At a crossroads: The future of central banking

Participants from PwC’s 2014 Central Bank Forum talk about how to address the challenges ahead.

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We have entered into a period of intense experimentation, in which central banks are moving towards new and largely untested policy remits and intervention tools.

Past norms may have little relevance in a financial system being transformed by technology, new entrants and the shift in global investment and growth. Central banks in fast growth emerging markets are striving to keep pace with rapidly expanding and increasingly complex financial services markets. Their counterparts in the markets most affected by the financial crisis are expected to play a much more prominent role in the management of financial stability and the wider economy. Yet, there is no clear blueprint for how this should work or even certainty that some of the expectations are achievable. To add to the challenges, the hard choices and trade-offs necessitated by these new and evolving demands are intensifying the public scrutiny and political sensitivities surrounding central bank operations.

The two days of round-table discussions were an opportunity for senior central bankers and PwC representatives from around the world to share ideas, learn from each other’s experiences and discuss the strategies needed to manage these changes. I had the honour of chairing the fascinating debates. What came through strongly was the importance of not replacing the pre-crisis orthodoxy with a new set of conventions that could prove to be equally flawed. The central banks that are set to be most successful are alive to new ideas and constantly adapting and refining their policies.

This summary paper is designed to provide a record of the issues debated, and a platform for ongoing discussions among the participants. To ensure full and free discussion, the participants’ comments are unattributable under the Chatham House Rule.

If you would like to know more about the annual Central Bank Forum or would like to discuss any of the issues in more detail, please feel free to contact me.

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“We need to understand what we’re doing and we need to justify what we’re doing.”
Central Bank Forum participant
Weaning economies off stimulus

“In a crisis, quantitative easing acts like an antibiotic staving off even greater catastrophe. But as it endures, it has come to resemble an addictive painkiller,” said a participant at September’s Central Bank Forum.

Stimulus has certainly endured far longer than many would have anticipated. In October, the Bank of Japan (BoJ) followed the European Central Bank (ECB) in a fresh round of what could be labelled as quantitative easing (QE). Several forum participants questioned whether emergency measures that were originally designed to bring frozen credit markets back to life have become little more than a tonic for underperforming economies. Some argued that governments now prefer the quick fix of stimulus to more politically sensitive structural measures, including labour market reform or weeding out unviable banks.

No cure-all

So is there a future without stimulus? Concerns over deflation mean that QE will remain an important part of the economic armoury for some time. With a number of leading economies operating with what are in effect negative interest rates, many policymakers believe that monetary expansion is the only option left. The sharp rise in share prices following the BoJ’s latest intervention underlines QE’s immense influence on capital market sentiment.

Yet, several participants argued that the medicine may be worse than the disease. “Private debt has simply been passed on to the public purse,” said a participant. Others believe that the distorting impact of QE on equity, housing and other asset prices can only increase as emergency measures take on an air of permanence. “Monetary policy boosts borrowing, asset prices and risk taking when these may already be too high, creating an inevitable tension between how policy works and the direction the economy needs to take,” said a participant.

Citing the UK as an example, a participant noted that while stimulus can help to boost GDP, this may not be reflected in either productivity gains or a rise in living standards. This would suggest that the impact of QE is uneven at best and possibly even an impediment to long-term growth.

Looking beyond the economies receiving direct stimulus, participants highlighted the destabilising influx of funds into fast growth markets that were less affected by the crisis, making this a global issue. The costs of foreign exchange sterilisation are the immediate headache. The bigger threat is the
sudden withdrawal of these ‘hot flows’ at some point in the future.

**Political minefield**

This leaves the question of how to wean the patient off the cure. The Federal Reserve has led the way by calling time on its bond buying programme. Yet, there are considerable risks.

The market and wider public anxieties over withdrawal highlight the mounting politicisation of central bank decisions. Preparing the ground through forward guidance is therefore crucial. But many central banks have subsequently strayed from the policies set out in their earlier guidance, which has created confusion and undermined credibility.

Sudden withdrawal could be especially risky. Citing comparable experience of interest rate rises in the US in the middle of the last decade, a participant noted that the 17 consecutive increases in the US between 2004 and 2006 generated a spike in defaults, which some believe helped trigger the financial crisis. Could an overly rapid tapering open up similar systemic risks, especially if accompanied by a sharp hike in interest rates?

Withdrawal could also provide a jolt to central banks’ own financial position. Many will be pleased to see a contraction in balance sheets bloated by asset purchases (see Figure 1). But as a participant noted, there could be significant trading and income losses when these assets are eventually relinquished, which will need to be carefully explained.

The general consensus among participants was therefore that the use of stimulus and the expectations that surround it need to be rebalanced. It’s important to communicate to politicians and the public at large that expansionary monetary policies are better used as a last resort rather than a primary economic tool. Moreover, as withdrawal is bound to be politically fraught, it should be governments that make the decision rather than simply leaving it to unelected central banks. And this in turn will require governments to find other ways to boost ailing economies, rather than just relying on the quick and politically convenient fix of monetary stimulus.

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**Figure 1: Central banks have adopted unconventional policy measures, boosting their assets**

<table>
<thead>
<tr>
<th>Central bank assets (% of nominal GDP)</th>
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<tbody>
<tr>
<td>140%</td>
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<tr>
<td>120%</td>
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<tr>
<td>100%</td>
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<td>80%</td>
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<td>60%</td>
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<td>40%</td>
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<td>20%</td>
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<td>0%</td>
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Sources: PwC analysis, National Central Banks and Datastream

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Intervening before it’s too late

*Much of central bank and wider regulatory policy seems geared to preventing a repeat of the recent global financial crisis. Yet, the next crisis will almost certainly be very different from the last.*

The potential causes of a fresh crisis discussed at the forum ranged from the buildup in non-bank credit to cyber-attacks within an increasingly digitised financial system. The rapid growth in emerging market financial systems is also opening up the risk of credit bubbles and misconduct (Figure 2 highlights the links between GDP and credit growth). Even greater threats may be lurking off the radar – the ‘unknown unknowns’.

**Figure 2 Charting the relationship between GDP and credit demand**

<table>
<thead>
<tr>
<th>GDP per capita (US$, 2012 prices)</th>
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<tbody>
<tr>
<td>120,000</td>
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<tr>
<td>100,000</td>
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<tr>
<td>80,000</td>
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<td>60,000</td>
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<td>40,000</td>
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<td>20,000</td>
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<td>0</td>
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<table>
<thead>
<tr>
<th>Domestic credit to private sector (% of GDP)</th>
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<tr>
<td>0</td>
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<tr>
<td>50</td>
</tr>
<tr>
<td>100</td>
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<td>250</td>
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<td>300</td>
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<td>350</td>
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Sources: PwC analysis of World Bank data
Looking in the right places

So how can central banks ensure they’re sufficiently forewarned and forearmed in this evolving environment?

Participants agree that they can no longer rely on inflation targets as the key benchmark for credit market equilibrium or solely use interest rates to temper demand. A participant cited the example of the sharply rising property price to income ratios in many economies in the lead-up to the financial crisis to demonstrate that “rising leverage can still cause macroeconomic instability without producing excess inflation”.

A number of participants stressed the importance of looking beyond whether credit supply is overheating to whether demand is rising too rapidly and why, with the levels and pace of growth of leverage being the most obvious indicators. This recognises that demand and supply are likely to vary quite considerably across different areas of the market. The imbalance between the amounts of credit going to real estate compared to business investment in developed economies is a visible example. Similarly, a participant highlighted the “amount of credit going to governments rather than the private sector. How can we channel these funds to the real economy?”

Yet, leverage is a lag indicator. How can central banks detect and avert problems before they get out of hand? “Big data analytics is set to emerge as a vital component of crisis prediction and management,” said a participant. Among the initiatives highlighted during the forum was a dynamic macroeconomic model of financial balances using flow of funds data. This would allow a central bank to map potential threats in a way comparable to seismic activity indicators for earthquakes.

Targeted response

So if threats are detected, what’s the most effective response? Several participants argued that higher interest rates are unlikely to rein in credit demand if borrowers believe rises in asset prices will be sufficient to cover the increased lending costs. Even if they do have some effect, it may already be too late.

A suggested alternative to raising interest rates would be to impose controls on leverage levels such as loan to income or loan to value (LTV) ratios. But these approaches aren’t a panacea. A participant noted that while his central bank had introduced LTV curbs, borrowers quickly found ways around them and they were subsequently withdrawn. “It’s better to keep LTV up our sleeve for emergencies rather than making it permanent,” he said. Others pointed to the potential distortions in asset prices that could arise from LTV controls.

Another alternative would be targeted prudential measures, which impose extra capital on lending in areas of the market deemed to be overheating. This pinpoint approach would help to ensure that regions or sectors where credit is at safe levels or may even be too low aren’t
adversely affected. But as a participant argued: “while prudential tools can be part of the mix, we shouldn’t use them to target a problem that is rooted in a wider economic problem”. Another participant argued that there should be more dedicated non-real estate lenders to ensure more credit goes to support business investment and productivity.

If problems escalate to the point that banks run into trouble, how should this be resolved? Looking at the EU’s new resolution procedures, a participant welcomed the introduction of a more systematic approach. This includes clearer criteria on when to intervene and how, though grey areas, political choices and issues over state aid remain. The new provisions also include allocating ‘bad assets’ to an industry-funded bridge bank. Viable operations can then be acquired without ‘poisoning’ the acquiring institution. But the participant argued that the need to save some systemically crucial banks means that taxpayer liabilities and associated moral hazards won’t go away. The costs of saving a system in collapse are also likely to exceed industry-funded insurance. A key part of the management of expectations in this new world will be explaining to taxpayers that bailouts are still a possibility.

Green light to intervene

Even if central banks have the right information and the right tools, how easy is it to intervene when both the public and politicians are on a ‘credit high’? “By 2003, central banks knew that there were problems in Ireland and other Eurozone markets, but it was 2008 before anyone stepped in, by which time it was too late,” said a participant. As several participants noted, this reluctance to be “pulled back from the punch bowl” underlines the importance of clear data and analysis in making a compelling case for intervention.

Can central banks protect against the unknown unknowns? Probably not. But they can bring together and communicate as much market-wide information as possible, allowing for the broadest possible analysis of emerging trends and identification of potential dangers by financial analysts, academics and others. “The more light we can shed on what’s going on, the fewer surprises there’ll be,” said a participant.

However, a participant voiced concerns about the accuracy of much of the data upon which so many financial decisions are based. “It wouldn’t stand up to scientific scrutiny,” he said. He noted, for example, that assets and liabilities are measured at the same discount rate. In times of stress, point-in-time measures may be rendered completely meaningless. One way to make the information more reliable would be to use distributions rather than discrete values. This would form part of a shift from using specific values to the use of interval estimates and confidence levels.
Redefining the role of central banks

“Central banks have faced a decade of confusion over what has been happening. They are now one of the many types of societal institution that has entered into a period of intense experimentation,” said a participant.

Many central banks are being asked to take on a stronger role in the management of financial stability, though there is no clear definition of what this actually entails. The use of monetary stimulus as an engine of growth is in turn bringing central banks closer to the centre of macroeconomic management. The risk is that rising public expectations about central banks’ ability to sustain the safety of the financial system and boost economic activity may be unrealisable.

Several participants questioned whether unelected central banks should be making what are essentially political decisions. “The more trade-offs central banks have to deal with as part of their macro-prudential remit, the greater the political scrutiny they will be under,” said a participant. “The instruments being used by central banks are being increasingly politicised, especially as some people are better off and others less as a result,” said another. Examples cited during the forum included the potential conflict between pensioners wanting higher interest rates and younger people looking for cheaper mortgages or the impact of higher capital charges on the cost of business loans and other economically essential credit. “These trade-offs are by definition political and can therefore only be used if there is a willingness to accept central bank authority,” said a participant.
Conclusion:
Credibility key to influence

In discussing authority and autonomy, several participants questioned whether the notions of central bank independence that preceded the financial crisis are now a historical anomaly when central banks need to collaborate so closely with other economy policymakers.

Pointing to the interagency committees set up to oversee financial stability, a participant warned that the “danger is that central banks will be outnumbered as these committees turn into a stalking horse for political control”. A particular issue is how much capital they need to operate with autonomy. Several participants noted that credibility rather than capital is the strongest way to ensure autonomy. Capital can help, but it is also important that markets and the public have faith in central banks’ ability to act in the public interest and make a difference. “The response to ECB President Mario Draghi’s commitment to doing ‘whatever it takes’ is a very telling example of the power of credibility,” said a participant.

With so many aspects of the future of central banks still to be resolved, many participants stressed the need for a public debate on the role of central banks, what they can realistically achieve and how. This should be an open debate that recognises that policy and direction will vary according to local circumstances and stakeholder demands. “Central banks are products of their socio-political system,” said a participant. It’s also important to ensure that central banks are alive to new ideas, threats and opportunities. “There is a danger that the orthodoxy of the ‘great moderation’ that preceded the ‘great depression’ is replaced by a new orthodoxy that is equally flawed and fails to keep pace with the rapid developments in the financial system,” said a participant.

PwC is preparing an in-depth report on the future of central banking in a time of relentless change. Please see [insert link for PwC central banking]
If you would like to discuss any of the content in more depth please speak to your usual PwC contact, or one of the following:

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