Challenges for central banks

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October 2020

Outline: Challenges for central banks (with strategy reviews in mind)

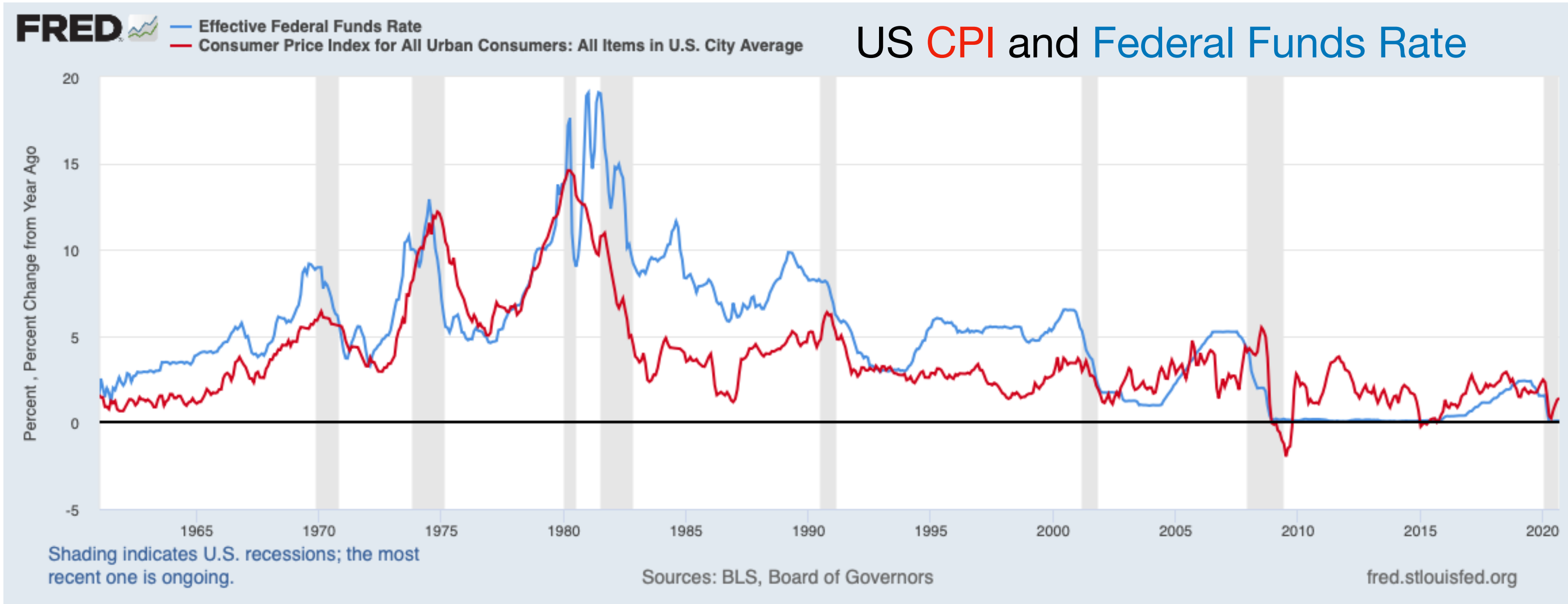
1. Interest rates and inflation, monetary policy framework.
2. Financial stability.
3. Dealing with the aftermath of Covid interventions.
4. Preparing for future risks.

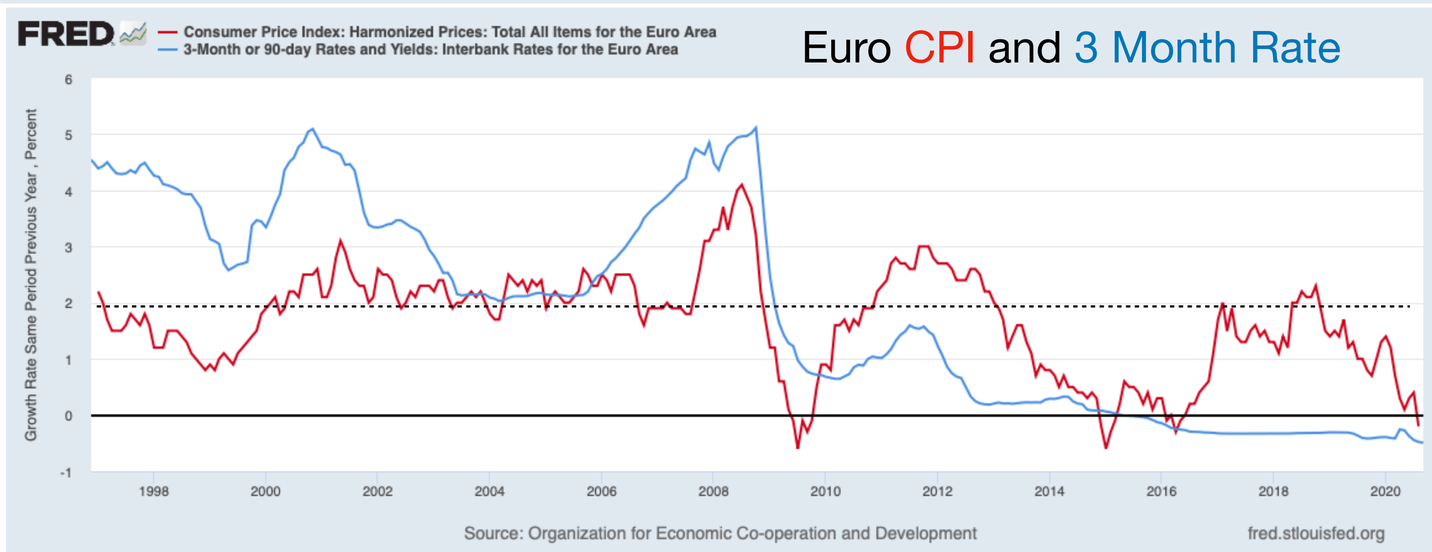
Written background

- The New Keynesian Liquidity Trap
- Michelson-Morley, Fisher, and Occam…
- Stepping on a Rake: The Fiscal Theory of Monetary Policy
- Towards a Run-free Financial System
- A New Structure For U. S. Federal Debt
- *Strategic Review and Beyond: Rethinking Monetary Policy and Independence (especially)*
- The Fiscal Roots of Inflation
- A Fiscal Theory of Monetary Policy with Partially Repaid Long-Term Debt
- The Grumpy Economist
- all at johnhcochrane.com

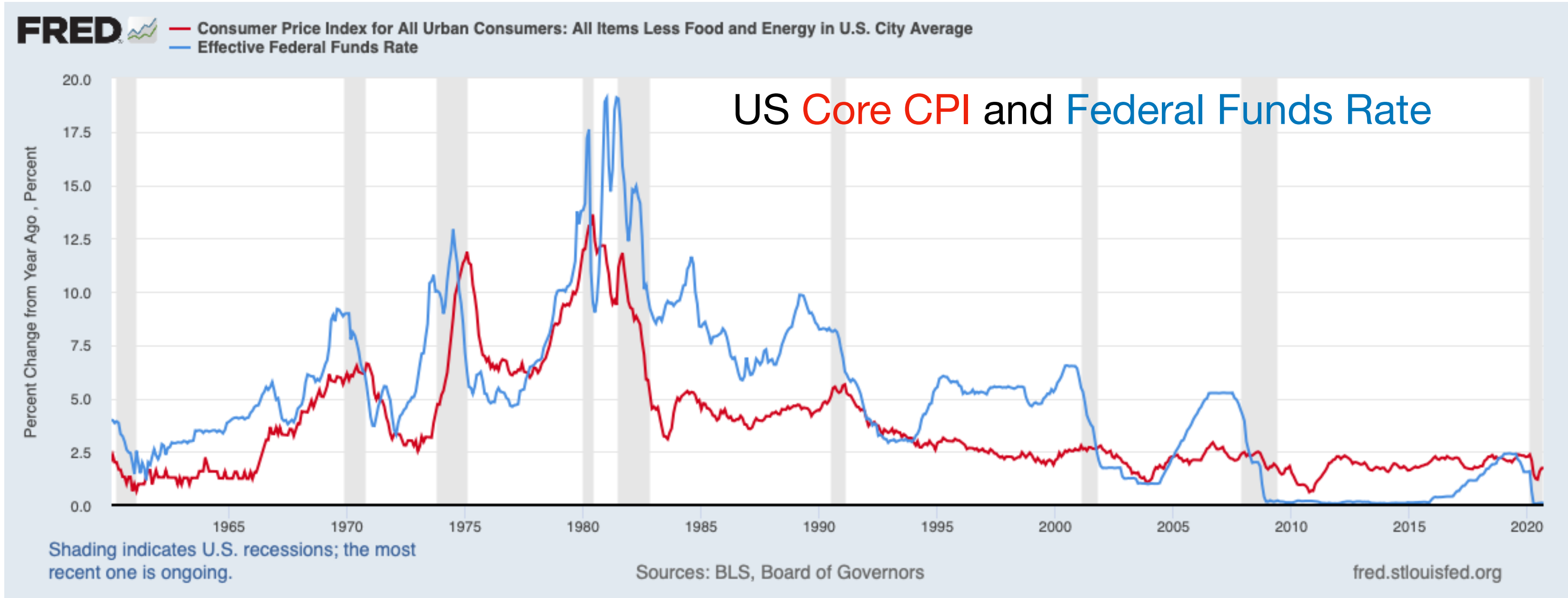
Challenge 1: Inflation and interest rates.

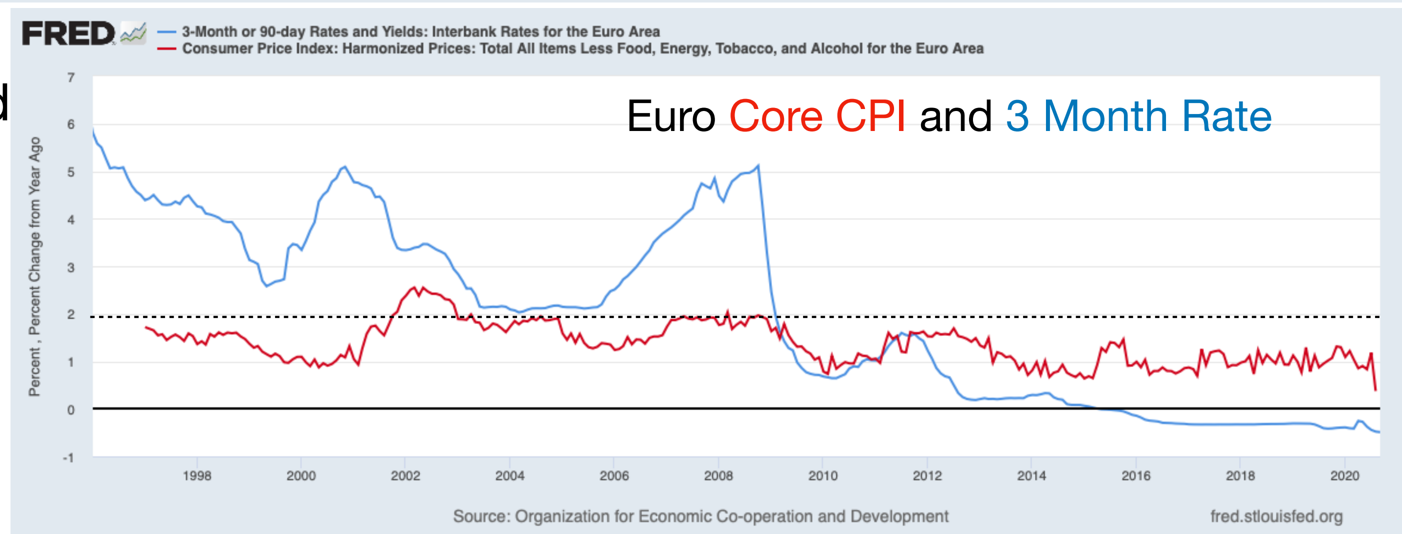
- The single most basic task and (hopefully) core competence of central banks.





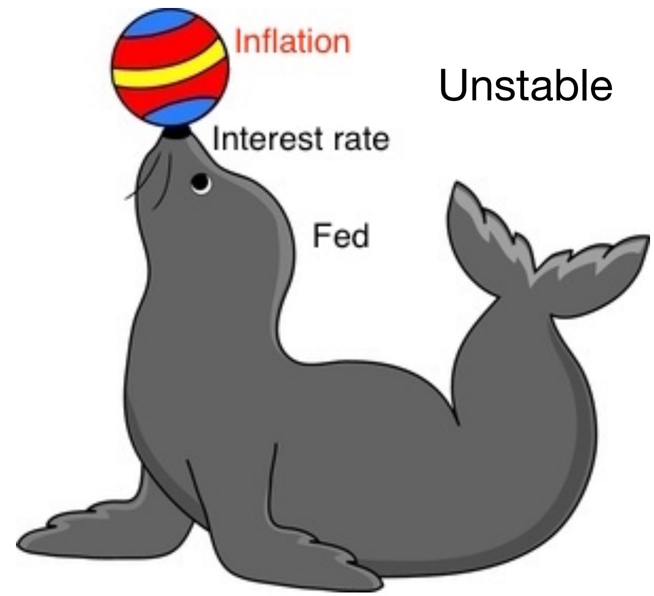
- Failure to make target.
- (Really a problem?)
- Postive correlation.
- Recent history?



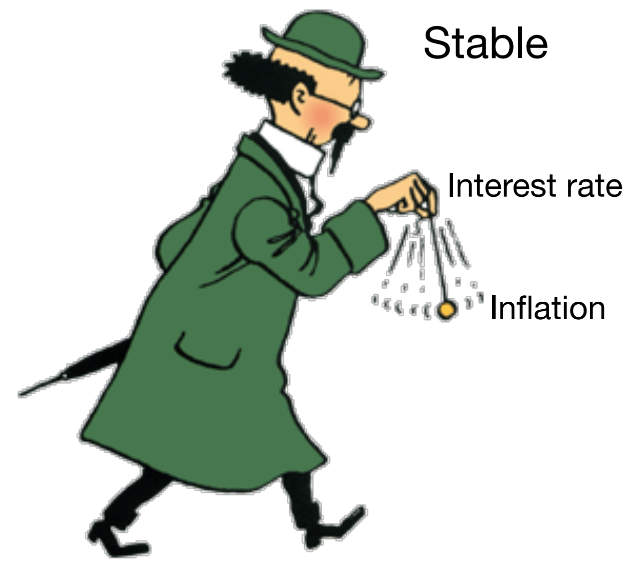


- Core inflation (Less Food and Energy)
- Inflation stuck at 1% (EU) - 2% (US)
- Despite ELB, massive QE and many speeches.

How does it work anyway?



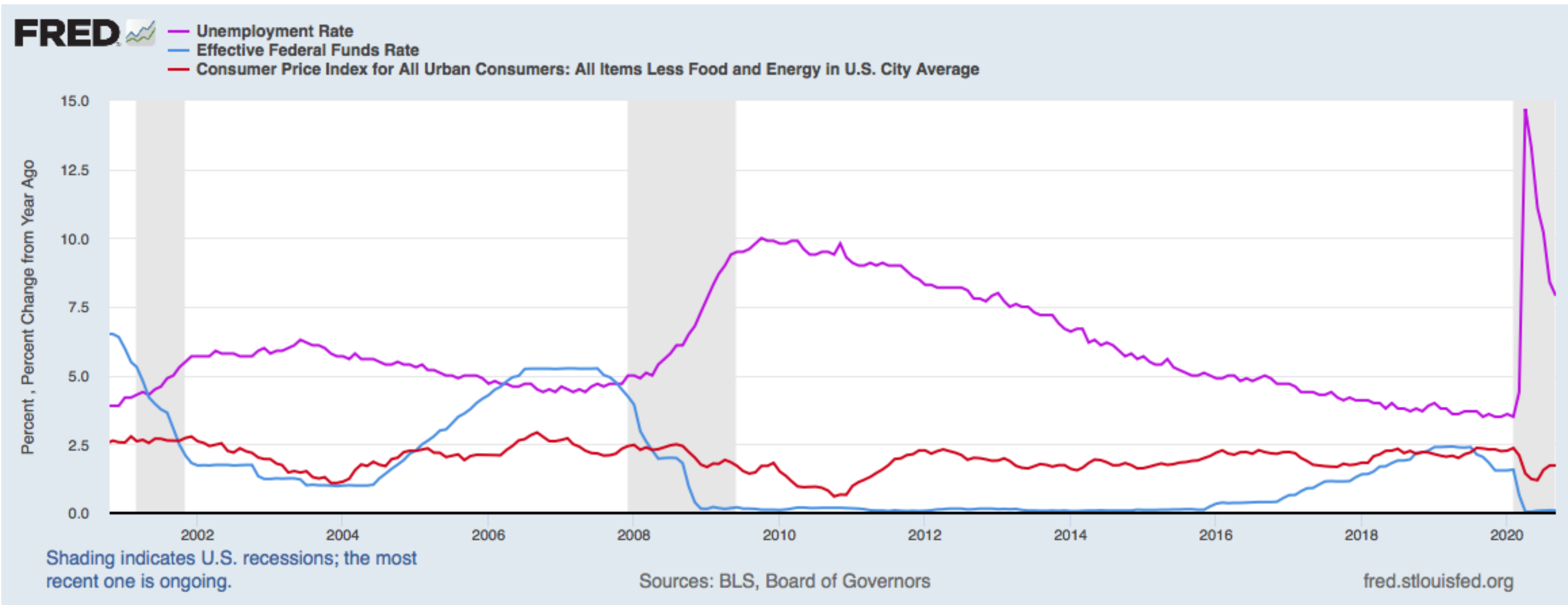
- Amazing stability of inflation at the ELB. A crucial experiment.
- $i = r + \pi$ is a steady state, i and π move together in the data.
- Is $i = r + \pi$
  - Unstable? (ISLM, adaptive expectations models. Predict a deflation spiral at ELB.)
  - Stable/indeterminate? (New-Keynesian, rational expectations models. Predict a big deflation, then sunspot volatility at ELB)
  - Stable/determinate? (New-Keyensian with active fiscal models. Predicts stable quiet inflation at ELB)
  - (~~MV=PY~~)
- Implication of facts and theories:
- *A widely anticipated, steady, persistent rise in interest rates **raises** inflation. (Accompanied by stable fiscal policy)*
- Do we really know this is false? What Bayesian probability should a policy maker put on this possibility?
- Shouldn't a central bank be devoting immense research to this central question?
- Beyond the interest rate target? Index-non-indexed spread?



Challenge 2: Strategic reviews.

US strategic review. Policy bottom line:

- Regret over raising rate when unemployment decided. (?)
- A pure inflation target, but "flexible" not a rule. Allow some inflation before moving (1970s?).
- Allow more inflation for "inclusive" employment. 1963 era static Phillips curve?
- No doubt over ISLM + verbal expectations framework — sign of the effect!

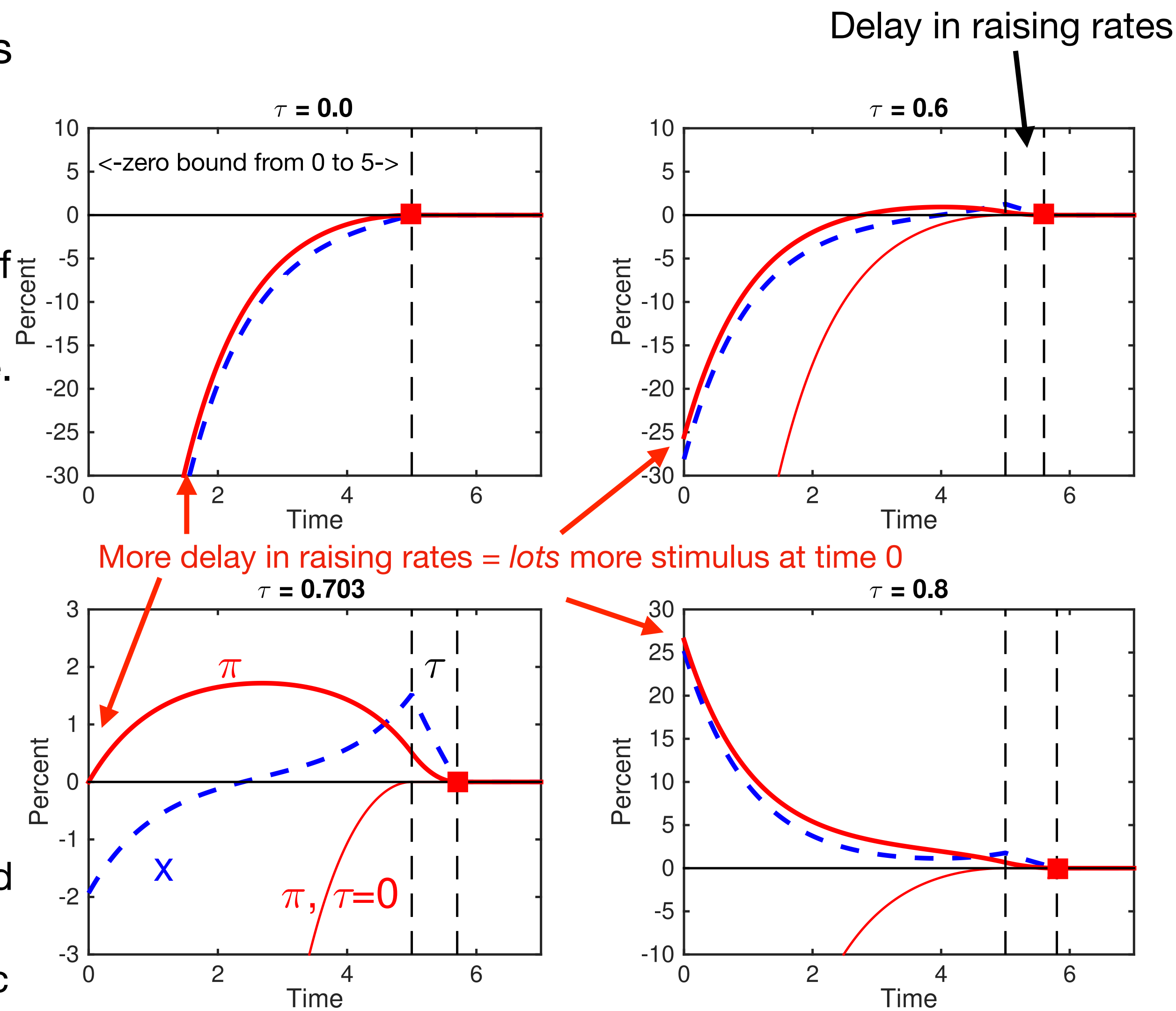


US strategic review-Academic lessons

- Victory of forward guidance over QE, negative rates for “stimulus.”
- Victory of discretion over rules.
- Forward guidance is a strange prediction of standard NK model:

1. Stronger for promises further in the future.
2. Stronger for more flexible prices, with infinite limit, zero limit point.
3. Regarded as a puzzle to be fixed.
4. Time consistency. Does anyone believe a central banker will do ex post what does not look best at that time, to fulfill forward guidance promises made years ago?

- FG not powerful in standard ISLM
- Is the best source of stimulus really more speeches by central bankers, accompanied by no action?
- Academia vs. policy disconnect in strategic review



Source: “The New Keynesian Liquidity Trap”

Challenge 3: Financial regulation post 2008

Choice:

☐ "Financial crises are everywhere and always caused by problems related to short-term debt." -Doug Diamond. Purge short-term run-prone financing.

☑ Monitor & regulate all asset risk taking. Prop up asset prices in crisis. Bailout creditors. "Macro-prudential", diagnose and deflate "bubbles." Stem (somehow) resultant moral hazard.

Euro: Can sovereigns default? If not, who pays and how to stop obvious moral hazard? Unresolved. (Us state and local may follow!)
ECB: "Do what it takes" await structural reform. Now what?

Challenge 4: Financial regulation post covid

- US: Massive intervention. Once again, lots of debt.
- Treasury markets. Money market funds. Corporate bonds. State and local government bonds. Airlines!
- Will Federal government bail out states? Student loans?
- Why save? Why keep cash to provide liquidity, buy assets, fund operations? Why not borrow like crazy, invest in risky debt?
- Nobody is even asking about moral hazard.
- Private profit, government losses, the Powell Put forever?

Challenge 5: Risks

What big unforseen risks could cause financial calamity? How to prepare the financial system? The covid lesson — it can happen!

Financial risks (results of the next big shock)
- Credit risks for central bank portfolios
- Sovereign risks (Italy, US states)
- US, advanced sovereign risk. (An utter calamity)
- Central Banks?
  - Swap risks to Treasuries
  - Encourage long-maturity sovereign debt! CB's first job (1694!).
  - Don't make matters worse! Fixed rate financing.

Events (sources of the next big shock)
- A real pandemic — 20% death rate. Bioterror? Crop pandemic.
- War. China? Russia? Middle east? Nuclear?
- Cyber. ATMs dark. Rumor that Citi is hacked.
- Political unraveling. US constitutional crisis.
- EU breakup.

- In this context, ECB, BoE, BIS, IMF examine 1 and only one risk….

Challenge 6. Climate, Mission creep and Politicization risk

- Disclaimer: Climate change is real and is important. Question: central bank role?
- Proposals (Schnabl 2020*)
  1. "…as prudential supervisor, … protect the safety and soundness of the banking sector. This includes making sure that banks properly assess the risks from carbon-intensive exposures…"
  2. "linking the eligibility of securities as collateral in our refinancing operations to the disclosure regime of the issuing firms."
  3. "reassessing the benchmark allocation of our private asset purchase programmes. In the presence of market failures,…the market by itself is not achieving efficient outcomes."

- These tear to shreds institutional limitations and mandates.
- Interpretation. Central bank is mandated only for inflation and financial stability:
  a) We looked evenhandedly at all the risks to the financial system, like those listed on the last slide, and the most important financial risk we came up with is climate.
  b) We want to get involved with climate policy. How can we shoehorn that desire into our mandate?
- This will end badly.
- To embark on this sort of policy, obtain explicit mandate from properly elected authority.
- To stay independent, trusted, and effective, central banks must be competent, narrow, and boring.

*https://www.ecb.europa.eu/pub/conferences/html/20201019_conferenceonmonetarypolicy.en.html

A deflation spiral under adaptive expectations ISLM