

Dieter Wermuth

Wermuth Asset Management GmbH

60329 Frankfurt am Main, Mainzer Landstrasse 47
Phone -49-69-95 92 54 78 , Fax -49-69-95 92 54 79
E-mail: dwermuth@wermutham.com

In spite of appearances, central banking has not become a boring job

September 29, 2006

1. This week in Frankfurt I attended a presentation by Adam Posen of the Institute of International Economics (IIE) in Washington. He is an expert on monetary policy and sometimes serves as an adviser to central banks. His main thesis was that we are now in **a new era of central banking which began some time between 1998 and 2001**. It is characterized by a near-vertical Phillips curve, de facto inflation targeting in the most important countries, with 2% as the generally accepted benchmark, and a new key variable, the long bond interest rate reflecting inflation expectations.
2. He has detected a general “ennui” of policy makers toward central banks because economics does not determine election outcomes the way it used to. Since there is **no sense any more that we live in a difficult world as far as macro management is concerned – all major goals have been achieved, and presumably for good** -, the research agenda of future policy makers will correspondingly be restricted to uncontroversial issues, issues that make it hard to believe that we have actually a new monetary paradigm. I disagree strongly with the view that central banks will be less important from here on. Let me point out the main future challenges that monetary policy makers are likely to face – and should do research on.
3. At first glance, one could be of the opinion that the central bankers of the US, Europe and Japan have indeed done their jobs well and may now be permitted to withdraw from the limelight. **Central banking could finally become as boring as dentistry**: efficient, reliable, predictable, professional and independent. Inflation is low, inflation expectations – even more important – are low as well and stable, the main exchange rates adjust in an orderly fashion, even the yuan has finally begun to appreciate which gradually removes one potential source of instability in the world’s financial system, and the banking industry, including Japan’s, is believed to be in robust health.
4. Moreover, for quite some time now, the world’s real GDP has been growing at rates of no less than 4 to 5%, helped to some extent by the benign environment created by monetary policies. **High growth rates and low inflation have finally arrived**. This is of course a considerable achievement, but central bankers will nonetheless not be able to relax, certainly not for too long, or go about their jobs as routinely as dentists do.

5. For one, **their achievements are partly owed to the rapid increase of the international division of labor and the addition of hundreds of millions of poorly-paid workers to the global labor force.** Large emerging countries and regions such as China, India, Eastern Europe and South-East Asia have become important and aggressive participants in trade and capital flows. This supply shock keeps global wage inflation in check and thus one of the main drivers of inflation.
6. So there has been an element of good luck in the seemingly **secular reduction of inflation. In other words, not all of the reduction can be attributed to the performance of central bankers.** I suspect that Messrs. Trichet, Bernanke and Fukui do not really understand why inflation is as low as it is. It cannot be money supply because very different rates of growth of the aggregates have yielded very similar inflation results. Wages of workers exposed to international competition offer a much more plausible explanation – but this is an explanation that does not need monetary policy as an explanatory variable.
7. **Secondly, long periods of calm and stability promote risk taking among market participants.** The catch-word in this context is the “Greenspan put”. The term refers to the observation that the US central bank has given markets the implicit guarantee that serious recessions will not be permitted. Policy makers will interfere early on by cutting interest rates and providing liquidity. Moreover, the buyers of the put - households, business - do not have to pay for the option to sell their assets at a reasonable price. This is obviously a wonderful thing. Why worry about the downside? The question for central bank researchers would then be whether it is an optimizing strategy to avoid recessions at almost all cost, or whether they play a useful role after all?
8. Related to this is the phenomenon that the **volatility of both inflation and economic growth has steadily fallen.** Market participants can be forgiven to conclude that this will continue because it looks like a well-established long-term trend by now. The new stability has resulted in a considerable reduction of risk premia which are reflected in relatively high price-to-earnings ratios on stock markets and a dramatic decline of yield spreads of all classes of bonds over AAA government bonds. Does macro stability together with benign policies lead to excessive risk taking, asset bubbles, their punctuation, followed possibly by deflation? Japan’s 15 lost years after the bubbles of the eighties loom large.
9. It is a safe bet that **leverage, ie borrowing to purchase real and financial assets, is rather high by now.** The lower the perceived risk the greater the incentive to boost returns in this way, especially if the yield on the underlying assets is as low as it is. Booming volumes in derivatives markets and ever more sophisticated financial products where the precise identification of risk profiles is near-impossible, such as credit default swaps, are also a sign of the times. Do policy makers really know the extent of leverage out there? Central bankers need to know.
10. Monetary policy makers are struggling to understand what they should be doing in case something awful happens. What will be the likely reactions of the banking sector, or the economy in general? **The rise of largely unregulated and opaque hedge funds and private equity funds makes it increasingly difficult to know who holds which risks.** Is this a house of cards, and what could bring it down? Central bankers cannot take this lightly, as the Bank for International Settlements in Basel continues to point out.

11. **Another development that does not yet, but might soon, keep central bankers awake at night again is exchange rates.** Emerging countries such as China, India, Russia or Saudi Arabia continue to intervene in FX markets in order to prevent their currencies from appreciating – which they would, considering these countries' balance on current account surpluses and the inflow of private capital that hopes to profit from the likelihood of high returns associated with catching-up processes. At some point policy makers in these countries will wonder why they continue to accumulate dollars and euros which yield 3 to 5% whereas money invested in their own economies could easily earn something in the order of 10%, i.e. in the neighborhood of the growth rate of productivity. Isn't this a wrong allocation and thus a waste of resources? Why should a poor country export capital to the rich world, beyond the amount needed as a cushion that protects it against a speculative attack on its currency?
12. These intervention policies boost domestic liquidity which in turn drives up asset prices and thus creates a source of future instability. **So it is only a matter of time before reserve accumulation will end.** What will happen then is anybody's guess. When capital imports dry up in the countries that issue reserve currencies, the US in particular, but also in the euro area, their currencies depreciate while interest rates will rise and overpriced assets lose value. This can be a benign process, but the probability of a violent correction of relative prices and a recession is not negligible. For the emerging markets the consequences can also be severe as their export prices rise while the demand for their exports declines. One key task for central bankers is therefore to use stress scenarios to prepare themselves for various possible outcomes.
13. **The main concern going forward will therefore be issues of financial stability,** as opposed to price stability. Looking after the health of the financial system is actually the original task of central bankers – once inflation has been brought under control, or even before that. This is the reason the ECB, the Bank of England or the IMF have begun to publish stability reports on a regular basis. These have a different emphasis than the traditional monthly or quarterly reports which focus on money supply, inflation and the real economy. The new key topics are risks, imbalances, the soundness of the banking system, and asset prices.
14. **Seems to me that life for central bankers is becoming more interesting, not less. The focus shifts while the sum of the problems that need to be addressed will not change much.**
15. Does the discussion above have any **implications for participants in financial markets?** One obvious message is that leverage is risky in markets which are clearly not in equilibrium. This includes a number of national housing markets as well as low grade bonds and credit. The dollar looks overvalued while the yen is strangely undervalued. This will change. The euro is somewhere in the middle. The main emerging market currencies are, in turn, less exposed to runs on them than in the past thanks to the vast currency reserves they have accumulated - the mirror image of America's huge capital imports. Investors should also stay away from overly complicated products where the distribution of risk among participants is not clear. These are usually profitable for brokers and investment banks, but may offer less protection than had been bargained for. The rule must be to keep it simple and avoid too many transactions.

