CENTRAL BANKS WITHOUT A RULEBOOK

Unorthodox Policy, Unorthodox Normalisation

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by John Nugée in London

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Reinvigorated economies are in evidence across much of the developed world. Growth is becoming more firmly established. Inflation is beginning to climb in the US, euro area and UK.

After seven years of unorthodox operations, primarily quantitative easing, central banks are beginning to consider when and how to normalise monetary policy. Earlier this month Mario Draghi, president of the European Central Bank, said that while the ECB's interest rates would stay unchanged, there was 'no longer a sense of urgency for taking further actions' on monetary stimulus. On 15 March the US Federal Reserve fulfilled expectations by raising interest rates 25 basis points. Commentators are forecasting another two Fed increases in 2017.

But, if rate rises are back on the agenda in much of the G7, another consequence of unorthodox policies is still very much with us. Central bank balance sheets remain substantial – well over 20% of GDP for the Fed, the ECB and the Bank of England, and much higher for the Bank of Japan. There are few signs that these circumstances will change soon.

This subject has been hotly debated within central banking circles. Central bankers have been discussing what constitutes the optimal long-term size and composition of central bank balance sheets almost since unorthodox policies were introduced. For every central banker who argued that there was no alternative to QE, there was another who asked, 'Where will this lead, and how do we end it?'

The counter argument of 'We must do something, this is something, so we must do it' prevailed. And despite concerns that these policies had dubious grounding in monetary theory, the results have, in many ways, been successful. Developed economies avoided a repeat of the great depression, and growth has returned to most of them.

But there are other more fundamental questions, such as what the role of the central bank is and what its optimal involvement in a free market should be.

At various times in the past seven years, central banks' direct involvement has been so extensive that markets have been in danger of ceasing to act as a window into the true workings of an economy. There is a risk that markets now show central bankers only the impact of their own policies. The desire to end the experiment of QE is, therefore, felt keenly. But to bring that debate into the public domain, central banks will need to address three issues.

First, they must rebut the beguiling argument that a small balance sheet will lead to prosperity simply because this is how things seemed in the past. This argument mistakes correlation for causality, and ignores all the other changes since QE was brought in, not least the effect that very low interest rates have had on the interaction between bank reserves and interest rate policy.

Second, they will need a coherent theory of whether the impact of the central bank balance sheet on an economy is predominantly a stock or flow matter – is it the fact of having a large balance sheet that matters, or the act of increasing it? And, after QE, central banks will need to determine whether 'normality' refers to the point when a balance sheet stops growing, or when it shrinks back to some predetermined size.

Third, if central bankers decide that their balance sheets should shrink, they will need to articulate to the public a clear proposal for how to accomplish this and what the economy's response is likely to be. It would be reckless to start the process in any other way. Central banks could cause real damage to the economy, markets and their own reputation if the process goes wrong.

The unorthodox nature of much recent monetary policy means that, just as there was no rulebook for how to conduct it, there is no rulebook for how to end it. But whereas the scale and urgency of the crisis seven years ago meant that central bankers had to be brave and unorthodox, there is no such urgency now, and no need to gamble the economy's future on an untried policy change. The route out of unorthodoxy is likely to be gradual, painstaking and nervous – with central bankers aware that mistakes could cause setbacks that could lead them back to another bout of unorthodoxy with still less chance of reversal.

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