Liberté, Égalité, Fragilité

The New Politics of Central Banking:

A Central Banking Trap

Andrew Sheng

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Escalating Growth in Central Bank Balance Sheets (2007-2013)

- Central bank balance sheets have grown from roughly 3% of global financial assets in 2007 to 8% (US$22 trn) of total financial assets of US$282 trn (IMF/FSB estimates) or 30% of world GDP
- Advanced country central bank balance sheets are smaller, but as high as 80% of GDP (SNB)
- EME central banks larger as % of GDP due to high FX reserves and bank based systems (PBC at 50% of GDP)
- Since crisis, Fed and BoE B/S 4X, ECB as high as 3X
- Big 5 (Fed, ECB, BoE, BoJ, PBC) increased BS from 22% of their GDP to 32% of GDP or 17% of their M2 to 21% of M2

Balancing Benefits and Costs of Enlarged Central Bank Balance Sheet

Operations	Pro	Con
FX Intervention	Stabilizing volatile market	FX mismatch with high long-term costs
Lender of Last resort/stabilizing dysfunctional markets	Crisis management	Moral Hazard/Central bank put/higher market
Revival of aggregate demand at zero bound	Theory is that lower interest rates revives demand	Exacerbate income + wealth inequality, as rich have more access to leverage
Aiding fiscal funding	Short-term support	Fiscal dependence on low interest rates – unsustainable deficits and debt overhang

Bernanke – Central Banks Not Responsible for Long-term Real Interest Rates

(March-April 2015, Brookings Blog)

- If not, then why increase the balance sheet to 4 times pre-crisis levels?
- Markets believe (proven by experience) that central banks will always provide liquidity to bail them out
- The belief that interest rates will remain low has created asset and credit bubbles at record levels
- The argument that central bank policies prevent deflation is countered by risk that they may instead generate expectations of hyperinflation that add to uncertainty and therefore hold back aggregate demand

Haldane – We Need “System of Systems” View of Complexity

(March 2015, “On Microscopes and Telescopes”)

- In complex systems, the whole behaves very differently than the sum of its parts
- Scale-free, superspreader, network effects also carry hierarchical “winner-take-all, winner-have-all” inequalities
- Since crisis, SIFIs larger, more concentrated without reduction in leverage
- Non-financial corporations more leverage, more concentrated in size and ownership
- Central banks have become larger and more concentrated – their purchases of risk-free assets have reduced supply, causing negative nominal and real yields on high quality bonds, increasing market volatility
- Complexity adds to fragility, increasing inequality

Crisis and High Real Interest Rates "Flatten" Inequality

- Although financial crisis and collapse hurt both rich and poor alike, high real interest rates that reduce leverage weed out inefficient borrowers, get rid of speculative bubbles and return economy to basics
- Unfettered finance has become channel to exacerbate inequality, since rich can borrow at negative real interest rates, whilst poor do not have collateral and little access to credit. Indeed, low real yields hurt pension and insurance schemes and therefore middle class savers
- Central bank action to intervene frequently has displaced financial intermediation role of market, bailed out and subsidized rich and speculators, whilst imposing quasi-fiscal taxation on savers

Central Bank Trap – No “Indeflation” Without Representation

- Democratic controls – no taxation without representation
- Central bank intervention through QE etc are crisis management efforts that have become entrenched in shoring up status quo inequality – but they are actually quasi-fiscal action because governments cannot raise taxes or cut welfare/inefficiencies
- Political economy of central bank not subject to democratic selection
- Process is subject to capture and central banks cannot exit their current policies (monetary or regulatory), without countering huge lobbying efforts
- To paraphrase the late Lee Kuan Yew: Central banks need to “do what is correct, not what is politically correct”

Central Bank Trap – No Hard Budget Constraint, Always Soft Options

- Leadership comes from doing what is needed, not what is popular
- Fiscal action already trapped by unwillingness to take tough action for structural reforms
- Central bank intervention is “soft option”, but cannot address structural issues, making system more dependent on soft money and low interest rates
- By expanding their balance sheets and willingness to intervene, without good theory and evidence that it works, central bank have become part of the structural “malaise” of liquidity trap with low growth
- Central bankers have to take tough decisions and speak truth to power. Remove themselves if they cannot remove the punch bowl

THANK YOU

Andrew Sheng
as@andrewsheng.net