THE AUSTRALIAN

Central banks repeatedly made to look very ineffective managers

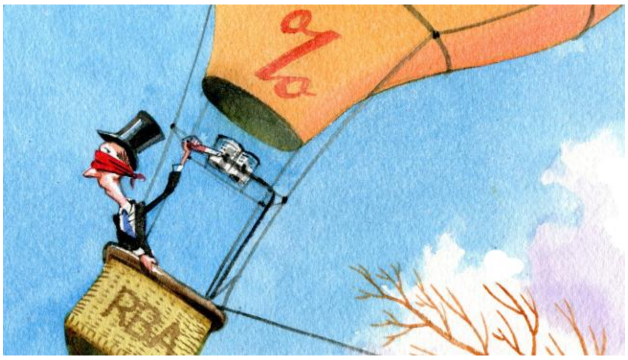

Illustration: Sturt Krygsman

HENRY ERGAS THE AUSTRALIAN 12:00AM September 26, 2016

William McChesney Martin Jr, who chaired the US Federal Reserve in the 1950s and 60s, famously observed that central bankers are the people who take away the punch bowl just as the party is heating up. Nowadays, his successors are the fellows who spike the drinks.

So far, the Reserve Bank has avoided that territory, as Philip Lowe, its new governor, stressed in his statements last week. But with the cash rate at a record low, even a modest slowdown could easily drive the RBA to the zero or negative interest rates and large scale purchases of financial assets adopted by many of its counterparts overseas.

Whether those policies are at all effective is controversial. What is certain is that their outcomes have fallen far short of central banks' expectations. And to make matters worse, despite the policies running into sharply diminishing returns, central banks have struggled to find an exit path, with the fear of denting what little growth there is overwhelming their recognition of the need to return towards normal policy settings.

Trapped in policies whose costs are becoming more evident just as doubts about their benefits mount, the world's central banks risk a backlash that could dramatically redefine their role.

Nowhere are the problems starker than in Japan.

Faced with persistent, albeit moderate, deflation, Haruhiko Kuroda, the governor of the Bank of Japan, promised three years ago to increase the inflation rate to 2 per cent, adding that the BoJ would achieve that target within two years.

To that end, the bank unleashed a massive program of quantitative easing, buying over $1 trillion of Japanese government bonds a year and pushing even long term bond yields below zero. But with consumer prices continuing to fall and economic growth no better than sluggish, Kuroda accepted last week that the policies had not worked — only to announce a new, no less aggressive approach while pledging to keep the bank's asset purchases at their previous levels.

Similar dilemmas confront the European Central Bank, with negative interest rates and large scale asset purchases doing little to lift inflation to the ECB's target or revive solid growth.

As for the Fed, which announced in December 2012 that it would normalise policy once the unemployment rate had fallen to 6.5 per cent, the fact that joblessness is now well below that level has not given it the confidence to unwind its swollen balance sheet and raise interest rates towards long-term norms.

In part, the problems reflect our lack of understanding of the present situation. Painful experience has taught policymakers how to bring rampant inflation under control. But economists really don't know why inflation rates are as low as they are, much less how to laser beam them from near zero into a 2 to 3 per cent band. As a result, central banks resort to ad hoc expedients, often with little analytical foundation. For example, recent work in monetary economics suggests that under circumstances such as those confronting the advanced economies, low nominal interest rates can cause low inflation; central banks may therefore be perpetuating the very malady they aim to solve.

With central banks dancing in the dark, it is unsurprising that markets put little faith in their commitments. But the challenge for central banks goes well beyond the erosion of policy credibility.

In effect, the prominence of monetary policy and the range of measures central banks have deployed have brought them to the centre of political controversy. That is inevitable, as their interventions increasingly have major consequences for income distribution and even for how individual markets function.

Japan is again a case in point. As it has scaled up its purchases of financial assets, the BoJ has become a significant investor in Japanese corporations. It is, for example, the largest single shareholder in piano maker Yamaha, and by the end of this year will also be in Fanuc, the world's leading producer of industrial robots, as well as in about 50 other substantial Japanese corporations. Its decisions about how to manage its portfolio already affect equity markets, and that influence will grow as its holdings continue to increase.

Nor is the BoJ alone. The ECB's asset purchases are encouraging large European corporates to issue bonds with zero or even negative interest rates, giving them a financial edge over new and smaller rivals and entrenching dominant market positions. Much the same is occurring in Britain, where the Bank of England is skewing its purchases towards large companies that invest not only in plant and equipment but also in training, thus indulging in "picking winners". All this makes central banks eminently political actors, deciding who gets what at the expense of whom. And they increasingly acknowledge that reality, with the Fed breaking new ground last month by meeting with left--leaning activists for a broad-ranging discussion of its policies.

The result is to damage, if not destroy, the bargain underlying central bank independence.

At its heart was the belief that central banks, in pursuing their economy-wide mandate, would not favour one group of special interests over the other, making it unnecessary to impose the checks and balances that the threat of rent-seeking invites and demands. As those hopes fade into history, the pressures to reduce central banks' autonomy will only rise.

By far the best antidote to that risk would be to ensure we do not get into such a mess as to lead the RBA down its counterparts' path.

But that is not in Lowe's hands. Rather, it depends on a political system that still shows few signs of understanding the dangers ahead. Ultimately, for all his undoubted skill, Glenn Stevens was lucky. His successor may not be.