Tuesday April 23, 2019

"Politicians" take their revenge
My weekly column

The world of politics and politicians wants to get its own back on the central banks. Central banks have been at the very heart of steering the economy since the start of the crisis at the very least, as they have been more present and reacted more swiftly than governments, bar a few exceptions such as coordinated fiscal stimulus moves in 2009.
Yet politicians are now wading in to tackle central banks' domination at various levels. Firstly, Democrats are championing the MMT – Modern Monetary Theory – approach, suggesting that governments are responsible for managing the economy. Then we have the politicization of the central bank, with Donald Trump's attempts to appoint members who are not renowned first and foremost as economic experts, or Erdogan taking control of the central bank in Turkey, while in India, Modi changes governor each time the current one no longer meets his requirements.
Politicians now want the pendulum to swing back in their direction as they seek to take back control after letting central banks play a key role in steering the economy. But it may not be that straightforward.

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A recap of central banks' independence
Central banks have had a considerable grip on economic trends for the past several years. At the start of the 1980s, their role was to cut back inflation, after governments had let it spiral out of control. Paul Volcker went all out on this front, and this shift in the balance of power gained greater ground over time. Theoretical and empirical indications bore out this idea that an independent central bank was required to facilitate and optimize regulation of the economy.
When the euro area was set up, the central bank's independence became the norm for member countries as well as several other countries.
Having two bodies to steer the economy and reform economic structures – the government and the central bank – was deemed wise. Work on coordination of economic policy has enhanced the way the two work together to make for more efficient running overall.

After the 2008 watershed, central banks' crisis management moves increased their influence. Implementation of unconventional monetary policy in the US and the UK gave monetary authorities a major advantage, enabling governments to take on debt to address the aftershock of the financial crisis and spread out its effects over the longer term, while also covering this debt via vast purchase programs, or Quantitative Easing. Meanwhile, the development of forward guidance on expected future interest rate trends enabled central banks to steer investors' expectations over the long term and avoid any potential unwanted rate trends.
In the euro area, the ECB became more independent when Mario Draghi took over at the helm: he made the monetary authority a true lender of last resort, gave the euro greater independence and shifted the central bank's political balance that had been so troublesome for his predecessor to the detriment of real economic questions. Quantitative Easing and the forward guidance process also helped assert this greater independence.

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Doubts over this independence
Politicians have now seen that reality is running away from them and central banks have too much clout in controlling the economy.
Donald Trump swiftly explained that excessively high interest rates hampered US growth, but Jay Powell, the Chair he had himself appointed, held up under this pressure. The President is now endeavoring to stymie the monetary policy committee by appointing members who do not have the rights skills and experience, such as Stephen Moore and more recently Herman Cain, before he retracted. The White House's nominations have to be approved by Congress so the game is not over yet, but a potential second term for Trump in 2020 could

upturn this balance due to the seats on the board coming up for nomination. This is a huge risk for the Fed's independence over the years ahead.
Republicans in Congress very recently wanted to set a well-defined framework for the Fed's actions along the lines of the Taylor rule. This would clearly limit the central bank's scope to make its own interpretations of the economic situation, with the risk of triggering excessive interest rates movements that could disrupt the pace of the economy in the long term.

In the shorter term, the main doubt over central banks comes from the American Democratic party and its most left-wing potential presidential election candidates.
Bernie Saunders and Alexandria Ocasio-Cortez (AOC) in particular want to give politics precedence over economics again, with politics leading and economics merely managing. They base their approach on Modern Monetary Theory, which suggests that the size of the deficit is not very important if debt is financed in local currency: against this backdrop, the economy is steered and adjusted via changes in spending and tax and no longer by movements on interest rates primarily.
With this approach, growth and inflation would thus be better steered by the government than the central bank. A number of economists are unconvinced by this method, which is a theory in name only: it is also worrying as when governments have taken control over the economy in the past, it has been to the detriment of the central bank and often ended with phases of marked instability. This particularly calls to mind hyperinflation in Germany, although this may seem an excessive viewpoint with evenhanded elected leaders.

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Long-lasting shift
What matters here is not so much the theoretical approach, but rather the potential change it could trigger in the pecking order for the economy's different managing authorities. If the pyramid of powers were to change, the central bank's action would then depend on the government's moves in a radical turnaround compared to the past 40 years. There are several points worth noting.
We will need to keep a close eye on the forthcoming replacement for Draghi and other members of the board at the ECB, as we keep this balance of power in mind, particularly as these changes will take place after the European elections.
However, the central banks have a major advantage: in the past, they have systematically stuck together during crisis periods to curb risks on liquidity. This ability to react and work together outside any political framework helped reduce both the length and the extent of crises. Yet we cannot spontaneously expect any similar behavior from governments in the long term, and coordination displayed at the time of stimulus measures in 2009 only lasted a short length of time, while this was not true of the central banks.
In a recent book, Paul De Grauwe suggested that the economy is like a pendulum swing back and forward between market and state in overall management of the economy. An excessive role for the market led to imbalances, which were corrected by greater government intervention as it took back control, leading to imbalances that were only evened out by accepting a greater role for the market…
This type of pendulum swing looks unlikely, but we must be realistic: politics and politicians have taken back greater power in both China and the US, particularly in China. Meanwhile the populist movement in Europe is primarily a political movement, and it seems unlikely that this trend will end soon and for such times as the middle classes do not derive the full benefits of growth.

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