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Monetary Alternatives: Rethinking Government Fiat Money

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> Claudio Borio, who heads the Monetary and Economic Department at the Bank for International Settlements, revisits three “intellectual pillars of monetary policy”: (1) the natural or equilibrium interest rate is best understood as one consistent with price stability and full employment; (2) money is neutral in the medium to long run; and (3) deflation is always costly. He argues that none of these beliefs are sufficient to understand current monetary policy or to guide future policy. First, the definition of the equilibrium interest rate would be improved by including financial and macroeconomic stability, not just price stability and full employment. Second, monetary disequilibrium, as reflected in distorted interest rates and misallocated credit, can persist for 10–20 years; it is not just a short-run phenomenon. Third, one should distinguish between deflation caused by deficient aggregate demand (as during the Great Depression) and deflation due to productivity gains. The former should be avoided, but the latter should be welcomed. The Fed and other central banks typically treat any deflation as bad, while striving to increase inflation. That is a recipe for trouble. A positive agenda for reform, argues Borio, requires that central bankers recognize that “easy monetary policy cannot undo the resource misallocations” brought about by distorted interest rates, and that the focus should be on “facilitating balance sheet repair and implementing structural

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> The reasoning is straightforward. Acknowledge, as indeed some of the proponents of the received view have, that low interest rates are a factor in fueling financial booms and busts. After all, intuitively, it is hard to argue that they are not, given that monetary policy operates by influencing credit expansion, asset prices and risk-taking. Acknowledge further that financial booms and busts cause huge and lasting economic damage—in fact, no one denies this, given the large amount of empirical evidence. Then it follows that if we think of an equilibrium rate more broadly as one consistent with sustainable good economic performance, rates cannot be at their equilibrium level if they are inconsistent with financial stability.

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> It is not uncommon to hear supporters of the “saving glut” and “secular stagnation” hypotheses say that the equilibrium or natural rate is very low, even negative, and that this rate generates financial instability.2 Seen from this angle, such a statement is somewhat misleading. It is more a reflection of the incompleteness of the analytical frameworks used to define and measure the natural rate concept—frameworks that do not incorporate financial instability—than a reflection of an inherent tension between natural rates and financial stability. There is a need to go beyond the full employment-inflation paradigm to fully characterize economic equilibrium. What I have said applies just as much to the short-term rate, which the central bank sets, as to long-term rates. For there is no guarantee that the combination of central banks’ and market participants’ decisions will guide long-term rates toward equilibrium. Just like any other asset price, long-term rates may be misaligned for very long periods, except that their misalignments have more pervasive effects.

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> We reach three basic conclusions. First, before controlling for the behavior of asset prices, we find only a weak association between deflation and growth; the Great Depression is the main exception (Figure 4). Second, we find a stronger link with asset price declines, and controlling for them further weakens the link between deflations and growth. In fact, the link disappears even in the Great Depression (Figure 5). Finally, we find no evidence of a damaging interplay

between deflation and debt (Fisher's "debt deflation"; Fisher 1933). By contrast, we do find evidence of a damaging interplay between private sector debt and property (house) prices, especially in the postwar period.

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How should we interpret these results? To my mind, they are consistent with the distinction between supply-driven and demand-driven deflations: the former depress prices while boosting output (i.e., they may be regarded as "good"); the latter coincide with both price declines and weak output (and, hence, may be regarded as "bad").5 The results are also consistent with the different size and nature of the falls in the price level and asset prices: the former are typically smaller and essentially redistributional; the latter are typically much larger and are normally perceived as nondistributional.

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The bottom line is that, over sufficiently long horizons, low interest rates become to some extent self-validating. Too low rates in the past are one reason—not the only reason—for such low rates today. In other words, policy rates are not simply passively reflecting some deep exogenous forces; they are also helping to shape the economic environment policymakers take as given ("exogenous") when tomorrow becomes today.

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Here the international monetary and financial system plays a key role (Borio 2014b, BIS 2015), because successive crises need not occur in the same country, although sometimes they have. Low rates in countries that are fighting a financial bust may induce problems elsewhere. Policymakers in the struggling economies try very hard to stimulate demand but get little traction through domestic channels, for the reasons mentioned before. As a result, exchange rate depreciation becomes the key transmission mechanism. This induces unwelcome exchange rate appreciation in countries that may also be in a bust or at different points in their financial cycle. Appreciation pressure is resisted by keeping interest rates lower than otherwise

> and/or by intervening in the exchange rate market (Rajan 2014). Thus, easing begets easing.7

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> There are good reasons to question three deeply held beliefs underpinning monetary policy received wisdom. First, defining equilibrium (or natural) rates purely in terms of the equality of actual and potential output and price stability in any given period is too narrow an approach. An equilibrium rate should also be consistent with sustainable financial and macroeconomic stability—two sides of the same coin. Here, I highlighted the role of financial booms and busts, or financial cycles. Second, money (monetary policy) is not neutral over medium- to long-term horizons relevant for policy—that is, 10–20 years or so, if not longer. This is precisely because it contributes to financial booms and busts, which give rise to long-lasting, if not permanent, economic costs. Here I highlighted the neglected impact of resource misallocations on productivity growth. Finally, deflations are not always costly in terms of output. The evidence indicates that the link comes largely from the Great Depression and, even then, it disappears if one controls for asset price declines. Here I highlighted the costs of declining asset prices, especially property prices, and the distinction between supply-driven and demand-driven deflations.

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> From this, I drew two conclusions. First, the long-term decline in real interest rates since at least the 1990s may well be, in part, a disequilibrium phenomenon, not consistent with lasting financial, macroeconomic, and monetary stability. Here I highlighted the asymmetrical monetary policy response to financial booms and busts, which induces an easing bias over time. Second, there is a need to adjust monetary policy frameworks to take financial booms and busts systematically into account. This, in turn, would avoid that easing bias and the risk of a debt trap. Here I highlighted that it is imprudent to rely exclusively on macroprudential measures to constrain the build-up of financial imbalances. Macroprudential policy must be part of the answer, but it cannot be the whole answer.

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> Although Bitcoin as yet doesn't quite qualify as money—that is, as a generally accepted medium of exchange—a monetary regime using Bitcoin's blockchain technology, whether based on Bitcoin or some other cybercurrency, would represent a variation on Friedman's computer-controlled open-market purchases, and one having the decisive advantage of relying on an open-source software that is highly tamper resistant. In the case of Bitcoin, the software is programmed so that the supply of bitcoins increases at a diminishing rate, eventually leveling-off as the limit of 21 million bitcoins is approached. Because such a quantity rule hardly seems calculated to avoid long-run economic distress stemming from growth and fluctuations in the real demand for money balances, its long-run sustainability as the basis of an actual, national, or international monetary regime, would be quite doubtful. A modified program using the same blockchain technology might, however, provide for more flexible and macroeconomically friendly patterns of money stock adjustment (Selgin 2015b).

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> An interesting proposal for a monetary rule enforced by design is Scott Sumner's plan for a "market-driven" NGDP targeting regime. According to Sumner (2013: 4), his plan involves "setting up a nominal GDP futures market and then adjusting the monetary base to stabilize nominal GDP futures prices. The market, not central banks, would set the level of the monetary base and short-term interest rates under this sort of policy regime." To arrive at his market-driven arrangement, Sumner would first establish a contract-based NGDP targeting scheme, in which FOMC members' salaries are tied to the accuracy of their NGDP forecasts (Sumner 2013: 11), with hawks being punished and doves rewarded if NGDP increases too slowly; and doves being punished and hawks rewarded if it rises too quickly. Next, Sumner imagines that FOMC members "vote" by actually taking either long or short positions in NGDP futures contracts, with the Fed offering to buy or sell unlimited quantities of NGDP futures contracts at a fixed price of $1.0365 per contract (reflecting a 3.65 percent NGDP growth target), while at the same time "linking" its open-market security purchases to NGDP futures market transactions. Finally, he would allow anyone to participate in the NGDP futures market and to thereby influence the Fed's open-market operations.

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> Many libertarian economists are acutely sensitive to the very real dangers of excessive inflation. But I believe some have a blind spot for shortfalls in nominal spending, which are arguably even more damaging. The United States had a relatively efficient small government policy regime under Presidents Harding and Coolidge. It was far from perfect, but as soon as the Depression began policy became more interventionist—and (with the exception of the dollar devaluation of 1933–34) almost completely counterproductive. An almost identical sequence of events took place in Argentina during the late 1990s and early 2000s. Argentina grew quite rapidly from 1990 to 1997, partly thanks to neoliberal policy reforms. But Argentine monetary policy became contractionary in the late 1990s and early 2000s, causing a significant decline in nominal GDP. Finally, a new and more left-wing government took command, devalued the currency, and pursued a statist policy agenda. The new regime blamed Argentina's troubles not on tight money, but on its former free market policies, just as FDR had done 70 years earlier. The fall in NGDP also worsened a fiscal crisis. This led the Argentine government to swing to the opposite extreme—printing money to pay its bills. The result was high and rising inflation. The government blamed "capitalists" and put on wage and price controls. More recently, the sharp decline in NGDP in the eurozone has led to calls for "fiscal union." This might slightly ameliorate the current crisis, but the resulting increase in moral hazard would be storing up much more severe problems down the road.

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> Nominal GDP targeting provides the best environment for free market policies to flourish. It removes one of the most powerful excuses for statist policies, the claim that they will somehow create jobs. In the current policy environment, where NGDP growth has fallen far below trend, there is an unfortunate tendency for some on the right to view NGDP targeting at a sort of left-wing proposal, aimed at inflation. In fact, from Hayek in the 1930s, to people like McCallum (1985), Hall and Mankiw (1994), and Selgin (1995) in the 1980s and 1990s, to the so-called market monetarists of today, nominal GDP targeting of some sort has long had strong appeal

> among economists sympathetic to free markets and low inflation.10 We need to look beyond the current crisis, and to think long and hard about what sort of pragmatic monetary regime will best serve the economy in the decades to come.

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