The *Lean or Clean* Controversy

By Klaus C. Engelen

Should financial stability considerations be part of monetary policy?

Some have lauded the U.S. Federal Reserve's first interest rate hike after seven years as a beginning step toward the normalization of monetary policy. In recent remarks at the Bank for International Settlements' Farewell Symposium in honor of outgoing Chairman Christian Noyer, the Fed's vice chairman, Stanley Fischer, addressed the issue that has been raised by the BIS for years but ignored by the major central banks: That central banks should incorporate financial stability considerations in the conduct of monetary policy.

In 2003, then-BIS General Manager Andrew Crockett argued, "In a monetary regime in which the central bank's operational objective is expressed exclusively in terms of short-term inflation, there may be insufficient protection against the build-up of financial imbalances that lies at the root of much of the financial instability we observe. This could be so if the focus on short-term inflation control meant that the authorities did not tighten monetary policy sufficiently preemptively to lean against excessive credit expansion and asset price increases. In jargon, if the monetary policy reaction function does not incorporate financial imbalances, the monetary anchor may fail to deliver financial stability."

The key BIS economists in the long-running "lean or clean" controversy in monetary policy—especially present and former BIS chief economists Claudio Borio and William White—remain skeptical. "As regards the latest speeches by Stan Fischer," says Borio, "some observers have

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interpreted them as pointing to a more sympathetic attitude towards the 'lean against financial imbalances' view. Personally, I would be more cautious. As we say in Italian, *una rondine non fa primavera,* meaning one swallow does not make a spring." And White echoes: "Not a great deal has changed in the last while, aside from the fact that the global economy looks weaker and the previous financial excesses (that is, narrow high risk spreads) are beginning to get unstuck. The Fed's stimulus worked initially by exporting imbalances into emerging markets, but these are now set to feed back negatively on the United States and others. If so, the contention of the BIS (and mine) that the stimulus of 'ultra-easy monetary policy' would not work to stimulate global demand and would have undesired financial consequences seems increasingly to be supported by the facts. However, the former development seems to imply lower rates and latter higher rates. The Fed then has a problem, which they will likely resolve by either cutting rates again or raising them much more slowly than they currently forecast. As the BIS might put it, the jaws of the 'debt trap' are closing. The only way out is government (not central bank) action as I described in the G30 report."

WHY HAVE CENTRAL BANK TOOLS NOT BEEN EFFECTIVE?

This magazine's publisher, David Smick, recently made the point, "It seems to me, stated very simply, that the world's central bankers have based policy on the theory that money is the central, highly predictable driver of all economic motivation, when it is clear the issue of money is a lot more complicated. This is why the central banker's tools have been less effective than anticipated."

This is what the BIS for years has been asserting. Since—in terms of forward-looking monetary policy orientation, independence from political influence, and quality economic research—this observer asserted "The BIS was right" (*TIE,* Summer 2015), the *TIE* publisher wanted to know more about how the economists from the "central banks' bank" in Basel look at the world of quantitative easing, zero-bound interest rates, growing imbalances, currency wars, and not enough economic growth and employment.

After the "Great Moderation" with low inflation that came to an end with the financial crisis of 2007–2010, followed by years of anemic economic growth, record high unemployment, and financial instability, there's a new conventional wisdom for central banks. It says that when all else fails to make economies grow, central banks can use balance sheet expansion to step up liquidity provision and increase their intermediation role. Central banks can act as a backstop to banks and financial markets when they see the functioning of interbank and broader financial markets impaired. Liquidity provision to the economy can take the form of temporary lending or outright purchases. This process of expanding a central bank balance sheet through asset purchases, financed by central bank money, is widely called quantitative easing.

Most economists, policymakers, and market actors think that quantitative easing worked in the United States and other advanced market economies such as the United Kingdom and Japan, preventing their economies from tumbling into depression.

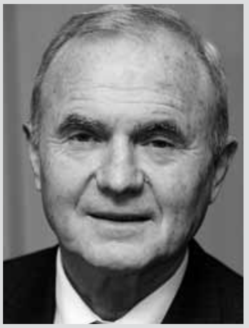
In the definition of the Bank of England, quantitative easing is "an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, like government bonds. This process aims directly to increase private sector spending in the economy and return inflation to target."

Most economists, policymakers, and market actors think that quantitative easing worked in the United States and other advanced market economies such as the United Kingdom and Japan, preventing their economies from tumbling into depression. The U.S. Federal Reserve bought a combination of public and private sector (including GSE) assets. The Bank of England mostly bought medium- and long-term government bonds (gilts). As Bloomberg noted recently: "Europe's central bank began buying government bonds in March—six years after the U.S. embarked on QE—as Europe's fragile recovery lagged the rest of the world. President Draghi overcame German-led opposition on the Bank's Governing Council and pledged an asset-purchase program worth €1.1 trillion ($1.2 trillion). The ECB finally turned to buying after cutting one of its main interest rates below zero last year, the first major central bank ever try such a move."

The Line of Defense

Axel Weber: *Thinks that inflation targeting needs to be rethought.*

Jürgen Stark: *Twice voted against the ECB's bond-buying programs.*



Otmar Issing: *Warns that the EU treaties were violated during the sovereign debt crisis.*

It was Axel Weber who in the dark days of Europe's sovereign debt crisis became so incensed over the European Central Bank's emergency bond-buying that he resigned early from the presidency of the Deutsche Bundesbank in 2011 and gave up the prospect of following Jean-Claude Trichet at the helm of the ECB. A BloombergBusiness headline of June 10, 2015, signals how strongly the former Bundesbank head still objects to the ECB's unconventional policies: "Axel Weber Tells Yellen, Draghi & Co: You're Doing It Wrong." Weber, now chairman of UBS, thinks that inflation targeting needs be rethought. He argues that "the orthodox regime of inflation targeting that exists at most of the world's major central banks—the U.S. Federal Reserve, the ECB, the Bank of Japan—is no longer fit for purpose. …As a result, it ignores the kind of financial buildups in asset prices and indebtedness that caused the last meltdown."

Two former ECB chief economists who came from the Bundesbank—Jürgen Stark and Otmar Issing—remain fierce critics of the ECB's unorthodox monetary policies. As a member of the ECB's executive board from 2006–2011, Stark twice voted against the ECB's bond-buying programs under then-President Trichet and is no more supportive of the current ECB President Draghi's announced strategy to purchase €60 billion in bonds every month until September 2016.

Last year, Stark reminded the CFA Institute annual conference: "Central banks have launched a risky experiment and we do not know the outcome. In my view, the impact channels do not work in Europe as they did in the United States and the United Kingdom. QE worked through the stock market and wealth effect, leading to higher consumption and GDP growth. There is no evidence that this will work in Europe. The impact of ECB policy is more likely to be seen in a depreciation of the euro exchange rate."

Otmar Issing, beginning in 1998, served eight years as member of the ECB executive board, responsible for the economics and research departments, after serving eight years as the Bundesbank's chief economist. He did not quit. But he can be counted among the ECB critics.

Issing warns that the EU treaties were violated during the sovereign debt crisis. In particular, he deplores that EU member states violated the no-bailout clause that prohibits the assumption of liability for other countries' debt. He criticizes the ECB for buying the government bonds of countries affected by the crisis. He disapproves of the establishment of a European banking supervision at the ECB. Speaking last year, he warned, "The biggest financial stability risk we are now confronting is a consequence of the very low interest rates and ample liquidity provided by quantitative easing. This is a world-wide phenomenon. It is leading to a situation like we have seen in the past. Low interest rates induce people to take high risks. As a result, spreads among asset classes will shrink so that interest rate differentials no longer reflect differentials in risk. This is a situation that cannot continue. And, when there is a correction, the result might be a new financial crisis."

—K. Engelen

PRICKING OF BUBBLES STILL HOTLY CONTESTED

Those who argue that central banks should look for ways to act preemptively when a dangerous buildup of liquidity and credit with ever-higher asset prices is looming had their say recently when the Group of Thirty presented a report on the "Fundamentals of Central Banking: Lessons from the Crisis." The report was released to coincide with last October's IMF/World Bank annual meeting in Lima, Peru. The steering committee for the report included former Bundesbank President Axel Weber, now chairman of UBS; former Bank of Israel Governor Jacob A. Frenkel, now chairman of JPMorgan Chase International; and former Central Bank of Brazil Governor Arminio Fraga. Former BIS chief economist William R. White was the project's director.

For many years, the BIS has opposed the conventional view, notably shared by former U.S. Federal Reserve Chairman Alan Greenspan, that any attempt to prick financial bubbles in advance is doomed to failure, and that bubble pricking may choke off growth unnecessarily and at a high cost.

In Lima, the current head of the BIS, Jaime Caruana, who served as Spain's central bank governor and headed the IMF's monetary and capital markets department, took the BIS line, arguing that the so-called "separation principle," whereby monetary and financial stability are addressed differently and tasked to separate agencies, no longer makes sense. "It is wrong to say that we know too little about financial instability to be able to act in a preemptive way. We know as much about bubbles as we do about inflation. The need of central banks to move interest rates for reasons other than the short-term control of consumer-price trends should be recognized."

The BIS's view is shared by Howard Davies, now chairman of Royal Bank of Scotland and formerly head of the United Kingdom's Financial Services Authority. Davies summed up the "arcane" central banker's debate in Lima under the heading "The trouble with financial bubbles." His caustic intervention was reported in Britain's *The Guardian:* "Industrial quantities of research, analysis, and debate have been devoted to the causes of the 2008 crisis and its consequences; so it seems odd that senior central bankers are still so sharply divided on the central issue of financial stability. All those days spent in secret conclave in Basel, drinking through the BIS's legendary wine cellar, have apparently led to no consensus."

Monetary policy should be more focused on "preemptive tightening" to moderate credit bubbles than on "preemptive easing" to deal with the after effects.

In Lima, the veteran British supervisor especially lashed out against Benoît Cœuré, who sits on the ECB's Executive Board, and who had argued that "a central bank needs a very simple mandate that allows it to explain its actions clearly and be held accountable for them." Central banks should "stick to the separation principle, which makes our life simple; we do not want a complicated set of objectives," according to Cœuré.

This was too much for Davies, who shot back: "For Cœuré, trying to maintain financial stability is in the 'too difficult' box. Even macroprudential regulation is of dubious value, supervisors should confine themselves to overseeing individual institutions, leaving macro-level policy to the grownups." Davies continued, "My view is that Caruana had the best of the arguments in Lima, and Cœuré the worst. Sticking to a simple objective in the interest of a quiet life, even if you know it to be imperfect, is an inelegant posture at best. We need our central bankers to make complex decisions and to be able to balance potentially conflicting objectives. We accept that they will not always be right. However, it is surely incumbent on them to learn from the biggest financial meltdown of the last eighty years, rather than press on, regardless, with policy approaches that so signally failed."

A NEW CENTRAL BANKER'S BLUEPRINT

The Group of Thirty used the presence of the financial elite from all parts of the world at the IMF/World Bank meeting in Lima to present the key message of their study: "The extraordinarily easy monetary policies of the last eight years succeeded in stabilizing markets during the financial crisis and may well have averted a second Great Depression, but much unfinished business remains for governments and central bankers to secure a lasting recovery."

On such crucial issues of central bank policy, Axel Weber, who sat on the report's steering committee, sides with the impressive research of Canadian Bill White, the former BIS chief economist. White gained global notoriety as an outspoken critic of Alan Greenspan's theory of the role of monetary policy early on. At the Fed's annual Jackson Hole economic policy symposium in 2003, based on a paper he had written together with his colleague Claudio Borio, White challenged Greenspan directly that

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central banks can't effectively slow the causes of asset bubbles. He recommended that central bankers "raise interest rates when credit expands too fast and force banks to build up cash cushions in fat times to use in lean years." It doesn't come as a surprise that from his Basel economist pulpit, White predicted the 2007–2010 subprime meltdown.

In his Federal Reserve Bank of Dallas study "Should Monetary Policy 'Lean or Clean'?" of August 2009, White presented many arguments that can be found in the new Group of Thirty blueprint.

"It has been contended by many in the central banking community that monetary policy would not be effective in 'leaning' against the upswing of a credit cycle (the boom) but that lower interest rates would be effective in 'cleaning' up (the bust) afterwards. In this paper, these two propositions (can't lean, but can clean) are examined and found seriously deficient. …[M]onetary policies designed solely to deal with short-term problems of insufficient demand could make medium-term problems worse by encouraging a buildup of debt that cannot be sustained over time. The conclusion reached is that monetary policy should be more focused on 'preemptive tightening' to moderate credit bubbles than on 'preemptive easing' to deal with the after effects. There is a need for a new macrofinancial stability framework that would use both regulatory and monetary instruments to resist credit bubbles and thus promote sustainable economic growth over time."

Still in the BIS tradition, in a Federal Reserve Bank of Dallas Working Paper dated September 2015 titled, "How False Beliefs About Exchange Rate Systems Threaten Global Growth and the Existence of the Eurozone," White launched another broadside against central bankers and those responsible in governments because of failed and costly policies.

"The current belief system that says 'all will be well' if domestic price stability can be maintained is fundamentally flawed," argues White. "If this can be achieved only through monetary, credit, and debt expansion, the end result will be an increased risk of systemic crisis. Moreover, false beliefs about how exchange rate systems function, at both the global level and within the eurozone, imply international 'spillover' effects that increase both the likelihood and seriousness of such crises. Gross international capital flows pose as many (perhaps more) dangers than do net flows (i.e., current account imbalances). And false beliefs about exchange rate regimes not only compromise crisis prevention, but they also hinder crisis management and resolution. At the global level, we still lack the instruments to do either effectively should current problems worsen. In the eurozone, the crisis which began in 2010 has not been well managed and remains fundamentally unresolved."

HOW TO EXIT FROM A DEBT TRAP

In White's view, the chapter "Undesirable Side Effects and the Need to 'Exit'" in the Group of Thirty report illuminates the present central bank dilemma: "The long period of extremely easy monetary conditions has not generated inflationary pressures in advanced market economies, as many initially feared. However, it might well have contributed to further misallocations of real resources in the economy, to reducing potential output, and to unsustainable increases in asset prices."

The chapter includes the admission that emerging market economies "have imported similar undesirable forces, in part due to their own efforts to hold down exchange rates subject to the influence of large-scale capital inflows." Other points the report addresses include: there seems to be widespread agreement that central banks must exit from these abnormal policies at some point; there is uncertainty about both modalities and implications of such an exit; there is a bias toward this happening too late rather than too soon; and a number of possible scenarios reveal a growing and worrisome set of exposures to future economic instability despite seven years of extraordinary easy monetary conditions.

Finally, there is this clear warning: There is "a crossover point at which central banks should exit from their policies regardless whether or not they have succeeded in stimulating near-term growth. In effect, such an exit would be recognition that central bank policies had begun to do more harm than good."

BIS AND IMF STILL IN DISAGREEMENT

In the central bankers' debate in Lima about quantitative easing, about "lean versus clean," about the implications of zero-bound interest rates, and about the timing and risks of exiting, the long-standing dispute between the BIS and the IMF about proactively mitigating crisis risks lingers on. In this dispute, the U.S. Federal Reserve Board with Janet Yellen and Stanley Fischer in the top positions—not surprisingly—was siding with the IMF staff.

The IMF experts came to Lima well prepared. In August 2015, the IMF staff had completed a sixty-six-page study on "Monetary Policy and Financial Stability." The report rejected the findings that the BIS economists have been advancing for years.

To secure attention, the *IMF Survey* magazine came out with a long summary under the heading "Monetary Policies in Advanced Economies: Good for Them, Good for Others." In the paper, the IMF staff countered the BIS assertions by arguing that "given the limited empirical evidence and the lack of an accepted theoretical framework, the question of leaning against the wind is hotly contested." But the IMF leaves a door open to new research findings that could eventually support the BIS position.

Some central bankers and economists put a big question mark behind the IMF's rejection of the "lean versus clean" arguments, pointing to the failures of the IMF in predicting financial crises.

HOW THE BUBA SIDES WITH THE BIS

For the euro area, with the European Central Bank operating under a mandate fixed by EU laws, buying government bonds is more complicated and controversial. Under the ECB's ultra-loose monetary policy with zero-bound interest rates, a nation of savers such as Germany is sinking ever deeper into a *de facto* confiscation of financial assets. There is the feeling that they have to keep economies and zombie banks in the eurozone periphery afloat in a defunct monetary union. The ECB is seen as the "eurozone wealth of nations redistribution mechanism" in which high savers in northern euro area member states are increasingly becoming victims of financial repression through the ECB's zero or close-to-zero interest rates.

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Different interpretations of EU law among the monetary union member countries causes bad blood, especially in Germany, the largest creditor and the largest euro area economy. Ever since the sovereign debt crisis—starting with Greece—forced euro leaders to come up with huge rescue operations, the "no bailout" clause anchored in the Maastricht Treaty has been ignored. The German government, the Deutsche Bundesbank, and the German Council of Economic Experts quickly sounded the alarm that easy money through the ECB's "unorthodox" monetary policy instruments such as buying public bonds could undermine efforts to push governments to revive their economies through needed structural reforms. As the ECB moves more and more into the position of the largest creditor of eurozone member states, the border lines of monetary policy and state financing become blurred.

Many of the objections voiced against the prevailing policy of quantitative easing and massive government purchases with zero-bound interest rates are shared in the current annual reports of the BIS and the Bundesbank.

Take the Bundesbank's annual report. "In 2014, low inflation rates and very subdued and uneven economic recovery in the euro area re-ignited the debate on the Eurosystem's monetary policy," argues Bundesbank President Jens Weidmann in the introduction. "In Germany, too, the historically low key interest rates and the large-scale government bond purchase programme that was adopted at the beginning of 2015 generated animated discussion. This also embraced the implications of the accommodative monetary policy for savers, consumers, and businesses as well as the risks to financial stability." He continues: "The government bond purchase programme is especially controversial" (page 13). "While an accommodative monetary policy stance is currently justified in principle, given the muted outlook for euro area inflation and growth, quantitative easing nevertheless entails its own specific risks. … One especially problematic aspect is that the massive government bond purchases will make the Eurosystem central banks the biggest creditors of the euro-area member countries. Fiscal policy and monetary policy will become even more closely entwined as a result, which could amplify political pressure on the Eurosystem in the future to such an extent that the independence of monetary policy might ultimately be compromised."

And the BIS annual report: With the question "Is the unthinkable becoming routine?," the BIS annual report echoes concerns about zero-bound interest rates: "Interest

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rates have never been so low for so long," states the BIS. "They are low in nominal and real (inflation-adjusted) terms and low against any benchmark. Between December 2014 and end-May 2015, on average around $2 trillion in global long-term sovereign debt, much of it issued by euro area sovereigns, was trading at *negative* yields… Such low rates are only the most obvious symptom of a broader malaise, despite the progress made since the crisis."

When Weidmann took over the chairmanship of the BIS Board of Directors on November 1, 2015, for a three-year term, he may have felt much more welcome in Basel than in Frankfurt's ECB Tower. There, the representative of the eurozone's largest economy and creditor is marginalized on the major monetary policy decisions, having only one vote in the twenty-five-member governing council. Struggling in the stability-oriented ordoliberal Bundesbank tradition, Weidmann is facing a hostile ECB climate as the odd man out. The debtor countries under the accommodative ECB leadership of "whatever it takes" Mario Draghi have been pushing unorthodox monetary policy measures that are stretching or exceeding the ECB mandate specified in the European Union Treaties.

As the debate continues over putting unconventional monetary policies on a more solid footing, Germany's central bankers—in and out of office—still find ways to raise their objections. ◆