ECONOMY AND FINANCE • VOL. 10. ISS. 3 • SEPT 2023 • DOI: 10.33908/EF.2023.3.5

A SELECTION OF PAPERS ON THE POSITION OF CENTRAL BANKS

Essay

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ABSTRACT

The central banks of the industrialised world faced an unusual and difficult challenge in 2022-2023 when inflation, public debt in several countries and the exposure of banking systems to private debtors rocketed all at once. Thus, interest rates needed to be raised (to curb inflation) and reduced the same time (to stop the growth of public debt, usually termed fiscal dominance), and/or save banks from losses (which means financial dominance). The question arises whether central banks must accept fiscal and/or financial dominance? And, really, how could this happen? Can one blame central banks for the processes leading up to it and if they can, in what sense? What has been misunderstood about the relationship of unemployment and the rate of inflation? Has quantitative easing (QE) by a number of central banks been the right response since interest rate reduction as a means to boost the economy failed? Is it possible that forward guidance may lead to better results? Or else, should the operating modes of central banks be changed temporarily? Those seem to be the most interesting issues dealt with by experts of the IMF and former and current central bank governors and experts in the 2023 March issue of *Finance & Development*. Final answers to the questions cannot be expected in the near future, but readers can find some worthy opinions here.

JEL codes: E5, E6, F4

Keywords: monetary policy, public debt, macroeconomic fluctuations

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1 INTRODUCTION

These days the central banks of the leading market economy countries have to face complex and difficult challenges unseen for a long time. In the 1980s they applied strict measures and were successful to curb the latest wave of inflation until recent times. It was then almost forgotten during the fifteen golden years of Great Moderation followed by the financial crisis and the COVID-19 pandemic. Some have hoped this cancer of paper-based money has been overcome once and for all. But even those who did not believe it were surprised as prices started to run away in late 2021. (Consumer prices increased by an average of 2.9 percent in the current 27 Member States of the EU in 2021 – not really fast but more than over the previous two years together and, within that, by 10.1 percent compared to Q4 2020, which predicted an average of 9.9 percent for last year.)

High inflation is only partly the result of one-off factors (energy and food price increase), so it would obviously require a tightening of monetary policy (raising interest rates and reducing the money supply). However, worrisome features appear quite unusually in two areas at the same time. On the one hand, public debts have soared with their interests (yield) payable from public money, which ultimately burdens the GDP. The US public debt at the end of last year was 124 percent of the GDP while it was 32 percent in 1979 when the central bank was last forced to significantly raise interest rates.[2] Creditors who are aware of the USD's role as global money will not be frightened much, but the situation is more worrying elsewhere, for instance, in some member states of the eurozone. In the eurozone, the average public debt/GDP ratio was 93.6 percent in 2022, including, for instance, 144.6 percent in Italy (56.5 percent in 1979), 114.0 percent in Spain (14.3 percent in 1979), 106.2 percent in Belgium (66.2 percent in 1979) and 105.3 percent in Portugal (35.2 percent in 1979)[3]. Interest rate increase is a major headache for those countries.

On the other hand, there is a strong fear in the financial system (with banks and other finance areas) of the expected rise of interest rates. Looking at major banks, it first occurred at one that had taken higher risks of maturity transformation and interest rates (Silicon Valley Bank) and one weakened by major losses, loans forced to be written off over the past period (Credit Suisse). Next, some doubts have arisen regarding Deutsche Bank and other banks too. Just the fact that experts predict further spread may become its reason (and stock exchanges are pes-

2 https://fiscaldata.treasury.gov/americas-finance-guide/national-debt

3 https://economy-finance.ec.europa.eu/economic-research-and-databases/economic-databases/ameco-database_en

simistic too: the share prices of major international banks declined by approximately 10 percent from early to late March – *The Economist*, 2023).

Fears eased after March, but the necessity to raise and reduce interest rates at the same time remained feeding the tension between the two. Financial integration has become global; the international spread of interest rate fluctuations causes further complications and makes the management of different situations in different countries more difficult.[4]Because of it, decisions made by major central banks can result in important consequences both for them and elsewhere too, which can also become critical.

The above new special situation is the reason why the editors of *Finance & Development* published by the IMF printed papers by former and current governors of central banks and other experts (New Directions for Monetary Policy, 2023) on how we have got to where we are now and what central banks should do now or in the future in general based on their present experience.

2 HOW HAVE WE GOT HERE AND WHAT SHOULD BE DONE NOT TO REPEAT IT?

All authors underline the part played by the *pandemic* among the reasons for the current situation. *Claudio Borio*, head of the monetary and economics department of the Basel Bank of International Settlements explains the role of COVID-19 with three factors. On the one hand, as the pandemic abated in 2021, global demand suddenly increased, partly as a natural continuation of its earlier artificial dampening and partly as a result of fiscal and monetary policies of unprecedented strength to support businesses and incomes. On the other hand, a change in the composition of global demand favouring products over services has proved to be lasting, which was unexpected and caused bottlenecks. Third, global supply could not meet demand.

The *Russian invasion* of Ukraine last February was another important factor, as it pushed up energy and food prices to new levels.

However, in addition to one-off factors as above, *the models of our profession* should also be mentioned, in particular, the weaknesses of the models that prevented the prediction that inflation would accelerate. Borio points out the existing

4 The most striking feature of growing international financial integration is that interest rates adapt to those of "stronger" currencies, which increasingly supplements or even replaces adaptation via exchange rate fluctuation. Cf. e.g. Gourinchas–Rey–Sauzet, 2019; Philip–Milesi-Ferretti, 2018).

macroeconomic models were used for a long time under the conditions of a slow and stable inflation. Therefore, the models are prone to supposing that inflation will return, by itself, to the targeted value of around 2 percent annually. In addition, they also assume changes in the rate of inflation do not have an impact on the economic context the models are based on, including the sensitivity of wages and prices to what part of the production factors of the economy remain unused.

Instead, the author is offering another approach closer to reality. In his approach there are two kinds of inflationary regimes, one with a low and one with a high inflation, and there is a self-boosting process leading from the first to the second. Inflation behaves quite differently under the two regimes.

When it settles at a low rate, what is usually measured as the rise of the general price level consists mainly of price changes in different industries that are loosely related to each other. Such changes only leave a temporary imprint on the general rate of inflation. It is also important that wages and prices being at the core of the inflationary process are only loosely linked to each other. Due to that, such low inflation does have certain self-stabilising effects.

However, a high inflation regime has no such features. Price changes carry more weight, wages and prices are much closer related and inflation is more sensitive to prices prone to frequent changes (such as food and energy prices) than currency fluctuations.

A regime shift is a self-boosting process for several reasons. One is that inflation leaves the zone of being rationally negligible, where companies or households hardly notice it, and gets into the focus of attention. In addition, it becomes more visible: price changes become similar and, more often that not, simultaneous. Thus, inflation behaves as a focal point, a kind of "tool of coordination" for business and household decisions. Therefore, the possibility of the appearance of a wage-price spiral increases.

Gita Gopinath, deputy managing director of the IMF emphasises the relationship between inflation and unemployment (also known as the *Phillips curve).* She believes the real nature of the relationship has been misunderstood and that is why the acceleration of inflation has come as a surprise.

Experience before the pandemic showed that a sudden reduction of unemployment as a result of the financial measures applied did not accelerate inflation; the Phillips curve was not very steep. The standard Phillips curve expresses the deviation of actual unemployment from the unemployment gap (non-accelerating inflation rate of unemployment – NAIRU).

However, a quick recovery of employment may have played a major role in shaping inflation recently, which indicates that "speed effects" may have a more important role than it was earlier believed. There might be some non-linear sections in the slope of the Phillips curve: the pressure exercised on prices and wages by the decline of unemployment will be stronger when the economy runs at full speed than when employment is not full. Finally, a sudden increase in the prices of goods at the time of economic boom, when the limitations of supply of and demand for services are a strong incentive to produce and market goods, underlines the importance of capacity limitations both in different industries and at an aggregate level too. That is why inflationary risks originating from an economy running at full speed may be much higher than it was thought earlier.

Gopinath also mentions another reason for the acceleration of inflation, which is discussed by other authors as well. It is an opinion used to be generally accepted, namely, a central bank, because of its credibility earned earlier for keeping inflation within boundaries, can “look over” (i.e., shun) *temporary supply shocks,* for instance, rocketing oil prices, assuming their impact on price increase will be temporary. The pandemic has proved such shocks may have wide ranging and lasting effects. Looking over temporary shocks may cause problems if the rate of inflation is high.

Over and above the answers given to the question of “what has misled us”, one should contemplate whether the state leaders responsible for macroeconomic decisions, or specifically the governors of central banks have fallen into traps they should have recognised and *should have avoided based on the information they had. Raguram Rajan*, a professor of Chicago University and former Governor of the Reserve Bank of India is the only one of the authors to raise the question and offer a fairly nuanced response.

He sets out from the limited nature of knowledge – no ethical responsibility there as bank leaders were fighting deflation and did not change tactics. Well, but who could have known that times were changing? And even if they knew, what could they have done?

As the author writes, “preemptive rate rises that slowed growth would have lacked public legitimacy — especially if they were successful and inflation did not rise subsequently, and even more so if they deflated the frothy financial asset prices that gave the public a sense of well-being. Central banks needed the public to see higher inflation to be able to take strong measures against it.” Central bank governors, naturally, are not engaged in election campaigns, but they need respect, credibility and acceptance to act successfully; it would have been problematic to take such a risk.

Rajan, however, thinks, this is not the end of the story. Although bank leaders can rightfully claim the latest processes have surprised them, they did have a role in limiting their playing fields, and their role was not restricted to what has been said before.

If interest rates are low and liquidity is high for a long time, it always leads to an increase of asset prices and a growth of indebtedness. And now both the government and the private sector have become indebted. It is true the pandemic and Putin's war increased government spending. But it was also increased by ultra-low long term interest rates and the fact that the bond market was made painless through central bank actions, such as quantitative easing (QE). It is true targeted government spending was necessary, which had to be funded from long term loans. However, the economists recommending increased spending failed to carefully examine its reasonable limits. Because the political environment was fragmented, increased spending could only be approved if it gave everybody something.

Central banks aggravated the problem by funding the purchase of government bonds from overnight deposits, which shortened the financial maturity of the consolidated balance sheet of the government and of the central bank. This, according to Rajan, means that government finances might become problematic as interest rates increased particularly so in countries of slow growth. Fiscal considerations already pressurise the policy of some central banks. For instance, the European Central Bank is worried because of the effect of its monetary transactions on "fragmentation"; i.e., the yield of debts drawn by fiscally weaker countries grows faster than that of stronger countries. Central banks should have at least recognised the volatile nature of the political sphere, which increased the likelihood of governments responding to the shocks with unbridled spending, even if they could not foresee those shocks. It could have made them more cautious with respect to eliminating long term interest rates and a commitment to long term low interest rates. Low interest rates and the abundance of money boosted the strong indebtedness not only of the treasuries but also of the private sector, households and enterprises.

3 DISTORTION OF THE SCOPE OF CENTRAL BANK RESPONSIBILITIES: FINANCIAL AND FISCAL DEPENDENCE SIDE-BY-SIDE WITH/INSTEAD OF ANTI-INFLATIONARY AND CONJUNCTURAL POLICY

The misguided policy of governments and central banks forces central banks to take measures which will cause minor or major disturbances in fulfilling their core task – providing stable money for the operation of the economy (and, in addition, ensuring the right level of employment). Firstly, their policies must ensure that the increase of government debt remains such that will not cause severe disturbance in the fulfilment of debt service and, with that, in government creditworthiness or in shaping and fulfilling primary (non-debt service) obligations while taxes can also be held within reasonable limits *(fiscal dependence).* Secondly, their interest and monetary policies must prevent the operational disturbances of the (private) financial system *(financial dependence).* Finally, the demand of the private sector for liquidity, which has become high as money was abundant and is declining slowly, must be fulfilled (*liquidity dependence,* some authors regard it as an element of financial dependence).

Markus K. Brunnermeier, professor at Princeton University describes the normal situation of central banks by saying they are kind of leaders of the economy that stabilise inflation by setting interest rates; in addition, their mandate often also covers supporting the achievement and maintenance of full employment. An approach like that which can be termed monetary dominance requires a strong basis, i.e., *the independence of central banks. De iure* independence is there if – in a legal sense – a central bank can set interest rates independently with no government interference. However, *de facto* independence is also necessary. It is ensured if bank decision-makers need not worry whether the interest rates intended to be raised would increase government debt or the risk of the government becoming insolvent. If a government must honour high debt service because of increased interest rates, it is expected to reduce primary spending, which will cool the conjuncture and reduce inflationary pressure. In difficult times, the independence of central banks is key for them to be able to define monetary policy and control the economy.

The period following the 2008 crisis was characterised by monetary dominance. Central banks set interest rates free of fiscal policy and followed their set goals. At the time the main problem was not identified in rising prices but in declining demand, which could have led to strong deflation, therefore, they focused their attention on taking monetary policy measures to boost the economy.

Then the pandemic has shown that inflation is also influenced by fiscal policy side-by-side with monetary policy. However, the strong use of fiscal incentives led to the accumulation of high government debt and as the burden of (rigid, non-reducible) debt service grew, spending had become more difficult to be controlled. While central banks and governments could cooperate well earlier when government debt was low and growth-incentive policies were necessary, they may be confronted in the new situation.

If a central bank eases the government's burden of debt service by failing to increase interest rates, which is necessary to curb the inflation, and/or if it monetizes government debt, monetary dominance is replaced by fiscal dominance. In some cases, one may regard it to be unavoidable, or granted. Brunnermeier, in contrast to other authors of the papers, denies that. He believes a central bank cannot accept fiscal dominance. Adaptation by reducing spending and/or increasing revenues is the responsibility of the government. He thinks a central bank must also have the right capitalisation so that it can resist pressure and can declare its intention to do so credibly.

Financial dominance is a situation often similar to and appearing together with fiscal dominance (currently true for many countries). It means the increase of interest rates aimed to curb inflation threatens the stability of the financial system, mainly of banks, because the interests of their passive operations generally increase at a faster rate than what they can apply to the interest rates of their placements. Therefore, a central bank will hesitate and will delay interest rate increases. Brunnermier's opinion on that is more cautious and not dismissive. Probably because, contrary to fiscal dominance, there is no alternative for managing the situation. (Reducing government spending hardly helps, because it is not enough to curb inflation in itself, any other actions are no help at all.)

Financial dominance is subject to the capitalisation of the banking system (its loss-bearing ability) and also depends on the rules of bankruptcy management.

The above problems necessitate rethinking the relationship of monetary policy and financial stability. It is quite important that central banks use a gradual approach to introduce price-type signals on the markets where they have recently interfered expansively regarding quantity. One must acknowledge there always are mutual impacts between their goals of price stability and financial stability, even if tensions only surface long term. Fattening their own balance sheets leads to financial distortion and limits their future playing field. They must foresee the tension and exercise stricter macroprudential control. So, they do not only have to pay attention to the operability of individual financial institutions (which historically used to be the objective of financial control) during their regulatory activity but they also have to ensure the operability of the whole financial system.

In Brunnermeier's paper discussed here the reason for financial dominance is that in an environment of interest rates held low for a long time the financial sector (particularly the banking system) can only adapt to interest rate increases in a limited way and slowly. Other authors including Rajan mentioned above also discuss the problem of financial dominance and Rajan points out two more reasons for it. One is the sudden jump in the prices of financial assets, which – no surprise – occurs in the low interest rate period (and a potential fast reduction of which carries the risk of major disturbances). The other reason is the banking system becoming liquidity-dependent. It also occurs in the period of low interest rates, good conjuncture, particularly if monetary policy also uses quantitative easing in addition to interest rate cuts. In such times, banks are happy to grant their business partners credit lines and liquidity promises they cannot walk back on easily later on. Even if one identifies more than one reason for financial dominance, its consequences remain the same: central banks hesitate and delay to raise increase rates (to limit the amount of money). In Rajan's wording, the bank behaves asymmetrically, since it has no grounds for such hesitation at the introduction of a lenient, growth-incentive policy.

The private sector is aware of the asymmetric behaviour of the central bank originating from financial dominance. What causes a problem is such knowledge has an impact on their expectations. Thus these days, irrespective of whether the American central bank (FED) wanted to yield to financial dominance or not, the predictions gaining momentum in the private sector (i.e., the FED will have to reduce interest rates quickly) made its task of getting rid of financial dominance more difficult. It has to raise interest rates harder and will have to keep their high level for a longer time than it should if the private sector did not have such expectations. It has grave consequences with respect to international conjuncture. It also means households, pension funds and insurance companies will book major losses when asset prices regain their new balanced level, but the losers are often not the same who have profited from the earlier rise of those prices. Thus, the rise of asset prices leads to problematic consequences of distribution the central banks are responsible for to a certain extent.

4 ZERO LOWER BOUND (ZLB) AND THREE DISPUTED INITIATIVES: QUANTITATIVE EASING (QE), FORWARD GUIDANCE (FG) AND TWO REGIMES OF CENTRAL BANK OPERATIONS ALTERNATING IN TIME

All three initiatives are the products of the past few years (the first and second are actually applied while the third is a proposal)

After the 2008 crisis following the golden age of the "great moderation", the rate of inflation did not accelerate, it remained close to zero percent and interest rates hit the "zero lower bound" (ZLB), which could not be reduced to below zero particularly not too much below zero percent, so it has lost its role as an incentive. Therefore, economic growth also remained close to zero, which could not be changed much by introducing fiscal incentives. So, experts in some academic and practical monetary workshops started to contemplate and/or establish practical measures to lead inflation (and, naturally, economic growth) out of the impasse in such a period. They wanted to use the measures of monetary policy, measures of a kind that will have to be replaced by others when inflation does accelerate and curbing it becomes the task. Three different initiatives have been suggested; the second and third ones are practically identical.

One initiative is *quantitative easing* (QE), during which a central bank purchases instruments (mainly or exclusively sovereign debts, but in contrast to usual open-market transactions, not only short but also long-term ones) on the open market to reduce interest rates (those of longer maturity that have remained above zero percent) and to increase the money supply. In theory, QE has many effects considered to be favourable in the financial-economic situation it is applied in. For instance, it will boost the price of financial assets, which will drive their holder business players to spending. It drives the national currency to be devalued as asset yields decline and money supply grows. It boosts credit supply. It drives investors to purchase other instruments by cutting back on the supply of sovereign debts, etc.

Empirical experience supports QE has such effects. For instance, in the US it reduced interest margins charged to borrowers by banks by 20 percent; the extent of the reduction was greater in the case of riskier loans than that of less risky ones (*Shen–Wang*, 2023). Nevertheless, it could only have a significantly positive impact if it could boost economic growth, the ultimate goal, by mediating such and other effects. But it is difficult to assess, because QE was quite quickly introduced in most countries when interest rates fell almost to nil, the lower boundary from the time of the 2008 financial crisis. Japan was the only exception. The problem already appeared there in 2000, but the introduction of QE intended to solve it only started much later, after 2013.

Masaaki Shirakawa the Governor of the Bank of Japan wrote about it in our collection of papers. The author emphasises there was no problem with economic growth in Japan from 2000 to 2012. The evolution of GDP per capita corresponded to the average of the G7 countries, while the growth of the GDP per working-age people was the highest within the G7. A still perceptible stagnation of the GDP, which was actually caused by structural factors (the fast rate of ageing and reduction of the population) was mistakenly explained by cyclical (conjunctural) weakness. Since Japan's "great monetary experiment", QE was launched in 2013, the balance sheet total of the central bank has increased from 30 to 120 percent of the GDP. Its impact on inflation or on real growth has proved to be rather modest.

Based on those experiences, both Shirakawa and Rajan believe QE was an unfortunate experiment. Rajan also adds it falsifies creditworthiness, distorts asset prices and liquidity and is difficult to give up[5].

Another initiative, *forward guidance* (FG), is in fact the communication and commitment of a central bank in a situation when the interest rates it controls get

5 Another paper by Rajan goes into more detail regarding the difficulties of giving up. In the period of QE commercial banks opened ample credit lines and provided companies with liquidity in other ways too. They only cut back on such commitments slowly; they could not have cut back on them quickly anyway after the quantitative reduction in 2017. Thus banks, particularly those with less capital, became sensitive to potential financial shocks, so the Fed was forced to provide further liquidity support in 2019 and then in 2020. Cf., Acharya–Chauhan–Rajan–Steffen, 2023).

stuck at zero percent or close to it, and they cannot / do not want to push them into the negative domain. Of major central banks, the European Central Bank and the American FED have landed in such a situation after the 2008 financial crisis. Then, as Brunnermeier writes, some affected central banks believed it was safe if, as forward guidance, they pledged to keep interest rates low until the distant future so as to boost demand and to draw inflationary expectations near their own inflationary goal (raise them). They did so, because it seemed unrealistic that such commitments would cause inflation even in the long run. However, Brunnermeier thinks such commitments cause disturbance in expectations if central banks cannot keep them later.

The third initiative was born at the Basel Bank of International Settlements (BIS). It is *the two kinds of central bank operational regimes* (Borio–*Lombardi–Yetman–Zakrajšek*, 2023), related to the regimes of inflation. The latter has been discussed above based on the paper by Borio, the head of the monetary and economics department of BIS.

Contrary to the traditional concept according to which a central bank must always follow one operational regime, for instance inflation targeting, the idea recommends different operating modes should be used under slow or fast inflation. In a regime of slow inflation, when the rate of inflation remains slow despite price shocks, a bank may need to be more tolerant of inflation so that it can accelerate inflation (and economic growth with it) in the short run. And via versa: in a regime of fast inflation, when every price increase triggers another one, a bank must be committed to curb inflation as fast as it can.

Rajan challenges the idea. The two commitments contradict each other, and central banks cannot switch their commitments based on regimes, as they may lose the core of commitment, its power in that way. The argument, not surprisingly, is basically identical to the one quoted above from Brunnermeier' paper on forward guidance (FG).

Rajan argues a central bank needs one operating mode, one regime, namely, it must – based on risk assessment – emphasise the fight against high inflation and apply its traditional measures, such as interest rate policy. The question here remains what to do if the rate of inflation is too slow. One may have to learn to live with it in the same way one has learnt to live with COVID-19. One need not make efforts to accelerate a slow rate of inflation until it turns into a deflation spiral. On the other hand, the scope of responsibilities of central banks should be expanded by giving them stronger mandates to promote financial stability their actions strongly affect.

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