Central Banks: Confronting the Hard Truths Discovered and the Tough Choices Ahead

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Introduction

Central banking was never an easy job. But it has certainly reached new levels of complexity since the crisis of 2008. Central banks all over the world have faced extraordinary conditions and met them with extraordinary tools. Along the way they were criticized both for what they did and what they didn't do, and as a result some are now facing governance reviews and mandate changes.

Today, arguably, central banks have themselves become a source of uncertainty. So-called forward guidance has long ceased to provide any guidance at all. The number of central bank decisions that surprised the markets in recent weeks has been notable, and every word uttered by Federal Reserve Chair Janet Yellen is dissected by thousands of pundits in the hope of reading her mind, which she probably has not made up yet. This is a strange state of the world where the BIS (Bank for International Settlements) itself, the central bank of central banks, puts out reports and speeches expressing considerable skepticism about the cost/benefit balance of unconventional policies deployed by so many central banks.

My own view is that the core group of central banks that stepped into unchartered territory since the onset of the crisis saved the day. And I think it is important to acknowledge here the extraordinary leadership—both intellectual and political—of Ben Bernanke. Without him, I suspect the world economy today would look different, and not for the better. At the same time, having gained some perspective both from time and from no longer being directly involved in central banking, I

also feel that we need to be cognizant of the risks associated with these unconventional policies and try hard to contain them.

What I would like to do in the remainder of this paper is to highlight six hard truths that I think we have learned *so far*, in roughly chronological order, and the hard choices they imply. I stress *so far*, because the story is not over. And the conclusions we draw in one, five, or ten years may very well be quite different.

Hard Truth #1:
Worrying about inflation alone is dangerous.

Of course, this has by now become a well-accepted truth, but I vividly remember the then-Economic Adviser of the BIS being shot at with heavy intellectual artillery when he effectively first put it forward at the Jackson Hole Federal Reserve Symposium early on in the Great Moderation period.[1]

Back in the days when inflation, rather than the lack of it, was a problem, the central banking community developed the view that to do its job, a central bank had to focus on inflation, and the narrower the focus, the more effective it would be.

But in fact, it's not that simple. During the Great Moderation, if you looked only at inflation, you would have thought policy makers were doing a fine job. And indeed, GDP was growing nicely, until it collapsed, along with inflation. What happened was that this great stability bred low volatility, and this led to excessive risk taking and a sharp build-up of leverage and debt. In the words of Mark Carney, "risk was at its highest when risk premia were at their lowest."

So we have had to learn that, actually, central banks had better keep a close eye on the stability of the system as well. Build-up of leverage and debt matters enormously. That was the prime lesson of the crisis.

Today, the tools are still not perfect but the lesson has been learned and all the key central banks except for the Bank of Japan now have a macroprudential arm/mandate attached to them, distinct from monetary policy.

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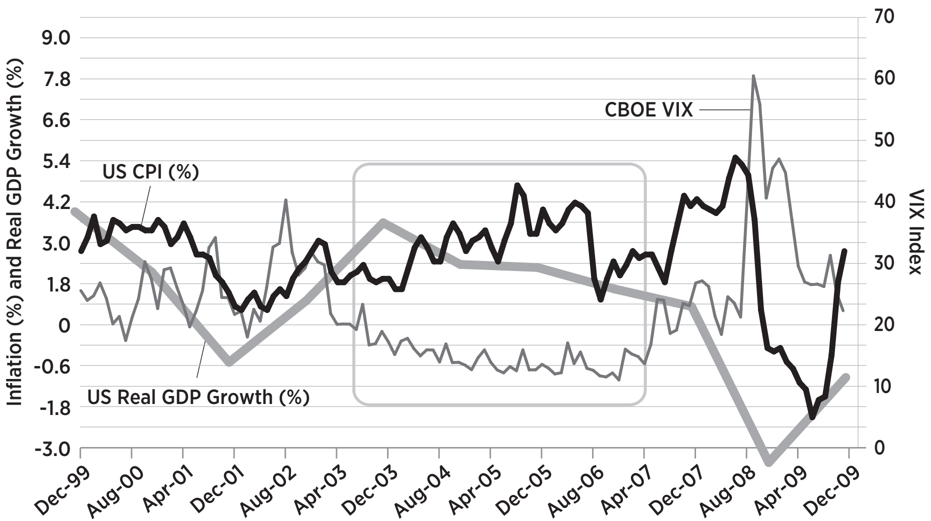
1 Borio and White 2004.

FIGURE 1. INFLATION, OUTPUT, AND VOLATILITY IN THE US



Sources: St. Louis FED (http://research.stlouisfed.org/fred2); U.S. Bureau of Labor Statistics (http://www.bls.gov/data/); Thomson Reuters Datastream; Bureau of Economic Analysis (http://www.bea.gov/national/index.htm#gdp).

Note: CBOE VIX = Chicago Board Options Exchange Market Volatility Index

There is of course a difficult choice we now face, though we have not confronted it yet: what if the macroprudential tools are not enough and a conflict arises between financial stability (requiring interest rate rise) and price stability (requiring accommodating macroeconomic policy for example, because of deflation risk)?

What might be the answer here?

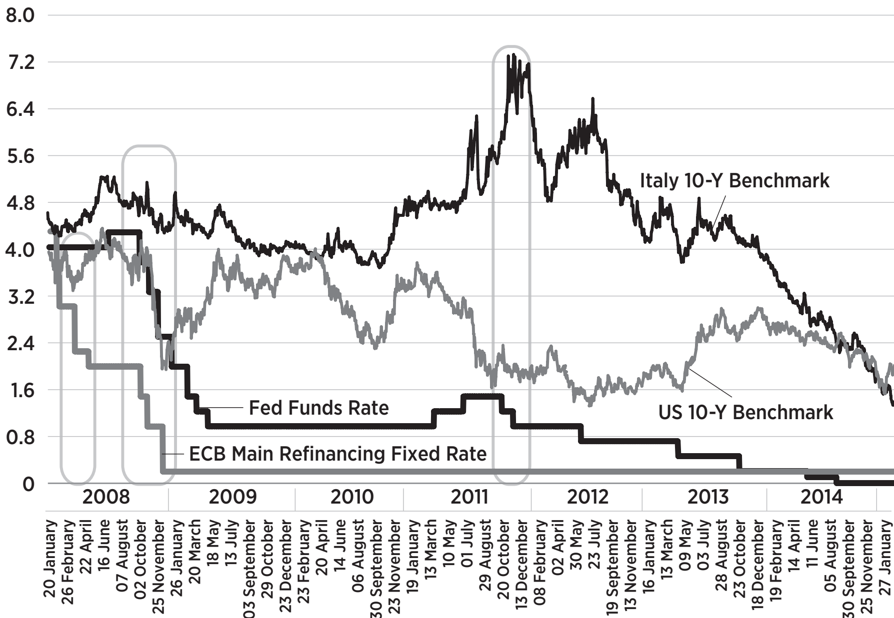
First, I believe that one should not be overly pessimistic about the efficacy of macroprudential tools. Of course, many are untested and there are difficult calibration issues. But let's remember that it wasn't so long ago that people thought price stability was unachievable.

Second, one needs to think courageously about better cooperation between monetary policy and government policies, notably fiscal. This is not at all to say that central bank independence should be revisited; quite the opposite. But recognizing that these different policies can be supportive of each other can also help alleviate the trade-offs each of them faces. And while independence is absolutely of the essence when fighting inflation, greater emphasis on cooperation may be more relevant when fighting disinflation, let alone deflation. Having said that, how to operationalize this is not obvious and raises slippery slope issues.

Hard Truth #2:
The interest rate is sometimes not a sufficient instrument.

We have discovered from experience, since the crisis, that there are states of the world where central bank manipulation of its policy rate can help only so much. I would argue there are two such states:

FIGURE 2. LAG BETWEEN POLICY RATES AND LONG-TERM RATES



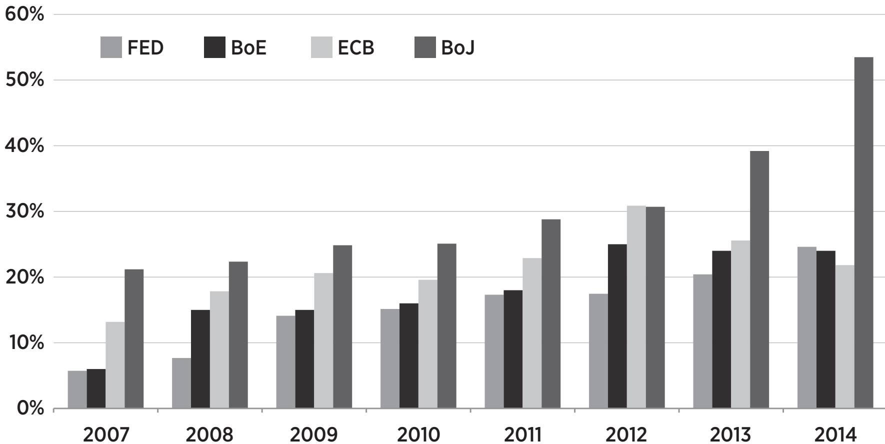
Sources: Thomson Reuters Eikon; Bloomberg.

- One is when monetary transmission is simply broken: sharp cuts in the policy rate fail to reduce market rates. This happened in the United States after the collapse of Lehman Brothers, and subsequently in the euro area when fears of euro breakup kept interest rates on the periphery highly elevated long after the ECB (European Central Bank) cut its policy rate.

- Another such situation is when the policy rate hits the zero lower bound—or the sub-zero lower bound—and falling inflation causes a tightening in the real interest rate that further tightens monetary conditions and deflationary pressures.

Faced with a broken monetary transmission mechanism and interest rates at the zero lower bound, central banks came up with an alphabet soup of new liquidity windows and a host of highly unconventional tools: negative interest rates (Sweden, Denmark, Swiss National Bank, European Central Bank); targeted lending (MBS [mortgage-backed security], FLS [Funding for Lending Scheme], T-LTRO [targeted long-term refinancing operation]); and, of course, massive balance sheet expansions.

FIGURE 3. TOTAL CENTRAL BANK ASSETS AS SHARE OF GDP



Sources: St. Louis FED (http://research.stlouisfed.org/fred2); BOE (http://www.bankof england.co.uk); Office for National Statistics (http://www.ons.gov.uk); Thomson Reuters Eikon.

Here, too, there is a difficult choice: these tools, however necessary, all have significant side effects, and sometimes adverse ones. They may reduce incentives for governments to act in other equally necessary areas, notably fiscal policy; they de facto give central banks quasi-fiscal responsibilities that they are not really equipped to handle; they affect negatively the profitability of banks and, in the extreme, in the case of negative interest rates, might cause disintermediation.

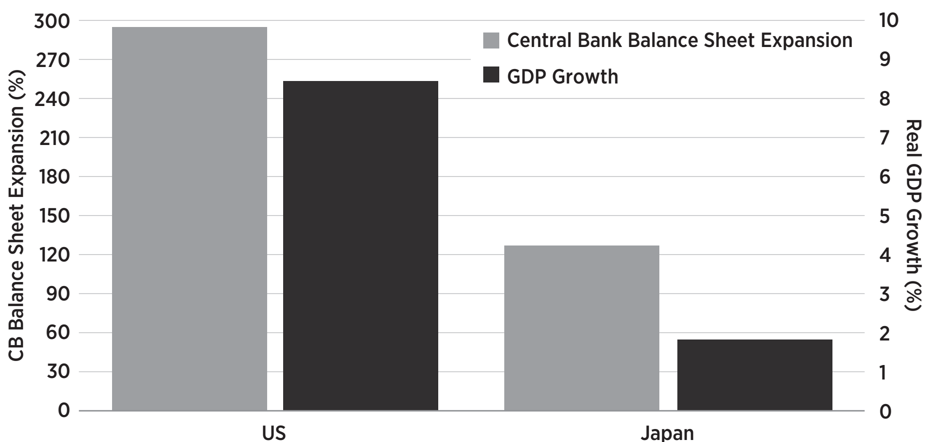
The question for central banks, though, is which is worse: failing to deliver on one's mandate or using tools that risk having adverse side effects. Our modern central banks have chosen to prioritize their mandate and, in my view, they deserve credit for that.

Still, they need to make absolutely sure that resort to such unconventional tools is limited—*ex post*—in time and scope to the minimum necessary to achieve effectiveness. *Ex post* is important to emphasize because ex ante, having an open-ended commitment—crystallized by Mario Draghi's famous "whatever it takes"—is in my view a condition for effectiveness.

Hard Truth #3:
Monetary policy, alone, can achieve only so much.

Loosening monetary policy in the absence of fundamental growth drivers is like pushing on a string. Looking at the example of the United States and Japan between 2008 and 2014 tells us that with the same balance sheet expansion, one can obtain very different growth outcomes.

FIGURE 4. GDP GROWTH AND CENTRAL BANK BALANCE SHEET EXPANSION IN THE US AND JAPAN, 2008–2014, %



Sources: IMF (http://www.imf.org); St Louis FED (http://research.stlouisfed.org/fred2); Thomson Reuters Eikon; JPM (http://www.japanmacroadvisors.com).

Why such a difference? Growth requires innovation to occur, banks to lend, businesses to invest, households to consume, and structural reforms to boost productivity, as well as a fiscal policy that, while credible, does not overly reduce aggregate demand. While the policy mix in the United States was by no means perfect during the QE [quantitative easing] years, several of these conditions have been present in the US for a few years, but were lacking in Japan in the 2000s.

Will they materialize in the euro area now? The jury is still out. Certainly, banks in Europe are much healthier today than they were a few years ago. Fiscal consolidation has been less aggressive in most countries than until recently. But household debt remains high in several countries, notably Spain, and structural reforms have a long way to go, albeit there are encouraging signs in France and Italy. Public investment will be boosted somewhat by the Juncker plan, but unless the private sector steps in, it won't make much difference. So business confidence is key. Fortunately there are now clear signs that the mood is improving; both in the core and at the periphery, many indicators are beginning to look up; the announcement and now start of QE have further boosted sentiment, and while one might quibble about how much interest rate compression it will achieve, at a minimum it should offset "collateral tightening" from the normalization of US monetary policy.

Here, the difficult choice for a central bank is that if the other conditions are not present, central bank intervention risks providing an incentive to postpone the necessary adjustments and reforms. What is a central bank to do? Sit on its hands and violate its own mandate, or act anyway with diminished effectiveness?

The best answer to this question was in my view expressed by Ben Bernanke, when he stated that central banks cannot be in the business of brinkmanship. The idea that they should try, through their actions or inactions, to force a reluctant government to do something they ought to do strikes me as wrong from a democratic accountability standpoint, and likely ineffective from a practical standpoint. Central banks should speak up without coyness about what needs to be done outside of monetary policy for monetary policy to work. And let electoral accountability do the rest.

Governments in Europe know that if unemployment does not come down, they will not be reelected. Ultimately that's why they will opt for structural reforms, with or without QE. That said, the issue is less straightforward for fiscal adjustment.

Of course, there may at times be extreme cases where policies outside of the monetary sphere are so inadequate, or conditions so severe, that there is no way monetary policy could ever achieve its goals. In such a case, it may be right for the central bank to sit back and refrain from engaging its credibility or its balance sheet further. In essence, this is the call the ECB made about Greece in March 2015, and about Cyprus two years ago. In both cases, they got criticized. Interestingly, in the case of Cyprus, the ECB got criticized both for making it too late and making it too soon. These are difficult choices, indeed.

Hard Truth #4: Central banks, even though independent, are not immune to political realities.

When the crisis broke out, and at every point since then, the Fed [the US Federal Reserve] was able to implement the decisions it deemed warranted when it deemed them warranted. And it went all out. It faced criticism and had plenty of explaining and defending to do, but it acted effectively unimpeded. And this despite being, on paper, one of the less independent central banks in the developed world. The Fed's ability to act decisively saved the world economy from the abyss. This to me is a compelling argument for not tinkering with it.

Other central banks are less fortunate. They felt for various reasons that they had to take into account political sentiment in their decisions. For example, the ECB launched QE arguably much later than it would have, had it not been for the staunch opposition of Germany and other countries. A less courageous and persistent ECB president may well not have launched it at all. In Japan, the Abe government had the good fortune to come to power just around the time a new governor could be appointed. Not surprisingly, it chose to appoint one whose views on the need for the BOJ [Bank of Japan] to combat deflation were fully aligned with those of the government. And overnight, the BOJ switched from a firm view that deflation was driven by demographics, and was hence not an issue for the central bank to handle, to an equally firm view that deflation reflected chronically insufficient demand against which monetary policy should be a prime remedy.

There, too, there is a difficult choice: along with Supreme Courts, central banks are among the unelected bodies with the most consequential decision powers. For their legitimacy to endure and their independence to enjoy continued popular support, they cannot afford to ignore overwhelming political sentiment. Central banks are a part of the state's institutional arsenal, regardless of the degree of formal independence they enjoy. Particularly in a severe crisis, it is totally unrealistic to assume that somehow that part of the arsenal could or should not be engaged.

This could have implications down the road for central banks' willingness to deploy macroprudential policy tools at the right time if, as one would expect given their targeted nature, there are strong vested interests.

Hard Truth #5:
We don't fully understand disinflation in key advanced economies.

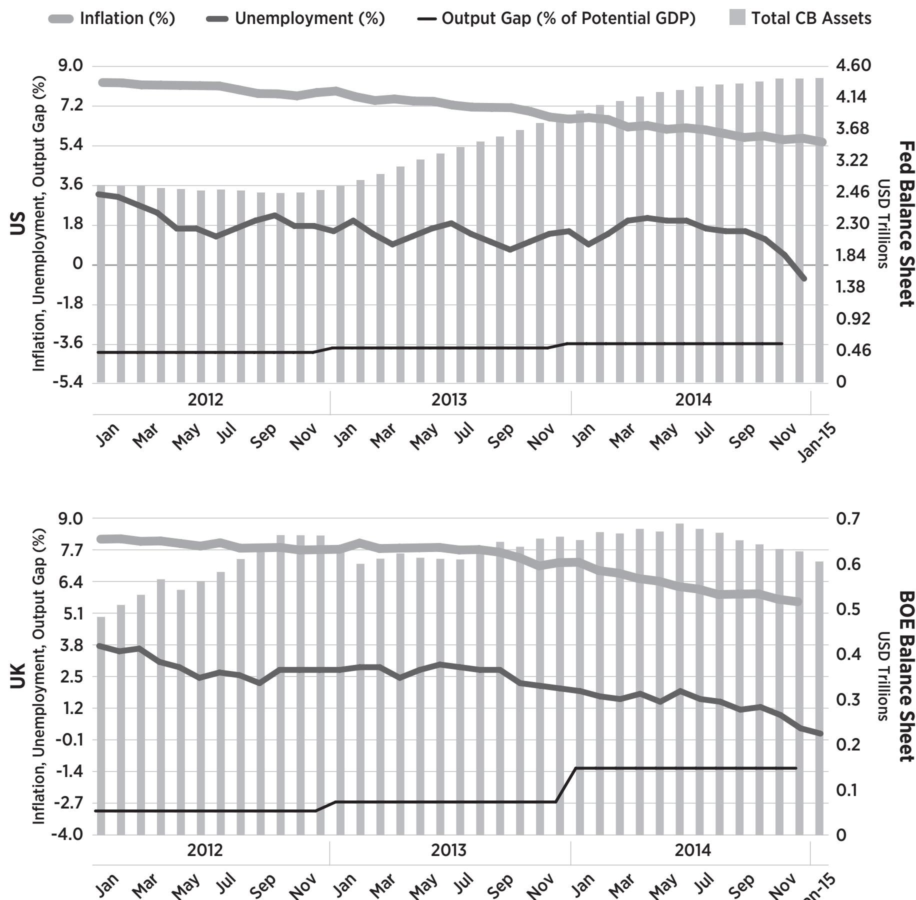
With the exception of Japan, disinflation has firmly set in in advanced economies from already low levels, despite unprecedented amounts of money poured into the economy, fast falling unemployment, and rapidly vanishing spare capacity in advanced economies, and this is also affecting inflation expectations.

In part, this reflects sharply lower oil prices; in part, the impact of new technologies. (A $650 iPhone embodies $1,200 of components at 1991 prices.) In part, it reflects the peaking of a global investment boom cycle, this time led by emerging markets, notably China.

But it could also reflect sustained weakness in aggregate demand, and many indeed expect that it will be prolonged, reflecting a combination of long-term forces such as population aging, stalled productivity gains, and so forth, that is, the secular stagnation hypothesis. In such a predicament, the economy would need very negative real interest rates in order to grow at a healthy clip. These are impossible to achieve owing to rock-bottom inflation. In the worst case, this could cause a disinflationary spiral that could ultimately turn into deflation.

So the difficult choice before us is to decide whether this strong decline in inflation should be considered benign or worrying, and therefore whether it should be actively combatted or not. In Japan and the euro area, which are actually experiencing deflation, the authorities have firmly taken the view that it must be combatted. In the UK,

FIGURE 5. INFLATION VERSUS CENTRAL BANK ASSETS, UNEMPLOYMENT, AND OUTPUT GAP



Sources: Thomson Reuters Eikon; U.S. Bureau of Labor Statistics (http://www.bls.gov/data/); IMF (http://www.imf.org); Eurostat (http://ec.europe.eu/eurostat).

they are applauding disinflation, while in the US, the Fed has made clear that while it does not envision additional easing at this juncture, it would not make monetary policy less accommodating than it currently is until it was confident that inflation was heading back up. Why these different reactions?

- Clearly, in economies that are not growing much and suffer from debt overhang, ultra-low or negative inflation is very detrimental, since it makes it harder to reduce debt. It also makes it harder to address competitiveness problems.

- In other cases, with accelerating growth and a closing output gap, very low inflation may be more benign, indeed boosting consumers' purchasing power and arguably helping redress the decade-long deterioration of the share of wages versus profits in national income.

- But even if low inflation per se is not a huge concern, very low interest rates for nearly a decade, or maybe more, might be. They might inflate asset bubbles and fuel excessive leverage (cf. Hard Truth #1), but also critically weaken the returns of pension funds and insurance companies, causing growing mismatches between their assets and liabilities. And if households are forward looking, it is even conceivable that, anticipating a depletion of their retirement savings, they will end up saving more today, thereby weakening aggregate demand and further contributing to disinflation.

So regardless of the conditions of the economy today, disinflation is clearly a phenomenon central bankers need to watch closely lest it should turn outright malicious.

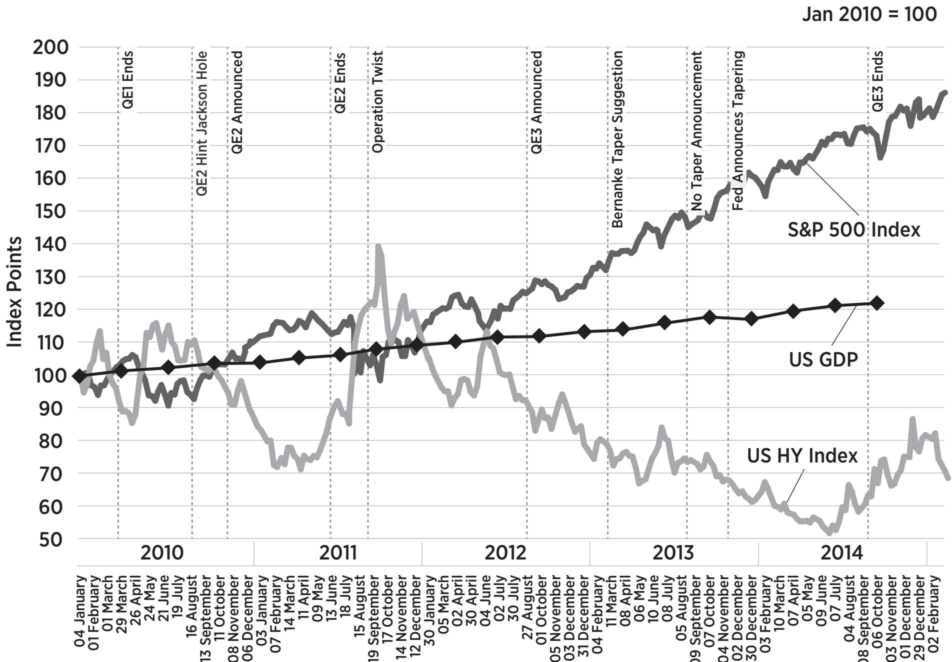
Hard Truth #6: We have no precise idea of the degree of distortion embedded in financial markets as a result of QE, nor of what will happen when QE is unwound.

The Fed and the Bank of England are at the stage when they—and everybody watching them—are thinking about exit. They have set out as cogently as they could what will guide their decisions as to when to actually exit. (In effect, we are now back to a world where data dependency is the key concept.) But what happens then is anybody's guess.

Prices have been deeply affected both in the markets where these central banks targeted their interventions, and in all the other markets investors were pushed into as a result of their search for yield. The same can now be expected to happen in the euro area, with the ECB's QE program set to purchase sizably more sovereign paper than its net new issuance.

Here, too, central bankers face a difficult choice: Almost certainly, unwinding these interventions will cause some volatility at best, possible turbulence at worst. Yet not unwinding them poses growing risks. Central banks need to remain vigilant and change course when the marginal damage exceeds the marginal benefits. That there are marginal benefits alone cannot be sufficient to justify policies with known downsides.

FIGURE 6. US EQUITY AND BOND MARKET, OUTPUT GROWTH, AND FED QE ANNOUNCEMENTS



Sources: Thomson Reuters Eikon; St. Louis FED (http://research.stlouisfed.org/fred2).

The trade-off can be significantly improved, and the choice made less difficult, by preparing markets for the inevitable volatility to come: insist on large capital and liquidity buffers, boosting market liquidity by standardizing securities, centralizing trading, ensuring transparency of trades, and relentlessly reminding market participants that liquidity might be mispriced.

Conclusion

In sum, since the global financial crisis, central banks have faced extraordinary challenges and decided to throw the kitchen sink at them. Now, there is a sense of having survived the hurricane, but there is a lot of clean up to do. But the question is: Was there a superior alternative? Probably not, although it is hard to tell categorically. Most central banks have decided to err on the side of action. But this action has trade-offs.

Thinking of the predicament facing central banks when they went down the path of unconventional monetary policies, one is reminded of the old Swiss folk joke that Jean-Claude Trichet brought back to life in a speech in Dublin when the Irish economy was in a tailspin: a tourist asks for his way back to his hotel after getting lost in the Irish countryside and the local farmer replies, “If I were you, I wouldn’t start from here…”

So today’s generation of central bankers has to discover by themselves the way to the new normal. They are skilled and patient professionals and I am confident they will find it, but we should not be too critical if there are a few bumps in the road on the way there. And most importantly, as market participants, we need to expect them and prepare for them. For a genuine assessment, more time needs to go by and, more importantly, we need to see what the beach looks like once all the hurricane debris has been cleaned up.

Important Notes

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