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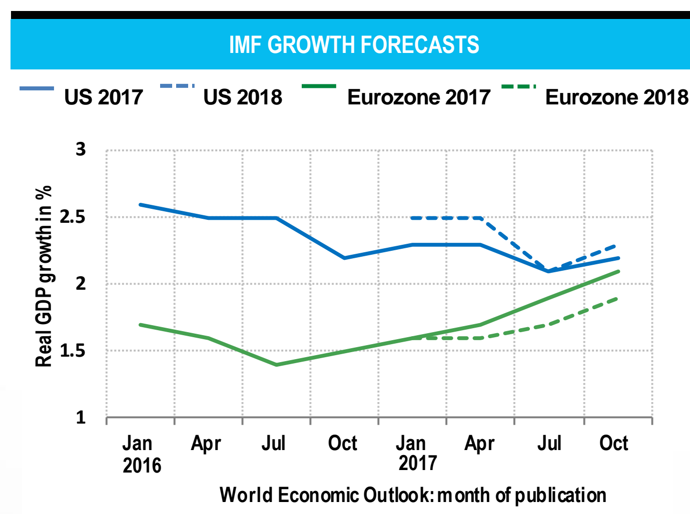
Hercules, Sisyphus and monetary policy

■ The IMF is upbeat on the growth outlook yet argues that the recovery is incomplete ■ It also expresses concern about yield chasing behaviour of investors ■ Multiple objectives imply one cannot solely rely on monetary policy

They look like the two sides of a coin. One is nice and shiny, the other a bit less so. Starting with the former, chapter 1 of the IMF's World Economic Outlook offers comfortable reading. Growth is strengthening, more so than expected. It is broad based in terms of demand components and geographies and forecasts have been revised upwards. Yet it considers that the recovery is not complete: growth remains weak in many countries, low inflation points towards slack which has not been eliminated and per capita growth prospects are too low. Against this background, the title of chapter 1 of the IMF's Global Financial Stability Report may come as a surprise: "Is growth at risk?" The message here is that better growth, low inflation and ongoing low interest rates have improved the near-term outlook for financial stability but that the ensuing search for yield and leverage by investors might end up increasing vulnerabilities in the medium run.

IMF GROWTH FORECASTS



Source: IMF

The implicit question of the two companion publications is how much is enough in terms of growth, monetary stimulus, leverage, risk taking. The answer is not straightforward. One, a pick-up in credit growth, an increase in investor risk appetite and a rise in asset prices are an integral part of the monetary transmission mechanism. They can be considered as intermediate objectives of monetary reflation, with the ultimate purpose of having inflation converging sufficiently towards its target. Two, the relationship is not linear. It has taken a Herculean monetary effort to trigger somewhat of an increase in inflation. Three, yield chasing strategies may end up creating fragility to minor interest rate or growth shocks, raising a concern of ending up back at square one: monetary policy as a work of Sisyphus. In that respect it is worth keeping in mind that low nominal interest rates and huge central bank balance sheets offer little policy leeway to address downturns.

The overall objective for economic policy is maximising the level of welfare. This implies that policy makers should try to avoid downturns. For some this would mean leaning against the wind: some monetary tightening to cool down investor risk appetite and, in some countries, the housing market. However this could be conflictual with the other policy objectives (raise potential GDP growth and meet the inflation target). The Dutch Nobel prize laureate Jan Tinbergen taught us a long time ago that multiple objectives require an equivalent number of instruments. Combining monetary, macroprudential and structural policy is a better idea than relying exclusively on central bank action to achieve what is after all an ambitious agenda.

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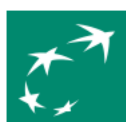

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