Monetary Policy in the New Mediocre

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ABSTRACT

Governments and central banks should be ready to deploy an effective response in the event of a negative shock to global output. The global economy has been stuck for a half-decade in a quasi-equilibrium, with inflation below target, weak employment, and slow output growth. The main risk is a slide into a new, worse, quasi-equilibrium. Central bank policy rates are already near their lower bound, and high deficits and debts constrain fiscal policy—hence the widespread perception that the main macroeconomic policy tools can no longer provide effective defense against a recession. We argue against this perception, focusing on the monetary policy aspect, for the cases of Australia and several Asian economies. A package of comprehensive, consistent, and coordinated actions, tailored to individual country requirements, could indeed provide an effective boost to avoid getting stuck in low-inflation traps. Transparent communications, and firm commitments to long-run stability objectives for the rate of inflation and for public debt, would reinforce the credibility that is essential for the success of the package. The policy actions would need to be assertive, and, in the interests of anchoring long-term expectations firmly at the target rate, central banks should not be averse to short-term overshooting of their announced long-term inflation objectives.