Panel Remarks on

"The Only Game in Town: Are Central Banks Expected to Do Too Much?"

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Governor Kyaw Kyaw Maung, Govenor Zeti, and Fellow Governors

The title of this panel "**The Only Game in Town: Are Central Banks Expected to Do Too Much?**" is suggestive that too much is expected of central banks today and I concur with that. Central banks themselves are partly responsible for building those expectations because they have either neglected or deliberately chosen to push the limits of monetary policy. Either way, I would argue that the outcome of prolonged overburdened monetary policy is counterproductive. "A man's gotta know his limitations". Today I would like to talk about those monetary policy limits.

At its core, the challenges of central banking can be broken down into **three elements: the operational, the functional, and the political.** Operational refers to the ability to effectively implement a prescribed policy course; functional refers to the effectiveness of the monetary policy transmission mechanism to the economy; and political refers to the legitimacy of the central bank. Today, the limits of monetary policy are being felt on all three dimensions.

In terms of the operational, the most obvious and much discussed limit is the **zero lower bound**. But as central banks have increasingly turned to balance sheet policies such as QE and asset purchases, operational limits are dictated by the **size and liquidity of the relevant market segments**. For example, the ECB's bond buying program has run into problems stemming from the limited availability of eligible bonds that could be purchased. Similarly, with the Bank of Japan holding almost 40 percent of government bond outstanding, concerns have been raised about financial institutions running out of JGBs to sell. More broadly, with any attempt to target an asset price, be it the exchange rate or long-term bond yields, the central bank needs to stand ready to **potentially buy and sell the relevant asset in unlimited quantities**, stretching its balance sheets and distorting the bond market. This practice will also create adverse impacts on long-term bond market development.

In terms of functional, powerful structural forces have **muted the responsiveness of inflation and output to monetary policy**. These include slowing world trade, the shift towards less capital intensive services, as well as headwinds from debt overhang and increased geo-political uncertainty. At the

global level, spillovers — both through the exchange rate as well as international credit conditions — from successive easing may lead to outcomes that are *collectively* suboptimal, implying a need for restraint. Finally, there are **limits to how much the economy and financial institutions** (especially banks, life insurance companies and pension funds) **can cope** with ever more radical easing measures such as negative interest rates. Many central banks also have mandate to preserve financial stability. By easing too much, central banks risk creating financial instability, compromising its core mandate, and creating potential backlash from society. These considerations represent a real constraint on how far central banks can go. This brings me to the third dimension, political limitations.

With regards to political, central banks don't operate in a vacuum and their **independence is always conditional** on continued perceived legitimacy and popular support, which should not be taken for granted. In this respect, extended easing could raise many potential flashpoints. Large central bank holding of securities, for example, could incur **significant losses** when interest rates normalize (central bank asset/GDP equals 90% for Japan and stand roughly at 30% for US, UK, and Euro zone). This could open central banks up to increased political pressure should they require recapitalization. Also, the *perception* that monetary ease hurts savers and retirees while boosting asset prices that benefit banks and wealthy asset holders could fuel **popular discontent** amidst rising income inequality.

Let me stress here that central banks **being the only game in town is not necessarily wrong**. In times of financial crises, it is precisely the function of central banks to step in and assume risks that no one else wants to hold. To go long when everyone wants to go short, to seek risk when everyone seeks safety, and to make markets when market makers don't. This lender of last resort function is as old as central banking itself.

But crises don't last forever. The underlying problem is the **failure to separate the crisis phase from the recovery phase**. We have been stuck in a crisis mentality for over 8 years. The extraordinary easing measures that were critical and appropriate to stem the financial crisis was not only maintained but actually expanded and intensified well into the recovery phase. **Just as painkillers can transform themselves from being needed medication to life-threatening addiction, so too can monetary stimulus transform from a savior of financial stability to a generator of financial fragility.** Granted, determining the point where the economy crosses from crisis to recovery is more art than science, but I think it can be said that we have crossed that point a long time ago.

So yes, central banks are expected to do too much. But that is partly because they have also *done* too much. Going forward, it is important to revisit our

frameworks and adjust them so that they allow us to take longer horizon views of our actions. Given its impact on long-term economic trajectories, I would suggest that paying **more consideration to the financial cycle** would go a long way towards this. The Bank for International Settlements has done much commendable work in this respect.

Let me end by noting that just as important as recognizing the limits of monetary policy is being aware of the **limits of our knowledge**. The vigorous pursuit of a given course of action with the best of intentions can sometimes produce unintended adverse outcomes. The events of the past few years have revealed **limits in economists' understanding of the economy and financial cycles**. Most recently, for example, Janet Yellen acknowledged in a speech at the Federal Reserve Bank of Boston that the Fed does not fully understand what determines inflation. Given that inflation is at the core of all that we do, that is startling. But she deserves to be commended for her forthrightness and it is a reminder that we should take a step back now and then to look at the big picture and question some of most basic assumptions underlying our monetary policy frameworks. With better understanding of the changing economic structure and long-term financial cycles, we will be in a better position to determine limits of monetary policy and whether central banks are expected to do too much or whether they have done too much.