Game over for Central Banks?

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"Fortunately, there is nothing predestined about what will come after the exhaustion of the new normal. The road out of the upcoming "T junction" can still be influenced in a consequential manner by the choices we make, as households, companies, and governments. But to make better choices, we need to understand the forces at play and their likely evolution. There is no better way of doing so than through an examination of the world's central banks...past, present, and future." -- Mohamed A El-Erian, "The Only Game in Town"

Monetary economics is gasping for breath. The usual links between the money supply, inflation and GDP seem tenuous after the Great Financial Crisis. The world's central banks -- whose job it is to orchestrate the first two links in order to maintain growth and economic stability -- have slowed to a crawl and in some cases are walking backwards. They might be "The Only Game in Town" the title of a new book by Mohamed El-Erian, but the rules are changing.

Irving Fisher, the father of monetarism, earned Yale's first PhD in economics. A mathematician, his academic advisors were a physicist and a sociologist. Despite his many contributions to economics, he became discredited after predicting that the stock market would remain at its "high plateau" days before the 1929 Crash. Eclipsed during his lifetime by John Maynard Keynes, and having lost his personal fortune as well as his reputation, Fisher tried to explain the cause of the Depression in terms of debt deflation. Building on Fisher's theory, Ben Bernanke, the former Federal Reserve Chairman, utilized his knowledge of this era to rapidly expand liquidity in order to help avoid a full-on Depression on his watch.

2008 is already eight years ago, and despite massive unprecedented intervention by central banks, worldwide growth is still sluggish and has not recovered to its pre-crisis levels. Beyond theory, there is practice, and the real economy. As Yogi Berra once opined, "In theory there is no difference between practice and theory. In practice, there is." That is why is so refreshing to read a book about economic theory written by a knowledgeable practitioner. El-Erian is the former CEO and co-chief investment officer of PIMCO, who dealt first hand (and very successfully) with financial markets as an investor.

El-Erian also coined the phrase that has come to describe the situation we find ourselves in-- "the New Normal". Given recent market jitters, the question on most investors' minds is, is this going to last? Or are we still living in a prolonged free fall that began in 2007, but because of the coordination and intervention by central banks, we just haven't hit bottom yet? El-Erian quotes Larry Summers "The world has largely exhausted the scope for central bank improvisation as a growth strategy." What he envisions is a new new normal- of instability and sustained bimodal decision making.

El-Erian's belief is that although a highly negative outcome could be ahead of us, nothing is foreordained. Much could depend on good policy choices by Janet Yellen, Haruyuki Kuroda, Zhou Xiaochuan and other central bankers, trying to get their arms around a new world order, as well as politicians brave enough to create fiscal stimulus in spite of demands for austerity. What makes El-Erian's book stand apart is that he knows the policymakers, and in fact is himself an active participant and respected voice in the ongoing debate. When he writes about the governor of the Banque de France Christian Noyer's central banking conference in 2014, which sparked discussion of the new role of central banks, the liveliness of El-Erian's description is based on the fact that he was there. His insider status infuses the narrative.

One of the book's chapter's focuses on communications, and the opacity of the central banking decision making process. This has been a popular topic in the media recently, and has been used to level criticism against many central banks, from the Federal Reserve to the People's Bank of China. I would like to take El-Erian's discussion to another level. The real issue is not communications, but the fact that the decisions of central banks are made by a very small, elite number of individuals. Communications is the cloak used to cover the real problem: the vagaries of small group decision making.

There is an entire literature about the foibles of small group decision making, which must be seen against a backdrop of increasing calls for democratization globally. The central banks represent the old guard to much of the population, and this is reflected in the US Congress. Chairman Janet Yellen's recent testimony was characterized by belligerence and ignorance of basic economic principles on the part of the questioners. But these politicians are simply reflecting their constituency, who post-crisis are not seeing the gains in terms of an increase in wages or standard of living that the big bankers on Wall Street, in spite of their errors, seem to enjoy. The irony of this of course, is Yellen's stalwart support of employment and labor gains, and her lack of concern about what Wall Street thinks about the Fed's actions.

The reality is that central banks cannot create growth; they can only create the necessary but insufficient conditions that will enable economic expansion. In an environment of fiscal austerity, even hyper-low interest rates that allow government debt to accumulate nearly cost-free will fail to ignite the economy. In his blogpost, The Strong Case Against Independent Central Banks Simon Wren-Lewis, professor of economic policy at Oxford explains why recently central banks have been hamstrung and ineffective, forced to dig deeper and deeper to find new policy tools:

Economists knew that the government could always get the economy out of a demand deficient recession, even if it had a short term concern about debt. The fail safe tool to do this was a money financed fiscal expansion. This fiscal stimulus paid for by the creation of money was why the Great Depression could never happen again. But the existence of ICBs (Independent Central Banks) made money

financed fiscal expansions impossible when you had debt obsessed governments, because neither the government nor the central bank could create money for governments to spend or give away. Central banks were happy to create money, but refused to destroy the government debt they bought with it, and so debt obsessed governments embarked on fiscal consolidation in the middle of a huge recession.

The slow and painful recovery from the Great Recession was the result. Economists did not get the economics wrong. Money financed fiscal expansion does get you out of a recession with no immediate increase in debt. But by encouraging the creation of ICBs, economists had helped create both the obsession with austerity and an institutional arrangement that made a recession busting policy impossible to enact.

So if Congress and other branches of the government refuse to play their fiscal parts to aid in an economic recovery, who are the other players? Back to the big banks, back to Too Big To Fail. The Federal Reserve can make liquidity available but it cannot lend to end users, and in fact, through stress testing and reserve requirements, seems to encourage restraint. Moreover, the Fed cannot ensure that lending decisions are being made to support the best new ideas that will grow the economy. It cannot directly create jobs or businesses or growth-oriented policy reforms.

Most economists would agree that the Great Financial Crisis was not really an economic crisis, but a failure of regulation of the banking and investment industry. El-Erian worries that reforms have been slow and inadequate, that risk is now shifting to the non-banking sector. Just as happened previously, the regulators will not be able to outpace financial innovators. Now, the Federal Reserve itself has begun to discuss a break up of the big banks to spur reform.

Simon Johnson, the former chief economist at the IMF and now at MIT, says the foundation of the financial system is changing:

After nearly a decade of crisis, bailout, and reform in the United States and the European Union, the financial system - both in those countries and globally - is remarkably similar to the one we had in 2006. Many financial reforms have been attempted since 2010, but the overall effects have been limited. Some big banks have struggled, but others have risen to take their place. Both before the 2008 global financial crisis and today, just over a dozen big banks dominate the world's financial landscape. And yet the ground is shifting beneath the financial sector, and big banks could soon become a thing of the past.

Few officials privately express satisfaction with the progress of financial reform. In public, most of them are more polite, but the president of the Federal Reserve Bank of Minneapolis, Neel Kashkari, struck a chord recently when he called for a reevaluation of how much progress has been made on addressing the problem of financial institutions that are "too big to fail" (TBTF).

El-Erian brings up innovations such as crowdfunding, in the context of regulatory risks. But what about disruptive technology and negative externalities that could change everything? These are multiplying. Backroom technologies could disrupt banking as we know it. According to Mile Gault, the founder and CEO of Guardtime:

The financial world has finally started to move beyond the bitcoin hype, as some of the world's biggest banks begin to research blockchain applications. The country of Estonia, which secures much of its banking infrastructure with a blockchain, boasts the lowest rate of credit card fraud in the euro zone. And startups like Bitreserve are enabling completely free online-money transactions, without the volatility and risk associated with bitcoin. July 5, 2015

El-Erian engagingly discusses P2P (Peer to Peer) lending, in which he is an investor, but again, he worries about lagging regulation if the banks are disintermediated. There might be no solution to this issue. Regulation has always lagged behind innovation, or regulators would themselves be innovators.

He presents ten issues that concern him most, beginning with an absence of effective growth models in the advanced economies and widespread political dysfunction. These are in reality one and the same and are caused by a lack of leadership. And naturally, political issues and economic growth are both confounded by increasing income inequality.

This book was completed in early 2015, and at least two of the ten issues he lists seem quite prescient, and have now in fact arrived: extreme stock market volatility ending the new normal, and low energy prices. Both have arrived with a vengeance for the precisely the reasons he has put forward. Unemployment misses the mark, at least in the US. One issue in particular however, was concerning but has not yet come to pass. El-Erian predicts "Post market paradigm shift liquidity problems are to be expected based on current diminished broker dealer structural capacity." He says that broker dealer capacity to handle rapid shifts in portfolios is actually smaller than pre-2008, and could lead to a massive liquidity bottleneck.

A range of proposals and initiatives are presented to solve these issues, the most compelling of which involves orderly debt and debt service reduction or DDSR. Influenced by his time at the IMF during the Latin American debt crisis, El-Erian is quite convincing as an advocate for debt forgiveness as a way to spur growth, rather than maintenance of unsustainable debt overhangs in the name of austerity.

Returning to his thesis on the effectiveness of central banks, El-Erian is quite sober:

No one should doubt if they remain 'the only game in town,' there is a real chance that they will go from being part of the solution to being part of the problem...There isn't much central banks can do to improve countries' growth engines. These institutions have neither the expertise nor the mandate to pursue reforms in education and labor markets. They are not in a position to lead national and

regional infrastructure drives. They simply do not have the power to influence fiscal reforms, let alone impose them.

"The Only Game in Town" presents the woof and warp of the post-crisis global financial system in its full complexity, as only someone with El-Erian's range of experience as a theorist, public servant, and private investor possibly could. He seems in no danger of making Irving Fisher's mistake of forecasting a continuation of a "high plateau" but neither does he think that a negative outcome is inevitable.