Central banking in a balance sheet recession

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It is a great pleasure and a privilege to have been invited to speak at this prestigious event in honour of Don Kohn. The breadth of this topic – central banking before, during and after the crisis – matches the breadth of Don's contribution. We at the BIS have benefited enormously from his experience, his thoughtful analysis and his extraordinary common sense. Don is the quintessential central banker.

The topic of the conference is a challenging one. There is no question that the crisis has been a defining moment in the history of central banking. It has raised first-order economic, intellectual and institutional challenges that, I suspect, will profoundly change central banking in the years ahead.[1] In my remarks today, however, I will just focus on one of them: that is, central banking in a balance sheet recession. The question is how to formulate policies that reduce the risk of protracted weakness and accelerate the return to a self-sustained recovery.

My main message is simple. Unquestionably, decisive action by central banks during the crisis has played a critical role in preventing a financial meltdown and a potential deflationary spiral. But the policies that are most suited to crisis management are not necessarily the best for crisis resolution. By crisis resolution, I mean the stage after the most acute crisis phase, when balance sheet repair must be addressed head-on to ensure a self-sustained recovery. Then, unless other fundamental measures are taken, there is a serious risk of overburdening monetary policy. From this balance sheet perspective, extraordinarily easy monetary policy – through both interest rates and the forceful use of central bank balance sheets – can certainly buy time, but it can also make it easier to waste that time. It is therefore important to acknowledge the possible limitations of this policy, to study them further, and to communicate them clearly.

In what follows, I shall first set the stage by exploring the special features of balance sheet recessions. I shall then turn to what monetary policy can and cannot do. I will then conclude with some reflections on the longer-term political economy and institutional challenges, with special attention to the need to preserve central banks' autonomy.

[1] See J Caruana, "Central banking between past and future: which way forward after the crisis?", speech at the South African Reserve Bank 90th Anniversary Seminar, Pretoria, 1 July 2011.

Balance sheet recessions

Balance sheet recessions differ from typical post-war recessions, which were commonly triggered by a monetary policy tightening to staunch rising inflation. They are often associated with permanent output losses and protracted stagnation. These unwelcome features arguably result from a combination of four factors: unsustainable output growth during the preceding financial boom, the misallocation of resources during that phase, the headwinds of the subsequent debt and capital stock overhangs, and the associated disruptions to financial intermediation.

The main challenge for policymakers is to prevent such balance sheet recessions from leading to protracted weakness. To this end, policymakers need to devise policies that ease the required balance sheet adjustments without setting off destabilising dynamics. They need to ensure that a major stock problem does not have lasting consequences for income and production flows.

Risk management practices and fiscal policies followed during the boom have drastically narrowed the room for manoeuvre, as the financial boom flattered fiscal and financial sector balance sheets. In some countries, fiscal authorities did not recognise the one-off and ephemeral nature of soaring revenues. Neither risk management practices nor market or public oversight recognised the latent under-capitalisation of the financial system. As a result, when needed, there were not enough fiscal and prudential capital buffers that could be drawn down to cushion the adverse effects of deleveraging. In fact, in some jurisdictions, we have seen the perverse feedback between lingering private sector debt overhangs, growing public sector debts and weakened banking sector balance sheets.

What can monetary policy do in such a context? There is no question that central banks should pull out all the stops when a crisis erupts to prevent an implosion of the financial system and dispel the threat of a downward economic spiral. And central banks have indeed risen to the challenge. They have cut policy rates aggressively, to effectively zero, and they have allowed their balance sheets to expand hugely, as they engaged in large-scale asset purchases and liquidity support. But, as crisis management gives way to crisis resolution, the balance of costs against benefits significantly worsens.

Balance sheet repair

Historically, prompt and thorough balance sheet repair has proved to be the best way to restore post-crisis growth and stability. This is the lesson of the Nordic banking crises in the early 1990s. Policymakers there intervened quickly and comprehensively to enforce the full recognition of losses, the recapitalisation of the banking system, the disposal of bad assets and the removal of excess bank capacity. These measures tackled the causes of the balance sheet recession and paved the way for a sustained post-crisis recovery. This is also the lesson from Japan's experience.

How does aggressive and prolonged monetary easing interact with balance sheet repair? To the extent that it shores up economic activity, it can generate income that may ease the process. To the extent that it boosts confidence and encourages greater risk-taking, it can counteract excessive risk-aversion, which might otherwise hold back economic activity. And to the extent that a refinancing option can be exercised at no cost, as with US mortgages, it can help to cut the present value of the debt overhang. These mechanisms are familiar.

But there are other, less familiar mechanisms that require analysis by which aggressive and prolonged monetary easing might actually hinder balance sheet repair. It can do so by influencing perversely the incentives of market participants and policymakers.

First, an aggressive and prolonged easing can delay the recognition of losses. Large-scale asset purchases and lending to banks can undermine the perceived need to deal with impaired assets. Low interest rates, in turn, can reduce the opportunity cost of carrying non-performing loans on the balance sheet, encouraging ever-greening. They can also lead banks to overestimate repayment capacity at more normal interest rates and to keep alive non-viable and non-productive businesses. This can raise the cost of credit for more productive investments. When deleveraging is necessary, allocating credit is as important as the amount available, or perhaps even more important.

Second, it can undermine the financial sector's operating profits. Low short-term interest rates and flattened yield curves can sap the earnings of banks by eroding deposit margins and the returns from maturity transformation. Moreover, low returns on fixed income assets can make it difficult for pension funds and life insurance companies to meet their long-term obligations and can even impair their solvency.

Third, it can create incentives for a renewed round of risk-taking and leveraging. For example, pension funds and insurers may respond to the pressure on their balance sheets by reaching for yield. Leveraged investors can readily finance even asset classes with low yields, such as gold and commodities. And banks, having recently been scorched by illiquidity, may favour risky trading activity over longer-term lending.

Fourth, it can distort and atrophy markets. Central banks can end up by taking over financial intermediation from the private sector, in the money markets and elsewhere, contributing to a form of so-called hysteresis there. Large-scale public sector holdings of financial assets, such as government bonds, may prevent markets from sending signals to investors and policymakers – and may ultimately degrade those signals to mere reflections of anticipated policy. And exceptionally loose policy can hamper the adjustment of the more sluggish types of asset prices, such as those of overvalued real estate, perpetuating excess supply and delaying the market's recovery.

If these mechanisms are at work, the challenge is great. Unusually accommodative and protracted monetary conditions can delay the necessary balance sheet repair and misallocate resources. Absent other more fundamental measures to address balance sheet problems head-on, the post-crisis recovery can be slow and weak – and the economy's longer-term growth potential may be impaired. This is another form of hysteresis.

Upon reflection, the source of the challenge is evident. Directly or indirectly, monetary policy influences economic activity by encouraging greater indebtedness, boosting asset prices and facilitating risk-taking. But the starting point for a balance sheet recession is precisely too much debt, excessively high asset prices and extreme risk-taking. There is thus a natural tension between how monetary policy operates and where the economy needs to go. Striking the right balance is inherently difficult. One important exception is the impact that monetary easing may have on the exchange rate. Exchange rate depreciation can boost revenues and support deleveraging without necessarily encouraging the build-up of debt and can thereby underpin a credit-less recovery. But for large economies in particular, such a policy may not be welcomed by trading partners.

Political economy considerations

Prolonged easy monetary conditions can also pose political economy risks for central banks over the long term. These could ultimately jeopardise their operational autonomy and hard-earned credibility.

The forceful use of central banks' balance sheets as well as financial stability decisions requires a greater degree of interaction with the government. How to manage this interaction

is no easy task, since such balance sheet policies blur the line between monetary and fiscal measures. Central bank balance sheet policy can generally be replicated by the government. And, conversely, central bank balance sheet policy alters the consolidated public sector balance sheet. Thus, the impact of such policy can only be fully assessed in relation to this larger balance sheet.

In this context, the very meaning of instrument independence becomes unclear. Protracted central bank balance sheet policies can create a tension with central banks' operational autonomy, especially as public debt is on an unsustainable path in many countries. The spectre of "fiscal dominance" could re-emerge.

The broader the scope of central bank activities, the greater is the political and public scrutiny they attract. If central bank autonomy is to be preserved, the mechanisms for interaction need to be carefully specified. Greater clarity about roles and responsibilities can be conducive to effective and rapid decision-making, to managing trade-offs smoothly and to accountability. Clarity can also help to prevent gaps opening between what the public expects and what central banks can deliver.

Against this background, it is reassuring to see that central banks are moving to clarify their price-stability objectives. In particular, the Federal Reserve's adoption of a long-run inflation objective of 2% represents an important and clear step in this direction. Another example is the Bank of Japan's recently announced goal of 1% inflation. An objective of sustainable price stability – and the key word here is "sustainable" – is fully compatible with ensuring financial stability, as it allows the necessary room for manoeuvre.[2]

Conclusions

Let me conclude. Faced with a balance sheet recession, policymakers need to strike a balance. They need to promote effective balance sheet repair so as to avoid overburdening monetary policy. By itself, extraordinarily easy monetary policy, whether through interest rates or the active use of central bank balance sheets, cannot be expected to solve underlying solvency problems. Such a policy can buy time, but may actually make it easier to waste that time. It can increase the risk that the balance sheet recession leads to protracted weakness, thereby delaying the return to a self-sustained recovery. At the same time, it can raise political economy risks; we must take care to preserve central banks' operational independence and their credibility.

Key challenges for central banks remain. We need to analyse and to understand the risks and limitations of policy responses to balance sheet recessions so as to recognise them, to factor them into policy decisions, and to communicate them clearly.

[2] See Caruana op cit.