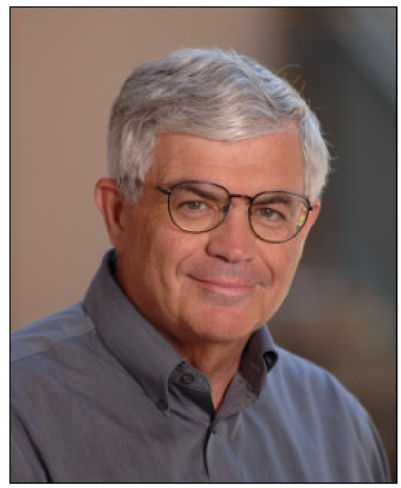
Interview with John Taylor, Mary and Robert Raymond Professor of Economics at Stanford University

"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 interventionist 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?

This is definitely much slower than it would be appropriate. And the Fed should have started increasing interest rates much earlier. But as I have said, there are always excuses for not doing something, for having concerns. Interestingly US central banker John Williams has recently said that the Fed is running out of excuses for zero interest rates.

Does your plea for normalization also include the European Central Bank (ECB) or does the situation in the Euro area justify the ECB's recent monetary policy stance?

The US is definitely the place everybody is focused on at the moment. If the Fed raises its interest rates it will become easier for other central banks to normalize their policy too. Who will be next? Is it the Bank of England, is it the Bank of Japan? Nobody knows exactly. The situation in the Euro area is of course exceptionally difficult, with these big economic divergences between the different countries. But also from within the ECB we hear more and more voices saying that they don't feel comfortable and are calling upon other policy areas for action. The problem is that with its current, very activist policy the ECB undermines the incentive for policymakers in other areas to do what is necessary – especially when it comes to structural policies. As long as the ECB sticks to this policy, there will be hardly any changes in other policies in the Euro area.

So the ECB's policy is even counterproductive? At the moment it seems as if the ECB at least will again extend its asset purchase program, the Quantitative Easing (QE).

The ECB has to make its point much stronger and it has to start normalizing its policy. Everybody has to understand that the ECB will not be able to do everything on its own and that their policy doesn't bring the expected success. The ECB only makes things worse if it does more QE and if it buys more assets. If that was the case other policymakers would lean back even more.

Is this a kind of "chicken game" between monetary policy and politics, in which central bankers always step in the breach first because they are concerned about growth and inflation?

Yes. Central bankers should stick to their task and do that in a more conventional way. If that was the case everybody else would understand and accept what their job is. But this process will not come if central banks expand their mandate more and more, as is the case at the moment. Buying mortgages as it is the case in the US, buying corporate bonds as it is the case in Europe, buying equities as it is the case in Japan – does help certain sectors but it is beyond what is the usual definition of what an independent central bank should do.

ECB board member Benoit Coeure recently has said in a speech that the central bank has to do more and more if other policy areas don't step in – because it has a mandate of 2% inflation. Not least because of such comments markets expect another extension of QE.

Just because the inflation rate is below its target doesn't mean that there is a need for zero or negative interest rates and a massive QE. It means that the monetary policy should be easier than would otherwise be the case - not more than that. Look at Japan: The Bank of Japan's own estimate is that the output gap is closed. But inflation is below 2%. This is why the central bank is doing all those things. But there is nothing wrong if an economy is growing and inflation is low. It would be better if the Bank of Japan would gradually normalize its policy.

But recently it has even piled the fire up and it now also wants to control the longer-term interest rates and keep it close to 0%. Does that show how desperate central bankers can become in their fight for more inflation?

The Bank of Japan has come to the conclusion that longer-term negative interest rates are counterproductive because they are a burden for financial institutions and pension funds. They think that negative short-term interest rates are less dangerous. I don't share this view.

And the Bank of Japan finally destroys the price discovery process, do you agree?

Yes, this is true. But this is an evil in all unconventional measures. Look at the ECB buying corporate bonds: Investors only focus on what the central bank is doing and they don't focus on the situation of a company, especially its credit worthiness. In Japan the situation is even worse with buying equities. And even in the US market interest rates are distorted by the former QE and Forward Guidance. These interest rates are set administratively. But we need to get back to a world in which interest rates are set by markets and not by central banks and governments.

Central banks justify their policies by saying that they have to avoid the risk of a deflationary spiral. The Bank for International Settlements (BIS), the central bank's central bank, considers this to be exaggerated. The BIS argues that with the exception of the 1930s there has never been such a downward spiral of prices, wages and growth. What is your view on that?

There is evidence that in modern history there has not been such a deflationary downward spiral. The Great Depression in the 1930s was completely different. Back then monetary policy was contractionary, money growth was declining. Today the situation is completely different. Even in Japan inflation has stabilized, even if it is slightly below zero.

US central banker Williams – you already mentioned his name – has recently attracted a lot of attention with a paper in which he called for a general rethink in monetary policy and for higher inflation targets than the wide-spread 2%. When the International Monetary Fund (IMF) back in 2010 called for increasing inflation targets from 2% to 4% there was enormous resistance from central bankers.

I think that there is still a lot of resistance among central bankers when it comes to such ideas. At the same time the recent inflation targets are not holy. Williams' assumption is that the real neutral interest rate…

… that means the rate that brings growth and inflation into the desired balance…

… has decreased significantly. Williams has influenced a lot of people with this idea. For example the Fed two years ago estimated the neutral rate to be slightly above 4%. Now it estimates the rate to be around 3%. Of course this changes its perspective and what it believes it has to do. But even if that assumption is right – and there are some reasons to have at least doubts about the concrete figure –the Fed is still far away from 3%. So it has to go a long way.

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 mustn't 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 foo 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.

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