FROM THE
FOUNDER

Mission Impossible

Lately it seems the industrialized world's central bankers are like the actors in the movie *Mission Impossible*. Officials are being unfairly asked to do the miraculous in covering up for governments' lack of fiscal and regulatory common sense. Central bank balance sheets, quantitative easing, and zero interest rates have become the new policy tools of choice to try to fix the global economy. The mission may be impossible.

The purpose of these new monetary tools is to try to keep long-term interest rates low. The economy's "animal spirits" will then ignite and increase domestic demand. Picture the Whac-a-Mole carnival game. The participants (the central bankers) wield large wooden mallets and smash down (through government bond purchases) on the heads of artificial moles (bond traders in short government bond positions) who continuously pop up out of the holes in a flat playing surface. The central bankers' message to the moles: "Betting on higher interest rates could be dangerous to your financial health."

Yet this great monetary hammering and record low rates sadly have failed to reverse the stagnation in wage and salary income. Global demand has actually sunk during this period of striking monetary policy creativity. The global economy has hit stall speed. Public debt keeps expanding.

One reason for disappointment is that government borrowing has been accompanied by a lack of private borrowing. People and companies instead are engaged in the tough job of paying down debt. With the monetary lending function not working, central bankers' last hope is that quantitative easing rallies equity markets, creating a wealth effect that spurs demand. Yet any wealth effect by definition will focus on more affluent consumers, and at this point how many toasters, automobiles, and flat-screen televisions can Mark Zuckerberg buy?

Central banks must do more, critics demand. But as John Berry argues in this issue (p. 8), it is not clear the central bankers have effective enough tools. Bernard Connolly suggests (p. 12) that the world has become "dynamically inefficient" as real interest rates are lower than the expected real trend growth. Expectations of future demand are overly optimistic. Economist Ronald McKinnon adds (p. 16) that zero interest rate policies have destroyed the financial intermediation process, and make escape from today's liquidity trap impossible.

It is not just that quantitative easing may be losing effectiveness; it is that the potential side effect costs are rising. In 2008, the benefits may have outweighed the costs, but today the costs and benefits are evenly matched—and arguably the costs of quantitative easing may now exceed the benefits.

So there is no monetary free lunch—just at best a tiny *hors d'œuvre*.

And as a result of these new stimulus efforts, the landscape for investment in government bonds may have been fundamentally altered. Yields are influenced less by economic fundamentals than by anticipation of central bank buying.

That's a problem. Global financial anxiety is no longer fully reflected in long-term government bond yields. Instead, markets often reflect the future through the stock market value of banks, which are retrenching. In the United States, for example, bank stock volatility has been surprisingly high for an economy in recovery. Some of this volatility may relate to the euro-

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Watching central bankers at work of late, it is not hard to picture the Whac-a-Mole carnival game.

zone crisis and the realization that the U.S. Congress will never again agree to another big bank bailout. Yet this volatility may also be reflecting nervousness about today's massive central bank balance sheet expansion, growing public debt, and ill-conceived regulatory environment.

There's also the fear of the potential final stop on this monetary journey. Could central bankers become the primary purchasers of all public debt? Sounds absurd, but this was the U.S. policy during and after World War II. Some who today argue for trillions more in fiscal stimulus suggest, if need be, a return to this policy. Yet it is tough to manage credit without regulating the price of credit, which is a slippery slope to a system of credit rationing. Such a Washington, D.C.-based system would almost certainly be politicized. The too-big-to-fail banks are already becoming the instruments of policy. America's banking system is looking increasingly like the Japanese and European systems with governments having a significant say in internal operations.

Central bankers are being asked to promise more than they can deliver.

The more immediate concern is that central bankers are being asked to promise more than they can deliver. They risk becoming the global economy's new fall guy. Central bank independence is a unique and rare commodity, and to a certain extent that train has left the station. The more the central banks have veered into fiscal policy, the more governments have demanded a voice.

Clearly central banks are vulnerable. Between 2003 and 2012, for example, the Federal Reserve's popularity in public opinion polls dropped 23 percentage points (meanwhile public support for institutions such as the FBI and the IRS remained unchanged).

And remember the so-called "Greenspan put," which used monetary policy to establish a stock market floor that led to financial bubbles? Big-time political pressure is on to establish a permanent "Bernanke put."

As a result of the eurozone crisis, European Central Bank President Mario Draghi and German Chancellor Angela Merkel have been forced to work closely as a unified team. They are said to talk daily. This is no doubt necessary but is nonetheless highly unusual for an independent central banker.

For central bankers in the months ahead, therefore, the stakes are enormous. That's why policymakers would be smart to pause now and reflect, and ask if indeed the mission is impossible.

—DAVID M. SMICK
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