The Missing Monetary-Policy Tool

Dec 16, 2024 |**JOHANNES BOEHM** and **XAVIER JARAVEL**

GENEVA/LONDON – Central banks around the world responded to the inflationary period following COVID-19 by raising interest rates. Now that inflation seems to be largely under control, monetary policymakers must begin preparing for the next crisis by expanding their toolkit.
This is particularly important because we may soon return to the situation of the 2010s, when nominal interest rates were close to zero, and central banks were unable to stimulate demand by cutting them. Policymakers ended up using "unconventional" tools – notably quantitative easing – which were later found to have limited effects on aggregate demand and to have inflated asset prices, thereby contributing to financial volatility and rising inequality.

To avoid falling into this trap again, central banks should prepare – both legally and operationally – to carry out direct transfers to households when conventional monetary policy fails. This approach has been shown to be sufficiently potent to stimulate demand and fight recessions even in a liquidity trap, when interest rates can go no lower. That said, it must be used carefully.

The idea of direct transfers is hardly new. But until recently, economists have dismissed it for the wrong reasons. The textbook argument against these payments is that when interest rates are at zero, money creation should not have a stimulus effect because households would simply sit on excess liquidity. The income bump from such assistance, the thinking goes, would lead to a negligible increase in consumption.

But our recent research contradicts this view. Using new microeconomic data and evaluation techniques, we estimated that stimulus payments would increase consumption even when interest rates are close to zero. This is bolstered by research on sizable lottery prizes and America's 2008 stimulus package, which show that households spend a large portion of unanticipated windfalls.

Many of our colleagues would say that conducting financial transfers to households is fiscal policy, not monetary policy. To be sure, fiscal authorities have traditionally managed stimulus programs during a downturn. But such measures significantly increase public debt, which monetary authorities counteract by purchasing government bonds.
Central banks effectively fund the government's direct transfers, so it is our view that they should supervise them, too – at least some of the time. Monetary policymakers can act faster and are less likely to overshoot, given their inflation mandate. Politicians, on the other hand, may be tempted to launch aggressive stimulus policies that could prove difficult to reverse.

All monetary policy is redistributive. But direct transfers make it easier for central banks to avoid undesirable distributional effects, in contrast to quantitative easing, which favors wealthy households that own assets. Even changes in interest rates have an unequal impact, because they primarily affect households seeking a mortgage. With transfers set to be the same for all households, everyone would "win" equally.

Of course, if monetary authorities began to distribute stimulus payments, they might face mounting political pressure to do so. This tool should therefore be used sparingly, after conventional monetary policy has proven ineffective, and only by a central bank that is independent, and whose independence is not threatened. This important restriction could be codified in a central bank's mandate to ensure that direct transfers are a last resort.

A useful analogy is to think of a central bank's stimulus payments as analgesics, which temporarily manage pain, rather than treating the underlying ailment, but can cause heightened tolerance and dependence if overused. Similarly, direct transfers can provide immediate short-term relief by increasing demand when needed most, but they could spiral out of control if used excessively – for example, even outside major crises. Just as it makes no sense to ban painkillers despite the risk of abuse, it makes no sense to forswear a monetary-policy tool because it must be employed with caution.

So, how would a central bank go about using this tool? To start, it should create a reserve account, with an associated payment card, for each citizen. The central bank would "lend" at zero interest in perpetuity to these individuals, crediting their accounts. The transaction's irreversibility would constitute a credible commitment to higher inflation and would thus raise inflation expectations.

To increase the demand response, the payment could be time-limited: recipients would have a few weeks to spend down the account, or else lose the remaining balance. Our experiment demonstrated that this approach results in higher spending than a standard transfer without an expiry date, boosting aggregate demand by twice as much. Payment cards with expiry dates have already been used on a large scale – with tens of millions of recipients – in several places, including South Korea, Hong Kong, and Northern Ireland. Now it is time for central banks to figure out how to incorporate them into their toolkit before the next big crisis strikes.

JOHANNES BOEHM

Johannes Boehm is Professor of Economics at the Geneva Graduate Institute.

XAVIER JARAVEL

Xavier Jaravel is Professor of Economics at the London School of Economics.

https://prosyn.org/EXQF80e