The monetary-policy maze

The simple rules by which central banks lived have crumbled. A messier, more political future awaits.

Illustration by Derek Bacon

In the world that existed before the financial crisis, central bankers were triumphant. They had defeated inflation and tamed the business cycle. And they had developed a powerful intellectual consensus on how to do their job, summarised recently by David Blanchflower, a member of the Bank of England's monetary policy committee, as "one tool, one target". The tool was the short-term interest rate, the target was price stability.

This minimalist formula fitted the laissez-faire temper of the times. A growing array of financial markets could price risk and allocate credit efficiently. Central bankers had merely to calibrate their interest-rate tools and all other markets would automatically adjust. Central banks still cared about financial stability and full employment, but could argue these were best served by stabilising prices—without, if you please, interference from politicians.

The financial crisis has upended all that. The business cycle was supposedly subdued, yet the world is in the deepest recession since the 1930s. Deflation has become a more dangerous enemy than inflation; with interest rates in many countries at or close to zero, central banks have had to reach for other tools.

More fundamentally, the collapse of stable relationships in financial markets has forced central banks to make judgments they once left to the private sector. From lenders of last resort, they became lenders of first resort when banks stopped trusting each other. They are, increasingly, arbiters of which types of borrowers get credit. With the reputation of market discipline in tatters, central bankers will get vast new supervisory powers. All this is dragging central banks back towards political turf from which they had been distancing themselves for years.

Central bankers still believe that once the crisis has passed they will return to their pre-2007 roles as apolitical technocrats pulling a single lever and eyeing a single variable. It may be a vain hope. "When you question the basic premise which you have worked under for the last 15 to 20 years, which is that markets are rational and efficient, there is a case for a different approach to both monetary policy and regulation," says Thomas Mayer, chief European economist of Deutsche Bank.

Start with the most immediate question: what tools will central banks use to steer the economy in the near future? Before the crisis almost all leading central banks operated

through the short-term (usually overnight) money-market rate. By itself, that rate mattered much less to economic activity than, say, those on 12-month corporate loans or 30-year mortgages. But the links between these and official rates were stable enough to allow the central banks to influence overall financial conditions and hence the entire economy.

Those links came under strain before the crisis, as a global saving glut caused a decoupling of long- and short-term rates. During the crisis they disintegrated as lenders worried that loans could not be sold on or would not be repaid. Central banks responded by expanding their lending operations through a mixture of more types of credit and collateral, longer terms and more counterparties (see chart 1). The Federal Reserve began lending to investment banks. The European Central Bank (ECB) guaranteed unlimited funds for up to six months instead of one week. Some have gone much further. The Bank of Japan has bought equities and the Swiss National Bank has intervened in the currency markets.

Broader-minded banking 1

Changes in central-bank operations since 2007

	Lending operations				Outright purchases				Bail-outs, capital injections
	More counter-parties	More liberal collateral	Longer term	Foreign exchange swaps	Foreign exchange	Equities	Private debt	Gov't debt	
Australia		✔	✔	✔					
Britain		✔	✔	✔			✔	✔	✔
Canada	✔	✔	✔	✔			*possible*	*possible*	
Euro area		✔	✔	✔			*possible*	*possible*	
Japan			✔	✔		✔	✔	✔	*possible*
Sweden	✔	✔	✔	✔					
Switzerland			✔	✔	✔				✔
United States	✔	✔	✔	✔			✔	✔	✔

Source: Central banks

Even if the crisis is getting no worse, it is not over and most of the world is in recession. No central bank is about to withdraw any emergency measures. Some are contemplating new ones. Both the Bank of Canada and the ECB are considering outright purchases of government or corporate debt to boost the quantity of credit.

Central bankers assume they will wind down these measures when the crisis ends. The Fed, for example, is required by law to end some when the need is no longer urgent. It charges a penalty for some programmes so that borrowers will return to private markets once these have healed. An exit strategy is necessary to "end up with a market-based economy that is more balanced and more resilient," Donald Kohn, the Fed's vice-chairman, has said. Mervyn King, governor of the Bank of England, has said the exit strategy will be dictated by the outlook for inflation and that central banks should not support markets that cannot survive on their own.

In need of new targets

But withdrawal may be harder than it sounds. A study last year by IMF staff asked, "What will 'normal' look like?" It argued: "There is no expectation that markets will return to their pre-crisis mode of operation soon, if ever. Market spreads taking account of credit and liquidity risk had arguably become too compressed pre-August 2007, and are now wider than they should be long-term. But it is not clear what the appropriate level should be."

After the Bank of Japan became the primary supplier of overnight funds to banks earlier this decade, the interbank market atrophied. It remains a fraction of its former size. European

banks today are now heavily dependent on the Fed for dollars (supplied via swap lines with local central banks) and on the ECB for six-month euro funds.

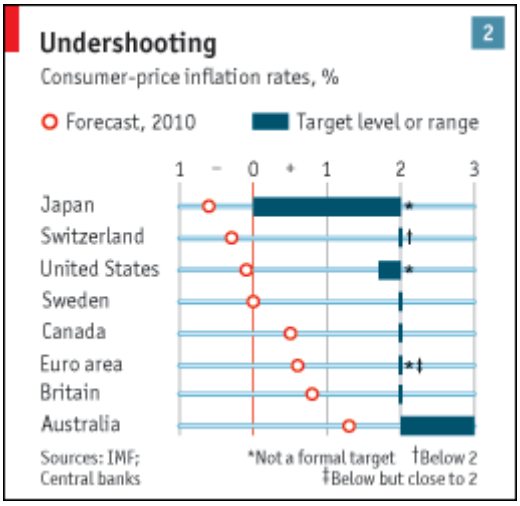
A tepid recovery will make central banks reluctant to withdraw support from critical markets, especially if business or politicians protest. In 1942 the Fed agreed to hold down long-term interest rates to help the Treasury finance the war; it did not extract itself from the commitment until 1951. When the time comes to sell its large holdings of mortgage debt, it may face resistance from America's housing lobby.

Central banks may not just have to rethink their tools. They may also have to rethink their goals. Governments and central banks had come to agree that they should focus only on achieving low and stable inflation. The Fed by law must emphasise employment and inflation equally, but in practice it, too, targets inflation. This consensus was forged in central banks' research departments and universities, and its adoption paralleled a rise by academics to the top ranks of central banks: among the leading lights are not only Ben Bernanke, chairman of the Fed, and Mr King but also Lucas Papademos, vice-president of the ECB, and Lars Svensson, a deputy governor of Sweden's Riksbank.

Macroeconomics in general has come under fire for depending too much on assumptions of efficient markets and its inability to incorporate the spasms of emotion that create economic manias and panics. "As a monetary policymaker I have found the 'cutting edge' of current macroeconomic research totally inadequate in helping to resolve the problems we currently face," said Mr Blanchflower, a labour economist, in a speech he gave on March 24th.

The exclusive focus on low and stable inflation is being questioned for the same reason. The recession began against a backdrop of price stability—as did America's Depression and Japan's lost decade. "Inflation targeting alone will not suffice," Mr Blanchflower said. "This approach failed to prevent the build-up of imbalances that presaged the crisis and was insufficient in dealing with failing banks and financial-market stress as the crisis developed. There is now a consensus that new tools are required to regulate the financial sector and prevent such crises in the future."

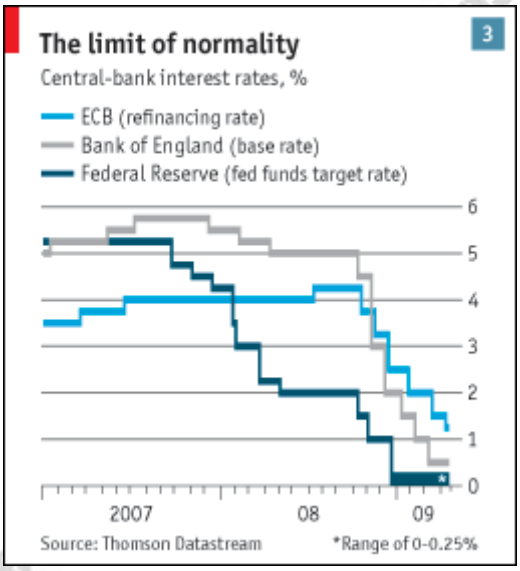
Mr Bernanke and his predecessor, Alan Greenspan, argued before the crisis that bubbles are hard to identify before they burst. Pricking them is even harder without wrecking the economy. Central banks should act only if bubbles threaten price stability; otherwise, they should wait and clean up after they burst. The shallow recession that followed the tech-stock boom of the late 1990s seemed to vindicate them.



Recent experience does not help their argument. William White, who retired last year as chief economist of the Bank for International Settlements, argues that because central banks were focused on price stability in the medium term, they allowed bubbles to form. The bursting of these raises the risk of deflation in the long run.

Inflation in many countries will be negative this year mainly because of cheaper fuel. But even in 2010, when that effect is fading, inflation will stay below the 2% most central banks define as price stability. In its latest forecast, published on April 22nd, the IMF says prices will fall in America, Japan and Switzerland (see chart 2).

To be sure, many central banks are more sanguine, noting that inflation expectations are, in the jargon, well-anchored. Many in the market fear that once the crisis passes central banks will be too slow to raise rates and wind down their credit programmes, unleashing inflation. But persistently falling prices would constrain central banks' ability to boost growth, because they would be unable to push interest rates below inflation—ie, make them negative in real terms. Using the Taylor rule, a popular rule of thumb, economists at Deutsche Bank suggest that given today's degree of economic slack and inflation rates, short-term rates should be negative in America, Britain and the euro area. Instead, they are at or near zero (see chart 3). Were deflation to deepen, real interest rates would rise, further hampering economic activity.



Eric Rosengren, president of the Federal Reserve Bank of Boston, noted recently that the Fed has hit, or all but hit, the zero limit twice this decade. That is more often than earlier simulations had indicated—and it suggests higher inflation targets should be considered. Another proposal is that central banks aim at a path for the price level rather than the inflation rate. Suppose that this path rose by 2% each year. Then after deflation of 1% in year one, the central bank would aim for inflation of more than 2% in later years (inflation of 5% in year two, say) to bring prices back up to the target. Greg Mankiw, a Harvard University economist, goes further, suggesting that inflation simply be given lower priority. "There are worse things than inflation," he says. "We have them today."

Altering or abandoning inflation targets would make a big dent in the credibility that central banks took decades to establish and is therefore highly unlikely. And although benign neglect of bubbles no longer appears an option, central bankers are not ready to advocate pre-emptive popping, because the problem of identifying them early enough remains unsolved. Better, they argue, to use regulation to identify and defuse dangerous accumulations of risk in the financial system.

The term for this is “macroprudential” supervision. Last year Mr Bernanke laid out how this would differ from the normal supervision of individual banks. He said a single firm may have an acceptable exposure to a particular type of risk that would be unacceptable if replicated across many firms. Similarly, a supervisor might press a particular bank to lend less during a slump whereas a “macroprudential supervisor would recognise that, for the system as a whole,” that could make matters worse.

The embrace of macroprudential supervision represents a reversal of another pre-2007 trend—for central banks to shed supervisory duties and concentrate on monetary policy. Academics argued that supervision was a distraction from the pursuit of price stability and created potential conflicts: a central bank might run an inflationary policy to cushion a failing banking system, or prop up an insolvent bank to cushion the economy. Central banks in Australia and Britain gave up some or all of their supervisory roles. The ECB was created with none.

The run on Northern Rock, a British bank, and problems at state-owned German banks were blamed in part on inadequate involvement by the central bank in supervision. This year the Bank of England received a more formal role in overseeing banks. A commission headed by Jacques de Larosière, a former head of both the Bank of France and the IMF, has recommended that the ECB chair a new European Systemic Risk Council made up of its member central banks and supervisors, but that it remain out of firm-specific supervision. The Fed until recently was the leading candidate to fill the American Treasury’s proposed job of “systemic risk regulator”, empowered to examine any corner of the financial system and act against emerging risks.

Yet macroprudential supervision smacks of a fad that will not live up to its billing. It faces the same difficulty as conventional monetary policy does in spotting and popping bubbles. Moreover, there has been no correlation between a central bank’s supervisory responsibilities and its ability to prevent or deal with the crisis. The Fed is America’s most powerful and best informed financial regulator but the trouble began under its nose. Neither Australia’s central bank nor Canada’s has any supervisory duties, yet the financial systems of both countries have been virtually unscathed. This record has less to do with who supervises the financial system than with local laws and behaviour. Subprime mortgages peaked at about 1% of the total in Australia and 2.5% in Canada, compared with more than 14% in the United States.

Illustration by Derek Bacon

New combatants in the political arena

Rightly or wrongly, central banks will emerge from the crisis with a bigger role in the markets and in supervision. This will challenge another element of the pre-2007 consensus: that central banks be as far removed from politics as possible. Formal independence insulated the central bank from politicians' desire to play fast and loose with inflation. And part of the appeal of "one tool, one target" was that it made monetary policy explicitly a technical rather than political affair.

The divide between central banking and politics looks much less clean today. Unconventional policies often require a central bank to make loans that may not be repaid in full. Because taxpayers will bear any losses, finance ministries need some say. Credit allocation and tighter regulation make some firms winners and others losers, and so require more public accountability. With interest rates at zero, the Fed and the Bank of England are buying government debt to boost the quantity of credit and the money supply. But governments could come to rely on such purchases to finance budget deficits. The potential for political conflict extends abroad too. Having cut its rates to zero, the Swiss National Bank has bought foreign currency to drive down the Swiss franc. Some labelled this competitive devaluation.

Managing such conflicts is a delicate job. The Fed and the Treasury attempted to assuage concerns by releasing a joint statement affirming the Fed's sole responsibility for price stability. Mr King broke a longstanding silence on fiscal policy to warn the British government against adding to a fast-growing national debt.

Such tensions are unlikely seriously to dent the institutional protections built around central banks in recent decades. Last year Japanese opposition parties blocked the appointments of two candidates to head the Bank of Japan on the ground they were insufficiently independent of the government. There are exceptions: Iceland's government amended the law so that it could fire David Oddsson, the head of its central bank. But Mr Oddsson had presided, first as prime minister and then as central-bank governor, over the policies that led to the country's crisis.

Central bankers' jobs matter even more than they did before 2007. At the same time, they have been drawing more criticism and political scrutiny. Public disapproval ratings have risen notably for Mr Bernanke, the Bank of England and the ECB. They are having to defend their policies to the public as well as to the markets. Mr Bernanke agreed to a profile by "60 Minutes", a news programme, in which he strolled down the streets of his hometown. Mr King sat for an interview with the BBC to explain quantitative easing. The six members of the ECB's executive board gave 200 interviews last year.

After the Riksbank slashed its interest-rate target to 0.5% on April 21st, its governor, Stefan Ingves, took questions from the public in an online chat session. Asked what he liked most about his job, the former economics professor said that what he used to study in theory he now gets to put into practice. He added: "It's fun to go to work every day." You may wonder how many of his peers would agree with him.

THE monetary-policy maze. **The Economist**, New York, 23 abr. 2009. Disponível em <www.economist.com>. Acesso em: 30 abr. 2009.