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Central Banks Fight to Ensure Monetary Manipulation Is New Normal

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Unconventional tools deployed by central bankers from Frankfurt to Washington to mitigate the economic fallout of the financial crisis may be conventional when the time comes to combat the next downturn.

The Federal Open Market Committee is already discussing the issue while other central bankers and economists in developed nations debate whether to holster emergency policies — bond buying, targeted credit programs and negative interest rates — or make them part of their everyday armories.

The shift beyond a short-term interest rate as the main lever of monetary policy could force investors, consumers and businesses to make sense of a world with multifaceted, sometimes arcane policies. Toolkits expanded since the crisis seven years ago are encountering resistance from lawmakers and others who argue central bankers have gone beyond their mandates.

"I really wish we would stop yielding the ground and acting as though these policies are something to be ashamed of or something to abjure except under emergencies," Adam Posen, president of the Peterson Institute for International Economics in Washington and a former Bank of England official, said at an IMF forum this month.

Policy makers are facing tough choices because of the unusual nature of the recovery across the developed world. Despite more than 600 interest-rate cuts and more than $12 trillion in asset-purchases, inflation rates remain well below the targets of most central banks and the speed at which economies can expand seems to have downshifted because of aging populations and declining worker productivity.

Such an environment also means rates will likely peak lower than in past cycles and the return to zero will be faster, said Maurice Obstfeld, the International Monetary Fund’s new chief economist.

"The risk is that when the next recession comes we will be at a low level of nominal interest rates so there is not a lot of ammunition to respond," Obstfeld said in an interview.

Federal Reserve officials last month made the same point, saying the policy rate that is likely to keep the economy humming at full employment and stable prices "would likely be lower than was the case in previous decades," minutes from the Oct. 27-28 meeting released Wednesday showed.

"The question is, 'what can monetary policy do about that?'" Obstfeld said.

The obvious answer for many central bankers and economists is to start promoting unconventional tools as part of the range of normal policy choices for the future.

Switzerland and Sweden have already proved it possible to cut benchmarks beneath zero without triggering bank runs or cash hoarding, while even the European Central Bank may next month charge banks even more to hold their cash overnight.

Additional Tools

Fed officials are expressing their interest in the issue, with the minutes noting "it would be prudent to have additional policy tools," according to some at the meeting.

On the other side of the debate, economists such as Mark Calabria, director of financial regulation studies at the Cato Institute in Washington, say the Fed should begin a conversation now with fiscal policy makers about the limits of interest-rate policy so they don't engage in an ever-expanding array of unusual tactics.

"If you want to protect the independence of monetary policy, then the Fed chair should be vocal about where the line is, what you can fix, and what you can't," Calabria said.

Turning the unconventional into the conventional is not as simple as it sounds, said Michael Bordo, an economic historian and professor at Rutgers University, who noted that the new policies are "worrisome" and carry their own set of risks.

For one thing, they create winners and losers. Savers, for example, could lose out from monetary largesse and negative rates, while bond holders and property owners are rewarded. Easy money on a prolonged basis could also end up inflating assets more than they do the real economy, risking financial instability as investors create bubbles in the hunt for returns.

Such bubbles also tend to favor asset holders over wage earners, breeding controversy. Bank of America Corp. estimates an investment of $100 in a portfolio of stocks and bonds since the Fed began quantitative easing would now be worth $205. Over the same time, a wage of $100 has risen to just $114.

Lawmaker Scrutiny

"It is not surprising that we have gotten a lot of scrutiny, and I am not surprised at all about the populist anger," Richmond Fed President Jeffrey Lacker told reporters last week.

Unorthodox monetary policies can also look a lot like fiscal policy boosting specific sectors of the economy, drawing the interest of politicians. The Fed currently owns $1.74 trillion of mortgage-backed securities, intended to help keep borrowing costs low to boost the housing market.

In the U.S. House, Republicans are skeptical about the Fed’s discretion and may vote on legislation this week that would force the FOMC to describe its policy rule and, under certain conditions, subject their decisions to audit.

In this political environment, more rounds of quantitative easing would beget more scrutiny, said Sarah Binder, a senior fellow at the Brookings Institution in Washington who is writing a book on the Fed and politics.

"The Fed has certainly not restored its political reputation that it could rely on to insulate itself pre-crises," Binder said.

Inflation Mandates

Central bankers say they are just doing their jobs. They have mandates to keep prices stable, and in the Fed’s case, to keep unemployment at a minimum. Recent experience has the bolstered confidence of some officials that unconventional tools work.

"A number of studies have suggested that the forward guidance and large-scale asset purchases conducted by the Federal Reserve boosted the levels of employment and inflation at a time when the level of short-term interest rates was constrained by the zero lower bound," Fed Governor Lael Brainard said in a Nov. 6 speech.

In Europe, Bundesbank President Jens Weidmann has been among the skeptics even as ECB President Mario Draghi considers fresh stimulative measures next month. The effectiveness of "ultra" lax policies is wearing off and their risks and side effects are growing, Weidmann told Tagesspiegel newspaper this month.

On the other side are some current or former central bankers, who argue that unorthodox policies may have actually been too timid and are the way of the future, like it or not.

"There is no reason to think that you have to give up balance sheet operations or quantitative easing-type operations once you get back to ’normal,’" Posen said.

Obstfeld said both the advocates for rules and those for action have sound arguments. Research has shown that discretionary policies don’t always produce the best outcomes, he said. On the other hand, studies have also shown that use of quantitative easing during the 2008 financial crisis and subsequent global recession, probably staved off a deeper slump.

Unconventional tools “are going to stay part of the toolkit,” Obstfeld said. Still, whenever they are used, “there will be tensions.”