



## EDITORIAL

### Monetary point of inflection getting closer

**C**entral bankers responded to the global financial crisis with a mix of unconventional policies, including negative rates and asset purchases. Addressing September's OMFIF main meeting in Rome, Banca d'Italia Governor Ignazio Visco noted that such policies helped cushion the initial shock, and that both subsequent GDP growth and inflation would have been lower without them. But they have hardly provided a panacea. As Visco also noted, such policies have distorted markets and created risks for financial stability.

Extraordinarily loose policies have not only failed to boost growth substantially, but have also created dangerous debt overhangs in many economies. There have been some collateral effects too, examined in this month's Bulletin. Charles Goodhart and Geoffrey Wood argue that these measures have hurt bank profitability, while Stijn Claessens and Nicholas Coleman of the Federal Reserve Board of Governors, and Michael Donnelly of MIT, consider evidence on the effect on banks' net interest margins. Ben Robinson presents the findings of an OMFIF report, produced with BNY Mellon, showing that unconventional policies have reduced the supply of liquid assets for collateral. Panicos Demetriades, former governor of the Central Bank of Cyprus, highlights the negative consequences for central banks' credibility and the notion of their independence.

The good news is there are signs that monetary policy is reaching an important inflection point. This might not be apparent at first sight. The US Federal Reserve defied expectations that it would raise rates at its September meeting. But as Darrell Delamaide argues, this was driven more by politics than economics – a December rate rise is now a virtual certainty. Meanwhile, the Bank of Japan's decision to refrain from a rate cut and introduce yield curve controls in asset purchases confirms a shift to a more flexible approach. Some monetary alchemy will still be needed to help Japan exit its debt trap without pain – the subject of OMFIF's latest report, published in September, by John Plender. The case of the Bank of England is more worrying, maintains Peter Warburton, who argues that even a shock as big as Brexit did not warrant the Bank's August rate cut.

Yet escaping from this unconventional quicksand dragging down central bankers will not be easy. As Luiz Pereira da Silva of the Bank for International Settlements told an OMFIF City Lecture in September, central bankers face a 'singular dilemma': continuing with such policies carries dangers in the long run, but exiting also risks market panic. One way to exit is to use more fiscal policy to ease the pain of tightening the monetary screws. With borrowing rates at historical lows, it is now time for governments to invest and they are not doing enough of it. This is not just a feature of developed markets: Donald Mbaka of the Central Bank of Nigeria echoes Visco's warnings of a 'suboptimal policy mix'.

Despite these risks, the central bank that was the slowest to join the QE party may still find it hard to leave. A third of responses to our Advisory Board Poll expect the ECB to expand its QE programme into new asset classes instead of letting it expire in March 2017. This could bring the economics back into the spotlight, but for now Europe's biggest headache remains its politics. As Vicky Pryce highlights, divisions across the euro area have risen and anti-euro movements are gaining ground in many countries. Steve Hanke alerts us to a doomsday scenario for Italian banks – even though the well-publicised problems of Deutsche Bank may provide Italy with a welcome distraction. There may be some silver linings for the European economy however, as Brexit creates an opportunity for financial centres on the continent. This month's edition includes the second in OMFIF's series of Focus reports, examining the case for Frankfurt. We round off with William Keegan's review of an account of his time in politics by Ed Balls, the UK Labour party's shadow chancellor who lost his parliamentary seat in the 2015 election.



## Perils of fiscal policy in disguise

### Zombie banks, zombie companies: the reckoning

William White, Organisation for Economic Co-operation and Development

**U**nconventional monetary policies – as the bond-buying programmes by central banks in Japan, the US and continental Europe have been baptised – are really fiscal policy in disguise. As a result of central banks' transgression into the political sphere, the 40-year period of central banking independence is now effectively over. We will discover whether this puts the world on to a more or less stable footing.

Current policies foster financial instability. By squeezing credit and term spreads, the business models of banks, insurance companies and pension funds are put at risk, as is their lending. The functioning of financial markets has changed dramatically, with many asset prices bid up dangerously high, threatening future growth. Resources misallocated before 2008 have been locked in through zombie banks supporting zombie companies.

The insidious effects of persistently 'easy money' policies can be seen in the alarming slowdown in global growth. Two vicious circles are at work, with a wounded financial system contributing to both. On the demand side of the economy, accumulating debt creates headwinds that slow demand, leading to still more monetary expansion and yet more debt. On the supply side, misallocations slow growth, again leading to monetary easing, more misallocation and still less growth.

There is a route out of the impasse – reliant on government action rather than that of central banks. We need to adopt precepts from both Keynes and Hayek. To please Keynes, governments should use whatever room they have for fiscal expansion, with an emphasis on infrastructure investment in concert with the private sector. Into the Hayekian category fall measures to address excessive debt through careful debt write-offs and restructuring; this might require recapitalisation or closure of those financial firms that made the bad loans. Structural reforms to raise growth potential and the capacity to service debt will pay longer-term dividends.

A paradigm shift in thinking about how the economy and policy actually work is required – and then the political leadership to bring about well-balanced and judicious solutions. One way or another, the bill for accumulated debts will have to be met. If we do not marry the approaches of Keynes and Hayek, the bill will be paid by Greek taxi drivers and German taxpayers – in a fashion that would not only be profoundly unsatisfactory but also highly disorderly. I hope that this is not the path we end up taking.

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