Central banks facing intrinsic conflicts

Problem stemming from 'reward for failure'

by David Marsh in Beijing

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Central banks face a series of challenges focused on intrinsic conflicts at the heart of the relationship between finance and politics. Governments around the world have acted with central banks to change these institutions' roles and move them into new policy areas with widespread and long-lasting financial, economic and political consequences. In a large-scale extension of their open market operations generated by the 2008-09 financial crisis, central banks in the main developed countries have been running unusually easy monetary policies through buying and holding very significant quantities of government bonds. This unconventional monetary policy, although brought about in a bid to mitigate the effects of the last crisis, could end up triggering the next one. Unwinding this monetary accommodation is taking place only slowly in the US and UK, and has not yet started in Japan and continental Europe.

These central banking actions co-exist alongside, and could potentially conflict with, another set of arrangements to safeguard financial stability – macroprudential regulation – under which central banks have acquired the additional role of supervising, controlling and guiding the assets and activities of banks and financial institutions throughout the economy.

One participant at the Singapore workshop said in many ways the central banks have been rewarded for perceived failures. Central banks have been blamed for policies that may have exacerbated the 2008 crisis, and for not detecting its build-up. Faith in their abilities, both from politicians and the general public, had declined. Yet in the aftermath of these upheavals, they have also been given wider duties and remits. Managing these conflicts would be a big problem for the future, especially as central banks could face further calls for additional action when the next world recession loomed. This could happen in the next two years as the US recovery, despite the procyclical tax cutting action of President Donald Trump, runs out of steam.

There could be a substantial redrawing of the boundaries of action and responsibility between governments and central banks. Questions were being raised whether, in the run-up to the next crisis, central banks would have the freedom to raise interest rates sufficiently to give them the necessary rate-cutting firepower to make a difference when the next downturn hits. There was a discussion of how some governments' debt levels made them unable to to accept interest rate rises - a 'debt trap' that may end of costing central banks' their independenmce.

In the management of their own balance sheets, central banks' linkages with governments and financial institutions could be heavily remodelled. This task would require much more effective and close coordination. One participant underlined that although communication among central banks was global, with many officials sharing similar backgrounds and education, international coordination was on a lower scale. There was also a discussion on areas like fintech which were potentially disruptive for financial markets, where growth had partly been spurred by accommodative monetary policies. It was agreed that central banks needed to keep a close eye on developments.

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