Perspectives

2nd quarter 2023

Central banks: returning to core tasks

IHAG PRIVATBANK

A much-needed return to normality

Dear investor

“No alcohol is no solution”. In the eponymous song by the German band Die Toten Hosen, the protagonist tries to justify his alcohol addiction. As with all dependencies, he is very aware of the problem but is neither willing nor able to fight the addiction. Only even greater problems might sufficiently ratchet up the pressure to act.

Over the last few years, a number of economies have been in a similar situation to our protagonist. Monetary policy essentially became the “sweet poison” of economic support, and gradually a certain dependency took hold.

The financial crisis of 2008 marked a paradigm shift in monetary policy. While keeping inflation under control remained a core task of central banks, inflation was almost non-existent in the years that followed 2008. Thus monetary policy increasingly became another tool to deliver economic stimulus – with a number of extremely creative manifestations that were accompanied by intellectual justifications. Concerns over government indebtedness and even possible national bankruptcy were suddenly brushed aside, as monetary policy was always relied upon to fix things. And even if inflation were to become problematic again, it could swiftly be dealt with through fiscal policy almost as an aside. Proponents of Modern Monetary Theory (MMT) probably feel rather uncomfortable looking back on these statements and predictions.

How did this shift in mentality come about? How did this dependency arise, and why did things go so well for so long? What withdrawal symptoms should we expect now that the emphatic return of inflation has led central banks to refocus on their true function?

These are the questions we are keen to explore in this issue of Perspectives. Given that monetary policy is now essentially normalising before our very eyes, the question arises as to what this means for the future development of the economy and financial markets.

Just as the situation in recent years may have been economically gratifying, the current development of monetary policy will look like a return to health in the long term. Or as Homer Simpson liked to say in his ambiguous way: “To alcohol – the cause of and the solution to all of life’s problems!”

We wish you an enjoyable read.

Christoph Boner
Chief Investment Officer

The role of central banks over the ages

As the guardians of monetary policy, central banks have a key role to play in the economic system. By managing the money supply, they ensure that the value of money remains stable. This is above all because both inflation and deflation can have a very negative impact on the economic development and prosperity of a country.

Whereas central banks played a passive role in the era of fixed exchange rates, as was the case in large parts of the world after the Second World War, the flexibilisation of exchange rates raised awareness that monetary policy could also be used to shape economic developments – whereas from the 1930s onward this had first and foremost been the role of fiscal and state expenditure policy. Suddenly a new instrument to control the economy had appeared.

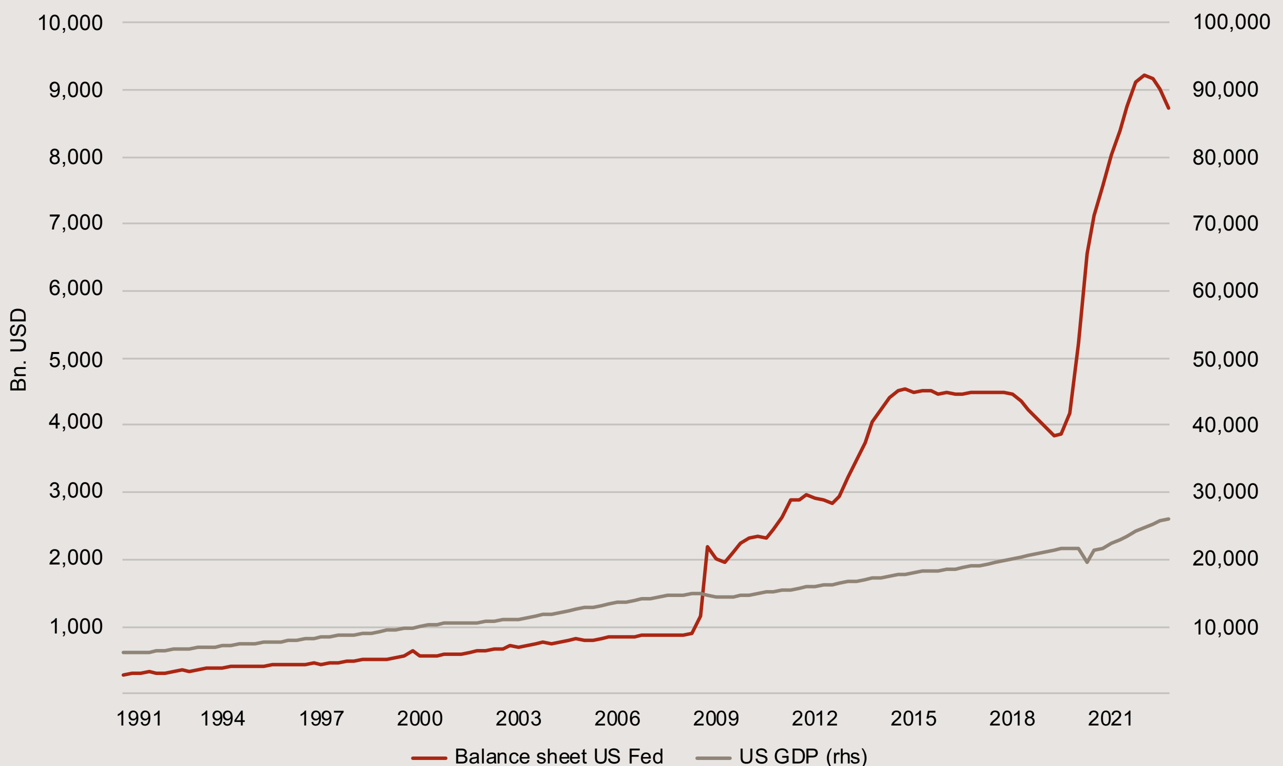
Accordingly, central banks and the policy they pursued gained greater significance, even if the objective of maintaining monetary stability remained the core task. Indeed, the wider new possibilities led to the introduction of a dual mandate for central banks such as the US Federal Reserve (Fed): in addition to preserving the purchasing power of the USD, the Fed was also tasked with taking economic developments into consideration and providing support whenever the need arose.

Although such an economic objective could logically only play second fiddle to the core mandate, this new aspect of central bank policy nonetheless took centre stage when the financial crisis of 2008 broke. Based on the realisation that supporting the financial system above all meant providing

plentiful and ongoing liquidity, countless billions were pumped into the economic system by the central banks.

This paradigm shift in monetary policy becomes starkly apparent when one looks at the development of the Fed's balance sheet. Whereas the Fed's total assets had been the equivalent of just a few percentage points of economic output for many years, thus growing in proportion to the size of the economy, the mushrooming of the money supply to combat the financial crisis ripped up this statistical pattern. At its peak, the size of the Fed's balance sheet corresponded to almost 40% of the entire country's economic output.

The measures introduced by central banks in 2008 were crucial in stabilising the financial system. As expected, they also had the effect of propping up the economy and bringing about an economic recovery – without triggering any surge of inflation, despite expectations to the contrary. The sweet poison of central bank liquidity had taken hold.



But it would only be true to talk about an absence of inflation insofar as consumer prices did not immediately start to rise – and these are typically the focus of central banks when they make decisions. By contrast, the prices of investment goods, with equity and real estate being good examples, exhibited a sharp and in some cases an inflationary increase in the years following the financial crisis. The reasons often cited for the prolonged absence of consumer goods inflation are the counter-balancing effects of increasing internationalisation and digitalisation, along with modest or even declining energy prices for a long period of time.

In 2022, that situation was suddenly turned on its head. A combination of supply and demand distortions following the Covid restrictions along with much higher energy prices caused inflation to rise sharply in the area of consumer goods too. This brought central banks back to the harsh ground of reality along with advocats of a new theory of controlling the money supply that was basically preaching the irrelevance of government debt due to the possibilities of central banks printing as much money as they wanted. Monetary policy has since refocused on the actual task of securing monetary stability – and with a vengeance. Interest rates are being raised drastically and central bank balance sheets are being gradually redimensioned.

5.70%

The average proportion of US economic output (GDP) accounted for by the Fed's balance sheet in the 1990s and the first years of the millennium up until the financial crisis of 2008.

USD 9,203 bn

The size of the Fed's balance sheet at its peak in March 2022. This equates to 37% of US GDP.

A normalisation of monetary policy must be the objective

The flexibilisation of exchange rates opened up new possibilities for the monetary policy of central banks. But the fundamental task of securing price stability has not changed as a result. This makes it all the more important, indeed critical, that central banks are shielded as much as possible from political influence so that they can make decisions autonomously.

Despite all the hullabaloo to the contrary, the core function of central banks therefore remains unchanged. The primary role of managing the economy must be the fiscal and expenditure policy of the state – with anti-cyclical intervention being the key. At times of economic downturn, the economy should be propped up by tax relief measures and state investment programmes; when an economy is starting to overheat, the state should act as a contractionary demand force and raise taxes where necessary.

The apparent absence of inflation in recent years, despite extremely expansionary monetary policy, painted a seductive picture. Current developments make it crystal clear that simple and fundamental economic rules – a disproportionate increase in the supply of money means inflation – have not suddenly lost their validity.

Given this background, we should be welcoming a normalisation of monetary policy and an even more consistent focus on the development of prices – including those of investments as well as consumer goods. It is clear that this process can be painful, and that not all economic subjects are equipped to handle the kind of sharp rises in interest rates that we are currently experiencing. The problems we have been seeing recently make this abundantly clear – even if it should be noted that bankruptcy rates have been unnaturally low in recent years and a certain amount of catching-up was inevitable.

The challenges faced by central banks are enormous, and the past has shown that the guardians of monetary policy have often failed to get it right. Specifically, a hawkish stance has often been maintained for too long, inevitably resulting in a hard landing. But let's be clear: there is no other option, and the normalisation of monetary policy is the right road to fixing the economy in the medium and long term.

The process will not unfold without inflicting economic pain. But ultimately this pathway is both sensible and necessary.

Economic fluctuations are unavoidable. Using monetary policy as a tool to avoid them is neither sensible nor expedient.

Securing price stability remains
a challenge for central banks.

Christoph Boner
Chief Investment Officer

What is a central bank, and how does it differ from a commercial bank?
A central bank is the most important financial institution in a currency zone. In this context, a currency is understood to mean the legal means of payment of a country (or of a currency union). Thus central banks – unlike commercial banks – are state institutions.

The main task of central banks is to manage the money supply, and their core objective is to ensure price stability. Put simply, prices are deemed to be stable if the money supply is in sync with the size of the economy. To achieve this objective, a central bank has to manage the money supply, its most important instrument being the so-called "key" or "reference" interest rate.

As profit-oriented private economic entities, commercial banks can invest money with the central bank at this rate of interest, or indeed withdraw it. If the key rate is languishing at a low level, commercial banks are more likely to withdraw money and use it for other purposes – such as lending to customers. This has the effect of expanding the money supply – and to a disproportionate extent, as for every unit of currency withdrawn from the central bank a commercial bank can lend out many more francs in loans. If a central bank raises its key rate, the demand for loans tends to decline and the money supply shrinks accordingly.

Why is managing the money supply so challenging?
While the key interest rate is the most important instrument for managing the money supply, it is also a very blunt and imprecise one. On the one hand there is a double adaptation effect at play: Firstly, it is not clear how commercial banks will adjust their behaviour to a change in the key rate; secondly, there is a time lag in the change in behaviour of all economic subjects. To some extent central banks are therefore permanently "flying blind", i.e. having to make their decisions based on a wide range of indicators without being able to observe the effect of their actions directly.

Other factors influencing developments are structural changes in the circulation of money and the money creation of the commercial banks. With increasing digitalisation and the corresponding payment methods, the existing money circulates around the system more quickly. In addition, the emergence of parallel currencies and the growing existence of a para-banking system also influence money circulation.

Central banks actually have tools other than the key interest rate at their disposal: particularly since the financial and euro crises, they have repeatedly resorted to new mechanisms for controlling the money supply, the yield curve and money creation.

Why is it so crucial for central banks to be independent?
Central bank independence is understood to mean a situation in which these institutions are detached from the remaining apparatus of state to the greatest extent possible – and, in particular, from the influence of political decision-makers. Since central banks can have a significant influence on the development of the economy via their control of the money supply, they should be set up in such a way that removes them from political influence: while a ruling government will have an obvious interest in an economy functioning well, this will often be a short-term goal – they may have no need to worry about possible negative medium-term consequences such as inflation and misallocations. Another reason why a central bank should remain independent is to prevent budget discipline from lapsing "Why not simply pay off debts with newly printed money?". The same principle applies here too: the negative repercussions might not manifest themselves immediately, but hugely negative consequences would result in the medium term.

To what extent has central bank policy changed over the years?
When the curtain came down on the Bretton-Woods currency era at the beginning of the 1970s, central banks assumed a fundamentally new function. As the previous system envisaged a combination of fixed and flexible exchange rates, central banks were above all preoccupied by managing their exchange rate. But the transition to flexible exchange rates rendered the task of managing exchange rates redundant, and the focus switched firmly to the preservation of purchasing power and the need to combat deflationary tendencies.

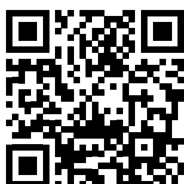
These key functions remain crucial. And yet with the onset of the 2008 financial crisis at the latest, another key function was expected of central banks in their role of constantly ensuring sufficient liquidity in the financial system. Over the years that followed, central banks increasingly began tackling crises by pumping liquidity into the economy, which at least in some cases saw them going well beyond their core mandate. Following the sudden resurgence of inflation in various currency regions over the last year, the true mandate of central banks – securing price stability – has returned to the fore.

Privatbank IHAG Zürich AG
Bleicherweg 18
P.O. Box
8022 Zurich

Tel. +41 44 205 11 11

info@pbihag.ch
pbihag.ch

PDF download



Disclaimer: This document has been produced for the recipient for promotional and information purposes only, and is not intended to be passed on to third parties. It does not constitute any offer, any invitation to provide an offer, or any recommendation, and makes no claim to completeness or correctness. In particular, this document does not constitute investment advice, does not take any of the recipient's personal circumstances into account, and does not contain any investment, legal or tax advice. On no account should investment decisions be made solely on the basis of this document. Your client advisor will be pleased to assist if you have any questions, and especially if you would like to see specific information materials such as any prospectuses and key investor information documents. The statements contained in this document are based on current assumptions and expectations that are beyond the influence of Privatbank IHAG Zürich AG (the 'Bank'), and are therefore subject to considerable uncertainty. Actual events and facts in the future may therefore differ significantly (both positively and negatively) from the assumptions and expectations set out here. The Bank does not assume any obligation, neither does it intend to update any forward-looking information given in this document, and it will not correct such information should events develop other than expected. The sources on which this document is based are generally regarded as reliable, but the Bank does not accept any liability or responsibility for the selection of such sources. Similarly, no liability or responsibility is accepted for the content of this document. This document is aimed primarily at persons domiciled in Switzerland, and not at persons domiciled abroad. Specifically, this document is in no way addressed to US, Canadian or British citizens or natural persons or legal entities resident or domiciled in the United States, Canada or the United Kingdom, or to persons subject to restrictions with regard to the information contained in this document (owing to their nationality or place of residence, for example).