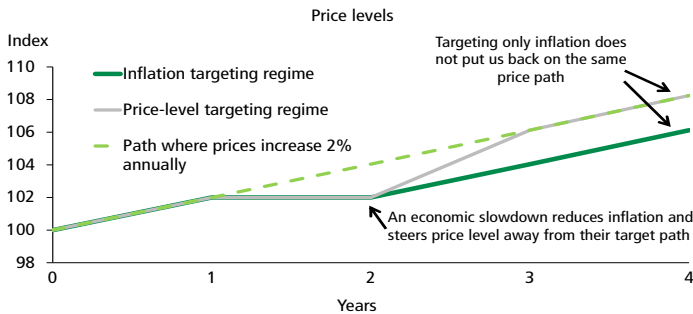
Targeting Price Levels, Not Price Variations

Another possible option for central banks would be to target price levels rather than price variations. For example, let's assume that the price index targeted by a central bank was 100 in 2018. A level of 102 could be targeted for 2019, then 104 for 2020, and so on and so forth based on the average growth rate sought. These average growth rates could remain at around 2%, like most current inflation targets. Nevertheless, additional leeway would be freed up with this approach.

First, by staying near the target price path, inflation expectations could technically be better anchored in the long term. After a period of low inflation, a period of higher inflation would be required to put us back on the target path. This is a major difference from a regime simply targeting price variations, where periods of lower or higher inflation do not have to be offset in this way (graph 4 on page 3). Given these movements, which compensate for any accumulated gaps, inflation expectations could then vary in the short or medium term. This would not affect the effectiveness of monetary policy; quite the contrary. It would cause temporary movements in real interest rates, giving central banks more leeway. If inflation were too low during a certain period, inflation expectations would temporarily rise and

² Laurence BALL, *The Case for a Long-Run Inflation Target of Four Percent*, IMF, June 2014; Pierre FORTIN, *A Stable 4% Inflation Could Get Canadians One Half Million More Jobs*, Working Papers 1604, CREFE, January 2016.

GRAPH 4
The price path over the long term varies depending on the regime selected



Source: Desjardins, Economic Studies

real interest rates could drop further. The economy would then be more easily stimulated if needed with this type of target.

Would expectations shift as foreseen?

The main criticisms of price-level targeting are the greater difficulty in understanding them and the uncertainty as to the anticipated change in consumer and business inflation expectations. After an extended period of low inflation, consumers and businesses might not believe in price acceleration to offset the accumulated gap. In that case, lower inflation expectations would raise real interest rates and the leeway for stimulating the economy would be reduced.

Central banks would have to maintain a high degree of credibility in such a regime. In particular, they would have to be convincing about their ability to influence prices at all times and in the desired way. However, this could prove quite a challenge, especially in situations similar to Japan’s and the euro zone’s, where interest rates are already very low and unconventional tools, such as asset purchases, have already been widely used.

For the same reasons, it could also be difficult for some central banks to raise their inflation target should this option be preferred. If economic agents do not adapt their expectations to a change in target, more monetary easing would be required to generate the required inflation. The problem with central banks’ reduced leeway would then be even more flagrant.

New Tools Need to Be Found

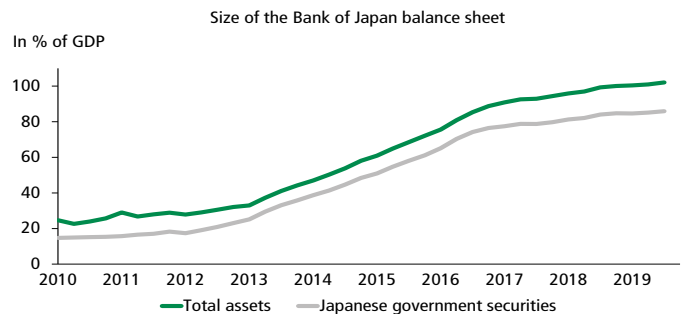
In addition to standard interest rate adjustments, central banks now use various tools to influence the economy and keep prices in check. Among these is forward guidance, which consists in providing more information on the future path of key interest rates. This increases the influence that central banks have over longer-term interest rates. Massive asset purchases are another tool, contributing to the same result in addition to encouraging

investors to look to other types of assets and take more risks. Lastly, there are negative interest rates.

However, these tools have limitations. Interest rates that are too low in negative territory can end up doing more harm than good³. For the same reasons, forward guidance and asset purchases cannot be used to continually reduce long-term rates. A central bank also cannot buy more government bonds than there are on the market.

There is always the option of buying corporate bonds, or even shares, to widen the pool of available assets, but that would mean that central banks would be taking much more risk, which is not desirable. Low-risk government securities should continue to be the ones most purchased by central banks. This has not prevented the size of the BoJ balance sheet from exceeding 100% of its GDP (graph 5). This is considerably more than any other central bank has reached. However, public debt would have to spike in Europe and the United States for the ECB and the Fed to go that far.

GRAPH 5
The size of the Bank of Japan’s balance sheet has exceeded 100% of GDP

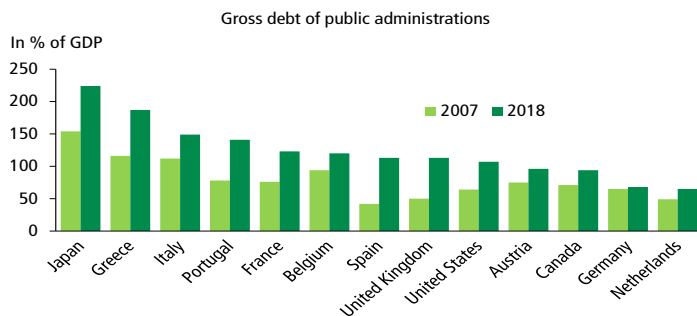


Sources: Datastream, Banque of Japan and Desjardins, Economic Studies

This brings us to governments that could adopt expansionary policies to help central banks stimulate the economy and raise inflation. Part of the debt issued to finance expansionary fiscal policies could be purchased by central banks to keep interest rates low, even long-term ones. However, there is no guarantee that this would last very long. Sooner or later, fears could rise about countries’ debt levels and the risks to long-term financial stability (graph 6 on page 4). There could also be a decline in consumer spending and business investment in anticipation of future tax hikes to pay back public debt, which is referred to as the “Ricardian equivalence” principle.

³ [Five Years of Negative Rates in Europe and It’s Far from Being Over!](#), Desjardins, Economic Studies, *Economic Viewpoint*, September 10, 5 p.

GRAPH 6
Debt levels have risen sharply in many countries



Sources: Datastream and Desjardins, Economic Studies

Helicopter Money

Rather than counting on additional efforts from already heavily indebted governments, an alternative solution would be monetary financing, also known as “helicopter money.” With money raining down on them, central banks would stimulate the economy through direct money transfers to governments, consumers or businesses. Public debt would not rise with this approach.

The principle was originally introduced by the father of monetarism, Milton Friedman. Ben Bernanke reiterated it in the early 2000s, stating that it was the ultimate weapon for combating deflation⁴. However, there is still no consensus on this potential tool and, especially, on how it should be used. Three former central bankers, in collaboration with another researcher, were the focus of attention in August when they laid out a procedure based on cooperation between monetary authorities and governments⁵. Broadly speaking, a central bank could decide on an amount to deposit in a special fund, which would be managed by the government. The government, in turn, would decide how that amount would be spent in the economy.

Determining the amounts to be injected to influence inflation by a few tenths of a point would not be easy⁶. The final effect could depend on a number of factors, and it would certainly be wise to start with smaller amounts to avoid sending inflation into overdrive.

⁴ Ben BERNANKE, [Deflation: Making Sure «It» Doesn't Happen Here](#), Speech by Mr Ben S Bernanke, Member of the Board of Governors of the US Federal Reserve System, before the National Economists Club, Washington, DC., November, 21 2002.

⁵ Elga BARTSCH, Jean BOIVIN, Stanley FISCHER and Philipp HILDERBRAND, [Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination](#), SUERF, The European Money and Finance Forum, No. 105, October 2019.

⁶ [The helicopter money: How does it work and how much would it take?](#), Desjardins, Economic Studies, *Economic Viewpoint*, October 6, 2016, 6 p.

There is no telling whether central banks could resign themselves to using a tool as extreme as this to keep their credibility as to achieving their inflation targets. This would truly be a tool of last resort. Governments would also have to be kept from further stimulating the economy, without the debt burden causing major upheavals in financial markets.

Other Objectives Contemplated

Central banks might prefer to simply give themselves more flexibility by, for example, being more tolerant of low inflation. In particular, inflation targets could be viewed as averages to be achieved over the long term, but less so over the short and medium term. Central banks could then focus on other objectives, such as the state of the economy, the labour market or financial stability. This is the trend that some of them have already been following. For example, the Fed has always placed a great deal of attention on the state of the economy and the labour market, even since adopting an official inflation target in 2012. Some economists would like to see the Bank of Canada Act amended to include an official employment support objective⁷.

However, the addition of the target may complicate the work of central banks. The monetary policy decisions needed could vary according to each objective sought. A single target for nominal GDP could consider both inflation and the state of the economy or labour market. The target could correspond to estimated potential economic growth plus a desired inflation rate for the long term. That said, potential economic growth tends to vary over time, and the target might need occasional revisions. Slightly longer timeframes for obtaining GDP data could also be problematic, as could their many revisions. Consequently, managing such a target may be complicated. This would be all the more true for a target on the level of nominal GDP rather than its variation.

As for financial stability, central banks could try to limit excessive debt or the formation of bubbles in some asset classes. The work of the Bank for International Settlements suggests that greater consideration of financial imbalances in the conduct of monetary policy could reduce the risk of a financial crisis and the risk of ending up in situations where interest rates must be kept very low for an extended period of time⁸.

However, it would be difficult to establish specific financial stability targets. Estimating the ideal debt level or the fair value of assets is not easy. Nevertheless, central banks are showing increasing concern over these issues. For example, the BoC adjusts its monetary policy by considering different sets of risks

⁷ [Letter Addressed to Honourable Bill Morneau, Federal Minister of Finance of the Government of Canada, by Canadian Economists in Support of a Multi-Goal Mandate for the Bank of Canada](#), May 28, 2018.

⁸ Claudio BORIO and al., [What anchors for the natural rate of interest?](#), BIS Working Papers, N° 777, March 26, 2019.

with an effect on financial or price stability. Canadian household debt and the state of the housing market are currently arguments for greater caution with respect to potential interest rate cuts.

Lastly, we should not be relying solely on central banks and monetary policy for financial stability. Governments and international organizations definitely have an important role to play in this regard through macroprudential measures and an appropriate regulatory framework.

Big Decisions Could Be Made in the Coming Years

The use of inflation targets is based on solid foundations and carries many advantages. However, the current situation, where targets are more difficult to reach despite very accommodative monetary policies, gives pause for thought.

There is still considerable pressure to find new tools in order to be able to cope with a new economic shock and another weakening of inflation. Forward guidance, massive asset purchases and negative interest rates have given central banks new leeway, but there are nonetheless limitations to their use. Governments could offset part of this problem, and the idea of direct financing from central banks could carry on. However, this would be the last resort for spurring inflation.

Central banks may amend their monetary policy framework in the coming years to give themselves new leeway, but no clear option stands out. Each of the options suggested has its advantages and drawbacks. The least restrictive seems to be opting for more flexibility when inflation is low and considering objectives complementary to monetary policy. This seems to be the path favoured over the past few years, but is it enough? We must make certain that keeping interest rates low for many years will not thrust us into another period of financial instability and an abrupt correction in employment.

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