The Monetary Realist

Central Banking Dermatologists

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Until the recent financial disturbance, much of the drama associated with central banking had turned to boredom. For the last fifteen years, forward-looking monetary policy oriented toward price stability had delivered low and stable inflation—and interest rates and growth responded well to this environment. Academics held an ever larger share of high positions at central banks, and policies globally were increasingly coming right out of the same few textbooks, not out of swashbuckling personas. Monetary policymakers might not yet have become as boring and useful as dentists, as Keynes famously hoped they would, but they sure seemed closer in recent years to dermatologists, monitoring at appointed intervals for the occasionally needed quick outpatient procedure, than ER surgeons, awash in testosterone, blood, and critical cases.

The current disturbance is overblown, and impersonal boredom will shortly return to central banking.

With the hubbub of the current financial panic, however, everyone's attention has returned to central banks and to the specific individuals leading them. The market buzz is that the European Central Bank's Jean-Claude Trichet is gaining fans through his decisive action, while the Federal Reserve's Ben Bernanke is eschewing activism—contrary to stereotypes and to the two institutions' own self-proclaimed orientations. Alan Greenspan's return to the headlines with his ridiculously serendipitous book release served to underscore the apparent importance of individual central bankers' qualities. A lot of Monday-morning quarterbacking has ensued, with the usual thick-necked traders blaming their more recent speculative losses on the academic predilections of the same sort of pencil-necked geeks who ruined the curve for them in Econ 101.

Yet, even in the current situation, there still is less difference between individual central bankers than meets the eye. Any seeming distinction between Trichet's and Bernanke's—and even Mervyn King's and Toshihiko Fukui's—responses to recent events arose largely from the local financial structures and economic forecasts each of them faced, not from differences in personal style or ideology:

- All of them have separated measures providing financial liquidity to the core banking system from interest rate decisions for the broader economy in both their actions and their communications.
- All of them are in the end ready to inject liquidity aggressively and discount a wider range of assets in order to bring down spreads in the overnight and commercial paper markets.
- All of them have based their policies on assessments of whether their respective financial systems would amplify or dampen transmission of a financial shock to the real economy.
- And all of them ultimately had to take into account the asymmetric risks of generating a persistent economic slowdown if they were too slow to act.

The current so-called crisis if anything reinforces the convergence of approaches among central bankers in the major economies, and the fact that they would and do behave in much the same way when presented with the same challenges.

A recent study I completed with Kenneth Kuttner of Oberlin College shows that while financial markets do react to surprise information about the appointments of new central bank leaders, the size of shifts in market expectations are generally quite small. We also showed that almost all central bankers in advanced countries seem to be driving for similar inflation goals at about the same rate (see figure). If markets with their money at stake trade as though they largely do not care whom the central bank governor is, even when uncertainty about their intents is greatest, and if various governors deliver largely the same inflation results, there probably is little to distinguish between them in practice. Our results are also consistent with an earlier body of research which establishes that, with rare self-destructive exceptions, all modern central banks follow pretty much the same policy rules when reacting to economic news and shocks.

Those pundits engaged recently in "I told you so's" about American real estate or exchange rate bubbles would

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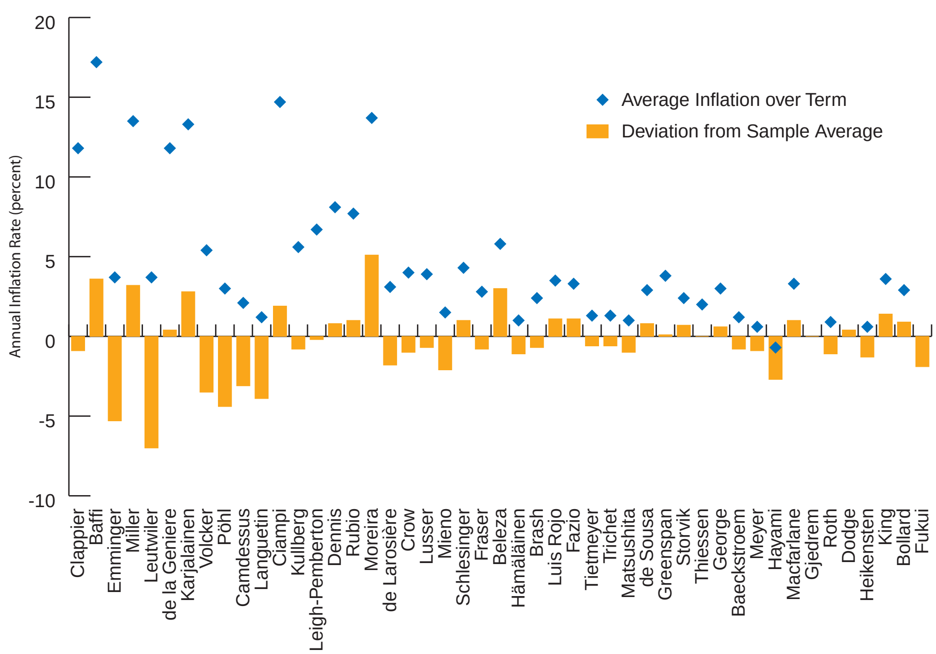
The Global Drive for Similar Inflation Goals



claim that this very sameness and intellectualization of central banking is precisely the problem: the narrow Bernanke-led syllabus for monetary policy willfully disregards the risks of instability from asset price bubbles in favor of academic principle. Supposedly, following the textbook sows future inflation and bubbles when central banks react to severe financial problems with ease. So these pundits claim that abstract group think by central bankers has ignored the main issue. There are, however, three problems with this claim.

First, it's untrue. While bubbles cannot arise when there is no liquidity provided, there is no correlation between variations over a broad range in monetary policy ease and the movements of asset prices, the likelihood of bubbles, or when bubbles burst. Despite the many efforts of the hand-wringing crowd to generate other results, all of the evidence is that structural changes in financial markets and in investors' risk aversion, not central banks' provision of liquidity, are what drive sustained asset price movements. You need water to grow roses, but rain alone does not produce a rose garden. Same with liquidity.

Second, it misses the point. The academic-influenced central bankers are the ones who are focused on the real world tradeoffs here: what it would take in terms of tightening to "pop" a bubble, what that would cost in terms of real economic losses, and how the impact of asset price busts on the real economy depends upon the financial system's capitalization and supervision. Those who want central banks to set monetary policy on the basis of preventing or preempting bubbles have no good examples for their side, while history is littered with examples (the United States in the 1930s, Japan in the 1990s) proving the textbook view of the dangers of using monetary policy to "get the rot out."

Third, it exaggerates today's problems. For all the "re-pricing of risk" and probably salutary cutbacks in mortgage lending in the United States, it is far from certain that there will be a significant or prolonged downturn in the U.S. economy as a result. In fact, given the proper textbook response of the Fed, this is increasingly unlikely. When the U.S. economy is back to trend growth by the second half of 2008, and inflation is still contained, what will the hand-wringing crowd be able to claim then? That another bubble in something else is coming and the problem just got put off? Keeping the major economies' growth and inflation rates stable for decades at a time cannot keep being characterized as a danger, let alone a policy failure, if no terrible things ever eventuate.

So the textbook approach to monetary policy predominates over central bankers' differing personalities, and generally seems to work. Even though "set it and forget it" strict monetary rules cannot function in the real world, central banking can follow the research-based recipes passed down from Blinder to Bernanke, Issing to Trichet, with pretty good success. The current disturbance is overblown, and impersonal boredom will shortly return to central banking. Monetary policy's new drama will come in the next few years from the interaction of globalization and politics, which the textbook approach does not cover. But for now, let us enjoy the benefits of de-personalized central banking, even if it makes for fewer celebrities among monetary economists. ◆