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When will central banks lift interest rates?

Central banks must serve notice to governments that they no longer can be relied upon to do all the heavy lifting. It is about being ready for when the next shock hits. A column by Charles Wyplosz.

CHARLES WYPLOSZ

«QE and near-zero interest rates have very limited effects beyond crisis periods.»

That may seem like a silly question at a time when central banks around the world are busy committing to keep rates low for long as far as the eye can see, and they are right. Yet, lessons must be learned. Ten years after the great financial crisis, interest rates were still very low, even negative in Europe and Japan. The pandemic was not supposed to happen, but it did, and central banks were stuck with limited room for maneuver just when they were needed most.

About the author

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Following the financial crisis, governments soon felt the urge to cut budget deficits, and most did. This may be one reason why the recovery has generally been weak, even though central banks stepped in. They kept their interest rates low for longer than they had initially imagined, and they kept nonstandard policies in place or, at least in some cases, reversed them at a crawl's pace. They refined their communication policies, calling them forward guidance. Initially, they announced an end date for their expanded weaponry to be set aside. The dates passed and they started to identify conditions under which they would change their stance, this was called state-contingent forward guidance. When the conditions were met, few reversed gears while others redefined the conditions or simply ignored them. They did not want to take the risk of hurting an already lackluster economic recovery. With inflation rates a long way from target, waiting looked like the obvious thing to do. Doves reigned supreme while hawks, hurt by their earlier predictions of exploding inflation, were rare and far apart.

This all made sense. Unless a new crisis would strike. Still awed by the financial crisis, central banks were focused on financial stability. Deep changes in regulation and oversight had successfully reduced the risk of a new shake-up. Forecasts of macroeconomic and financial variables were smooth curves. This is when the unexpected happened, in the form of a pandemic. Facing a historical economic collapse, central banks could only double down on their old and new instruments, which had almost exhausted their course. New lessons have to be learned, now.

Learning the lessons

Lesson number 1 is that unexpected shocks happen. It is totally futile to even pretend that we can dress a list of possible shocks. Even if we could, and assign to each one some probability, that would still be useless. Unless the probability of an event is precisely zero, the event will occur for sure, maybe in a thousand years, maybe tomorrow. Central banks must be ready at all times to cope with unexpected shocks. For many years, it seemed prudent not to rock a fragile boat, but prudence may be the exact opposite: it is dangerous to be locked in «low for long» with bloated balance sheets when a shock occurs.

Lesson number 2 is that central banks have to be humble and resist the temptation to see themselves as heroes in first resort. For a decade, they have taken upon themselves the task of ensuring continuous growth, which they delivered. But their success freed governments from sharing this responsibility. Officially, governments were dedicated to bringing public debts down, which some actually did but many others failed to achieve. In the first place, they had no valid reason to previously let debts grow in most years, and the bad habit to be cavalier with indebtedness led to widespread benign neglect. There is huge room for improving fiscal policies, but incentives are missing when central banks stand ready to carry alone the burden of macroeconomic stabilization.

Lesson number 3 is that exceptional instruments are to be used in exceptional times. Progressively, nonstandard monetary policies, including low for long interest rates and QE, have been declared a new part of the standard toolbox. Central banks are rightly proud of this technological innovation. Their new tools were invaluable at the time of the financial meltdown of 2008, but were they still needed a decade later? Certainly, they were convenient but not without drawbacks. For instance, although banks are overwhelmed with cash, credit growth has been sluggish. And when firms borrow, they all too often use the money to buy shares back, handing large gains to shareholders without adding new productive capacity. QE and near-zero interest rates have very limited effects beyond crisis periods.

Lesson number 4 is that advocacy is different from analysis. We are still debating how effective these instruments are. Central banks have produced many studies that conclude that nonstandard instruments have been effective, a result that few independent academic studies confirm. While an increasing number of analysts consider that, even if these instruments have been effective, the growing view is that there is not much power left. Central banks, on the other hand, repeat the mantra that «we have available tools and we are ready to use them». Surely, they cannot be fully confident about this assertion but they do not share their doubts. Credibility is at stake.

To investors, losses must be part of the game

None of that means that central bank should raise their interest rates any time soon. We first need to see the pandemic go away and to ensure that the ensuing recovery is firming up. But central banks must not repeat what increasingly looks like a mistake, believing that the next shock lies far away. Central banks still worry about the temper tantrum of 2013 when Ben Bernanke gently indicated that QE would have to stop at some undefined point. Spooked by the risk of losses, stock markets reacted violently. In the event, a chastised Fed led other central banks into not going back to normal. But Bernanke was right, the markets were just looking after their own interests, and here we are, stuck with powerless central banks.

Central banks must serve notice to governments that they no longer can be relied upon to do all the heavy lifting. They must do so before governments repeat the mistake of 2010 when they prematurely withdrew their expansionary policies. They must stand firm in preparing financial markets to return to normalcy (huge capital gains have accrued to investors, losses are part of the game). They must follow the precept of former Fed Chair William McChesney Martin who argued in favor of taking the punch bowl away when the party gets going. It is not about the fight between doves and hawks, it is about being ready for when the next shock hits, for there will be more shocks, big and small.