Central Bank Less-Is-More Strategy Doubted as ECB Role Debated

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(Bloomberg) -- The time has come for central bankers to think about widening their focus, economists told monetary- policy makers gathering on the western edge of the euro area.

For more than two decades, the dominant reasoning has been that by concentrating mostly, or even exclusively, on keeping inflation in check, central banks can create the conditions for sustainable growth and lower unemployment. Since the financial crisis, the advantages of aiming just at price stability may be waning, and leading economists are calling for a rethink.

“The pendulum has swung much too far. While monetary policies are surely not determinative of output outcomes, they can, and in some cases had, have major effects on average levels of output over periods of decades,” Larry Summers, former chief economic adviser to U.S. President Barack Obama, said on Friday. “The failure to well integrate monetary policy-making with other areas of policy has had substantial pernicious effects.”

Summers was speaking on a panel at the European Central Bank’s second Forum on Central Banking in Sintra, Portugal, where he sat together with Bank of England Governor Mark Carney. The second day of the gathering of policy makers and academics was opened by ECB President Mario Draghi, who called on politicians to deliver on structural reforms or risk more frequent recourse to unconventional stimulus.

Draghi, Peers

The forum, which wraps up today, is an opportunity for Draghi and his peers, including most of the ECB’s Governing Council, as well as Federal Reserve Vice Chairman Stanley Fischer and Bank of Japan Governor Haruhiko Kuroda, to step back from the daily noise of policy discussions and look at the larger economic and financial issues. The theme for this year is “Inflation and unemployment in Europe.”

Since the start of the financial crisis in 2008, almost 6 million jobs have been lost in the euro area, according to ECB research. Structural unemployment is at about 10 percent and potential growth, which measures the rate of expansion at which inflation typically takes off, is below 1 percent, less than half than in the U.S. Inflation in the euro area was flat in April.

Most worrisome for policy makers, the effects of the crisis -- high unemployment and lower growth -- could prove more long- lasting than anticipated, having eroded the economy’s capacity to spring back to health once the bad times are over. The condition is known as “hysteresis” by economists.

No ‘Anchor’

“There is no ‘anchor’ that guarantees that unemployment will revert back to some ‘natural’ level,” Jordi Gali, a professor at Pompeu Fabra University in Barcelona, wrote in one of the papers presented at the conference. “Accordingly, in the absence of a forceful counter-cyclical policy, the economy may be stuck with an inefficiently low level of activity for a protracted period.”

At first look, this doesn’t directly affect the ECB’s mission, which is primarily to keep inflation just below 2 percent. Yet, in his speech, Draghi pointed out that the damage done to the economy by the region’s double recession, if left unrepaired by governments, will make it permanently more difficult for the ECB to fulfill its mandate.

“Low potential growth can have a direct impact on the tools available to monetary policy to deliver its mandate,” the ECB president said. “Structural reforms that reverse the downward drift in potential growth are now vital for the euro area, which is why I believe, as the guardian of the currency, we have a legitimate interest in talking about them.”

Inflation Level

About a quarter century ago, central banks started explicitly targeting an inflation level, usually set at around 2 percent. Simply choosing an explicit goal has helped ensure price stability by influencing so-called inflation expectations.

Paradoxically, this enhanced their credibility just as the economy was becoming less responsive to the stimuli coming from central banks, outgoing International Monetary Fund Chief Economist Olivier Blanchard, IMF senior economist Eugenio Cerutti and Summers wrote in a paper presented at the conference.

“The faith in the ability of central banks to achieve their target has increased, while the ability of central banks to actually achieve it has decreased,” they said. “The worry is a clear one, namely whether the faith will remain, and if it does not, what may happen to inflation and to monetary policy in the future.”

This is not a secondary matter for policy makers.

“For the next recession, we want to be ready with a monetary policy that works, not one that relies on prayer,” said Citigroup Inc. Chief Economist Willem Buiter, who is a former BOE policy maker.