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Long-term issues for central banks

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Foreword

The 15th BIS Annual Conference took place in Lucerne, Switzerland, on 24 June 2016. The event brought together a distinguished group of central bank Governors, leading academics and former public officials to exchange views on the topic "Long-term issues for central banks". The papers presented at the conference and the discussants' comments are released as *BIS Working Papers* 653 to 656.

BIS Papers no 92 contains the opening address by Jaime Caruana (General Manager, BIS) and remarks by Kevin Warsh (Hoover Institution and Stanford Graduate School of Business).

Programme

Thursday 23 June 2016

18:00 Cocktail and informal barbecue

Friday 24 June 2016

09:00–09:15	**Opening remarks**	**Jaime Caruana**, Bank for International Settlements
09:15–10:40	**Session 1:**	**International prices, exchange rates and growth**
	Chair:	**Haruhiko Kuroda**, Bank of Japan
	Author:	**Gita Gopinath**, Harvard University
	Discussants:	**Philip Lane**, Central Bank of Ireland
		Richard Baldwin, the Graduate Institute of International and Development Studies, Geneva
10:40–11:10	**Coffee break**	
11:10–12:30	**Session 2:**	**Inequality and globalisation**
	Chair:	**Raghuram Rajan**, Reserve Bank of India
	Author:	**François Bourguignon**, Paris School of Economics
	Discussants:	**Barry Eichengreen**, University of California, Berkeley
		Raquel Fernández, New York University
12:30–14:00	**Buffet lunch**	
14:00–15:20	**Session 3:**	**Financial structure and economic growth**
	Chair:	**Stefan Ingves**, Sveriges Riksbank
	Author:	**Thomas Philippon**, New York University, Stern School of Business
	Discussants:	**Martin Hellwig**, Max Planck Institute
		Ross Levine, Haas School of Business, University of California, Berkeley
15:20–15:50	**Coffee break**	

15:50–17:10	**Session 4:**	**Population ageing, debt and economic growth**
	Chair:	**Stanley Fischer**, Board of Governors of the Federal Reserve System
	Author:	**Charles Goodhart**, London School of Economics
	Discussants:	**Masaaki Shirakawa**, Aoyama Gakuin University
		Alan Auerbach, University of California, Berkeley
17:10–18:20	**Wrap-up panel: Long term challenges for monetary policy/central banks**	
	Chair:	**Guillermo Ortiz**, BTG Pactual Mexico
	Panellist:	**Kevin Warsh**, Hoover Institution and Stanford Graduate School of Business
19:30	**Conference dinner**	

Saturday 25 June 2016

10:00 Buses depart for Basel (AGM weekend)

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Long-term issues for central banks

Opening remarks

Jaime Caruana*

Good morning to all of you. It is a pleasure to welcome you to the 15th BIS Annual Conference. The topic for this year is "long-term issues for central banks".

The global political, economic and financial landscape is constantly evolving. Some of the changes may prove short-lived. But others may be slow-moving and persistent, and only detectable over time as evidence accumulates. Although central banks' day-to-day operations and policymaking tend to focus on near- or medium-term developments, longer-term trends and structural changes will at some point come into the picture – not least because of their impact on the economic relationships that are central to policy formulation and analysis.

This year's conference will investigate some of these slow-evolving developments and their implications for policies. To help set the scene, let me highlight four long-term issues – and some of the related policy questions – around which we will organise our discussion today.

In the first session, we will explore the link between international prices, exchange rates and growth. The past decades have witnessed global evolutions in trade, production and financial activities. As a result, the traditional understanding of certain economic relationships is increasingly being challenged. For example, the growth of global value chains – in which different stages of production are dispersed and coordinated geographically around the globe – has transformed the nature of international production and trade. Domestic production costs depend not only on price developments at home but also on developments abroad both directly, via imported inputs, and indirectly, via implicit competition. How do global value chains influence inflation dynamics?[1]

Greater financial integration is also likely to have increased the influence of the exchange rates of major international funding currencies on global financial conditions, especially in emerging market economies (EMEs). What is the economic impact of currency depreciation in EMEs? Is it expansionary or contractionary? Can the traditional net exports channel outweigh the financial amplifier effect through currency mismatches?[2] The outcome of yesterday's EU referendum may give these questions yet another new spin.

The second session this morning will be on inequality and globalisation. Indications of a growing dispersion of income and wealth – not only in advanced economies and but also in emerging market economies – have sparked public debates. These discussions go beyond the issue of fairness or solidarity with the

* General Manager, Bank for International Settlements.

1 R Auer, C Borio and A Filardo, "The globalisation of inflation: the growing importance of international input-output linkages", BIS mimeo.

2 Bank for International Settlements, *86th Annual Report*.

underprivileged – they are also about the broader economic consequences. Although there is not yet a clear consensus on the relationship between inequality and growth, there are concerns that rising inequality may become a serious economic headwind.

Globalisation and technological progress have increased the skill premium (the ratio of skilled to unskilled wages) and widened the income distribution. However, there may be other forces at work. For example, remuneration at the very top of the distribution could be linked to the rapid growth of the financial sector or the tilt of shareholder payments to share repurchases. Moreover, could inequality also depend on the higher level of return on capital relative to labour, as some commentators have suggested? In general, distributional policies have traditionally been the purview of the fiscal authorities. But central banks cannot ignore it altogether. Indeed, the question of whether the impact of a prolonged period of low interest rates on financial asset valuation might have added to wealth inequality is a new aspect in the current debate.[3] Should central banks put more weight on distributional effects?

After lunch, the third session turns to the issue of financial structure and economic growth. We will explore how banks and markets play complementary roles in fostering economic growth. In particular, their support for the real economy may have limits: beyond a certain point, more finance may not mean better real economic growth. Is there an optimal level of financial development or a Laffer curve for its social benefits?[4] Moreover, the constant innovations in finance – whether in terms of participants, forms of financing, or instruments – can alter the financial structure. New technologies can bring significant benefits in terms of cost efficiency and access to services, but they can also bring new challenges that will require careful assessment and appropriate rules of the game. How can regulation and supervision help manage the challenges or even new risks without stifling beneficial innovations?

Session 4 explores population ageing, debt and economic growth. The ageing of the baby boomers and a lower birth rate mean a smaller current and future labour force in many economies. If this trend continues, it will challenge social security systems and slow potential economic growth. How to manage the resulting economic risks and burdens is an urgent policy question. In searching for the appropriate responses, a key aim should be to strengthen the foundations for economic growth so that the demographic burdens can be sustained as readily as possible. Raising not only labour productivity but also total factor productivity would be vital. Adjustments in the birth rate or in migration could help to some extent, but would not fully halt the population ageing process in the next two to three decades. Moreover, the strong increase in debt in both advanced and emerging market economies constrains the responses. What mix of policies should be adopted?[5]

These four long-term issues are rather broad, with many implications for the work of central banks and other authorities. These will be explored in the wrap-up panel later in the afternoon.

[3] D Domanski, M Scatigna and A Zabai, "Wealth inequality and monetary policy", *BIS Quarterly Review*, March 2016, pp 45–64.

[4] S Cecchetti and E Kharroubi, "Reassessing the impact of finance on growth", *BIS Working Papers*, no 381, July 2012. L Gambacorta, J Yang and K Tsatsaronis, "Financial structure and growth", *BIS Quarterly Review*, March 2014, pp 21–35.

[5] M Juselius and E Takáts, "Can demography affect inflation and monetary policy?", *BIS Working Papers*, no 485, February 2015; E Takáts, "Ageing and asset prices", *BIS Working Papers*, no 318, August 2010.

To conclude, slow-moving, structural changes come in many different guises. Dialogue and interaction between policymakers and academics are therefore essential – not only for identifying and understanding these changes, and finding answers for the resulting challenges, but also for posing the right questions for further research. That is precisely the reason we invited you here.

So let me thank all of you for taking time to join us here today. Many thanks, in particular, to the session chairs and the speakers for agreeing to lead off the discussions. I wish you a fruitful day – with thought-provoking debates both on and off the podium.

Reform or perish

Kevin Warsh*

We gather at a fateful moment. That the citizens of the United Kingdom chose to depart the European Union last evening is neither the cause nor the catalyst for my disquiet. Brexit is of first-order consequence to Britain to be sure. And the Bank of England and HM Treasury are rightly on alert to the possibility of regime change in capital, investment, trade and consumption flows.

For the rest of the global economic policy community, however, Brexit's economic effects are not yet known. I recommend a heavy dose of humility before concluding that Brexit is of first-order consequence to global output or inflation measures. Humility and patience, however, are virtues often in short supply. Perhaps Brexit explains the downturn in global economic fundamentals. The only trouble is that the data turned down last fall, and if anything, have stabilised in recent months.

Brexit may not be a satisfactory explanation for global malaise, but it's a good alibi. If recent history is a guide, Brexit will be used to rationalise a doubling down on the existing policy paradigm. Brexit is also a useful catalyst for a discussion on long-term challenges for central banks. It reveals a deep and damaging affliction of too many policymakers and academics: the groupthink of our guild; an unwillingness to revisit a priori assumptions; an excess of affection for the latest trends in academia; and, a generalised lack of humility in spite of anachronistic models and massive forecasting errors.

I observe some smart and earnest economic professionals running with the pack, less willing to undertake a rigorous assessment of ideas that could belie their hypotheses, and more disposed to making *ad hominem* arguments to relegate alternative views. An immodest disposition from the leading lights in our guild might be understandable amid an economic boom. It is more puzzling given the meagre state of economic output.

The antidote to groupthink involves revisiting and, ultimately, reforming the role of central banks and the conduct of monetary policy. For those like me who believe in the promise and purpose of independent central banks – and believe that central banks find themselves at a particularly vulnerable and vexing policy conjuncture – we must raise our voices to break the conformity of views and consider a new paradigm for policy.

The annual meeting of the BIS is the proper venue to seek support for consideration of a rigorous reform agenda. The BIS deserves great credit for its data, analysis and scholarship. Its leaders merit the highest praise, however, for their courage – the courage to question the fashionable trends in monetary policy theory and to raise doubts about the favoured fads in policy practice.

What is the groupthink of which I speak? It's a groupthink on monetary policy tactics, tools, governance and strategy, all. Its stated mantra of data dependence causes erratic lurches owed to noisy economic measures. Its statutory medium-term policy objectives are at odds with its myopic compulsion to keep asset prices elevated. Its inflation objectives are far more precise than the residual measurement error. Its

* Hoover Institution and Stanford Graduate School of Business

preferred output gap models are deeply flawed and troublingly unreliable, obfuscating uncertainty and masking policy bias.

Moreover, the groupthink seeks to fix interest rates and control foreign exchange rates simultaneously. Its forward guidance begets ambiguity in the name of clarity. It licenses a cacophony of communications in the name of transparency. It recasts poor economic results with a high-sounding slogan of secular stagnation. And it expresses grave concern about income inequality while refusing to acknowledge the effect of its policies on more consequential asset inequality.

All the while, the groupthink gathers adherents as its successes become harder to find. Too many in the guild tighten their grip when they should open their minds to new data sources, new data analytics, new economic models, and a new paradigm for policy.

With low and declining global economic growth rates, rising debt levels, weak productivity measures and stagnant incomes, we should be engaging in a more robust debate about the economy, and be willing to rethink the causes of low growth and the appropriate conduct of macroeconomic policy.

With high and rising global asset prices – aided and abetted by aggressive quantitative easing – we should subject the vaunted portfolio balance channel to stricter scrutiny. The guild is unwise to treat financial markets as some beast to be tamed, cub to be coddled, or market to be manipulated. Too many policymakers appear in thrall to financial markets, and financial markets are in thrall to policymakers, but only one of them will get the last word. Reconsidering the transmission mechanism of financial markets and the responsibility of policymakers is of a piece with a reform agenda.

With monetary policy (pre)dominance, we should be clearer about the lines that circumscribe central bank authority and central bank prudence, alike. We should reverse the trend that increasingly turns central banks into the general-purpose agencies of our governments.

A common view of the guild is that central bankers – non-partisan, high-minded experts – are particularly well equipped to make a wide range of governmental decisions. I praise the virtue of most in our profession, but disagree strongly with the prevailing ethos that elevates us to the level of wise central planners. The scale of central bank power is permissible in a democracy only when its scope is limited, and its accountability assured.

Let me test this proposition against the backdrop, however parochial, of the Federal Reserve and the American experience. In the United States, the central bank is suffering from a marked downturn in public support. The Fed's unpopularity is not merely a function of the economic malaise, or some nuanced misunderstanding of quantitative easing by our citizenry. Allow me to posit another explanation: American citizens are rightly and instinctively concerned about the concentration of power.[6] More so than in Europe, the aggregation of power in government is considered the gravest of threats. For that reason, America's founders sought to limit the power of government and to disaggregate any necessary power among government authorities. An amateur's perusal of the Federalist Papers is scarcely required to reach such a conclusion.

6 The concentration of income is a fast-growing area of scholarship and intrigue at policy forums. But, curiously, the aggregation of power by expert central bankers has escaped rigorous self-examination.

The Fed's post-crisis activities, however wise or ill-considered, involve a large expansion of government power. The Fed exercised new control of the activities of the largest banks and effectively established a permissible rate of return on capital. The Fed expanded its authority over non-bank firms. The Fed directly purchased trillions of dollars of assets that would otherwise be held in private hands. And it took action with the ostensible purpose of managing financial asset prices, including bolstering the share prices of publicly held corporations.

We should take note of a simple, troubling fact: from the beginning of 2008 to the present, more than half of the increase in the value of S&P 500 occurred on the day of Federal Open Market Committee (FOMC) decisions.

Concentration of power in private hands also raises deep suspicions. The culture of American capitalism only survives in the public square and prevails over global competitors when market power is relatively diffuse, decentralised and, equally important, fleeting. An ethos of economic liberty and open competition are essential bulwarks against undue, quasi-permanent concentrations of private power.

The culture of capitalism in the United States is sometimes confused with a birthright. At other times, it's trivialised in its importance to the success of the country. I take it as a defining, distinguishing element of the micro foundations of US macroeconomics – and one that can easily be lost.

The post-crisis era, including the adoption of the Dodd-Frank Act, purports to have reformed the system of banking and finance. But, the largest financial firms now fit a public utility model. They have grown in size and status alongside that of their principal regulator, the Federal Reserve. The biggest banks and biggest government agencies have achieved a mutual, albeit uneasy, understanding. This big-government, big-business collaboration is antithetical to the history of American style capitalism. Smaller, more dynamic financial firms are not just unable to compete; they are unable to get noticed.

When the embers of the financial crisis were still warm, Zingales (2009) forewarned of the coming challenge: "The system that allocates finance allocates power and rents; if that system is not fair, there is little hope that the rest of the economy can be. And the potential for unfairness or abuse in the financial system is always great." Our citizenry fears the concentrations of power at the Fed, and they fear an unholy alliance with big banks. If those reasonable fears are not addressed, the economic system will not just produce poorer economic outcomes.

As the dispenser of faults and favours, the Fed will be perceived as contributing to an unfair, inequitable economic system. Hence, the urgent need for a robust reform agenda. Most leaders in our guild judge that the Fed's actions were necessary, wise and advantageous. Even if that were all true, the Fed finds itself in a precarious position. Congress will tag the Fed for its failures. And the public will assail the Fed for favouritism for its ostensible successes.

In the best of circumstances, the US economy accelerates to escape velocity. Higher growth would generate higher incomes and higher interest rates. And high asset prices might be explained by markedly improving fundamentals. If this upside scenario were to happen, the Fed might get the benefit of the doubt from our citizenry, and survive the cycle.

Neither the Fed's latest projections nor the growing mass of experts proclaiming the inevitability of secular stagnation, however, anticipate such a benign outcome. And for reasons of policy error and opportunities squandered, my own judgment is that the economy is showing signs of late-cycle weakness.

Come the next recession, the Fed is, at present, poorly positioned to respond with force, efficacy and, most important, credibility. The Fed's status will be called into serious question when it's needed most. That America's two prior experiments in central banking failed to sustain public support should serve as supporting evidence. The more recent and successful incarnation of an American central bank is the more remarkable development. The Fed's recent centennial, however, should not be confused with its permanent acceptance in the American political system.

David Brooks describes an optimal position in any organisation. He applauds those who are "at the edge of the inside". They are sufficiently respected members of the group, but they can resist its central seductions: "A person at the edge of the insider can see what's good about the group and what's good about rival groups… A person at the edge of the inside can be the strongest reformer. This person has the loyalty of a faithful insider, but the judgment of a critical outsider…[such] a person knows the standards and practices of an organization but [is] not imprisoned by them…the person on the edge of the inside is involved in constant change." (Brooks (2016))

We are proud to be members of the economic policymaking community. We believe that our hard work and good judgment can help foster an environment that allows for flourishing of human welfare. However, in our guild as in any other, there is a dangerous tendency to advance by running with the herd. That temptation must be resisted. And a robust reform agenda adopted.

The BIS sits at the edge of the inside, and I hope it proves successful in helping to lead a reform agenda. Time is short, and the need is real.

Thank you.

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