Charles Goodhart

Central bank policies in recent years

Article (Accepted version) (Refereed)

Original citation:
Goodhart, Charles (2018) *Central bank policies in recent years*. Central Bank of Malta's Quarterly Review, 51 (2). pp. 71-78. ISSN 1811-1254

Central Bank Policies in Recent Years

By C.A.E. Goodhart
Financial Markets Group, London School of Economics

Introduction

1968 was a memorable year. While it was the year in which the Central Bank of Malta was founded, that was not the most newsworthy event of that year. This latter was, almost certainly, the student uprising in Paris, which nearly toppled the government headed by Charles de Gaulle. During the year there had been troubles in universities around the western world, starting in Berkeley, California, but continuing in many other such universities, including the London School of Economics, where I was at the beginning of that year. Turning more directly to monetary policies, 1968 was the year when Milton Friedman gave his famous Presidential Address at the American Economic Association, which, with his many other associated publications, laid the ground work for the upsurge in Monetarism as a policy regime for central banks. It was also the year when, in the autumn, I first entered the Bank of England as a, relatively young, economist. The Central Bank of Malta is now 50 years young as an institution, while, alas, I am now 50 years older.

I am not going to review all the past 50 years. But I do not want just to start with the Great Financial Crisis (GFC), since macroeconomists as a group, and to a lesser extent central bankers, have been accused of, and have whipped themselves in an orgy of self-flagellation for, failing to foresee the onset of the crisis, and for the sluggish recovery since then. I want, therefore, to balance the record by noting how good the NICE years (non-inflationary continuous expansion) were in the previous decade and a half, 1992-2007. Indeed, I shall be mainly discussing three separable periods:-

- NICE years, 1992-2007.
- GFC and its aftermath, 2008-18.
- The future outlook for central banks; can they escape the debt trap?

NICE Years, 1992-2007

The early 1980s saw Paul Volcker defeat inflation in the USA. But to do so he had to allow official short-term interest rates to rise over 20%; and this led directly to the crisis in Mexico, Argentina and Brazil, otherwise known as the Less-Developed Country (LDC) Crisis, in 1981/82. Following the successful resolution of that crisis, nominal incomes, inflation and interest rates all fell along the trend path that most economists, including the Monetarists, would have, and indeed did, intend. But during these years, towards the middle of the 1980s, the relationships between the monetary aggregates and nominal incomes and interest rates became volatile and rather unpredictable. As a result, the policy of pragmatic monetarism, which many leading central banks had adopted, became politically unsustainable. As Governor Bouey of the Bank of Canada remarked, “We did not abandon the monetary targets. They abandoned us.” With monetary targetry falling out of favour towards the end of the 1980s, a number of countries, including the UK, sought to set their monetary regime by pegging to a stronger currency, in the UK’s case to the Dm, within the context of the Exchange Rate Mechanism (ERM). But the ERM, a pegged but occasionally adjustable exchange rate system, itself collapsed in 1991/92. That meant that, at the end of the 1980s and beginning of the 1990s, there was great uncertainty about how to set the monetary regime.

Into this void, there soon came a sweeping move towards the adoption of Inflation Targetry (IT). This had been first applied in New Zealand in 1988 (when I was an advisor to the RBNZ), then not specifically as a monetary regime, but rather as a mechanism for checking whether the central bank (RBNZ) there was, as a public sector industry, achieving a quantifiable and appropriate target; the incoming Labour Party wanted to set proper objective targets for all the nationalised industries in NZ, after they had been mishandled by the previous National Party Prime Minister, Muldoon. However, it soon became clear that such an IT regime was a most attractive mechanism for central banks to follow; and it was taken up by Canada in 1991 and the UK in 1992. Amongst other virtues it largely resolved the macroeconomic struggle between Monetarists and Keynesians. The Monetarists could view an IT regime as being in essence a monetary target adjusted for unpredictable fluctuations in the demand for money functions, while the Keynesians could emphasize the direct link between interest rates and real expenditures. Initially, along such lines, the ECB, under the intellectual leadership of Otmar Issing, adopted a two pillar, twin track, approach, emphasising both real and monetary outlooks. But the then current trend of both academic and central bank thinking shifted in the 1990s quite rapidly towards a neo-classical synthesis combining an underlying Real Business Cycle model with the addition of wage price stickiness. This led to the generalised adoption of the so-called Dynamic Stochastic General Equilibrium models (DSGE).

In such models there were then no financial frictions. The transmission mechanism ran directly from the short-term official policy rate via expectations to longer rates, and thence from the yield curve directly to expenditure decisions. Banks and the monetary aggregates were increasingly ignored, indeed the Federal Reserve Board (FRB) even ceased to publish data on the monetary aggregates. I am quite proud of the statement that I made at the time, which was that "such DSGE models effectively assume away almost everything about which a central bank should be particularly concerned."

Nevertheless, these NICE years, of the 'Great Moderation', brought with them extraordinary success. There was:-

1) Stable low inflation.
2) Stable growth.
3) Low unemployment.
4) Some slight increase in inequality within countries, but inequality in the world economy declines for the first time in several centuries.
5) The euro was successfully introduced, despite fears of Anglo Saxon economists about the adequacy of adjustment mechanisms.

Such problems as there were, were largely financial in form. The main problems were:-

- Japan, 1991-2000s, the lost decade.
- SE Asia and Long-Term Capital Management (LTCM), 1997/98.
- The Tech Bubble, 2001/2.

But these were largely resolved by sharp easings of monetary policy, otherwise known as 'the Greenspan put'. Partly because of the dramatic success of such measures and other policies, it led to the apotheosis of central bankers. Leading central bankers, like Greenspan, Trichet and Eddie George, were put on a pedestal and regarded as, perhaps, the second most important people in the country.

Crisis and Aftermath, 2008-18

What went wrong?

The main problem was that almost all of us believed in three related myths, which turned out to be incorrect. These were:-

1) The first was that the achievement of price stability would ensure that there would be no general economic downturn. What we had forgotten was the teaching of Hy Minsky (1982 and 1986) that the more stable, and less risky, seemed the real economy, the more that financiers and businessmen generally would take on extra leverage and essentially riskier, higher yielding, activities. What has been notable over the last century has been that the most severe financial crises have followed the best and strongest periods of growth; thus the 1920s were a stellar period of economic expansion in the USA; the 1980s were the same in Japan; and, as already noted, the 15 years prior to 2007/8 were NICE. It is just when everyone is most confident about the real economy is that financial over-optimism hits.

2) The second myth was that adherence to the Capital Adequacy Regulations (CAR) of Basel II, combined with the absence of any general downturn, would ensure the maintenance of bank solvency. What had been forgotten was that the application of CARs as a constraint on bank portfolios would lead bankers to manipulate them to ease their impact on their own profitability. Thus the weightings to be applied in the risk weighting of assets, and the definitions of the necessary capital to be held against that, were manipulated in favour of banks, often with the implicit connivance of the regulators.

3) The third myth was that, with bank solvency thus assured, there was no need for banks to maintain liquid assets on their own books, because they could always borrow cash through the wholesale markets. Thus, when I first entered the Bank of England, some 50 years ago, British banks held some 25% of their total assets in British Government securities (gilts); by

2008, on a net basis, British banks held virtually zero high-quality liquid assets. As is now obvious, in a panic context of suspicion about general solvency, wholesale markets tend to collapse. Without High Quality Liquid Assets (HQLA), commercial banks are then forced into fire sales when faced with adverse clearings. This leads to further sharp drops in asset values, making all such financial institutions appear much weaker yet, especially on a mark-to-market basis.

The Crisis

The downturn and further weakness in the US housing market, especially the sub-prime sector, and excessive financial leverage, with the latter especially marked amongst US investment banks, led to a weakening and subsequent breakdown of wholesale financial markets. The lack of own asset liquidity then led banks to have to make fire sales of assets and brought about conditions of contagious collapse. All this was much worsened by allowing Lehman Bros to go bankrupt.

Fortunately, central banks then rallied quickly to restore confidence in liquidity by some forceful and dramatic measures. These were:-

- Massive Lender of Last Resort (LoLR) measures, and the adoption of the first round of Quantitative Easing (QE) restored liquidity. Central bank balance sheets rocketed upwards.

- TARP (the Troubled Assets Relief Program) and the Geithner stress test led to a restoration of capital adequacy in the United States. This was not done as well in Europe, because there was no equivalent here of the TARP funds for forcing recapitalisation of the weaker European banks.

- Interest rates were brought down rapidly to the Zero Lower Bound (ZLB) to encourage borrowing and to inhibit saving. This had a beneficial effect on housing markets, but otherwise was not so successful, as will be discussed later in this note.

- Towards the end of 2008, the governments of most countries agreed on concerted fiscal expansion. This was highly beneficial, but was somewhat limited in amount, and only temporary before it was scaled back. This had to be so, because public sector deficits generally were already rising faster than virtually ever before during peace time, and the prospect of an ageing population, involving both higher pensions and much increased medical expenditure, led the outlook for future fiscal balances to be disturbingly bad.

The result of all this was by the end of 2009 the initial financial crisis was largely over. Considering the scale of financial shock, the extent of unemployment was reasonably well contained, with some exceptions, especially youth unemployment in Southern Europe. But growth did not recover, remaining hesitant. The implication was a sharp decline in productivity, virtually everywhere among developed economies. All this was made much worse in Europe by the solvency crises in Southern Europe in 2011/12, especially amongst the PIIGS (Portugal, Ireland, Italy, Greece and Spain). This was resolved by the adoption by Draghi of the policy of Outright Monetary Transactions (OMT).

Why were growth and productivity so subdued?

There are several reasons why this may have been so; note that the reasons are not mutually exclusive. They include the following elements, and there may be yet others:-

1) Globalisation and demography. The combination of a post WWII baby boom, followed by a steady decline in the birth rate, with the expectation of life then increasing steadily, led to both a sharp increase in the labour force at the same time as the dependency ratio became increasingly favourable with a growing ratio of workers to dependents. The decline in the birth rate sharply cut the proportion of young dependents, whereas the increase in life expectancy only started to lead to a huge increase in old age pensioners towards the end of the period. Perhaps even more important, the arrival of China and of Eastern Europe, after the collapse of the Soviet Union, led to a truly massive increase in the available labour force for the global trading system. Indeed, the available labour force effectively more than doubled during the 25 years from 1992 until 1997.

   This massive positive shock to the labour force inevitably led to a relative decline in returns to labour, especially unskilled labour, with commensurate benefits to capital, management and highly skilled labour. Inequality within countries surged. The results were lower inflation, high savings ratios and low investment. Particularly in China, with no welfare safety net, and the one child policy, with one grandchild between four grandparents, workers were forced to save massively to finance their own retirement.

2) Technology. Bob Gordon (2016) has argued cogently that all the easy technological innovations have already been discovered. It will be increasingly difficult to replicate the kind of productivity improvements that indoor plumbing, steam and electricity brought to the world during the last century. The counter to that is that we are in the middle of an electronic and digital revolution, to be followed by artificial intelligence, which may revolutionise again the way our economies may work. But a further problem is that this new revolution depends primarily on human capital rather than fixed capital, so that the need for investment expenditures to embody such innovations may be quite low. All this has been brought together by Larry Summers (2016) to suggest that we may be entering a period of Secular Stagnation.

3) Corporate governance. What has been remarkable over the last decade has been the continuing low level of corporate investment, despite exceptionally low interest rates and continuing high profitability. One argument has been that the current system for remunerating top managers, largely related to the short-term development of equity valuations, has had an adverse effect on longer term investment projects. Perhaps the easiest way to achieve enhanced equity valuations is to raise debt by borrowing in order to buy back equities. That involves much less risk than long-term investment; and the continuing low level of wages has meant that managers have not needed to invest in order to maintain competiveness and profitability.

4) Regulation. Bank regulation has been toughened at a time when bank profitability has remained low. Partially as a result, banks have found it easier to meet the higher CARs by reducing leverage, rather than by raising new equity. And the pressures arising from the system of corporate governance mentioned above, have meant that they were keen to do so anyhow. Regulation is always, and almost inevitably, procyclical. Regulation is enhanced after a crisis, when bankers are, in any case, more risk adverse. And regulation tends to be eased after the crisis has passed and the economy appears to be progressing quite smoothly. As already noted, financial crises tend to occur just after periods of greatest economic expansion and optimism. Such optimism and confidence will lead most people to think that the previous tough regulations were otiose. Attempts to ease financial regulation may themselves be a leading indicator of future financial crisis.

What of the Future?

The standard DSGE models have become largely discredited. Their failure to incorporate financial frictions became glaringly obvious. There has been a concerted effort to try to incorporate such financial frictions within new generations of such models, but with rather varied success.

There is also another inherent problem with them. Their structure leads forecasters to believe that once wages and prices adjust to temporary shocks, the economy recovers then quite rapidly back to its equilibrium level. But in practice our economies have remained mired in low-level expansion, with low productivity and low inflation, whereas most forecasts continuously assume, year after year, recovery back to 'normal' in both output growth and inflation.

But in both the USA and Europe, 2017 appeared to usher in faster growth, with the prospect of a possibly stronger sustainable recovery. Moreover, the underlying demographic background is now changing very rapidly. The growth of the labour force in most developed economies, especially in Europe, is slowing rapidly, in many continental countries now absolutely declining; and the migration of available labour from the inland provinces of China to the manufacturing sectors on the eastern seaboard is slowing rapidly. The combination of the economic recovery with these demographic forces is leading to a continuing and steady reduction in unemployment. At some point the Phillips curve will kick in. Labour shortages will lead to a faster rise in real wages and earnings, and profitability will become harder for business managers to sustain. In order to do so, they may be forced back to invest more and to raise productivity. In the middle of this, the Trump Presidency has injected sharp fiscal expansion into the US, though the advent of trade wars may slow down trade, activity and efficiency everywhere. The political situation remains febrile in many countries; the resulting uncertainty may damp animal spirits, including prominently the UK in the toils of Brexit. Monetarists are warning that the recent slow-down of the growth of credit and the monetary aggregates may herald a generalised reversion to slow growth after the short-lived optimism of 2017.

But let us be optimistic, and assume that conditions will allow the renormalisation of monetary policies. But that will involve a turning point in the trend of interest rates, reverting to a slow but steady upwards path, after some 30 years of declining interest rates. The central banks will no longer be the best friends of borrowers, notably of Ministers of Finance, because the public sector is, in most countries, the biggest borrower of all. How will politicians react when central banks cease to be expansionary, and start raising interest rates, thereby making the financing of the enhanced debt ratios, current and prospective, even harder? Meanwhile, both non-financial corporates and households have taken advantage of the exceptionally low interest rates of recent years, as was in a sense intended, to increase their indebtedness and leverage. Raising interest rates in this context will inevitably lead to more corporate insolvencies and may put some of the more extended mortgage borrowers into difficulties. How will central bankers handle that?

Indeed it is arguable that central banks have got themselves into a debt trap. This trap works as follows. In order to try to extricate our economies from the GFC and its aftermath, at a time when fiscal policy was quite constrained, central banks have had to lower interest rates to exceptionally and persistently low levels. This has inevitably led to all the other sectors, public sector, non-financial corporates and households, extending their indebtedness, their leverage, massively; all this despite it being appreciated that the GFC was itself a crisis of over-indebtedness. The only exceptions have been Germany and the banking sector where debt ratios have generally declined.

But in general, debt ratios are now so high that even relatively slight increases in interest rates could lead to a severe worsening of debt service problems. So, if central banks try to raise interest rates either quickly or even back to normal levels, they could well cause insolvencies among exposed borrowers, so much so that recession occurs. But, if to avoid that, they continue with exceptionally low interest rate levels, there will be no incentive or inducement to stop raising additional debt and leverage.

Is there any way out of this debt trap? Let us consider some potential routes:-

1) Faster real growth. This will not happen for demographic reasons. The slow-down in the labour force in many countries will inevitably mean that real growth will remain low. Japan is frequently considered to be an example of a country doing relatively poorly. But its labour

force over the last decade has been declining at a rate of about 1% per annum, while its real growth has also been about 1%; so the growth of its output per worker has been about 2% per annum, which is much faster than the growth rate of output per worker in almost every other country. With many other countries now facing equivalently declining labour force growth, they will be very lucky if they could maintain growth at above 1% per annum in future years.

2) Cancel debt. In many countries the most indebted sector is the public sector; its debt is mostly held internally by citizens of the same country. So the question is sometime raised, why can we not just cancel the internal debt? In particular, following several rounds of QE, a large proportion of public sector debt is now held within the central bank. Why not just cancel both sides of that? In practice, however, the structure of our economies has so altered since the earliest civilisations in the Middle East successfully undertook such Debt Jubilees that a replication of such debt cancellation would now be practically impossible. With Michael Hudson (2018), I have done a paper describing both how such Jubilees worked in ancient civilisations and the problems of trying to apply them now, but suggesting some measures which could have an analogous effect on wealth inequality, rather similar to proposals introduced in the latest paper by the Resolution Foundation (2018), on 'A New Generational Contract'. But the subject is too long and too complicated to go through at any length here.

3) More inflation. One of the reasons why the 25 years from 1993 until 2018 were so deflationary has been the pressure arising from demography and globalisation. As earlier noted, these will now reverse sharply. If so, the next 25 years are likely to be much more inflationary than the last. So the fundamental background to the global economy will cause inflation to rise anyhow, and it may well be in the interest of Ministers of Finance and of populist politicians, to allow some of that to occur. People may start making a distinction between 'good inflation' and 'bad inflation'. If central bankers find themselves at logger heads with politicians, the politicians are likely to win. Central bank Independence (CBI), which central bankers naturally wish to maintain, could be at risk.

4) Default and failure. Hopefully not.

5) Debt restructuring, also known as 'extend and pretend'. Some of this is likely to occur, but it will be a limited palliative. What is remarkable has been how the effective duration of public

sector debt, especially after incorporating the central bank within the boundaries of the public sector, has generally fallen, despite historically low long term interest rates. This was done intentionally as an expansionary mechanism, but will store up trouble for the future.

6) Switch to equity. Again, as noted earlier, the incentive has been to replace equity by debt, in all sectors other than banks. If possible, this should be dramatically reversed, partly by fiscal measures reducing the asymmetric advantage of debt finance, or even reversing that. There need to be many other associated changes both to the structure of corporate governance, to the role of auditors and to the structure of housing finance. But this is a major subject, which deserves far more space than is feasible in this brief paper.

But if there should be another recession, what could be done to mitigate and reverse that, with both monetary and fiscal policies now constrained? There is no silver bullet to be seen. It is, perhaps, a fortunate time to be old, but the Central Bank of Malta is institutionally young and will have to deal with these problems over coming decades. Best of luck.

Bibliography

Goodhart, C.A.E., and M. Hudson, (2018), 'Could/Should Jubilee Debt Cancellations be Reintroduced Today?', CEPR Discussion Paper DP12605, 16 January.

Gordon, R.J., (2016), *The Rise and Fall of American Growth: The U.S. Standard of Living Since the Civil War*, Princeton University Press. ISBN 978-0691147727.

Intergeneral Commission, Final Report, (2018), *A New Generational Contract*, Resolution Foundation: London.

Minsky, H., (1982), *Can "It" Happen Again?*, M.E. Sharpe, Armonk. ISBN 978-0-87332-213-3.

Minsky, H., (2008) [1st. Pub. 1986], *Stabilizing an Unstable Economy*. McGraw-Hill Professional, New York. ISBN 978-0-07-159299-4.

Summers, L., (2016), 'Secular Stagnation and Monetary Policy', Federal Reserve Bank of St. Louis *Review*, Second Quarter, 98(2), pp 93-110.