LESS IS MORE

More focused, less interventionist central banks would likely deliver better outcomes

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Central bankers of industrialized countries have fallen tremendously in the public's estimation. Not long ago they were heroes, supporting feeble growth with unconventional monetary policies, promoting the hiring of minorities by allowing the labor market to run a little hot, and even trying to hold back climate change, all the while berating paralyzed legislatures for not doing more. Now they stand accused of botching their most basic task, keeping inflation low and stable. Politicians, sniffing blood and mistrustful of unelected power, want to reexamine central bank mandates.

Did central banks get it all wrong? If so, what should they do?

The case for central bankers

I'll start first with why central banks should be cut some slack. Hindsight is, of course, 20/20. The pandemic was unprecedented, and its consequences for the globalized economy very hard to predict. The fiscal response, perhaps much more generous because polarized legislatures could not agree on whom to exclude, was not easy to forecast. Few thought Vladimir Putin would go to war in February 2022, disrupting supply chains further and sending energy and food prices skyrocketing.

Undoubtedly, central bankers were slow to react to growing signs of inflation. In part, they believed they were still in the post–2008 financial crisis regime, when every price spike, even of oil, barely affected the overall price level. In an attempt to boost excessively low inflation, the Federal Reserve even changed its framework during the pandemic, announcing it would be less reactive to anticipated inflation and keep policies more accommodative for longer. This framework was appropriate for an era of structurally low demand and weak inflation, but exactly the wrong one to espouse just as inflation was about to take off and every price increase fueled another. But who knew the times were a-changing?

Even with perfect foresight, central bankers—who are in reality no better informed than capable market players—might still have been understandably behind the curve. A central bank cools inflation by slowing economic growth. Its policies have to be seen as reasonable, or else it loses its independence. With governments having spent trillions to support their economies, employment just recovered from terrible lows, and inflation barely noticeable for over a decade, only a foolhardy central banker would have raised rates to disrupt growth if the public did not yet see inflation as a danger. Put differently, preemptive rate rises that slowed growth would have lacked public legitimacy—especially if they were successful and inflation did not rise subsequently, and even more so if they deflated the frothy financial asset prices

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that gave the public a sense of well-being. Central banks needed the public to see higher inflation to be able to take strong measures against it.

In sum, central bank hands were tied in different ways—by recent history and their beliefs, by the frameworks they had adopted to combat low inflation, and by the politics of the moment, with each of these factors influencing the others.

The case against

Yet stopping the postmortem at this point is probably overly generous to central banks. After all, their past actions reduced their room to maneuver, and not only for the reasons just outlined. Take the emergence of both fiscal dominance (whereby the central bank acts to accommodate the government's fiscal spending) and financial dominance (whereby the central bank acquiesces to the imperatives of the market). They clearly are not unrelated to central bank actions of the past few years.

While central banks can claim they were surprised by recent events, they played a role in constraining their own policy space.

Long periods of low interest rates and high liquidity prompt an increase in asset prices and associated leveraging. And both the government and the private sector leveraged up. Of course, the pandemic and Putin's war pushed up government spending. But so did ultralow long-term interest rates and a bond market anesthetized by central bank actions such as quantitative easing. Indeed, there was a case for targeted government spending financed by issuing long-term debt. Yet sensible economists making the case for spending did not caveat their recommendations enough, and fractured politics ensured that the only spending that could be legislated had something for everyone. Politicians, as always, drew on unsound but convenient theories (think modern monetary theory) that gave them license for unbridled spending.

Central banks compounded the problem by buying government debt financed by overnight reserves, thus shortening the maturity of the financing of the government and central bank's consolidated balance sheets. This means that as interest rates rise, government finances—especially for slow-growing countries with significant debt—are likely to become more problematic. Fiscal considerations already weigh on the policies of some central banks—for instance, the European Central Bank worries about the effect of its monetary actions on "fragmentation," the yields of fiscally weaker countries' debt blowing out relative to those of stronger countries. At the very least, perhaps central banks should have recognized the changing nature of politics that made unbridled spending more likely in response to shocks, even if they did not anticipate the shocks. This may have made them more concerned about suppressing long rates and espousing low-for-long policy rates.

The private sector also leveraged up, both at the household level (think Australia, Canada, and Sweden) and at the corporate level. But there is another new, largely overlooked, concern—liquidity dependence. As the Fed pumped out reserves during quantitative easing, commercial banks financed the reserves largely with wholesale demand deposits, effectively shortening the maturity of their liabilities. In addition, in order to generate fees from the large volume of low-return reserves sitting on their balance sheets, they wrote all sorts of liquidity promises to the private sector—committed lines of credit, margin support for speculative positions, and so on.

The problem is that as the central bank shrinks its balance sheet, it is hard for commercial banks to unwind these promises quickly. The private sector becomes much more dependent on the central bank for continued liquidity. We had a first glimpse of this in the UK pension turmoil in October 2022, which was defused by a mix of central bank intervention and government backtracking on its extravagant spending plans. The episode did suggest, however, a liquidity-dependent private sector that could potentially affect the central bank's plans to shrink its balance sheet to reduce monetary accommodation.

And finally, high asset prices raise the specter of asymmetric central bank action—the central bank being quicker to be accommodative as activity slows or asset prices fall but more reluctant to raise rates as asset prices bubble up, pulling activity along with them. Indeed, in a 2002 speech at the Kansas City Federal Reserve Bank's Jackson Hole conference, Alan Greenspan argued that,

while the Fed could not recognize or prevent asset price booms, it could "mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion," thus making asymmetry a canon of Fed policy.

High asset prices, high private leverage, and liquidity dependence suggest that the central bank could face financial dominance—monetary policy that responds to financial developments in the private sector rather than to inflation. Regardless of whether the Fed intends to be dominated, current private sector forecasts that it will be forced to cut policy rates quickly have made its task of removing monetary accommodation more difficult. It will have to be harsher for longer than it would want to be, absent these private sector expectations. And that means worse consequences for global activity. It also means that when asset prices reach their new equilibrium, households, pension funds, and insurance companies will all have experienced significant losses—and these are often not the entities that benefited from the rise. Bureaucrat-managed state pension funds, the unsophisticated, and the relatively poor get drawn in at the tail end of an asset price boom, with problematic distributional consequences for which the central bank bears some responsibility.

One area in which reserve country central bank policy has consequences but their central bankers little responsibility is the external spillovers of their policies. Clearly, the policies of the core reserve countries affect the periphery through capital flows and exchange rate movements. The periphery central bank must react regardless of whether its policy actions are suitable for domestic conditions—if not, the periphery country suffers longer-term consequences such as asset price booms, excessive borrowing, and eventually debt distress. I will return to this issue in the conclusion.

In sum, then, while central banks can claim they were surprised by recent events, they played a role in constraining their own policy space. With their asymmetric and unconventional policies, ostensibly intended to deal with the policy rate touching the lower bound, they have triggered a variety of imbalances that not only make fighting inflation harder but also make it difficult to exit the prevalent policy mix, even as the inflation regime has changed to one of substantially higher inflation. Central banks are not the innocent bystanders they are sometimes made out to be.

Mission creep

So what happens now? Central bankers know the battle against high inflation well and have the tools to combat it. They should be free to do their job.

But when central banks succeed in bringing inflation down, we will probably return to a low-growth world. It is hard to see what would offset the headwinds of aging populations; a slowing China; and a suspicious, militarizing, de-globalizing world. That low-growth and possibly low-inflation world is one central bankers understand less well. The tools central bankers used after the financial crisis, such as quantitative easing, were not particularly effective in enhancing growth. Furthermore, aggressive central bank actions could precipitate more fiscal and financial dominance.

So when all settles back down, what should central bank mandates look like? Central banks are not the obvious institutions to combat climate change or promote inclusion. Often they have no mandate to tackle these issues. Instead of usurping mandates in politically charged areas, it is best that central banks wait for a mandate from the elected representatives of the people. But is it wise to give central banks mandates in these areas? First, central bank tools have limited effectiveness in areas like combating climate change or inequality. Second, could new responsibilities influence their effectiveness in achieving their primary mandate(s)? For instance, could the new Fed framework requiring it to pay attention to inclusion have held back rate increases—since disadvantaged minorities are usually, and unfortunately, the last to be hired in an expansion? Finally, could these new mandates expose the central bank to a whole new set of political pressures and prompt new forms of central bank adventurism? All this is not to say that central banks should not worry about the consequences of climate change or inequality for their explicit mandate(s). They could even follow the express instructions of elected representatives in some matters (for instance, buying green bonds instead of brown bonds when intervening in markets), though this opens them up to the risk of external micromanagement. However, the task of directly combating climate change or inequality is best left to the government, not the central bank.

But what about their mandate and their frameworks for price stability? The earlier discussion suggested a fundamental contradiction central banks face. Hitherto, there was a sense that

they needed one framework—for instance, an inflation-targeting framework that commits them to keeping inflation within a band or symmetrically around a target. Yet as Bank for International Settlements (BIS) General Manager Agustín Carstens argues, a low-inflation regime can be very different from a high-inflation regime. Depending on the regime they are in, their framework may need to change. In a low-inflation regime, in which inflation does not budge from low levels no matter the price shock, they may need to commit to being more tolerant of inflation in the future in order to raise inflation today. Put differently, as Paul Krugman argued, they have to commit to being rationally irresponsible. This means adopting policies and frameworks that effectively bind their hands, committing them to stay accommodative for long. But as argued above, this may precipitate regime change, for instance, by loosening perceived fiscal constraints.

Conversely, in a high-inflation regime, where every price shock propels another, central banks need a strong commitment to eradicating inflation as early as possible, following the mantra "when you stare inflation in the eyeballs, it is too late." The framework-induced commitment for inflation tolerance needed for the low-inflation regime is thus incompatible with the one needed for the high-inflation regime. But central banks cannot simply shift based on regime because they lose the power of commitment. They may have to choose a framework for all regimes.

Choosing frameworks

If so, the balance of risks suggests that central banks should reemphasize their mandate to combat high inflation, using standard tools such as interest rate policy. What if inflation is too low? Perhaps, as with COVID-19, we should learn to live with it and avoid tools like quantitative easing that have questionably positive effects on real activity; distort credit, asset prices, and liquidity; and are hard to exit. Arguably, so long as low inflation does not collapse into a deflationary spiral, central banks should not fret excessively about it. Decades of low inflation are not what slowed Japan's growth and labor productivity. Aging and a shrinking labor force are more to blame.

It is not good to complicate central bank mandates, but they may need a stronger mandate to help maintain financial stability. For one, a financial crisis tends to bring on the excessively low inflation that central banks find hard to combat. Second, the ways they typically tackle an extended period of too-low inflation, as we have seen, fuel higher asset prices and consequently leverage and further possible financial instability. Unfortunately, even though monetary theorists argue that it is best to deal with financial stability through macroprudential supervision, that has proved less than effective thus far—as evidenced by house price booms in key economies. Furthermore, macroprudential policies may have little impact in areas of the financial system that are new or distant from banks, as evidenced by the crypto and meme stock bubbles and their bursting. While we do need better coverage of the financial system, especially the nonbank shadow financial system, with macroprudential regulation, we should also remember that monetary policy, in Jeremy Stein's words, "gets into all the cracks." Perhaps then, with such power should come some responsibility!

What about responsibilities for the external consequences of their policies? Interestingly, central banks that are more focused on domestic financial stability will likely adopt monetary policies that have fewer spillovers. Nevertheless, central bankers and academics should start a dialogue on spillovers. A largely apolitical dialogue can begin at the BIS in Basel, where central bankers meet regularly. Eventually the dialogue can move to the IMF, involving government representatives and more countries, to discuss how central bank mandates should change in an integrated world. Pending such dialogue and a political consensus on mandates, though, refocusing central banks on the primary mandate of combating high inflation while respecting the secondary mandate of maintaining financial stability may be enough.

Will these twin mandates condemn the world to low growth? No, but they will place the onus for fostering growth back on the private sector and governments, where it belongs. More focused and less interventionist central banks would probably deliver better outcomes than the high-inflation, high-leverage, low-growth world we now find ourselves in. For central banks, less may indeed be more. FD

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