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The search for growth

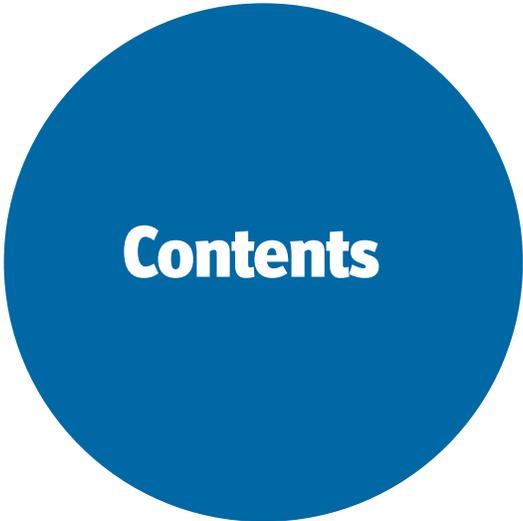
Central banks in
uncharted territory

A report from the Economist Intelligence Unit

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1

Introduction

The European Central Bank (ECB) created a small sensation in August when it said that it was considering buying unlimited amounts of government bonds in order to cap the yields on the debts of Spain, Italy and other beleaguered euro zone states. A month later, the US Federal Reserve announced a third round of quantitative easing that it said would end only when economic conditions improved. The two announcements were widely anticipated; two years ago, they would have been unthinkable.

In their ongoing response to the aftershocks of the global financial crisis, central banks are abandoning the narrow role they traditionally played in economic affairs. In developed economies in particular, they have greatly expanded their direct participation in financial markets, working to sway investor sentiment and restore confidence. Much of this shift has been reluctant, and arguably it is spurred by lack of government action to stimulate the global economy or correct structural imbalances. But many observers expect the changes to be permanent.

Through it all, institutional investors and corporate executives have maintained relatively high confidence in central banks. In a survey by the Economist Intelligence Unit of over 800 investors and corporate leaders conducted in January 2012 and sponsored by BNY Mellon, 54% expressed confidence in central banks' handling of monetary policy, up from 51% in 2011.

Asked why overall positive views of central bankers remain so prevalent, investors interviewed pointed to the long-standing respect for central bankers in the financial world and their assumed detachment from politics. Others suggested that central banks have indirectly benefited from the dim view that many institutional investors and corporate leaders have taken of governments' performance following the financial crisis. Only 36% of survey respondents said they were confident of governments' ability to make the right decisions.

But the vast and fundamental changes in the role of central banks have unlocked a host of questions about the wisdom and impact of these changes. Some give credit to central bankers for averting financial catastrophe and preventing a much deeper economic slump—a point that the Federal Reserve chairman, Ben Bernanke, himself made at the Fed's annual symposium in Jackson Hole, Wyoming, in early September. But questions remain about the wider role central banks have assumed since then. Others blame central banks for creating the conditions that led to the 2007-08 meltdown, and doubt they have fundamentally rethought the policies that preceded it. Some criticise central bankers for being too accommodating of large financial institutions. Others accuse them of enabling improvident governments to continue to run up large deficits that have destroyed confidence in long-term

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economic recovery and of causing market distortions as a result of their accommodative interest rate policies. There are also unanswered questions about how long central banks will retain the wider role they have carved out for themselves, and if they even have a choice in the matter.

To examine these questions and to better understand the challenges facing central banks in

the post-recessionary period, the EIU conducted in-depth interviews with nine prominent economists, analysts and portfolio managers. These experts expressed a wide range of views. Some were especially critical of central bank action over the last four years. All had pointed opinions about the role central banks should assume in the future. ■

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The critics

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Ethan Harris, co-head of global economics research, Bank of America Merrill Lynch

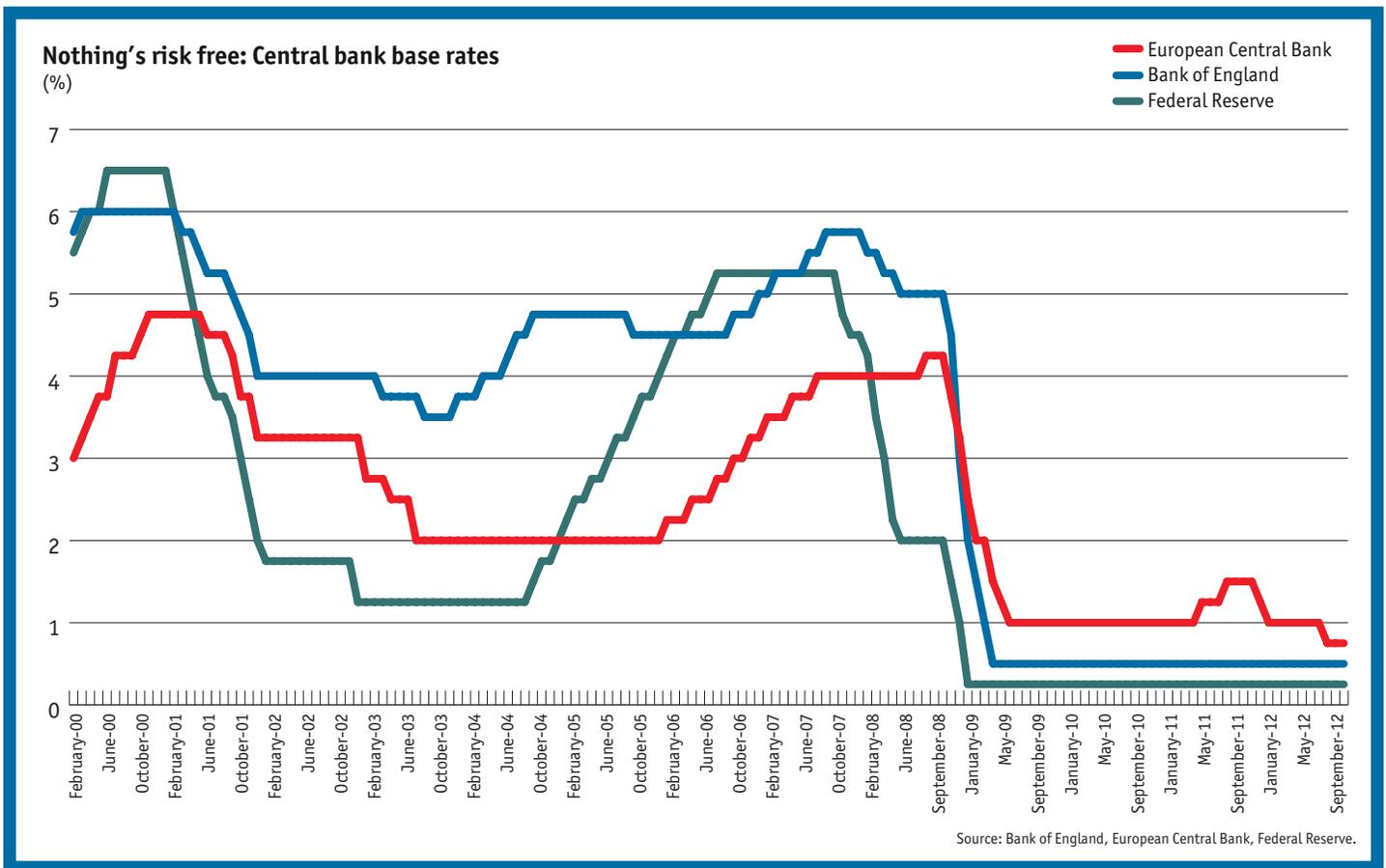
Most observers agree that central banks cannot restore a healthy global economy by themselves. But they disagree on where to place the blame for the current crisis, and on their critiques of current central bank policies. There is deep disagreement about what specific actions governments need to take, and whether central bank policies might be hindering governments from taking those steps. There is also concern that central banks may be subjected to greater political wrangling. At the Jackson Hole meeting, some expressed fears that the Fed could be pressured to extend its accommodative interest rate policy or even to compromise its independence by subjecting its monetary policy to regular audits.

Central banks' strongest critics argue that easy credit policies, while perhaps justified in the immediate aftermath of the 2008 crisis, now threaten long-term economic recovery and stability. The critics also accuse central bankers of having failed to notice the formation of the housing bubble that led to the crisis and then failing to appreciate the extent of the collapse until it was too late. Furthermore, the central banks did not learn the appropriate lessons from the period leading up to the crisis—although there is disagreement about the substance of those lessons.

Peter Schiff, CEO of Euro Pacific Capital, argues that the Fed, the Bank of England and others maintained a low interest rate policy for too long

after the recession following the dot.com collapse of 2000. This engendered global investors' "search for yield" that helped to create the housing bubble and overinvestment by European banks in peripheral economies like Greece. Mr Schiff expressed these views as early as 2006, and was interviewed extensively post-financial crisis as being the "man who got it right". But low interest rates were not the root of the problem, points out Ethan Harris, co-head of global economics research at Bank of America Merrill Lynch. Mr Harris, who worked at the Federal Reserve Bank of New York for nine years, believes that the main failure of the Fed, and other regulators, was weak regulation of the subprime mortgage market. "With so many regulators—both federal and state-level—overseeing different parts of the market, it was unclear who was really in charge," he says.

The most dangerous consequence of maintaining a low interest rate environment, according to critics like Mr Schiff, is that it distorts the pricing of supposedly risk-free government debt—and, by extension, the pricing of the many other assets that are directly or indirectly based on a risk-free rate of return. This facilitates the formation of asset bubble in many areas, most notably in government debt. Once investors grasp this, Mr Schiff suggests, they could retreat en masse from bonds to equities and "other assets that are in scarce supply". Jason Hsu, co-founding principal and CIO at Research Affiliates in Newport



Beach, California, believes that new asset bubbles are forming today. He warns that investors in search of higher returns are shifting some of their holdings into precious metals and high-end real estate in emerging markets, bidding up these investments and threatening to “export” inflation to these markets.

If these imbalances result in inflation in the emerging markets, some believe that they could have a global feedback effect. Warwick McKibbin, professor of economics at Australian National University and a former board member of the Reserve Bank of Australia, who has made this argument, believes that inflation is going up everywhere except in the US and that “it will go up in the US over the next six to 12 months”. While

central bankers insist they now have the tools to guard against another bubble forming, their failure to prevent the last credit bubble in 2003-07 has dented their claims to prescience.

Mr Schiff warns that central bank efforts to lower interest rates are also enabling governments to delay needed cuts in spending. Low rates augment the temptation for investors to shift from the most troubled markets, such as Greece, Spain and Italy, into high-rated sovereign debt such as US Treasuries, British gilts, German bunds and Japanese government bonds. This enables the favoured governments to sell their debt at ultra-low rates, which in turn encourages them to continue to fund deficit spending without suffering any consequences. ■

3

The defenders

The central banks have few defenders on some counts, particularly their failure to respond to a metastasising financial bubble prior to 2008. There is considerable scepticism that central banks and their regulatory counterparts are doing enough to police large institutions. The 'London Whale' episode in May 2012, which resulted in a US\$5.8bn

trading loss for JP Morgan Chase, appeared to confirm these fears. The defenders are far less inclined to believe the central banks' policies are fuelling another disaster; many, however, believe that the banks may retard recovery through excessive accommodation of big banks.

In the central banks' defence, these experts

The euro zone

The euro zone is at the epicentre of most experts' concerns about a mismatch between fiscal and monetary policy. Dan Steinbock of the India, China & America Institute described the response to the crisis in Europe as being like fixing a plane in mid-air. In the second quarter, the euro zone economy contracted at an annualised rate of 0.7%—a figure that might have been worse save for a weak but positive performance by Germany.

Despite the constraints of its mandate, the ECB has done more than is sometimes recognised. Given the unwillingness of creditor euro members, led by Germany, to commit sufficient resources to bailout funds, the ECB is the only institution with the firepower to ease the funding pressures on peripheral sovereigns and banks. But according to its mandate, the ECB is charged with only maintaining price stability (unlike the Fed, whose mandate also encompasses employment) and direct financing of governments by the ECB is expressly forbidden by EU treaties.

In early September, the ECB's president, Mario Draghi, made good on a promise to do whatever it takes to ensure the

survival of the euro zone. He terminated the Securities Markets Programme (SMP) and replaced it with a pledge to buy unlimited quantities of one- to three-year bonds from European governments, in conjunction with the rescue fund, the European Stability Mechanism (ESM). This moves the euro zone considerably further down the road towards more centralised control of individual countries' economic policy. To receive the assistance, however, governments must agree to a "macroeconomic adjustment programme" with the ESM. It remains to be seen whether the Spanish and Italian governments will be willing to do this, although the markets may force their hands.

The euro zone is edging, slowly, towards a comprehensive plan that could stabilise the single-currency zone. But the process remains painfully slow, and the risk in coming months of a market-induced shock—which could drive one or more countries (starting with Greece) out of the euro zone—remains high. This, then, is a race between euro zone authorities and the markets, and it is by no means clear that the governments will win. ■

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James Galbraith, Lloyd M. Bentsen Jr. chair in government and business relations, University of Texas's Lyndon B. Johnson School of Public Affairs.

note that once the disastrous chain of events began in September 2008, the Fed stepped in strongly to assure liquidity and prevent a market collapse. They also take issue with the argument that central banks may be facilitating the formation of new asset bubbles. According to James Galbraith, Lloyd M. Bentsen Jr. chair in government and business relations at the University of Texas's Lyndon B. Johnson School of Public Affairs, such arguments do not take full account of the depth of the recession that began in 2008. Mr Galbraith notes that even after multiple rounds of quantitative easing by the Fed, the ECB, the Bank of England and the Bank of Japan, the risk of asset-fuelled inflation remains far lower than that of a Japanese-style cycle of debt deflation in the developed economies.

Mr Galbraith and others disagree that today's low-interest environment is destined to end soon, or is even unusual for a period of sluggish growth—or that it is necessarily all the central banks' handiwork. Christopher Reicher, a researcher at the Kiel Institute for the World Economy focused on the effects of monetary policy, notes that recession and depression have typically resulted in low-interest regimes that can last for many years. Interest rates remained low in the US from the

early years of the Great Depression into the 1950s. Japanese rates have been low since the real estate bubble burst in 1990.

Mr Galbraith believes that interest rates are likely to follow the same pattern this time. Consequently, he dismisses fears that they will shoot up in the near future, ratcheting up public-sector borrowing and debt-service costs to economically crippling levels. “The entire exaggerated concern over projected budget deficits in the US is premised on the idea that short-term interest rates will go back to 3-6% in the next five years,” says Mr Galbraith, “Come back in 30 years and see if we're out of this yet.” In his scenario, government debt costs remain low, keeping deficits under control and creating new opportunities for governments to invest in infrastructure, education, and other long-term economic building blocks.

However, Mr Galbraith is one of several experts who argue that central banks should do more to push banks to restart lending. Accommodative policies by the Fed and the ECB allow banks to hoard capital rather than use it to give consumers and businesses more access to credit. In the US, “the Fed should squeeze the margins on the banks to get them to take more risks in the real economy,” argues Mr Galbraith. ■

4

The future

Most experts agree that the more fundamental problems facing the global economy are political, not monetary, and that governments are best positioned to address them. They disagree significantly, however, on which problems are more urgent and what measures governments should take.

The US and the euro zone need “credible, long-term fiscal adjustments,” says Dan Steinbock, research director of international business at the India, China & America Institute in New York. “The US needs a debt-and-deficit deal, but the elections have contributed to an even more polarised environment, while in Europe they don’t have the

A larger role for emerging-market central banks?

For some time, fast-growing emerging economies—particularly in Asia—have been demanding a larger voice within the multilateral bodies overseeing the global financial system, such as the IMF and the World Bank. While the developed economies are reluctantly accepting this new order, over time it will become harder to resolve global issues without the participation of central banks from the emerging economies.

These institutions are now better able to assume the role because their ability to manage monetary policy has matured and thus inspires greater confidence, observes Mr Reicher. He believes the decline in Brazil’s long-term interest rates indicates that its economy may be moving beyond a long boom-and-bust cycle, although rates in Brazil remain high in comparison with most industrialised countries. Central banks in China, Brazil, South Africa and elsewhere have also received high marks for their response to the 2008 financial crisis. Most experts approve of the efforts of the People’s Bank of China (PBOC) to control a potential bubble in the country’s housing market.

A larger role for the PBOC, comparable to that of the Fed or

the ECB, is still years away, according to Mr Jadresic, echoing the views of other experts. The PBOC still plays a bifurcated role, believes Mr McKibbin, managing the national economy and managing complex exchange-rate relationships with the US and other trading partners. Until the renminbi is unpegged from the US dollar and becomes a more widely held currency, the PBOC will not exercise a larger role in managing the global monetary system.

The PBOC is only moving very slowly in this direction. Foreign-exchange trading centres for the renminbi are still few—London established one only in January. Some experts believe it would be a mistake for China to seek a larger global role too quickly for its central bank. Mr Hsu notes that China’s banking sector is still dominated by state-owned entities that have a different relationship with the central bank than in other countries. The PBOC itself is less transparent in its operations than its counterparts in the developed world and it has considerably less institutional memory as a global currency manager. ■

institutional design to support that kind of action.”

Mr Galbraith, who calls concerns over the size of US budget deficits “hysteria”, argues that continued focus on central bank policy has become “a big efficiency loss”, distracting from measures that could revive economic growth, such as raising the minimum wage, making room for younger workers by making early retirement easier for their older counterparts and exploiting new, cleaner energy sources.

Both arguments underscore the fact that governments in many developed countries are paralysed by political gridlock, preventing decisive action in either direction. So long as government policy remains stymied, Mr Harris argues, central banks can, and probably should, continue to search for means within their power to spur growth, “even if it isn’t particularly effective”, as a way to maintain a degree of confidence. ■

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Conclusion

Most experts give central banks high marks for tempering what could have been a far worse global financial crisis in 2008 and providing breathing room for governments to reach agreement on measures that would build a stronger and more durable long-term economic recovery. Absent such measures, however, central banks have found themselves stuck with the job of propping up the recovery, often through measures that, some critics believe, could be setting the scene for inflation and further asset bubbles.

Will central bankers be able to raise interest rates and withdraw other supports from the financial sector before another crisis of this sort takes hold? “Central banks have made mistakes, but from a medium-term perspective I expect them to do the right things,” says Esteban Jadresic, chief economist and global investment strategist at Moneda Asset Management and a former adviser to the board of the Central Bank of Chile. “I’m more concerned about what other policymakers—governments, parliaments, euro zone leaders—will do,” he adds.

Central banks nevertheless are unlikely to pull back from the more prominent role they have carved out for themselves post-2008. This has less to do with the recent crises and lack of government action than with the growing complexity of the

global financial markets. “The Fed, which was created as a lender of last resort, is now also a provider of liquidity and a dealer of last resort,” comments Jeffrey Cleveland, senior economist at Payden & Rygel in Los Angeles.

The Fed and the ECB “won’t return back to their pre-crisis stance,” he says, “where the Fed, for example, was minimally invasive in markets, mostly tinkering with the federal funds rate as the situation called for.” In particular, he anticipates that the Fed will retain an active role in the commercial paper and repo markets—major segments of the shadow banking system. The ECB, too, he expects will be a very different institution, assuming a role much closer to the Fed’s than its original, narrower focus on currency management.

The West’s problems—high unemployment, creaking infrastructure, unsustainable healthcare and pension costs, and the need to move to greater federalism in the euro zone—are structural. While monetary easing will provide some relief, it is no panacea, and it is unable to galvanise the global economy alone. Solutions require political compromises that are not within central banks’ powers to devise but that are proving elusive amid polarisation in Washington and the stand-off between the creditor core and debtor periphery in the euro zone. ■

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