Can central banks save the global economy?

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Emphatically: No. The main problems confronting the world economy are not of monetary origin. Therefore, central banks do not have the tools to solve them. At this stage they are not and should not be the main players on the economic stage. There are many things central banks can do. But they are not almighty. They are many more things they cannot do!

Before I elaborate let me open a Swiss parenthesis. As a small open economy with a safe haven currency Switzerland has a very unique problem. In times of crisis the CHF has a strong tendency to appreciate, in times of a very severe crisis, when traditional monetary actions have been exhausted and interest rates are at the zero lower bound (ZLB), the CHF can take values that are simply unbearable for the real economy and generate strong deflationary tendencies. This is primarily a monetary problem. The situation of the Swiss economy is thus at variance with the situation of the other major economies alluded to in the introduction for which the main problems are not of monetary origin. Once at the ZLB, the margin of action for the central bank (CB) is very limited. It must directly confront the exchange rate (ER) problem. This is what the Swiss National Bank (SNB) has done since March 2009, first with relatively conventional measures, and from September 6, 2011 onwards, with a very extraordinary measure, an ER floor. The ER floor lasted for almost 3.5 years, answering the needs of large segments of the real economy, but it did not come for free. Maintaining it has required a very significant expansion of the SNB balance sheet. For an extraordinary measure such as an ER floor to be justified, the circumstances must themselves be extraordinary. The economic situation and the resulting ER situation in mid-2011 qualified as such. In January 2015 however, the SNB came to the conclusion that the conditions were no longer met. A difficult but necessary analysis of the costs and benefits of maintaining the policy concluded with an unfavorable ratio: the increased costs were no longer covered by the decreased benefits. Indeed, on the one hand, the financial and economic situation was very different in 2015 from what it was in 2011 – indicating less financial tensions and renewed hopes of a progressive economic recovery in Europe and worldwide. On the other hand, monetary policy divergences between the Euro area and the US threatened to make the upholding of the ER floor feasible only with a very massive, potentially explosive, expansion of the bank's balance sheet. The SNB considered that, in these changed circumstances, it was appropriate to return to a more traditional policy, that is, to a flexible ER guided by interest rate differentials – hence the introduction of a negative (-0.75%) interest rate on commercial banks' deposit at the SNB - while remaining ready to intervene on the foreign exchange markets if needed. Circumstances do not always afford following a first-best policy. The ER floor was not a change in regime: it was an extraordinary and temporary measure. Ideally the inevitable return to normal would have waited a full stabilization of the situation in the Eurozone. The diverging economic situations and monetary policies between the euro-zone and the US that were progressively confirmed in the course of 2014 did not permit waiting this long. The circumstances justified accepting what was a second best move when viewed in light of the price stability mandate.

Let me now return to my main subject. CB's are not almighty. There are many things they cannot do. But what can they do?

First and foremost, CBs have the knowledge and the tools to achieve price stability in the medium run. The taming of inflation in the last two decades of the 20th century was an achievement of major proportion. It is deservedly a source of pride for central banks around the developed world. I have however added the qualifier "in the medium run" and do so for two reasons. I say this first because I am naturally inclined to take the perspective of a small open economy for which exchange rate shocks may at times be dominant and make the precise fulfillment of a quantitative inflation target often impossible and generally suboptimal. This reality is well reflected in the objective and the rhetoric of the SNB.

But, in my view, some degree of modesty is also in order more generally for central banks aiming at a precise quantitative inflation target. When inflation exceeds the upper bound of the range of the definition given to price stability, say 2%, it is not always optimal for a central bank to push on the brakes immediately, notably if the underlying forces, as estimated with the help of models, suggest this to be a temporary phenomenon with an identifiable outside cause. The experience of the Bank of England between 2010 and 2013 was a case in point. More controversially, the same applies, I believe, in the current times of ultra low inflation. Here again it may be appropriate to rely on our estimates of the underlying forces rather than let us be driven to panic or overreaction. The fear of deflation is understandable but deflationary cycles are exceptional. And low inflation is often either the result of outside forces, such as the current fall in oil and commodity prices, something that it is probably better to "look through", or it may be the symptom of a more profound economic malaise that is not of monetary origin. In and of itself, low inflation is not the source of additional welfare losses. In fact, low inflation opens up a window of opportunity for central banks since it typically means that they will be able to maintain accommodating policies for a longer time period, i.e., it pushes further into the future the date at which they will have to step on the brakes. Central banks' level of ambition in these circumstances should also be influenced by the fact that the forces that they can muster to fight excessively low inflation are on the "push on a rope" type, an action which affords considerably less control than the one needed when inflation accelerates. Reaching a precise inflation target from below is harder than doing so from above.

What else can central banks do? Second but equally important, CBs around the world have demonstrated that they are ready and capable of acting decisively as lenders of last resort (LOLR). Here, we have learned a lot from the experience of the Great Depression and these lessons were put to good use in the recent crisis. The massive liquidity shock that followed the fall of Lehman Brothers was met with appropriately massive liquidity providing measures with all major central banks acting in tight cooperation. There is a consensus on the assessment that, here as well, CBs were up to the task and this is something they can also be proud of.

Are central banks good at generating maximal employment? The answer is yes if we adopt once again a medium run perspective. CBs' contribution is through a smooth fulfillment of their price stability mandate. Price stability offers the best conditions for the economy to prosper and create jobs. By minimizing the occurrences of stop-go policies, it limits the number and lengths of high unemployment episodes. Whether central banks have a single or dual mandate does not change this fundamental orientation. Nor does it change the fact that when inflation goes out of control all central banks tighten policy despite the inevitable negative consequences on employment of doing so. The definition of the mandate may impact central banks' communication. A dual mandate facilitates justifying accommodative policies at times of weak economic activity. More fundamentally a dual mandate increases the pressure on the central bank to act in extreme circumstances. It can be argued that the European Central Bank (which has a single mandate) was constrained in its adoption of QE policies until inflation started to fall in the course of 2014 while the Fed (with a dual mandate) would have acted earlier under similar circumstances. I find it difficult, however, to discriminate between what follows from alternative definitions of the mandate and what results from different policy views of decision makers. All in all, I prefer the clarity and the higher accountability of a single mandate, all the more because, as I will argue next, the renewed emphasis on the financial stability dimension of CBs' mandate is inevitable and, in some sense, it already "loads the ship" to the point where it may be more appropriate to speak of triple rather than dual mandates!

Let me now move to the subject of financial stability. Here it may reasonably be argued that CBs have failed in the recent past. This offers a natural resolution of what is otherwise a paradox: the paradox of CBs being so disliked (or so much under attack) despite having been so successful in the pursuit of their two main objectives, as discussed above. Of course central banks were not alone with a mission to deliver financial stability. But they clearly have to accept some responsibility for the immense failure that the Great Financial Crisis represents. Let me be precise, however, as to the extent of this admission. The crisis was the result of several faults, most of which were not in the purview of central banks. First and foremost, come real estate bubbles. These, many argue, were the result of the low rates and the accommodative policies of central banks. My view is that monetary policy was not at the center of the problem. I am rather of the opinion that if essential micro-prudential and macro-prudential measures are not in place, reasonable deviations from a monetary policy exclusively oriented towards price stability ("leaning against the wind") will not prevent a bubble from emerging. The structural stimulation of real estate markets in most advanced countries, all in the name of encouraging home ownership, a debatable social objective, taking the form of tax deductibility of mortgage interest payments and/or semi-public guarantee for mortgage backed securities is much more critical. We must be realistic. When such policies are accompanied by lax microprudential rules – in terms of LTV (loan to value) and LTI (loan to income) criteria – and generally bad incentives for mortgage originators and creditors, monetary policy is powerless to tame the real estate cycle. A second dominant cause for the crisis was an excessively leveraged and fragile banking system. Here the main fault lies on the shoulders of regulators and supervisors. They rarely were central banks but central banks shared in the general misunderstanding of the pre-crisis fragility of the financial system and the underestimation of the potential macroeconomic costs of a modern financial crisis. Because of the former, a realistic appreciation of the outstanding systemic risks was lacking before the crisis; the latter made central bankers complacent in drawing the implications of their co-responsibility in financial stability matters. The crisis has changed all that. Central banks are re-interpreting the financial stability part of their mandate and there is a high degree of awareness as to the necessity to monitor and address attendant systemic risks. It remains that CBs are still not the only, and often not the main, players. True, the tightness of regulation is a function of our common knowledge about financial systemic risks, knowledge to which central banks are important contributors. But ultimately it is primarily in the hands of governments and parliaments and commensurate to the collective willingness to pay the price of precaution.

Let me now turn to what CBs cannot do! I'll start with three compact statements that I believe are relevant given the predicaments of many advanced economies. First obviously CBs do not produce goods or services; they do not create value! Second, CB's policies cannot directly foster innovation and growth. They can produce conditions for macroeconomic stability and these conditions are indeed conducive to the creative and innovative spirit. But CBs cannot do more on that front. Third, CBs have no mandate and no tools to reform structurally sick economies, nor to conduct the structural reforms that are required to meet the new challenges confronting the world economies (aging and climate change, to name two of the most significant). It is in that sense that they should not indefinitely be the main players on the economic scene.

It may be argued that at least one important problem confronting many advanced economies is within CB's purview. The debt overhang, which is the consequence of the excess leverage accepted or encouraged before the crisis, is a major structural handicap for a return to a healthily growing world economy and here CBs have a bigger role to play. While I agree with this element of the diagnosis, I tend to think that, here as well, the ball is not really in central banks' court. True, inflation may have a role in eating away the debt burden, but this is a much too slow and protracted way to get at the debt issue if and when it is the main source of economic anemia. Moreover, as indicated by my previous remarks on the ability of monetary policy to achieve precise quantitative inflation targets, in particular at times of low inflation, I do not think CBs should devote disproportionate efforts to reaching a precisely defined higher inflation target and certainly not in the name of offering a solution to the debt problem. CBs are good at reining in inflation; they are less well equipped to stimulate inflation in times of pessimistic assessments of an economy's potential. Pushing on a rope is not a very effective mode of action.

This leads me to my concluding remark. At the ZLB we have seen CBs being very active with the goal of generating artificially low long interest rates and artificially weak exchange rates, and these measures have helped to some extent (although the cost of the collateral damages is still to tally). In my view, QE (quantitative easing) type of monetary measures are definitively second or third best. If central bankers in the last years may sometimes have left the impression that they were the only game in town, this is the very unfortunate outcome of a leader-follower type of game where those who should be the major players, the governments and the parliaments, moved first and asserted their inability to act thus leaving the followers, the CBs, with little choice but to do what they could; and, in order to have a chance of success, with the obligation to claim that their tools were not exhausted and that they could reach the goal. Central Bankers have thus let themselves be pushed into a corner where too much weight is placed on monetary instruments and too much is expected from them. This is a suboptimal equilibrium. Overestimating the ability of CBs to deliver suits everyone in the short run but is not positive for their credibility in the medium and the long run. Seven years after the start of the crisis, we now need a broader and more realistic assessment of the policies apt to foster a return to a healthy rate of growth. This will lead us to place less focus on the words and deeds of central bankers.