

# How Mind Games Played Out In Monetary Policy

Central banks may have been done in by confirmation bias and overconfidence.

By Carl Tannenbaum



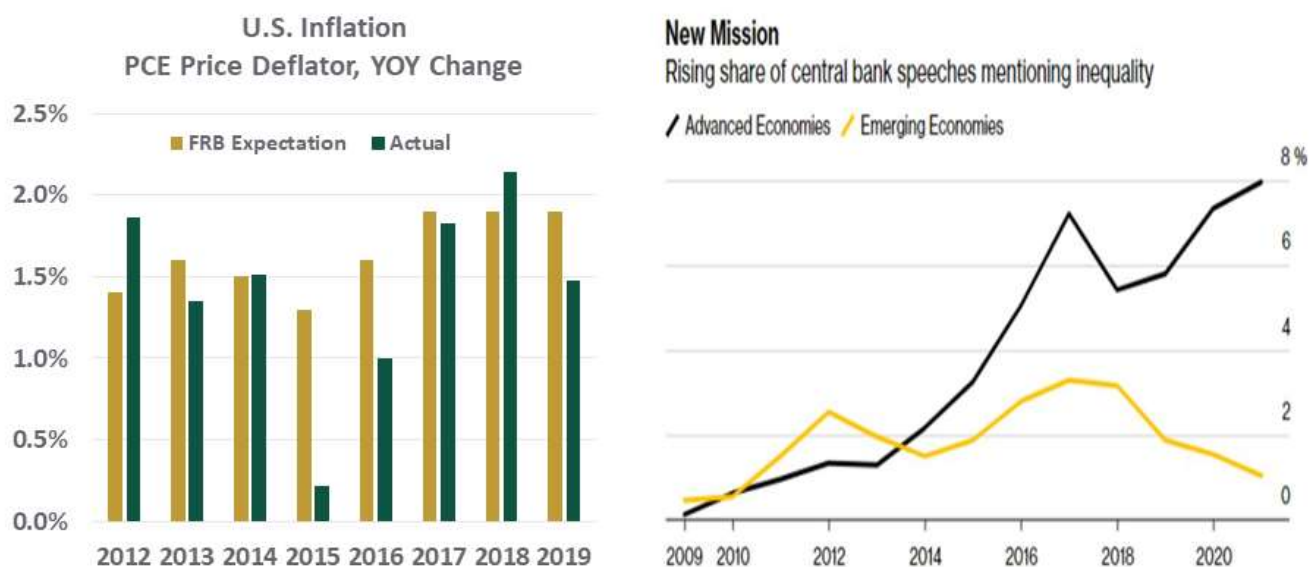
Central banks around the world were hailed in the spring of 2020 for taking quick and decisive action to arrest the economic damage inflicted by COVID-19. Two years later, central banks are being vilified for their actions during that interval, which have allowed inflation to become

unchained. How did monetary policy go from a cure-all to a curse? With the benefit of hindsight, behavioral factors played a significant role.

During the 2010s, inflation was stubbornly low. At several points during the decade, central banks were convinced that prices were about to take off, only to see them remain in check. Expectations became anchored by this experience, and perceived inflation risk diminished. This supported very easy monetary policy, which was seen as producing broad gains in employment and narrowing economic inequality.

As incoming inflation readings became progressively more troubling, confirmation bias initially led officials to blame transitory factors. Now that high inflation has proven persistent, central banks are initiating programs to raise interest rates and shrink balance sheets on a scale that has not been seen in a very long time.

**Central banks may have been done in by behavioral economics.**



*Sources: Federal Reserve, Haver Analytics, BIS, Deutsche Bank, Bloomberg*

Another behavioral aspect that has played into the policy error is overconfidence. No matter the blend of luck and skill that leads to success, human beings tend to take the lion's share of credit for themselves.

Central bankers could be excused for being proud of what they achieved over recent decades: long expansions, strong markets and limited inflation. But this experience may have led them to believe that they had mastered the business cycle, and could always fine tune policy to achieve desired outcomes.

Central banks may also have convinced themselves that they could replicate their success in other arenas: climate change, the payments system and economic inequality. While all three of these topics have ties to growth and inflation, they are all better addressed through legislative and diplomatic channels. In allowing their missions to creep, some say, central banks lost sight of their central purpose.

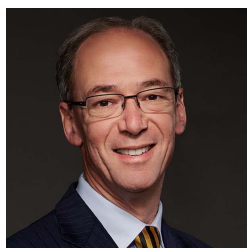
It is unfair to criticize policy in retrospect, as we now know with certainty things that were uncertain when choices were made. But as central bankers reconsider strategy, they should

make sure that they have their minds right.

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Carl Tannenbaum is the Chief Economist for Northern Trust. In this role, he briefs clients and colleagues on the economy and business conditions, prepares the bank's official economic outlook and participates in forecast surveys. He is a member of Northern Trust's investment policy committee, its capital committee, and its asset/liability management committee.