Finance and Economics

Economics focus

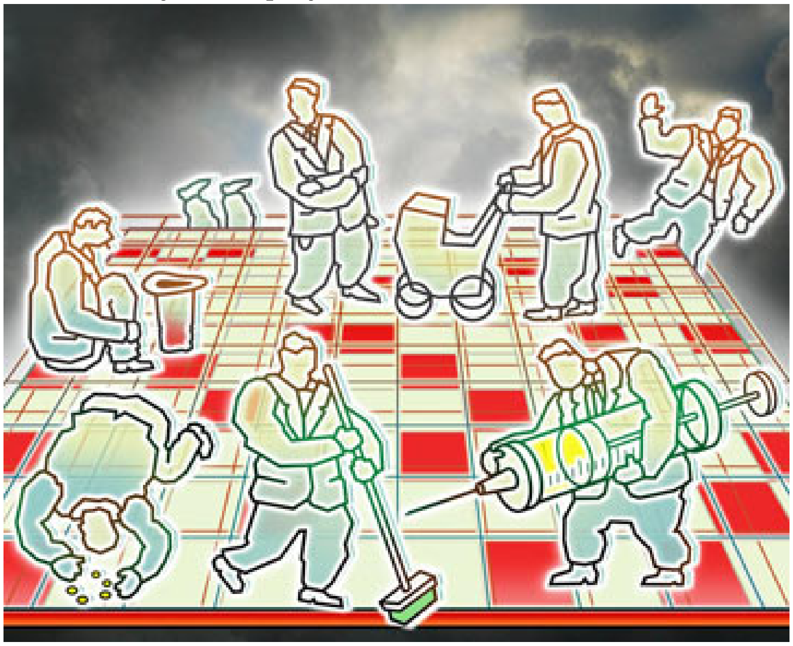
Jackson's Holes

Aug 27th 2009
From *The Economist* print edition

The financial crisis will change central banking more than many central

bankers care to admit

Illustration by Jac Depczyk



COMPARED with the past two crisis-dominated gatherings, the atmosphere at this year's central bankers' meeting in Jackson Hole, Wyoming, was relaxed. Ben Bernanke, the Federal Reserve chairman, whom Barack Obama nominated for a second term on August 25th, found time to go hiking and horse-riding. The mood was one of quiet relief at the signs of economic recovery and not-so-quiet pride at central bankers' role in saving global finance. But below the surface lurked concern and confusion. Many central bankers worried that the recovery would be feeble and fragile. Few have come to terms with how fundamentally the crisis has changed both their tasks and their toolkit.

For the past decade central banking has been dominated by what could be called the "Jackson Hole consensus", since many of its elements were developed during the annual summer shindig organised by the Kansas City Fed. This consensus holds that central bankers' prime task is to keep inflation low and stable. It favours an inflation target as a way to anchor people's expectations of future policy, and puts a lot of weight on the transparency and predictability of central banks' interest-rate decisions.

The consensus was not absolute. The Fed, for instance, has never adopted an explicit inflation target (though it has an implicit one). Some central bankers in Europe and Japan argued that monetary policy should "lean against" asset bubbles, whereas Fed officials thought bubbles were hard to spot, and that it was less costly to clean up by cutting rates after they burst. No one, however, focused much on central bankers' responsibility for broader financial stability, or thought much about the financial plumbing through which changes in short-term interest rates affect the broader economy.

Now, in the wake of the financial crisis, it is commonplace to demand that central banks must worry about the health of the financial system, not just price stability. In many countries there are plans to give them responsibility for "macro-prudential supervision", an ugly term for fretting about financial excesses. Less well understood, though, is how much these new tasks will change the central bankers' world. The main tenet of the Jackson Hole consensus—that central banks earn their credibility by having a simple target which the public understands and to which they are held accountable—will be much harder to maintain.

Unlike price stability (which can be measured by a price index), financial stability is hard to define, let alone measure. Nor is it clear what tools to use. Most central bankers reckon regulation should be the first line of defence, though it is now more widely accepted that rates might also need to rise to stem an asset bubble. Just what regulations, though, is less clear. Many countries plan tighter rules on liquidity and capital for systemically important firms. But, as Stanley Fischer, governor of the Bank of Israel, pointed out to the Jackson Hole attendees, older tools such as margin requirements or maximum loan-to-value ratios could also be used. Jean-Charles Rochet of the University of Toulouse argued that the whole focus on systemically-important institutions was misguided. Instead, central bankers should guarantee the stability of vital markets (such as the money market).

The difficulty of defining financial stability and the plethora of potential tools means central bankers will, in future, have much more discretion. Their new mandate will also affect the old focus on inflation in ways that are, as yet, ill understood. Mark Carney, the governor of the Bank of Canada, pointed out that rules to promote financial stability, such as higher capital charges for big banks, will affect the process through which monetary policy decisions are transmitted to the broader economy. And using interest rates to promote financial stability means that inflation-targeting central banks may well deviate from their inflation targets for longer periods (for instance, if asset prices are soaring but consumer prices are stable). That is a sensible trade-off, but could compromise the central banks' public credibility.

Another threat to this credibility comes from uncertainty over just how monetary policy works in a world of near-zero interest rates. In the conference's main paper on monetary policy, Carl Walsh, an economist at the University of California at Santa Cruz, was sceptical about the efficacy of quantitative easing and other unconventional measures. But he argued that central bankers could boost output today by promising higher inflation in the future, which they would achieve by pledging to keep interest rates low even after the economy had begun to recover.

One way to do this would be to target a price level, rather than an inflation rate. With a price-level target, central banks would have to follow a period of excessively low inflation with higher inflation in order to get back to the target. But, he argued, central banks could not simultaneously promise to keep interest rates low for an "extended" period of time and promise to keep inflation stable (which is exactly what the Fed is now doing).

Not surprisingly, Fed officials denied there was an inconsistency between keeping inflation stable and rates low for a long time. The point, they argued, was to stop inflation expectations falling, not to push them up. Nonetheless, some central bankers were intrigued by the idea of price-level targeting. Mr Carney, especially, argued that it might prove a good way for central banks to retain their credibility while targeting both price and financial stability. But many, including Mr Walsh, worried that price-level targeting would be harder to explain to the public. Worse, a change in monetary-policy rules in the aftermath of a crisis would itself damage central bankers' hard won credibility.

Unfortunately, this credibility will in any case be under attack. Over the next few years achieving vaguely defined financial stability as well as avoiding both inflation and deflation will only get harder thanks to a nasty backdrop of lower trend growth and high public debt. The Jackson Hole consensus evolved in calmer times. Central banking is now a lot harder.

Back to top ^^