FROM THE
FOUNDER

Central Bank Magicians

Central bankers are being unfairly cajoled into becoming the global economy's new magicians. But can they really save the day?

Around the world, middle-class working families have reason to be worried.

Since the beginning of the financial crisis, global policymakers, using a variety of aggressive fiscal and monetary policies, have committed $17 trillion—an astonishing one-quarter of the world's GDP—trying to levitate the assets on bank balance sheets and revive the economy. Policymakers offered the banks unprecedented mark-to-market accounting forbearance, along with tax and regulatory forbearance. Yet reviving the economy has been challenging.

Between 2008 and the beginning of this year, the world economy has grown at an anemic 1.5 percent annual rate. The world may have avoided a depression, but the economy has hit a dangerous stall speed. At the same time, global debt has increased by more than 14 percent.

Policymakers deserve credit for having moved quickly. But how shall we judge their success? Their report card contains only two grades—one for avoiding a Lehman-like liquidity event, the other for preventing an inflationary or deflationary breakout. But shouldn't there be a third grade? One for preventing a slow-bleed, Japan-lite scenario of industrialized-world economic malaise?

The entire world has become skittish because demand has collapsed, but perhaps also because global public and private debt now exceeds an astounding 300 percent of GDP. Like a giant bow wave, the debt threatens to swamp the world economic ship. It doesn't help that in the United States, uncertainty over future fiscal and regulatory policies reigns supreme.

Economic orthodoxy suggests this debt explosion should somehow be reflected in the capital markets. Yet long-term interest rates (with of course the exception of the spreads of the eurozone periphery countries) remain strangely at extremely low yields. What is the market saying about the future? Keynesian, Ricardian, and Austrian theorists all provide explanations. Some point to an output gap that won't go away. Others suggest that a double-dip scenario is still in the cards. Others suggest that a spike in inflationary expectations and rising interest rates are only a matter of time.

Economists Jacob Kirkegaard, Belen Sbrancia, and Carmen Reinhart make the most interesting argument:

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that the central bankers themselves are a large part of the reason interest rates have remained so low. Today's policymakers are intervening in markets to achieve negative real interest rates. The economists label this process "financial repression." Governments cajole buyers—mostly central banks and their new proxies, the large international banks—to buy public debt to maintain negative real interest rates to increase inflation. While inflation may reduce the value of the debt, it is also a highly regressive "tax" on struggling middle-class working families.

No one denies that in periods of crisis, policymakers need to think creatively. But what are the potential unintended consequences of policy actions? Here are some questions:

■ Will financial repression turn out to have simply been a clever way for governments to expand at cheaper interest rates? Does this policy socialize losses, unfairly shifting the burden of debt from the public sector to the struggling private sector?

■ Are there limits to the expansion of central bank balance sheets, the length of time liquidity is being made available, and to the diminishing quality of the assets on those balance sheets?

■ What does it mean if all the world's central banks engage in quantitative easing while their governments target export-led growth? What is the chance this monetary expansion morphs into a *de facto* ugly race-to-the-bottom global exchange rate policy to achieve competitive advantage?

■ To what extent is the economy becoming immune to monetary stimulus? In 2008, at the beginning of the financial crisis, for example, it took roughly $1 trillion in central bank stimulus to calm bond and equity markets. During the next period of financial market turbulence, 2010–11, it took more than $2.5 trillion to do the job. Is central bank stimulus acting as a kind of monetary morphine? Is the economic body gradually becoming immune to the drug? During the next panic, will $5 trillion be needed before financial markets stabilize?

Has central bank policy reduced the pressure on governments to exert fiscal restraint?

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■ Has central bank policy reduced the pressure on governments to exert fiscal restraint? And is a monetary bubble the latest attempt to compensate for the economy's underlying disappointments, including inadequate innovation to increase productivity and enhance economic growth?

■ To what degree has recent central bank policy moved the world away from "the rules of a market economy toward a system with centrally planned capital flows," as economist Hans-Werner Sinn argues? Do today's massive short-term liquidity injections risk "a renewal of the [pre-financial crisis] 'reach for yield' phenomenon," as former New York Federal Reserve President Gerald Corrigan suggests?

■ The world seems a lot closer to a disinflationary scenario than to a breakout in inflation. Nevertheless, at what point in providing liquidity have central bankers set the conditions for much higher inflation? Is there some crossroad reached where banks suddenly have adequate reserves with offsetting liabilities reduced through transfers to central banks such that a sooner-than-expected optimism sets in? At that point, could the monetary conditions become a tinderbox of vulnerability? With the long bond no longer effective as an early warning tool, how can central banks act preemptively toward a point of potential danger?

The world is in search of a magic pill to restore the international economy to health. As such, central bankers are being unfairly cajoled into becoming the global economy's new magicians. But can they really save the day…and do so with no ugly unintended consequences?

—DAVID SMICK
Founder and Editor, TIE