Central banks have been doing their best to pep up demand. Now they need help

September 24, 2016 – *The Economist*

They do not naturally crave the limelight. But for the past decade the attention on central bankers has been unblinking—and increasingly hostile. During the financial crisis the Federal Reserve and other central banks were hailed for their actions: by slashing rates and printing money to buy bonds, they stopped a shock from becoming a depression. Now their signature policy, of keeping interest rates low or even negative, is at the centre of the biggest macroeconomic debate in a generation.

The central bankers say that ultra-loose monetary policy remains essential to prop up still-weak economies and hit their inflation targets. The Bank of Japan (BoJ) this week promised to keep ten-year government bond yields around zero. On September 21st the Federal Reserve put off a rate rise yet again. In the wake of the Brexit vote, the Bank of England has cut its main policy rate to 0.25%, the lowest in its 300-year history.

But a growing chorus of critics frets about the effects of the low-rate world—a topsy-turvy place where savers are charged a fee, where the yields on a large fraction of rich-world government debt come with a minus sign, and where central banks matter more than markets in deciding how capital is allocated. Politicians have waded in. Donald Trump, the Republican presidential nominee, has accused Janet Yellen, the Fed's chairman, of keeping rates low for political reasons. Wolfgang Schäuble, Germany's finance minister, blames the European Central Bank for the rise of Alternative for Germany, a right-wing party.

This is a debate on which both sides get a lot wrong. It is too simple to say that central bankers are causing the low-rate world; they are also reacting to it. Real long-term interest rates have been declining for decades, driven by fundamental factors such as ageing populations and the integration of savings-rich China into the world economy. Nor have they been reckless. In most of the rich world inflation is below the official target. Indeed, in some ways central banks have not been bold enough. Only now, for example, has the BoJ explicitly pledged to overshoot its 2% inflation target. The Fed still seems anxious to push up rates as soon as it can.

Yet the evidence is mounting that the distortions caused by the low-rate world are growing even as the gains are diminishing. The pension-plan deficits of companies and local governments have ballooned because it costs more to honour future pension promises when interest rates fall. Banks, which normally make money from the difference between short-term and long-term rates, struggle when rates are flat or negative. That impairs their ability to make loans even to the creditworthy. Unendingly low rates have skewed financial markets, ensuring a big sell-off if rates were suddenly to rise. The longer this goes on, the greater the perils that accumulate.

To live safely in a low-rate world, it is time to move beyond a reliance on central banks. Structural reforms to increase underlying growth rates have a vital role. But their effects materialise only slowly and economies need succour now. The most urgent priority is to enlist fiscal policy. The main tool for fighting recessions has to shift from central banks to governments.

To anyone who remembers the 1960s and 1970s, that idea will seem both familiar and worrying. Back then governments took it for granted that it was their responsibility to pep up demand. The problem was that politicians were good at cutting taxes and increasing spending to boost the economy, but hopeless at reversing course when such a boost was no longer needed. Fiscal stimulus became synonymous with an ever-bigger state. The task today is to find a form of fiscal policy that can revive the economy in the bad times without entrenching government in the good.

That means going beyond the standard response to calls for more public spending: namely, infrastructure investment. To be clear, spending on productive infrastructure is a good thing. Much of the rich world could do with new toll roads, railways and airports, and it will never be cheaper to build them. To manage the risk of white-elephant projects, private-sector partners should be involved from the start. Pension and insurance funds are desperate for long-lasting assets that will generate the steady income they have promised to retirees. Specialist pension funds can advise on a project's merits, with one eye on eventually buying the assets in question.

But infrastructure spending is not the best way to prop up weak demand. Ambitious capital projects cannot be turned on and off to fine-tune the economy. They are a nightmare to plan, take ages to deliver and risk becoming bogged down in politics. To be effective as a countercyclical tool, fiscal policy must mimic the best features of modern-day monetary policy, whereby independent central banks can act immediately to loosen or tighten as circumstances require.

Small-government Keynesianism

Politicians will not—and should not—hand over big budget decisions to technocrats. Yet there are ways to make fiscal policy less politicised and more responsive. Independent fiscal councils, like Britain's Office for Budget Responsibility, can help depoliticise public-spending decisions, but they do nothing to speed up fiscal action. For that, more automaticity is needed, binding some spending to changes in the economic cycle. The duration and generosity of unemployment benefits could be linked to the overall joblessness rate in the economy, for example. Sales taxes, income-tax deductions or tax-free allowances on saving could similarly vary in line with the state of the economy, using the unemployment rate as the lodestar.

All this may seem unlikely to happen. Central banks have had to take on so much responsibility since the financial crisis because politicians have so far failed to shoulder theirs. But each new twist on ultra-loose monetary policy has less power and more drawbacks. When the next downturn comes, this kind of fiscal ammunition will be desperately needed. Only a small share of public spending needs to be affected for fiscal policy to be an effective recession-fighting weapon. Rather than blaming central bankers for the low-rate world, it is time for governments to help them.