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The uncertain future of Central Bank supremacy

Mohamed El-Erian | PIMCO | 12 November 2013

History is full of people and institutions that rose to positions of supremacy only to come crashing down. In most cases, hubris - a sense of invincibility fed by uncontested power - was their undoing. In other cases, however, both the rise and the fall stemmed more from the unwarranted expectations of those around them.

Over the last few years, the central banks of the largest advanced economies have assumed a quasi-dominant policy making position. In 2008, they were called upon to fix financial-market dysfunction before it tipped the world into Great Depression II. In the five years since then, they have taken on greater responsibility for delivering a growing list of economic and financial outcomes.

The more responsibilities central banks have acquired, the greater the expectations for what they can achieve, especially with regard to the much-sought-after trifecta of greater financial stability, faster economic growth, and more buoyant job creation. And governments that once resented central banks' power are now happy to have them compensate for their own economic-governance shortfalls - so much so that some legislatures seem to feel empowered to lapse repeatedly into irresponsible behavior.

Advanced-country central banks never aspired to their current position. They got there because, at every stage, the alternatives seemed to imply a worse outcome for society. Indeed, central banks' assumption of additional responsibilities has been motivated less by a desire for greater power than by a sense of moral obligation, and most central bankers are only reluctantly embracing their new role and visibility.

With other policymaking entities sidelined by an unusual degree of domestic and regional political polarisation, advanced-country central banks felt obliged to act on their greater operational autonomy and relative political independence. At every stage, their hope was to buy time for other policymakers to get their act together, only to find themselves forced to look for ways to buy even more time.

Central banks were among the first to warn that their ability to compensate for others' inaction is neither endless nor risk-free. They acknowledged early on that they were using imperfect and untested tools. And they have repeatedly cautioned that the longer they remain in their current position, the greater the risk that their good work will be associated with mounting collateral damage and unintended consequences.

The trouble is that few outsiders seem to be listening, much less preparing to confront the eventual limits of central-bank effectiveness. As a result, they risk aggravating the potential challenges. This is particularly true of those policymaking entities that possess much better tools for addressing advanced economies' growth and employment problems. Rather than use the opportunity provided by central banks' unconventional monetary policies to respond effectively, too many of them have slipped into an essentially dormant mode of inaction and denial.

In the United States, for the fifth year in a row, Congress has yet to pass a full-fledged budget, let alone deal with the economy's growth and employment headwinds. In the eurozone, fiscal integration and pro-growth regional initiatives have essentially stalled, as have banking initiatives that are outside the direct purview of the European Central Bank. Even Japan is a question mark, though it was a change of government that pushed the central bank to exceed (in relative terms) the Federal Reserve's own unconventional balance-sheet operations.

Markets, too, have fallen into a state of relative complacency.

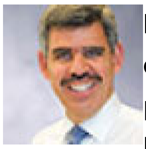
Comforted by the notion of a "central-bank put," many investors have been willing to look through countries' unbalanced economic policies, as well as the severe political polarisation that now prevails in some of them. The result is financial risk-taking that exceeds what would be warranted strictly by underlying fundamentals - a phenomenon that has been turbocharged by the short-term nature of incentive structures and the lucrative market opportunities afforded until now by central banks' assurance of generous liquidity conditions.

By contrast, non-financial companies seem to take a more nuanced approach to central banks' role. Central banks' mystique, enigmatic policy instruments, and virtually unconstrained access to the printing press undoubtedly captivate some. Others, particularly large corporates, appear more skeptical. Doubting the multi-year sustainability of current economic policy, they are holding back on long-term investments and, instead, opting for higher self-insurance.

Of course, all problems would quickly disappear if central banks were to succeed in delivering a durable economic recovery: sustained rapid growth, strong job creation, stable financial conditions, and more inclusive prosperity. But central banks cannot do it alone. Their inevitably imperfect measures need to be supplemented by more timely and comprehensive responses by other policymaking entities - and that, in turn, requires much more constructive national, regional, and global political paradigms.

Having been pushed into an abnormal position of policy supremacy, central banks - and those who have become dependent on their ultra-activist policymaking - would be well advised to consider what may lie ahead and what to do now to minimise related risks. Based on current trends, central banks' reputation increasingly will be in the hands of outsiders - feuding politicians, other (less-responsive) policymaking entities, and markets that have over-estimated the monetary authorities' power.

Pushed into an unenviable position, advanced-country central banks are risking more than their standing in society. They are also putting on the line their political independence and the hard-won credibility needed to influence private-sector behavior. It is in no one's interest to see these critical institutions come crashing down.



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