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Can central banks control money in a borderless world of financial wizardry?

GLOBAL integration and innovation in financial markets, some people say, has blunted the effectiveness of monetary policy. They usually worry about two things: that governments may have lost the power to set interest rates because international capital flows can steamroller domestic monetary moves; and that changes in interest rates may now have much less effect on the economy, much later, than they used to.

These points tend to get muddled with two poorly understood rules about what monetary policy can or cannot do. The first is that when capital is free to move internationally, governments have to choose between an exchange-rate policy or an independent monetary policy; they cannot have both. With a fixed exchange rate, governments do indeed lose monetary control: domestic interest rates will need to move in line with those abroad. This explains why the loudest complaints about the loss of monetary sovereignty to financial markets have come from those European countries that have tried to peg exchange rates.

If international capital markets were perfectly integrated and exchange rates were fixed, then capital would shift until the cost of finance was the same in all countries. Domestic monetary policy would be powerless to affect real interest rates, and hence real economic activity. Floating exchange rates, however, allow governments to have an independent monetary policy. Even when capital is highly mobile, countries can still set domestic interest rates independently so long as they are prepared to forgo control of their exchange rate. Indeed, countries such as Britain which currently allow their exchange rates to float have more domestic monetary autonomy today than under the Bretton Woods system.

A second misunderstanding about monetary policy is the (by now rather antiquated) belief that there is a long-term trade-off between inflation and unemployment, and that monetary policy can be used, at the cost of a little more inflation, to make countries grow faster and so reduce unemployment. Anybody who still clings to that belief might well conclude from current high levels of unemployment that monetary policy is no longer effective in boosting jobs. But the truth is that it never was. A looser monetary policy can stimulate growth only for a short period; in the long term it will feed through into accelerating inflation. That is why many economists say that monetary policy must concentrate on price stability, because it provides the best environment for investment and growth.

Given these limitations on what monetary policy was ever able to do, is it true that financial globalisation and innovation have now made it less effective? The two questions raised by the worriers--whether central banks can still steer interest rates, and whether changes in interest rates can still affect output and inflation--are easy. The answers must be yes and yes. America's Federal Reserve or Germany's Bundesbank can clearly still set short-term interest rates, and central banks all over the world have recently demonstrated that they can still use high interest rates to cause a recession and squeeze inflation.

Even so, the job of central bankers has certainly become more difficult. Financial deregulation and innovation have made it harder to measure money. Financial liberalisation has changed the demand for money and so upset the traditional relationship between the money supply and inflation. As people shift their savings between different instruments, different measures of money send out different policy signals. For example, in 1993 the 11.6% growth in America's M1, its narrow measure of money, seemed to indicate that inflation was about to take off, while the modest 1.5% increase in M2 broad money seemed to signal an economic slowdown (see chart 4). In the face of such confusion, all the big economies except Germany have more or less given up on formal monetary targets. Central banks can therefore no longer set policy simply by their monetary compass; they now have to look at a wider range of economic and financial indicators, and exercise more judgment.

The cybercash express

Central banks' grip on money, however measured, also appears to be weakening. As deregulation has encouraged the growth of new financial institutions and instruments, the banking sector--traditionally the channel through which central banks have carried out their monetary policy--is shrinking. Thirty years ago banks provided three-quarters of all short- and medium-term business credit in America; now, thanks to the growth in secur-it-isation (allowing firms to raise money directly from the market), their share is barely half. Commercial banks' share in total financial assets has come down from more than half to only a quarter over the past 70 years (see chart 5).

This trend is likely to go much further. Some analysts point to the dangers of a cashless society of smart cards and electronic money (so-called E-cash) which moves through computer networks, bypassing the banks and hidden from the prying eyes of the central banks. Some have suggested that as E-cash becomes more widespread, central banks will lose all control over money and short-term interest rates. Yet the same worries were voiced when credit cards first came in, and central banks nevertheless remain firmly in the driving seat.

At first sight this poses a puzzle. As Benjamin Friedman, an economist at Harvard University, points out, America's Fed operates in a $ 7 trillion economy, with some $ 25 trillion of financial claims outstanding. How can it control interest rates when its open-market operations (ie, purchases or sales of securities) amount to only a few billion dollars in an entire year?

The answer is that the Fed exercises monopoly control over the creation of currency and the reserves which banks must hold. As a monopoly supplier of reserves, a central bank can affect the price of those reserves (ie, the rate at which banks lend them to one another) by changing their supply through open-market operations. In America, total bank reserves were only $ 61 billion at the end of 1994, so in relation to that it makes a big difference whether the Fed increases bank reserves by $ 1 billion or $ 10 billion in a year.

So long as banks need reserves and so long as central banks keep their monopoly, they will retain their control of short-term interest rates. If everybody switched from using conventional money to E-money, then in theory a central bank's monopoly could be undermined. But even if everybody used E-cash for their transactions, balances would still be settled through the banking system. Creditors would want to settle in something they can trust: the funds of central banks.

This is not to deny that the shrinking role of banks and a more elastic relationship between bank reserves and money make it harder for central banks to influence credit flows through their open-market operations. In America, for example, nobody knows how much further the banks' role needs to diminish before the Fed's monopoly over reserves becomes irrelevant. But for the moment, argues Charles Goodhart, an economist at the London School of Economics, central banks' traditional ability to control short-term interest rates is not seriously under threat.

Blunter tools

What about the idea that changes in financial markets have made the economy less responsive to interest-rate swings? Financial market deregulation has clearly altered the way monetary policy works. Before deregulation, governments could directly control the amount of bank lending through credit controls, and impose ceilings on deposit rates that made monetary policy much more precise than it is today. Take America's regulation Q (phased out by 1985), which imposed interest-rate ceilings on savings deposits. When the Fed lifted its interest rates above this ceiling, the flow of funds into savings and loan associations would quickly dry up, turning off the housing-finance tap and causing an instant drought in construction.

The elimination of interest-rate ceilings has made monetary policy a less exact business. Central banks now have to rely on changes in their interest rates alone to influence the level of demand in the economy. It may therefore take a bigger increase in rates to achieve a given impact on spending. On the other hand, the increasing openness of economies has made the exchange rate a more important channel for monetary policy. If a rise in interest rates pushes up the exchange rate, this will reinforce the effect of monetary policy, though the results can be somewhat unpredictable. The impact of interest rates on the economy may also have been blunted by the use of derivatives, such as futures, swaps and options (see chart 6). An estimated 85% of America's Fortune 500 companies make some use of derivatives to insulate themselves from swings in interest rates and currencies. The bulk of these contracts are on interest rates, and some say that as the use of de-rivat-ives continues to expand, changes in interest rates will have progressively less effect on the economy.

Of the myriad studies on the potential risks of derivatives, curiously few deal with the implications for monetary policy. The best one of those, published by the Bank for International Settlements (BIS) last year, considered what difference derivatives made to the impact of monetary policy on spending and inflation.

The use of derivatives can clearly reduce individual firms' sensitivity to changes in interest rates; but all it really does, says the BIS, is to redistribute interest-rate risk within the economy. Anybody wanting to shed the risk of changes in interest rates has to find a counterparty willing to bear it, so the economy as a whole cannot be sheltered. Furthermore, argues the BIS, although derivatives temporarily insulate existing loans from changes in interest rates, they do not change the marginal cost of borrowing (ie, market interest rates), which is the benchmark for all new investment decisions.

On the other hand, if the counterparties differ in the sensitivity of their spending to changes in interest rates, derivatives may affect the response of aggregate spending to such changes. For example, a risk-averse firm whose spending is highly sensitive to changes in interest rates would presumably be willing to pay a less risk-averse firm, whose spending is less sensitive, for bearing the risk of interest-rate movements. So the impact of any given change in interest rates on spending will be reduced for the period of the contract. However, nobody has yet established whether counter-parties differ sufficiently to cause noticeable effects.

The BIS concludes that derivatives may delay the economic impact of interest rates for the length of the contracts, but they cannot eliminate it. Borrowers cannot hedge forever, so eventually spending decisions will be affected by higher market interest rates. If necessary, says the BIS, interest rates may simply have to be changed by more than before to achieve the desired effect on output.

In short, derivatives may make monetary policy more difficult and its effects less predictable, but they will not stop it from working. Indeed, they provide central banks with important new indicators for gauging market sentiment. Because derivative markets are more liquid, they offer more information than cash markets. Futures markets provide useful insights into market expectations of future interest and exchange rates, and options markets reflect investors' views on uncertainty. For example, the Bank of England watches long gilt futures and short sterling futures for its day-to-day analysis of interest-rate expectations.

All in all, the effect of financial deregulation and innovation has been to make the impact of a change in interest rates on the economy less certain than it used to be, and to increase the scope for mistakes. But then monetary policy was never a simple matter of cause and effect: lags have always been variable, and often long (up to two years).

Central bankers in bondage

Even if monetary policy remains effective, governments may feel they have lost autonomy on another front: they are shackled by investors who hold their currency, in particular bond holders. Although central banks can set short-term interest rates, they can no longer control long-term rates. The effect of a change in monetary policy on bond yields depends on the market's assessment of its impact on the economy, adding to the unpredictability of it all. For example, if a central bank tries to loosen policy at a time when inflationary expectations are rising, its attempts will be partly neutralised by a rise in long-term rates. To some extent, therefore, central banks must conduct monetary policy by influencing expectations.

Broadly, long-term bond yields are made up of a real yield, expected inflation and a risk premium. If, for example, markets suspect that a government is pushing its luck with inflation, they will raise long bond yields. This has two effects. First, it amounts to an automatic tightening of policy. In America, Germany, Japan and France 60% or more of private-sector debt is linked to long-term interest rates. Second, it may put pressure on policy-makers to increase short-term interest rates sooner than they otherwise would.

The sharp rise in bond yields last year probably helped to slow America's economy earlier than the Fed's gradual tightening of short-term rates would have done by itself. Some argue that this amounts to a partial "privatisation" of monetary policy, leaving less power in the hands of central banks.

Some critics accuse central bankers of being obsessed with the bond market, bowing to its every demand. This, they claim, imposes a deflationary bias on monetary policy. Central bankers clearly need to pay attention to financial markets, partly because monetary policy works through asset prices, but also because bond markets convey information about future expectations and thus help the bankers decide whether policy is appropriate. But the claim that central banks follow the bond market blindly is wildly exaggerated. Take the Bank of England's quarterly Inflation Report. Of the 50 pages in its August 1995 issue, only five are devoted to financial markets, far less than to an analysis of the real economy, and costs and prices.

Over the past quarter-century, monetary policy has been said to have lost its teeth on many occasions. Yet central banks turn out to have quite a few fangs left, even though they may have to bite harder to leave an impression. The power of the bond market now makes it more difficult for monetary authorities to run inflationary policies. On the other hand, though, liberalised financial markets have boosted the power of central banks that are committed to fighting inflation--for example, by pushing up bond yields when they scent higher inflation. If monetary policy seems not to be doing its job, it may be because it is being undermined not by financial markets, but by lax fiscal policies. It cannot do everything by itself.

"The Role of Judgement and Discretion in the Conduct of Monetary Policy: Consequences of Changing Financial Markets", by B. Friedman, Federal Reserve Bank of Kansas City Symposium, 1993

"Financial Globalisation, Derivatives, Volatility and the Challenge for the Policies of Central Banks", by C. Goodhart, Financial Markets Group, London School of Economics

"Macroeconomic and Monetary Policy Issues Raised by the Growth of Derivatives Markets", BIS, Nov. 1994

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