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Do Central Banks Have an Exit Strategy?

by Kenneth Rogoff

SINGAPORE – A year into the global financial crisis, several key central banks remain extraordinarily exposed to their countries' shaky private financial sectors. So far, the strategy of maintaining banking systems on feeding tubes of taxpayer-guaranteed short-term credit has made sense. But eventually central banks must pull the plug. Otherwise they will end up in intensive care themselves as credit losses overwhelm their balance sheets.

The idea that the world's largest economies are merely facing a short-term panic looks increasingly strained. Instead, it is becoming apparent that, after a period of epic profits and growth, the financial industry now needs to undergo a period of consolidation and pruning. Weak banks must be allowed to fail or merge (with ordinary depositors being paid off by government insurance funds), so that strong banks can emerge with renewed vigor.

If this is the right diagnosis of the "financial crisis," then efforts to block a healthy and normal dynamic will ultimately only prolong and exacerbate the problem. Not allowing the necessary consolidation is weakening credit markets, not strengthening them.

The United States Federal Reserve, the European Central Bank, and the Bank of England are particularly exposed. Collectively, they have extended hundreds of billions of dollars in short-term loans to both traditional banks and complex, unregulated "investment banks." Many other central banks are nervously watching the situation, well aware that they may soon find themselves in the same position as the global economy continues to soften and default rates on all manner of debt continue to rise.

If central banks are faced with a massive hit to their balance sheets, it will not necessarily be the end of the world. It has happened before – for example, during the 1990's financial crises. But history suggests that fixing a central bank's balance sheet is never pleasant. Faced with credit losses, a central bank can either dig its way out through inflation or await recapitalization by taxpayers. Both solutions are extremely traumatic.

Raging inflation causes all kinds of distortions and inefficiencies. (And don't think central banks have ruled out the inflation tax. In fact, inflation has spiked during the past year, conveniently facilitating a necessary correction in the real price of houses.) Taxpayer bailouts, on the other hand, are seldom smooth and inevitably compromise central bank independence.

There is also a fairness issue. The financial sector has produced extraordinary profits, particularly in the Anglophone countries. And, while calculating the size of the financial sector is extremely difficult due to its opaqueness and complexity, official US statistics indicate that financial firms accounted for roughly one-third of American corporate profits in 2006. Multi-million dollar bonuses on Wall Street and in the City of London have become routine, and financial firms have dominated donor lists for all the major political candidates in the 2008 US presidential election.

Why, then, should ordinary taxpayers foot the bill to bail out the financial industry? Why not the auto and steel industries, or any of the other industries that have suffered downturns in recent years? This argument is all the more forceful if central banks turn to the "inflation tax," which falls disproportionately on the poor, who have less means to protect themselves from price increases that undermine the value of their savings.

British economist Willem Buiter has bluntly accused central banks and treasury officials of "regulatory capture" by the financial sector, particularly in the US. This is a strong charge, especially given the huge uncertainties that central banks and treasury officials have been facing. But if officials fail to adjust as the crisis unfolds, then Buiter's charge may seem less extreme.

So how do central banks dig their way out of this deep hole? The key is to sharpen the distinction between financial firms whose distress is truly panic driven (and therefore temporary), and problems that are more fundamental.

After a period of massive expansion during which the financial services sector nearly doubled in size, some retrenchment is natural and normal. The sub-prime mortgage loan problem triggered a drop in some financial institutions' key lines of business, particularly their opaque but extremely profitable derivatives businesses. Some shrinkage of the industry is inevitable. Central banks have to start fostering consolidation, rather than indiscriminately extending credit.

In principle, the financial industry can become smaller by having each institution contract proportionately, say, by 15%. But this is not the typical pattern in any industry. If sovereign wealth funds want to enter and keep capital-starved firms afloat in hopes of a big rebound, they should be allowed to do so. But they should realize that large foreign shareholders in financial firms may be far less effective than locals in coaxing central banks to extend massive, no-strings-attached credit lines.

It is time to take stock of the crisis and recognize that the financial industry is undergoing fundamental shifts, and is not simply the victim of speculative panic against housing loans. Certainly better regulation is part of the answer over the longer run, but it is no panacea. Today's financial firm equity and bond holders must bear the main cost, or there is little hope they will behave more responsibly in the future.

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