"The ECB only makes things worse"

Professor Taylor, the global monetary policy is more expansionary than ever before and for a longer period of time than ever before. Haven't central bankers learnt the lessons from the global financial crisis?

It was absolutely right that during the crisis and especially in 2008 central banks acted as "lender of last resort" and that they cut interest rates. But I see the period afterwards as very critical, especially the period from 2010/2011 onwards with long lasting zero interest rates and even negative interest rates in some countries and very unconventional measures, to boost economic growth. This policy didn't work very well. But at the same time it carries enormous risks. Central banks should normalize their monetary policy as soon as possible and if that were the case policy would work better again.

Is the situation even worse than it was before 2008? In the years before the crisis the Federal Reserve held the interest rate low and raised the interest rate very slowly, 25 basis points each meeting, and a lot of people say that this caused excessive risk taking that led to the crisis. Today the Fed is even more hesitant.

It's different this time but both are bad. The policy back then was an important factor in causing the crisis that followed. Today it seems as if the search for yield is a little bit more complicated. We don't know exactly which markets are distorted, but some of them definitely are. The most important thing is: This kind of monetary policy is not very stimulating. It would be much better if other policy areas took over, especially structural policies. There is also another problem: This kind of monetary policy is very interventionist and it leads to ever more interventions. It is absolutely necessary that central banks get out of this intervention spiral.

Are central banks already sowing the seeds for the next financial crisis?

Yes, in some sense. Of course it is difficult to prove it. But they cause disruptions to financial markets and excessive risk-taking. This can end up in a crisis. But in any case they cause an enormous misallocation of resources in the economies.

Is the ultra-loose monetary policy in itself deflationary because misallocated resources finally lead to less growth and inflation and dampen the potential growth of an economy?

This kind of monetary policy is not stimulating and in part it is even a drag on the economy. At the moment it is not deflationary, but it may finally be the case if this monetary policy leads to a crisis or a collapse in growth. This is why it would be much better if central banks normalized their policies. We know from the past and from theory which kind of monetary policy works. The recent monetary policy does not. I'm sure that a gradual return to normality would help the entire world economy. There are also a lot of spillovers: Low interest rates in one region, let's say the Euro area, leads to low interest elsewhere. This is a dangerous development.

The Fed also is concerned with such spillovers, but the other way around. The Fed is afraid of adverse effects of interest rate hikes in the US, for example to emerging markets, and it uses this argument to justify its hesitance.

Rising interest rates in the US would certainly be welcomed around the world – and especially in Europe. A further normalization by the Fed would be beneficial to the entire world, even if there could be some adverse effects in the short term. What has done much damage globally in the past years has been the Fed's very unconventional policy. This monetary policy activism has heavily affected the emerging markets through capital inflows and outflows. It is absolutely right to take international aspects into consideration. But this is much more complicated than simply saying: "Let us delay the interest rate hikes." A central bank can always find excuses not to do what it should do. But it doesn't help anyone.

Is it also a problem that central bankers don't want to admit that they have made mistakes?

Almost everyone is reluctant to admit that something hasn't worked as expected. But sometimes you have to admit that and change your way. We are still discussing whether the low interest rates from 2003 until 2005 have been a reason for the financial crisis or not. Some central bankers still find it difficult to admit that.

When it comes to the Fed, is it still appropriate to speak about an interest rate normalization path – with one interest rate hike per year, if at all there will be a second hike this December after the first one in December 2015?
As I have said, there are frameworks for monetary policy that have worked very well for a long time. Central banks should gradually normalize their stance. The same is the case now.

But in general you would argue that it would be appropriate to rethink monetary policy?

It would not be appropriate to argue that central bankers must not reflect any more. But the most important thing to me is: There are frameworks that work. The problem was that central bankers deviated from these frameworks in the years before the crisis. They simply have to start again doing what these frameworks tell them.

You probably also allude to the Taylor rule, named after you, that stipulates how much a central bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions. In the years preceding the crisis the Fed kept the interest rates much lower than signaled by this rule. The same is the case now.

As I have said, there are frameworks for monetary policy that have worked very well for a long time. Central banks should gradually normalize their
unconventional monetary policy now and get back to these frameworks. This view is gaining traction. Outside the central banks people worry more and more about the negative side-effects of the most recent policy. I presume it will also go on inside the central banks.

By doing this unconventional monetary policy central banks have increasingly moved into the public focus and there is a lot of criticism – and already some doubts about the central bankers’ independence. Do you see a risk that the era of independent central banks will come to an end?

There is a definitely such a risk. But there are also encouraging signs in the US. The Congress is discussing legislation stating that the Fed has to explain its strategy clearly and that it has to explain if it deviates from traditional rules. In the end this could even strengthen the independence.

But you would still argue that the separation of monetary and fiscal policy is still right or is there a need for more cooperation? Some economists say the separation might have been the right concept when the goal was to dampen inflation, but that it might not be right concept when the goal is to increase inflation.

Cooperation means something different for everyone. A good central bank has a limited task and it should stick to that. Policymakers in other areas have their tasks and they should comply with them. This is also a form of cooperation: Everybody complies with its responsibility – not more. Fiscal policy and credit allocation is definitely not the task and the target of a central bank.

So the so-called “helicopter money”, meaning cash gifts to households, companies or the state, would be a step too far?

Helicopter money is not something that a responsible central bank should implement. Central banks have the task to control the money supply. That does not mean issuing fiscal policy with a blank cheque.

Some central bankers argue that there is a risk of a credibility crisis if they don’t act, as it was the case in the 1970s but with reversed sign: Back then people had no trust that central bankers were able to bring inflation down – nowadays nobody believes that they are able to get the inflation rate back to 2%. Is that a legitimate concern?

Of course I understand this concern. But central banks would definitely reach their targets earlier if they return to a more normal monetary policy – instead of taking ever more unconventional measures. It would be much better to explain that there are good reasons why inflation is below the targets. It definitely doesn’t help the central banks’ credibility if they desperately run after an inflation target using unconventional monetary policy without reaching it, and thereby create enormous risks, which in the medium- or longer-term can lead to the next crisis.

The interview was conducted by Mark Schrörs.