Monetary Policy Paradigm Shifts

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Paradigm shifts in monetary policy: SDRF thoughtful questions

*Many central banks are launching easing policies again, which seems to turn unconventional policies into conventional ones.*

I. **Modern Monetary Theory (MMT)** has aroused widespread controversy. Views?

II. What **fundamental changes** are taking place in the **practices** or **theories** of monetary policies?

III. Why do they happen? How do they **effect the global economy and finance**?

IV. Conclusions and **Solutions**.
I. Modern Monetary Theory

Modern Monetary Theory (MMT) is:

• Neither Modern …

• Nor Monetary …

• It is all Theory. No models and quants are page numbers.

• Experience … Latin America and elsewhere.
“Wrestling with the government budget constraint and monetary disorders set Gail [Makinen] on a productive lifelong quest to explore and understand monetary and fiscal experiments and disorders on a much broader stage.”

“By studying mistakes of the past, [we can] shed light on how we can improve things.”

Thomas J. Sargent
Nobel Memorial Prize in Economics (2011)
Forward comments in 
*Studies in Hyperinflation & Stabilization* by Gail Makinen (CFS, 2014)
Studies in Hyperinflation & Stabilization

Results and theory from studies and empirical analysis:

• Hyperinflations … are also instructive for better understanding normal-world policies and principles.

• Shouldn’t we be scared? No (2014). Maybe (2019)?

• Very rapid inflations are rooted in fiscal conditions.

• Central bank independence that permits the refusal to buy government debt is essential.

Studies in Hyperinflation & Stabilization
by Gail Makinen (CFS, 2014)
II. Fundamental changes in Theory and Practice…
Triggered by policy miscalculations (*)

• Deflation and inflation scares in 2002 and 2010, respectively.

• Unclear monetary targets or measurements after 2008.

• Negative interest rates.

(*) Focus is largely centered on the U.S. However, relevant shifts have also occurred in Europe, China, and Japan.
Monetary and financial measures matter

Source: Federal Reserve Bank of St. Louis and Center for Financial Stability.
Unclear targets and limited benefit from QE 2 and 3: CFS Divisia M4 and base money move oppositely

Source: Federal Reserve, Bloomberg LP, and the Center for Financial Stability.
Negative real interest rates distort economic and financial incentives...
III. Effect on global markets and economics

• Asset price distortions… equity and bond market valuations.

• Skewed incentives for savers and investors.

• Uncertainty.

• Limited growth.
Accommodative Monetary Policy spurs Speculative Investor Behavior

Real policy rates fell below 0 in 2002 and remained there until 2006.

Major Central Bank balance sheets expended from roughly $8 to nearly $18 trillion.

Note: Includes futures positions in NYMEX crude, S&P 500 index, JPY, gold, CHF, Nikkei, and GBP held by speculative investors.
Source: CFTC, Bloomberg LP, and Center for Financial Stability.
Accommodative Monetary Policy boosts Volatility and Long Bets

Volatility ('93 - '01) = 98k contracts
Volatility ('01 - '08) = 113k contracts
Volatility ('09 - '18) = 165k contracts

Note: Includes futures positions in NYMEX crude, S&P 500 index, JPY, gold, CHF, Nikkei, and GBP held by speculative investors.
Source: CFTC, Bloomberg LP, and Center for Financial Stability.
IV. Conclusions and Solutions

• **MMT is a dangerous policy idea.** It has already been tried and performed poorly.

• Practice and theory have changed. **Monetary mistakes in the past have paved the way for more experiments and the surfacing of ideas such as MMT.**

• Extension of extraordinary monetary policies has damaged the global economy and distorted financial markets.

*Although tricky, a slow and careful restoration of normalcy is essential. It is today’s critical constrained maximization problem.*
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