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Central bankers must update outdated analytical toolkit

By Gillian Tett

Eight years ago, Claudio Borio, a senior economist at the Bank for International Settlements, co-authored a paper which warned that the world's financial system was spinning out of control, due to excess in the complex credit world. At the time, the paper was largely ignored, if not derided by many senior policymakers. But now it looks prescient; so much so, in fact, that Borio and his co-author, Bill White (who also used to work at the BIS), are some of the few economists who have emerged from the recent financial crisis with their reputations intact.

Given this, investors might do well to look at another paper that Borio has just produced. This looks not at securitisation – or issues such as collateralised debt obligations – but at the loftier question of central banks. While it remains to be seen whether this work is equally prescient, the conclusions are sobering.

He argues that the world's central banks are currently labouring with an almost impossible task: although the expectations of investors and politicians of these institutions are rising apace, central bankers themselves are at sea in this post-2007 land. Or, to use his metaphor, they are struggling to find any workable "compass" in these new, stormy waters.

The essential problem is that the crisis has tossed central banking into an intellectual limbo. Before 2007, their reputation appeared to be sky high, since central bankers appeared to have produced a Great Moderation of low inflation and growth (remember, those pieces lauding Alan Greenspan as the so-called "maestro"?). But these days, it is clear that many elements of that pre-2007 central bank intellectual model were flawed: central bankers were too obsessed with watching price stability, at the expense of monitoring financial stability; they overestimated the power of short-term interest rates in controlling the economy; and they thought – wrongly – they could shape monetary policy by watching national issues alone.

So far, so obvious. And Borio offers a sensible list of measures that might address these flaws: central banks need to adopt a wider sense of responsibility that combines an awareness of monetary trends and financial stability; they need to take an international, not national, view of the markets; they need better toolkits to monitor financial stability; they must take steps to protect themselves from political meddling. Last, but not least, he also thinks they need to wean themselves away from the idea that suppressing short term interest rates – via quantitative easing or anything else – will fix the current woes; while this might work during a normal business recession, it does not cure a balance sheet recession. Instead he – like many Japanese officials – argues that excessively cheap money tends merely to stave off the eventual adjustment, prolonging the woes. Call it a "time inconsistency" problem.

But while Borio's proposed checklist of necessary reforms might sound obvious, the gloomy fact is that most of these are merely pipe dreams. To be sure, some central banks are adopting more flexible mandates that incorporate financial analysis; "macro-prudential policy measures", for example, are now all the rage. Central banks are also talking about the need for more global collaboration. But when it comes to practical policies, they are still acting with a domestic intellectual framework and mandate (just look at the Bank of England's challenge in explaining how "imported" commodity prices are messing UK inflation forecasts). The "mainstream analytical frameworks at policymakers' disposal" are inadequate, Borio points out, to explain how finance and the real economy interact.

And since central banks are still trying to boost the economy by chasing ultra low interest rates – via quantitative easing – they are becoming sucked into fiscal policy decisions. This leaves them politically vulnerable in many ways. "In the years ahead, the independence of central banks is likely to come under growing pressure," he writes, adding that "they are facing enormous pressures to prove that they can manage the economy, restore full employment, ensure strong growth and preserve price stability … this is a taller order than many believe and one that central banks alone cannot deliver. To pretend otherwise risks undermining their credibility and public support." America obviously springs to mind here, though Borio is too tactful to mention it.

Now a cynic might retort that this all just reflects a wider malaise today. After all, it is not just central bankers who lack a "compass"; politicians and investors do too. But the fact that these comments have come from the heart

of the BIS is striking. Not least because they reflect what some central bank governors are muttering now in private too. If nothing else, it should prompt investors to ask what central banking might look like eight years hence. Not just in America, but above all in the troubled eurozone.

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