Central Banks as Saviors

"The Economist as Savior" is the title of the second volume of Robert Skidelski's definitive biography of John Maynard Keynes. This volume focuses on how his ideas helped US and European economies deal with the 1930s depression, using monetary and fiscal stimuli. The same measures were once again adopted in the wake of the 2008 financial crisis, which triggered the largest fall in global output since the depression era.

Since the crisis, in many ways, major economies are being managed by central bankers rather than the elected sovereign governments. Fiscal austerity is in fashion, at least in the US and the euro zone, and central bankers have become the new "saviors". One example: it was the Governor of the European Central Bank who promised to do "whatever is necessary" to halt the slide into deflation and to "save the euro". (As for latter, it is not quite clear whether the euro zone would survive the next crisis in Greece, at least in its present form.) Too many media reports seem to paint central bankers as models of technical competence and doing their best in a difficult situation; politicians as irresponsible, populist, spendthrift. What is truly amazing is that central bank governors are being lionised precisely at a time when the crisis was the result of the failure of central banks, in a different role, namely that of bank supervision, that led to it in the first place. To be sure, in Europe, the ECB was not in-charge of banking supervision, and in UK, the Bank of England was charged only with achieving an inflation target, with a separate Financial Services Authority (FSA).

But this apart, what has been their record in achieving inflation targets, their primary function? The ECB is trying to increase inflation to 2% (from zero now), to avoid the possibility of deflation; Japan has recently recorded inflation of 2% not so much because of monetary policy, but an increase in sales tax from 5 to 8%, and a sharp fall of the yen. The Federal Reserve has also followed easy money and near zero interest rates for a long time in the hope of spurring economic growth. As it happens, US growth in Q1 of 2015 was just 0.1%. In the meanwhile, there has been enough speculation about when the Federal Reserve will start increasing rates, and what its impact would be on global markets. It looks like, with the latest growth numbers, the rate rise may be postponed once again, as inflation remains low. Clearly, inflation does not seem to be a purely monetary phenomenon as Milton Friedman had believed. Or is empirical evidence of little import to "true believers"?

The standard model used by most central banks is the so-called dynamic, stochastic, general equilibrium (DSGE) model. This is based on "*unbelievable assumptions concerning how rational and knowledgeable people are, and how universally and perfectly markets function …..There was no objection, it seemed, which the new orthodoxy of so-called dynamic, stochastic, general equilibrium models could not meet."* (*Money – The Unauthorised Biography* by Felix Martin). Martin goes on to comment sarcastically, "*The academic profession might spend its time in transcendental meditation on the mystical abstractions of a general equilibrium theory of the economy devoid of money, banks and finance",* and demographics – as DSGE is. By the late 1990s, a cosmetic modification was made and the New Keynesian DGSE model became more fashionable: one wonders whether Keynes would approve of this mis-use of his name. No mean mathematician himself, Keynes did not believe in the efficacy of probability based (stochastic) models in the macro (or financial) economies.

To be sure, there are some heretics. To give one example, in a speech in 2012 at the London School of Economics, on "*Twenty years of inflation targeting*", Mervyn King, then Governor of the Bank of England, said, the standard model "*lacks an account of financial intermediation, so money, credit, and banking play no meaningful role"*. More recently, in an article on Dr. Raghuram Rajan, in *Finance and Development*, the Quarterly Publication of the IMF/World Bank, Olivier Blanchard, the Chief Economist of the IMF, confessed that "*we are not sure what financial stability means*". Nevertheless, stability and equilibrium remain the holy grails of macroeconomic policies. (Incidentally, the 2% level as the ideal rate of inflation was given birth to by the New Zealand Central Bank, back in the 1990s, with no logic or justification for why it should not be 3% or 4% or 5%!) The article also credits Dr Rajan with moving *"quickly.. to reduce inflation sharply":* one had naively thought that the global fall in commodity prices and a smaller increase by government in the minimum support prices of foodgrains, are more responsible for the fall in the rate of inflation!

One effect of ultra-low policy rates is that an astounding $2.4 trn bonds today have negative yields! Life insurance companies are facing major problems in asset liability management. The hunger for higher returns is attracting investors to “junk” (i.e. below investment grade) bonds; covenant-lite, risky debt; structured debt securities; etc. etc. This was exactly the background to the financial crisis of 2008!

In India, transfer of government debt management to an independent agency has been removed from the Finance Bill, but the issue remains alive: one should not forget that government debt management is really “yield management” which only the central bank can do through its open market operations.

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