The evolution of monetary policy:
A new era for central banks?

Central banks around the world are trying to see how to encourage growth in the wake of crisis, and monetary policy is entering a new phase. We're entering a period where each economy has different issues to tackle, and the biggest story is the increase in volatility and decrease in cross-border correlations of interest rates.

The current challenges facing the major economies require very different approaches to monetary policy, which will create increasing disparity between central bank interest rates. The United States Federal Reserve has to work out the limit of the non-accelerating inflation rate of unemployment (NAIRU). The Bank of England has productivity concerns and a potentially worrying housing boom to deal with. Many emerging markets face the traditional challenges of avoiding overheating, while in China the question becomes how to reform the financial sector while not tightening policy too much.

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Traders at work in the crude oil and natural gas options pit at New York's Mercantile Exchange
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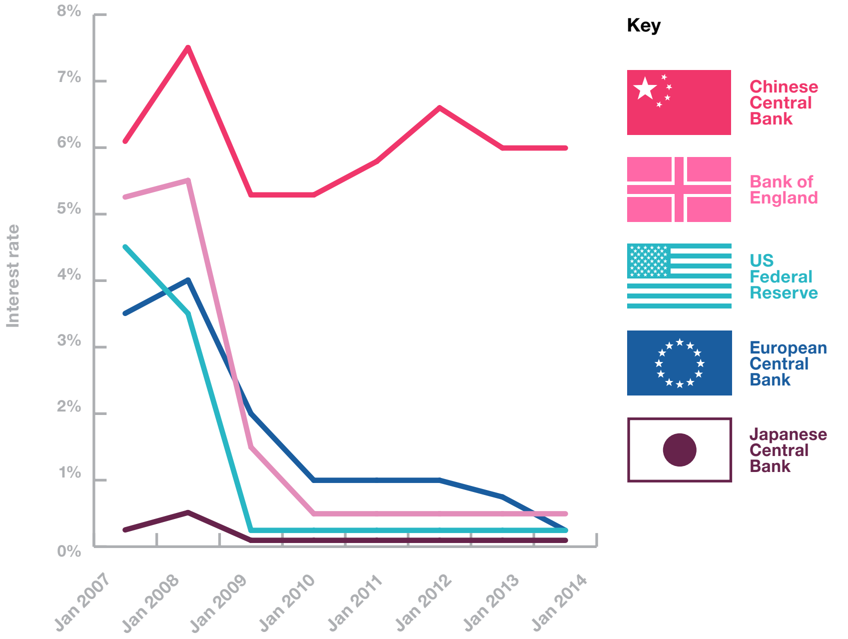
Evolution of interest rates of major central banks



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But by far the most pressing monetary policy challenge faces the euro area. The European Central Bank's recent announcement that it would purchase-asset backed securities and bonds, and cut the interest rate was a step in the right direction, but it now needs to do enough to prevent a downward spiral. In the future, I hope that the euro area will think of different means of weighing countries' inflation goals, rather than setting monetary policy for the core economies in a way that has bad spill-over effects.

As a result of these global monetary policy issues we should expect further volatility. For the EU, poor choices could lead to continued low growth and high unemployment, threatening social cohesion and the future of the economy. In developing countries, reactions to slowing growth need to be checked to avoid potentially disastrous bubbles arising. The US economy itself will be relatively stable, but the value of the dollar is likely to fluctuate.

The most pressing intellectual challenge for monetary policy authorities is figuring out how countries from Norway to Australia and from Singapore to Chile can deal with massive capital inflows, and the potential for volatility those create. The bubbles caused by these inflows tend to manifest themselves in the housing market, which means that central banks' use of macro-prudential instruments will become more important. Possible solutions include looking at loan-to-value ratios, trying to reduce demand, or impacting mortgage supply by adjusting banks' capital targets, which forces them to hold more funds in reserve.

There's also been considerable discussion about the broader prospect of secular stagnation, which raises the possibility of negligible or no economic growth in the most developed market-based economies. This is a serious concern, but there are several reasons why we should be cautious about assuming this is to occur, given the speculative nature of the discussion.

It is true that we can expect lower growth rates in the medium-term due to changing demographics and a decrease in the development of breakthrough technologies. However, the discussion about secular stagnation has largely been around country – rather than per capita – growth rates, so it overlooks the rise of incomes in emerging markets, which might accelerate despite stagnation in the frontier. Both matter, but I would argue the rise in average per capita income has a greater impact on world affairs and stability.

Another reason is that there's always room for structural reform. We talk about it in Europe and Japan, but we certainly should be doing it in terms of healthcare and primary education in the US. Over two to five-year periods, structural reform initiatives can make huge differences to growth rates.

Regardless of whether secular stagnation proves true, we are entering an important period in monetary history. Central banks are going to have to take a more active role in dealing with the challenges facing the major economies if they are to be successful in reducing financial volatility. What was called unconventional will become increasingly common ■