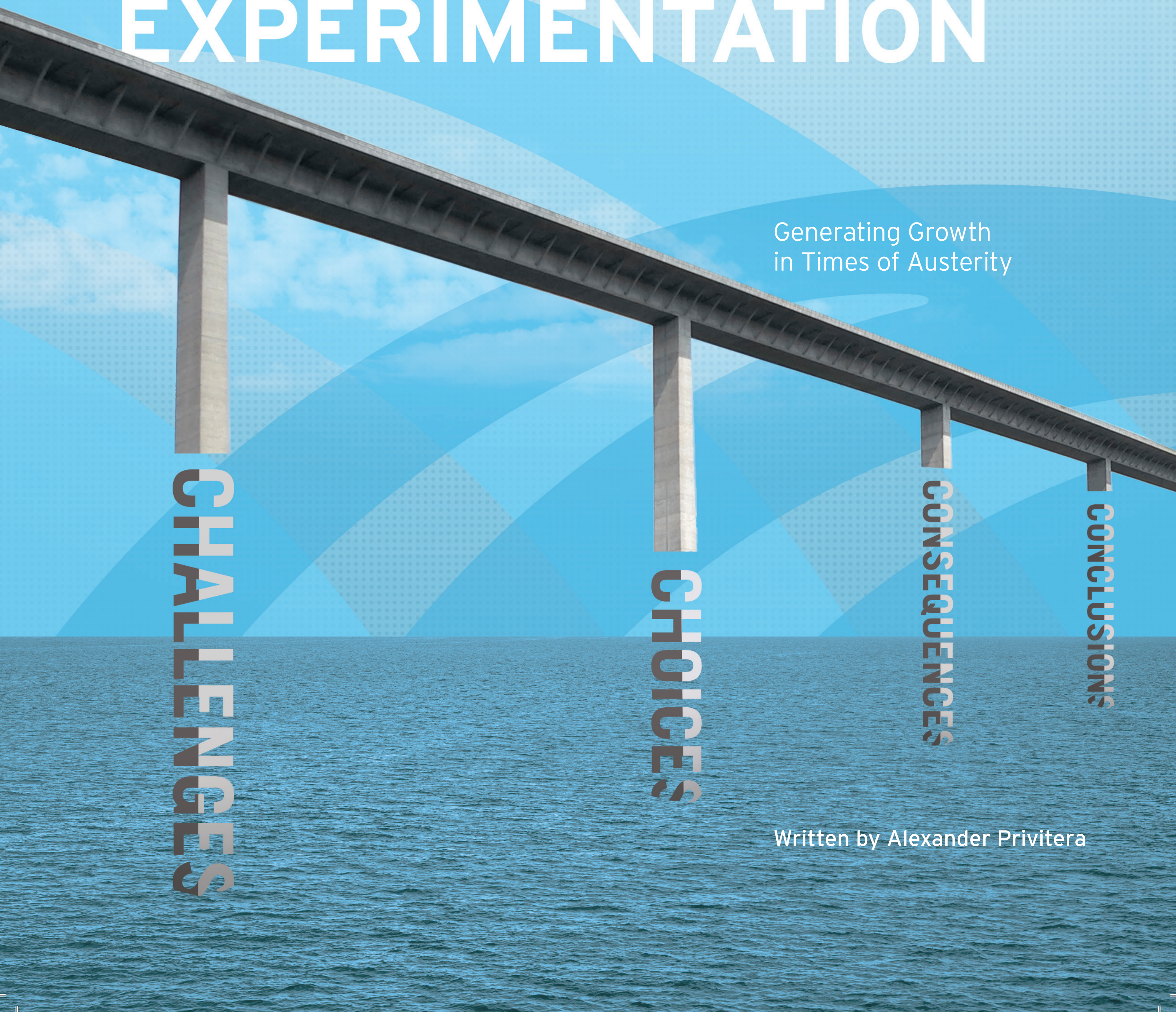
30 YEARS · JAHRE

AICGS
American Institute for Contemporary German Studies
JOHNS HOPKINS UNIVERSITY

THE AGE OF CENTRAL BANK EXPERIMENTATION



Generating Growth in Times of Austerity

Written by Alexander Privitera

Following the outbreak of the worst financial crisis in more than half a century, central banks of all major advanced economies tried to contain the crisis. They succeeded in preventing a financial and economic meltdown and assisted the recovery. But, so far, they have failed to spur genuine, self-sustaining growth.

Since 2008, central banks developed and launched a host of unconventional and sometimes untested monetary policies. According to the President of the European Central Bank (ECB), Mario Draghi, they "all […] have adjusted their monetary policies along hitherto unexplored lines: some have been abandoned and no new paradigm has yet been formulated. The wish is to put an end to the emergency and to return to normality where the rules are based on a well established discipline of long standing, but it is not known with any certainty what reality will emerge in the long term."[1] Some investors believe that the new normal is a "stable disequilibrium," in which central banks have "ventured deep into experimental policy territory" and will stay there. "In the process they [central banks] have inserted a remarkable wedge—a disconnect—between market prices and underlying economic and financial fundamentals."[2]

Central banks continue to play a remarkable role. In late summer of 2012, Draghi effectively stopped speculative attacks against weaker members of the common currency area by "promising to do whatever it takes." He announced—but has not yet activated—a bond-buying program linked to strict conditions. Its mere existence, however, eliminated the so-called redenomination risk, or the possibility that one or more member countries could be forced to exit the common currency area. Some call the ECB's bond-buying program a bazooka, or even a nuclear option. It is a deterrent against speculative attacks on the very existence of the euro. It needed to be deployed, but ideally should never be used.

Across the Atlantic, the Federal Reserve (Fed) announced and launched its third quantitative easing program in five years in September 2012. In a new effort to support the anemic economic recovery, it promised to purchase assets to the tune of $85 billion per month until the unemployment rate falls to about 6.5 percent. As a result of these policy actions, the Fed has tripled its balance sheet to over $3 trillion. Acronyms such as Quantitative Easing (QE), Operation Twist, Longer Term Refinancing Operations (LTRO), and Outright Monetary Transactions (OMT) have become part of our vocabulary.

The Only Game in Town?

For critics of the timid and often dysfunctional responses given by political authorities to the current challenges, the past year proves that central banks are the only game in town. Benefits and risks associated with ultra loose monetary policies are the object of an ongoing debate that reaches well into the wider public opinion. Even critics concede that in the short term those policies have stabilized financial markets. But will they eventually spur self-sustaining economic growth? And, given the fiscal consolidation now well under way on both sides of the Atlantic, can and should central banks offset the contractionary effects of tight fiscal policies by stimulating their respective economies until they finally reach "escape velocity"? How big is the danger that the current search for yield could push investors to make dangerous decisions, thereby causing new asset bubbles? Can growth be self-sustaining when markets are drugged? What would happen if central banks exited their extraordinary programs too early?

Exhaustive answers to these questions are beyond the scope of this analysis. Instead, we would like to compare and highlight some of the similarities and differences between two major central banks, the Federal Reserve and the European Central Bank, forced by circumstances to play both the role of Chief rescuer and Chief stimulator in their economies.

Different Mandates – Different Policy Choices?

Restoring financial stability and stimulating growth should be seen as two sides of the same coin. Without one there cannot be the other. In recent years, both the Fed and the ECB have often been generically associated with similarly loose and unconventional monetary policies. But significant differences remain.

MANDATES

The Fed and the ECB have different mandates. The Fed's task is to pursue low inflation and high employment while the ECB is more narrowly focused on fighting inflation. Both critics and supporters of the ECB point out that this is the main reason for its slightly more "conservative" incremental response to the crisis. Some believe that in order to act as a true lender of last resort, the ECB's mandate should be modified and the central bank should be allowed to "print money," another way of saying that it should monetize sovereign debt. Others object that by promising "to do whatever it takes" in order to preserve the euro zone, the Eurotower in Frankfurt has already overstepped its mandate and abandoned its sound founding principles. According to these critics, the central bank should wind down its non-standard policies and regain true independence from fiscal, i.e., political, authorities and only worry about inflation. Hawks push the ECB to exit unconventional policies while doves advocate that the central bank should step even more decisively into the same monetary landscape that the Fed has chosen to explore in the past five years.

In overly simplified terms, the debate pitches debtor countries against creditor countries, a southern group of nations, led—or at the very least inspired by—France, against a hawkish, Bundesbank inspired northern European block. Caught in the middle, the president of the ECB has tried to act with boldness and flexibility while being mindful that the ECB cannot rewrite its own rules. It is a difficult balancing act that requires impressive diplomatic skills.

POLICY CHOICES

Political and institutional constraints led to different policies. While the Fed aggressively tried to stimulate the economy and push unemployment down by launching successive rounds of QEs, in effect by printing money, the ECB is very careful to avoid such a step. It mopped up excess liquidity in order to keep a tight lid on inflationary pressures. Rather than stimulate the euro zone's economies, the ECB tried to address and reverse financial fragmentation across the euro area. Rather than try to exit the emergency phase and support the recovery, the ECB engaged in a fight to prevent the euro from collapsing. Hence, the rationale for most of its unconventional interventions still rests on the need to repair the so-called monetary transmission channel, reversing the financial fragmentation caused by the risk of the euro's demise and making sure that interest rates set by the governing council of the ECB are once again uniformly transmitted to all member countries. According to the ECB, as long as monetary transmission channels remain impaired, i.e., clogged, and in the absence of a full banking union, the central bank will not be able to fulfill its mandate.

The more recent unconventional steps undertaken by the Fed are different: there is no need to repair monetary transmission channels. Instead the Fed is trying to use those channels in order to break the barrier imposed by very low interest rates; it is flooding the economy with liquidity. According to the Fed chairman, "With our main policy rate near its effective lower bound, we have been using two complementary tools to carry out monetary policy—balance sheet actions and forward guidance."[3] In other words, the Fed has chosen to *buy* assets (such as treasuries or mortgage backed securities), while the ECB has primarily focused on *lending* liquidity to the financial sector. Both institutions have offered guidance to make sure that market participants will not be caught on the wrong foot by sudden policy changes.

Repercussions beyond the Transatlantic Relationship

Despite differences, in both cases deploying new tools is associated with risks. Low interest rates on either side of the Atlantic triggered a frantic search for yield by investors. Even junk bonds experienced an impressive comeback. Bernanke publicly acknowledged that ultra loose monetary policies could lead to a misallocation of capital and cause asset bubbles. He has signaled an awareness and a willingness to act in order to make sure that investors' "animal spirits" do not lead to a new bout of irrational exuberance. At the same time, Bernanke has remained conscious of the lessons of the Great Depression and the decade-long stagnation of the Japanese economy. He believes that a hands-off or timid approach would not have been the safer choice, preferring to act boldly and quickly.

In the spring of 2013, central banks of major advanced economies started to send contradictory messages. While Bernanke's Fed is signaling to financial markets its readiness to exit ultra loose monetary policies, the Bank of Japan dramatically stepped up its efforts to fight deflation by launching a new, unprecedented bond-buying program. Indeed, while "exit" is becoming the buzz-word in the U.S., "entry" is all we hear from Japan. Its governor Haruhiko Kuroda promised that he would not abandon unconventional policies until inflation increases to about 2 percent. He plans to double the monetary base by 2014. At the same time, the ECB is looking for new ways to revive access to credit in the periphery of Europe. "A sound financial system is a necessary condition for an orderly exit from ultra loose monetary policies," explains ECB executive board member Benoit Coeure, adding, "hence the importance of a swift implementation of the banking union in the euro area."[4] As long as European politicians continue to debate what form the banking union should take, the ECB will have to remain very accommodative in its monetary policy stance. Only a full banking union can eliminate the vicious link between sovereigns and banks and create a truly integrated financial market with greater convergence of interest rates for companies and consumers across the euro zone. But Europe can hardly afford to wait for the banking union to become a reality, as funding shortfalls are squeezing small and medium sized enterprises (SME) today—hence the renewed focus on ways to ease SME lending.

Indeed, restoring a healthy flow of credit is necessary to support growth. Growth is necessary to repair banks' balance sheets. Healthy banks are needed in order to overcome the recession. For the moment, in Europe, we have none of the above.

As a consequence, the premature exit from current non-conventional policies would further damage already weakened economies. Given the European situation, should the Fed wait for the euro area to catch up with the U.S.? Or is the old continent hopelessly mired in a long and painful process of economic and institutional adjustment that will take many more years to be completed?

Whatever the answer to these questions, it is clear that a decision by the Fed to start winding down some of its non-standard measures could have serious repercussions on financial markets, as for the first time in many years central banks of advanced economies would make strikingly diverging policy choices.

Striking a Balance

POLITICAL CONSTRAINTS

Faced with choices that put them between a rock and a hard place, central banks have become politically vulnerable, attacked for doing too little or too much, criticized for not being democratically accountable.

Political constraints are not a feature unique to the ECB. Just as in Europe, where by attaching conditions to some of its interventions, the ECB has de facto become a political actor, in the United States too, the crisis forced the Fed to act "politically." As a consequence, it found itself exposed to harsh criticism. The launch of one of the Fed's more timid non-conventional policies, the so-called "Operation Twist" of September 2011, can be seen in this context. It was the result of a political compromise, made in order to appease hawks and doves within and outside the Fed.[5] As a consequence of the need to experiment, as well as to stay within their institutional framework, both the ECB and the Fed have tried to strike the right balance between overcoming the financial crisis and minimizing the political damage for their respective institutions. So far they have been quite successful. But the current situation should not be taken for granted.

And then there is the real economy and the difficulty in taking into account how structural changes to the global economy affect the recovery. The Fed certainly expected or at least hoped that loose monetary policies would help to fill the output gap caused by the recession. Fed policymakers refused to settle for a long hard slog out of the debt crisis. They refused to accept high unemployment as a consequence. Flooding the economy with cheap money surely would quicken the pace of the recovery, so the prevailing thinking among doves at the Fed. Hence, the central bank targeted both short and long-term interest rates by buying government bonds. It also purchased mortgage back securities, believing that by doing so, it would revive the struggling housing market. Of course, nobody knows what would have happened without the bold steps undertaken by the Fed. But it is certainly true that despite the Fed's actions, the recovery was slow and unemployment remained too high for too long.

Bernanke finally recognized that the crisis might have caused some structural damage to the economy. This comes very close to admitting that it will take longer to replace some economic activities that thrived in a pre-Lehman environment. Some economists would go further and point out that certain businesses were not viable in the first place. The resulting focus is on the need to rebalance the economy, a process that is not only challenging but most certainly takes time.

Yet, despite these caveats, the U.S. economy has performed better than the euro zone's. While the U.S. has moved away from the depths of the great recession, Europe just plunged back into it. At least in the short term, the Fed has been more effective than its European counterpart in Frankfurt in achieving the objective of assisting growth.

Throughout the crisis, the ECB pointed out that its role in restoring growth is limited. The crisis exposed weaknesses in the real economy that remained hidden for a decade, drowned in easy and cheap access to credit across the euro area regardless of economic fundamentals. In the wake of the financial crisis, structural weaknesses became all too apparent. The loss of competitiveness experienced by some euro member countries was exacerbated by a flight of capital from the periphery to the core, from risk to safety. This process caused the financial fragmentation that the central bank is currently trying to reverse. However, capital is attracted by good investments and risk aversion remains a factor that hampers a return to normal credit conditions for companies and consumers in many euro area countries. The ECB can try to create conditions favorable to a return of capital to the periphery. But it should not be expected to be a substitute for the structural reforms needed in order to make a country's economy more competitive. "We should not forget that growth is currently weaker in some countries than in others and not just because credit is scarce," explains Draghi. "It was weaker even before the crisis, notwithstanding turbulent growth in public spending, because structural weaknesses were not tackled."[6] Draghi tries to remind politicians that the ECB has no magic wand capable of making the crisis disappear. Indeed, making countries' economies more competitive is not the central bank's job.

Conclusion

Rather than simply reigniting a stalled engine, the ECB has tried to tell member states' governments that their motor needs some urgent repair. All the central bank can do is to help the process. Draghi's view of the state of the euro zone's economy is much darker than Bernanke's take on the U.S. economy. Throughout the crisis and its aftermath, the Fed chairman remained rather optimistic about the U.S.' prospects, convinced that the real economy had merely been the victim of the financial crisis and not one of its root causes and could therefore be pushed back to escape velocity with the right dose of stimulus.

But despite their differences, Bernanke and Draghi both recognize that central banks' actions have limits. Ultimately all they can do is to buy time for politicians that need to make unpopular choices and for a real economy to adapt to a rapidly changing global environment.

However, central banks will also stay committed to exploring new ways to help their economies along this difficult path. Five years after the collapse of Lehman Brothers, the boldest experiment in central banks' history is far from concluded.

NOTES

1 "The euro, monetary policy and reforms," Speech by Mario Draghi, President of the ECB, on receiving an honorary degree in political science, LUISS "Guido Carli" University, Rome, 6 May 2013.

2 Mohamed A. El Erian, "The New Normal….Morphing," *PIMCO Secular Outlook*, May 2013.

3 Transcript of Chairman Bernanke's Press Conference on 13 September 2012.

4 "Where to exit to? Monetary policy implementation after the crisis," Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the 15th Geneva Conference on the World Economy: "Exit strategies: time to think about them," Geneva, 3 May 2013.

5 Also see: Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* (New York: Penguin Press, 2013), 383.

6 "The euro, monetary policy and reforms," Speech by Mario Draghi, President of the ECB, on receiving an honorary degree in political science, LUISS "Guido Carli" University, Rome, 6 May 2013.

Alexander Privitera is a Senior Fellow and the Director of the Business and Economics Program at AICGS. He focuses primarily on Germany's European policies and their impact on relations between the United States and Europe. Previously, Mr. Privitera was the Washington-based correspondent for the leading German news channel, N24.

Support for this publication was provided by the German Academic Exchange Service (DAAD), with funds from the German Foreign Office. Additional support for AICGS' 30th anniversary events is generously provided by: Allianz SE; Carl Siebel; Daimler AG; Deutsche Bank; Lufthansa; Roland Berger Strategy Consultants; Skadden, Arps, Slate, Meagher & Flom LLP; and The German Marshall Fund of the United States.