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The Global Financial Crisis and the New Monetary Consensus

Marc Pilkington



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The Global Financial Crisis and the New Monetary Consensus

The Global Financial Crisis has reshuffled the cards for central banks throughout the world. In the wake of the biggest crisis since the Great Depression, this volume traces the evolution of modern central banking over the last 50 years. It takes in the inflationary chaos of the 1970s and the monetarist experiments of the 1980s, eventually leading to the New Monetary Consensus, which took shape in the 1990s and prevailed until 2007. The book then goes on to review the limitations placed on monetary policy in the aftermath of the global meltdown, arguing that the financial crisis has shaken the New Monetary Consensus.

In the aftermath of the worst crisis since the Great Depression, the book investigates the nature of present and future monetary policy. Is the Taylor rule still a satisfactory monetary precept for central bankers? Has the New Monetary Consensus been shaken by the Global Financial Crisis? What are the fundamental issues raised by the latter cataclysmic chain of events? How should central banks conceptualize monetary policy anew in a post-crisis scenario?

Existing books have dwelt extensively on the characteristics of the New Monetary Consensus, but few have cast light on its relevance in a post-crisis scenario. This book seeks to fill this gap, drawing on the lessons from five decades of contrasted theoretical approaches ranging from Keynesianism, monetarism, new classical macroeconomics, inflation targeting and, more recently, pragmatic global crisis management.

Marc Pilkington is Associate Professor of Economics at the University of Burgundy, France.

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Preface

Starting in the 1990s, a ‘New Monetary Consensus’ (NMC) emerged in the world of central bankers. Alan Greenspan was soon acclaimed as the world’s greatest central banker ever, even though a few dissonant voices were to be heard in academia at the peak of his career. After discovering the NMC as a pragmatic response to the demise of monetarism, he sought to manage expectations in order to control real-world outcomes by building credibility and transparency to ensure price stability and low inflation.

Prior to the Global Financial Crisis (GFC), Ben Bernanke, Alan Greenspan’s successor, proclaimed the era of ‘the great moderation’ characterized by lasting macroeconomic stability. Until the GFC, there was a remarkably strong consensus among academics and professional economists that central banks should adopt explicit inflation targets and that all key monetary policy decisions should be subordinated to price stability and low inflation. Since its introduction in New Zealand in 1989, inflation targeting has gained prominence in the central banking community.

The subprime crisis broke out in August 2007. Following the demise of Lehman Brothers, it mutated one year later into the first global crisis of the twenty-first century, the latter episode of which being the enduring Euro sovereign debt crisis. The aim of this book is to assess whether the latter cataclysmic chain of events has shaken the New Monetary Consensus. It is indeed difficult to convey how much doubt has been thrown on the entire corpus of central banking theory by the current global crisis. Macroeconomic indicators have become unpredictable, rare (so-called black swan) events have become common and accepted orthodox frameworks have lost their appeal.

Following an overview of the situation, our introductory chapter briefly depicts the evolution of central banking practices over the last half century, with the underlying theoretical frameworks and the corresponding macroeconomic outcomes. We then thoroughly analyse the mantras of the 1990s, leading to the worldwide configuration of monetary policy until 2007. In the aftermath of the worst crisis since the Great Depression, we try to understand the unconventional policy responses of central banks, and we sketch out the nature of future monetary policy. Is the Taylor rule still a satisfactory monetary precept for central bankers? Has the New Monetary Consensus been shaken by the Global

Financial Crisis? What are the fundamental issues raised by the latter cataclysmic chain of events? How shall central banks conceptualize monetary policy anew in a post-crisis scenario?

Existing books have dwelt extensively on the characteristics of the NMC. Very few authors have cast light on its relevance in a post-crisis scenario, drawing on the lessons from decades of contrasted theoretical approaches ranging from Keynesianism, monetarism, new classical macroeconomics, inflation targeting and, more recently, pragmatic global crisis management. It is precisely this gap in the literature that this book intends to fill.

Abbreviations

ABM	agent-based modelling
AMLF	Asset-Backed Commercial Money Market Mutual Funds Liquidity Facility
BIS	Bank for International Settlements
BoE	Bank of England
CPFF	Commercial Paper Funding Facility
CPI	Consumer Price Index
CW	Collected Works
DB	Deutsche Bank
DRIVE	Do – Restrictions – Investments – Values – Essential
DSGE	dynamic stochastic general equilibrium
ECB	European Central Bank
EMH	Efficient Market Hypothesis
EMU	European Monetary Union
ESCB	European System of Central Banks
ESRB	European Systemic Risk Board
EU	European Union
Fed	Federal Reserve
FOMC	Federal Open Market Committee
FTPL	Fiscal Theory of the Price Level
FX	Foreign Exchange
GDP	gross domestic product
GEM	Global Economy Model
GFC	Global Financial Crisis
GG	Grundgesetz
GPL	General Public Licence
HET	History of Economic Thought
HICP	Harmonized Index of Consumer Prices
HIV	human immunodeficiency virus
ILO	International Labour Organization
IMF	International Monetary Fund
ISDA	International Swaps and Derivatives Association
IT	Inflation Targeting

ITers	inflation-targeting central banks
JAMEL	Java Agent-based Macroeconomic Laboratory
LATW	lean against the wind
LB	Lehman Brothers
LSAP	Large-Scale Asset Purchases
LTRO	Long-Term Refinancing Operations
MP	Member of Parliament
MPIP	Monetary Policy Ineffectiveness Proposition
MTFS	Medium-Term Financial Strategy
NBFI	Non-Financial Banking Institutions
NEMO	Norwegian Economic Model
NKPC	New Keynesian Phillips Curve
NMC	New Monetary Consensus
OCA	Optimal Currency Area
OECD	Organisation for Economic Co-operation and Development
OTC	over-the-counter
POWER	Positives – Objections – What else? – Enhancements – Remedies
PPP	Purchasing Power Parity
QE1	Quantitative Easing 1
QE2	Quantitative Easing 2
RAMSES	Riksbank Aggregate Macromodel for Studies of the Economy of Sweden
RBC	Real Business Cycles
RBNZ	Royal Bank of New Zealand
SDRM	Sovereign Debt Restructuring Mechanism
SOMA	System Open Market Account
TAF	Term Auction Facility
TBTF	too-big-to-fail
TFEU	Treaty on the Functioning of the European Union
TIPS	Treasury Inflation-Protected Securities
VAR	vector autoregression
VPS	variable payments system

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