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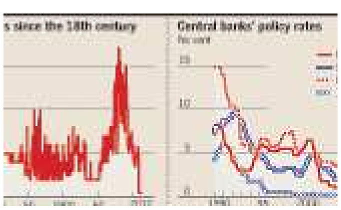
After the bonfire of the verities

By Martin Wolf

What is the future of central banks? It will be busy, because they are now expected to deliver both monetary and financial stability. It will be controversial, because the decisions they make have a huge impact on the distribution of income, people's access to finance, the way the financial system operates and even the solvency of governments.

Before the crisis, the rise of sophisticated modern finance was thought to render redundant the role of central banks as guardians of financial stability. It had been long believed that their role as financiers of government brought only inflation. Thus, central bankers became priests of a monetary policy aimed at low and stable inflation.



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This past is a foreign country. Central banks have not abandoned the religion of price stability, though some economists have muttered heretical thoughts about the need for higher inflation. Nevertheless, central banking has been transformed, in practice and theory.

The practical transformation is a direct result of the crisis. Central banks found themselves forced into historically unprecedented monetary easing, not just via extremely low interest rates but also via huge expansions in their balance sheets (see charts). Of the big central banks, the Federal Reserve was the most innovative, partly because of the role of non-bank institutions and partly because of the inability of the fiscal authorities to act. But the European Central Bank has been surprisingly innovative, too.

The huge expansions in central bank balance sheets are thought to be harbingers of hyperinflation. Those who live on income from savings are enraged by the low interest rates. Almost everybody is angry about the bailout of the banks. The fact that the central bankers saved the world from a second great depression is disregarded. Nobody gains credit for eliminating a hypothetical event. It is perhaps surprising that central banks have not been even more discredited.

The theoretical transformation is an indirect result of the crisis. The list of the assumptions that turned out to be false is lengthy: that the financial system would be self-stabilising, that managers of banks would prove competent, that financial innovation would improve risk management, that low and stable inflation would guarantee economic stability. We have witnessed a bonfire of the verities.

In short, central banks are doing far more with less political capital. To be fair, not all are tainted by failure. The central banks of Canada and Sweden, to name two examples among high-income countries, can hold their heads high. But this is part luck: these countries had crises in the 1990s. Sooner or later, as Hyman Minsky warned, complacency breeds excess and crisis.

What, then, is to be done?

The immediate task is to manage an exit from the interventions. Critics exaggerate the difficulty of this task. The fears of imminent hyperinflation are idiotic. As Ben Bernanke, chairman of the Federal Reserve, explained in an important speech on April 13, central banks have expanded their balance sheets because those of the private financial sector collapsed.* That is what a lender of last resort is supposed to do during a severe panic. We have known this since the 19th century.

Then, as and when private lending recovers, the central banks will reverse course, selling assets into the market and reducing their credit to banks. But this will be a lengthy and fragile recovery. A far greater danger exists of premature retrenchment than of excessive delay. The risk of inadequate action and premature retrenchment is greatest in the eurozone. If so, there is a chance that the euro and much of the fabric of postwar European co-operation will be swept away. Central banks are not playing for small stakes.

Then, if they manage the exit successfully, which we will probably not know until the 2020s, central banks will confront a new world. They will need to balance their old roles as formulators of monetary policy with new roles as guardians of financial stability. Making this still harder will be the dire fiscal legacy of the crisis. The higher levels of public sector debt threaten a return to “fiscal dominance” in which central banks will, willy nilly, be forced to finance the government, however inappropriate that may be.

The new world of post-crisis central banking will create significant institutional challenges.

Domestically, the issue will be how to secure needed co-operation among the fiscal authority and the bodies charged with oversight of individual institutions, oversight of financial stability and management of monetary policy. Even where, as in the UK, the last three responsibilities are all going to be part of the central bank, relationships with the ministry of finance will be crucial. Moreover, the centralisation of authority in one institution carries its own risks of insufficient airing of differences, groupthink and ultimate failure.

Yet the world of macro-prudential policy will also generate cross-border overlaps. Banks operating in one jurisdiction have the capacity to generate large negative spillovers on to other jurisdictions. Managing these is going to prove very difficult, particularly within Europe.

Yet the most difficult challenges are not institutional, but intellectual. How, in practice, will policies aimed at securing financial stability interact with monetary policy? Consider, for example, the possibility that the committee charged with the former is trying to cool lending in, say, the property sector when the committee charged with the latter is seeking to heat it up in the economy. They could find themselves operating in contradiction.

More fundamentally, nobody can be confident that the propensity of the financial system towards huge crises can be halted. Indeed, the longer that success is achieved, the greater will be the complacency and the bigger may be the crisis. Yet the regulators, central banks foremost among them, are doomed to try. The price of past failures is their present increase in responsibility. It really is a strange and eventful history.

**'Some Reflections on the Crisis
and the Policy Response', www.federalreserve.gov*

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