

Ben Bernanke, the great innovator

The bold innovations of the self-effacing chairman of the US Federal Reserve may indeed turn out to be the monetary tools of the 21st century

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There are several central bankers one could admire, especially those who held steadfast against widespread political opposition because the measures took time to take effect. Notable in this regard is of course Paul Volcker, who slew the dragon of inflation. In India, there was C Rangarajan, who did much the same thing, and Y V Reddy who explicitly targeted asset prices when it was unfashionable, indeed heretical, to do so. And there is the self-effacing Ben Bernanke, with his bold innovations and perspicacity — even though the jury is still out on whether he is indeed fashioning the monetary tools of the 21st century.

Following the fiscal excesses of the 1970s, the mantle of stabilising growth fell increasingly on central bankers, as monetary policy conducted by independent central banks rather than politically-charged fiscal policy became the first line of macroeconomic defence against economic downturns.

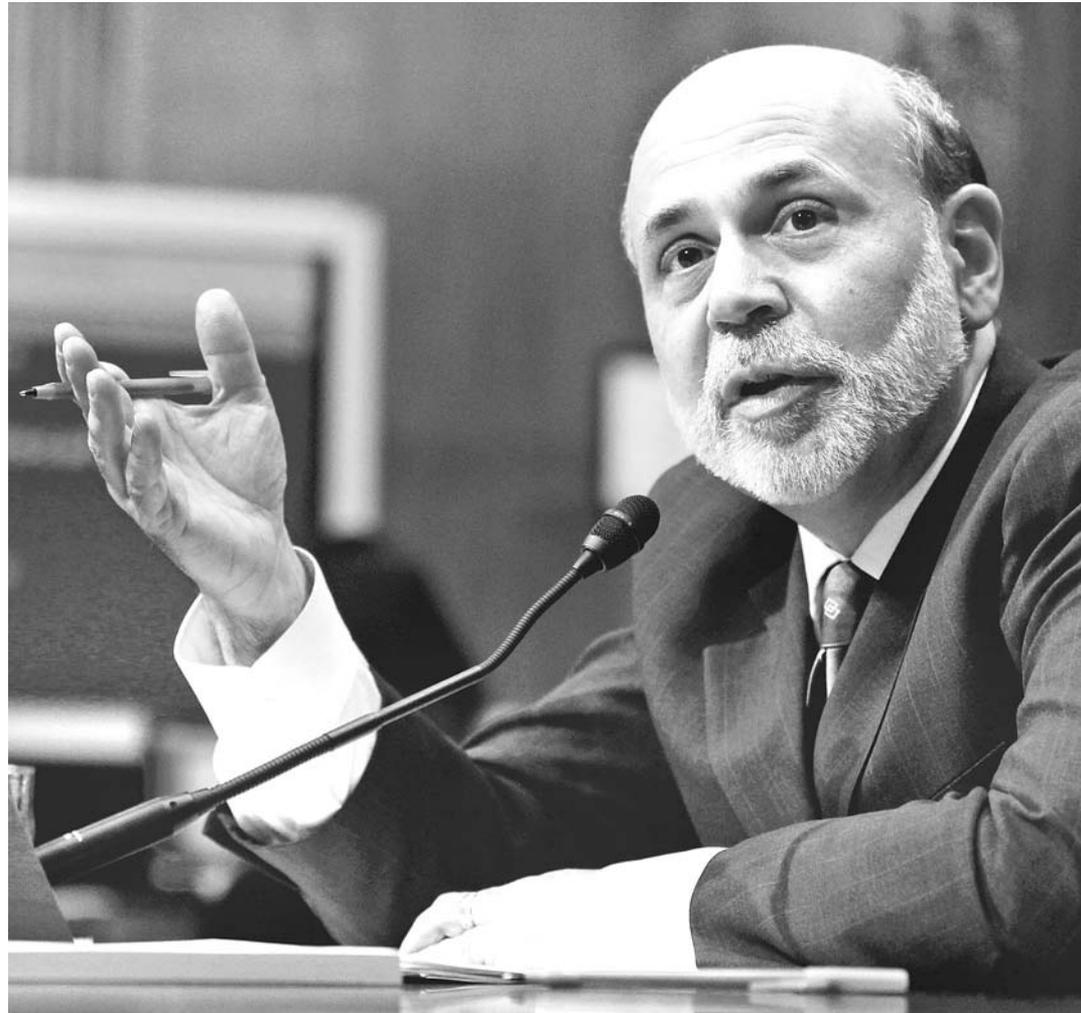
Ironically, as central bankers turned to inflation targeting, with short-term interest rates as their primary tool, the forces of globalisation were relentlessly striking at the roots of both: the entry of large economies into the global market for labour unleashed deflationary forces that kept inflation low, making it less sensitive to domestic overheating. Meanwhile, large-scale cross-border capital flows undermined central banks' ability to influence short-term rates, as Alan Greenspan presciently noted in what has come to be known as "the Greenspan Conundrum".

The consequential failure of monetary policy based on inflation and short-term policy rate targeting is widely blamed for inflating asset bubbles by keeping monetary policy unusually loose. Central bankers therefore must share the blame for the recent global financial crisis. As a member of the US Federal Reserve Board, Ben Bernanke could be considered complicit with these policies.

As a historian of the Great Depression, Ben Bernanke was called upon to test his theories in real life when he took over as chairman of the Fed. The lessons he drew from the Great Depression probably explain why the American monetary authority's response to the subprime crisis was so different from that of the European Central Bank, which focused on the inflationary threat even as Bernanke saw potential deflation as the greater threat, on account of the deleveraging underway. He rapidly started lowering rates all the way down to the zero bound. In retrospect, he made the right call, and other central banks followed suit.

Zero-bound interest rates did prevent deflation, but could not prevent recession. To address the latter, governments supplemented aggressive monetary easing with equally aggressive fiscal policy to counter both faltering private demand, and to support financial institutions that had become too systemically important to be allowed to fail. Fiscal policy, however, can be used only in short spurts, as protracted use can trigger market revolt, and it did. With both fiscal and conventional monetary space exhausted, it was time for Ben Bernanke to bite the bullet and put in practice a controversial theory he had propounded several years ago.

He had recognised the limits of conventional monetary policy, for interest rates cannot be pushed below zero. In such a scenario he advocated a money-financed tax cut essentially equivalent to a "helicopter drop" of money — or what is now popularly known as quantitative easing, or QE. Unlike a bond-financed tax-cut, which leads to tax increases down the line, a tax cut financed by money creation should theoretically not emasculate fiscal expansion through Ricardian Equivalence. Money creation would also have the impact of depreciating the currency, which



US Federal Reserve Chairman Ben Bernanke testifies before a US Senate budget committee hearing on the outlook for American monetary and fiscal policy on February 7, 2012. PHOTO: REUTERS

he saw as another tool to combat deflation.

The US Fed under Bernanke was not, of course, the first central bank to deploy QE. Developing country central banks, like those of India, had long been accommodating loose fiscal policy by buying government bonds. This policy was phased out by C Rangarajan in the 1990s as it impinged on the effectiveness of monetary policy, and hence on the independence of the central bank. Indeed, considering the bland experience of the Bank of Japan with QE, it was bold of Ben Bernanke to put QE to the test yet again.

However, he has used QE far more aggressively than the BoJ did, introducing innovations as he went along. QE became "credit easing" when private assets were bought to stabilise financial markets. While central bankers typically intervene through short-term rates, QE was now also used to directly influence the upper end of the yield curve through "operation twist", since long-term rates could no longer be influenced by short-term rates that were already near zero.

Although QE has been able to keep the deadly downward deflationary spiral at bay by making up for the declining velocity of money caused by deleveraging; has had the effect of keeping sovereign borrowing rates low in the face of market revolt; and quickly cleaned up the balance sheets of stressed financial institutions through cheap funding, it has its critics

and downsides.

First, much of the criticism has come from emerging markets, where there is a sense that the excess liquidity created is spilling into commodity markets, asset bubbles and inflation overseas. Second, QE has not depreciated the dollar, because of its reserve currency status. Third, it has obliterated the firewall between fiscal and monetary policies, with monetary policy increasingly becoming an extension of fiscal policy, thereby undermining the independence of the central bank.

Fourth, whereas fiscal expansion leads to higher taxes down the line, the combination of zero-bound interest rates and QE is an immediate tax on savers, who in effect finance the stimulus. The tax on savings should induce people to consume and invest more and save less, but with impaired balance sheets they are possibly saving even more. It is therefore arguable to what extent QE is a way out of the liquidity trap, if it can revive animal spirits to kick off a virtuous cycle of demand and supply of credit to the real economy. Fifth, there are inflationary dangers ahead unless the QE is carefully unwound, calibrated to the recovery.

Nevertheless, Ben Bernanke has found an innovative answer and response to each new problem thrown at him so far, at a time when the recent past provided little guidance. It is too early to tell whether his remedies are the correct ones, whether they are working, and whether they will lay the basis of monetary policy in an age of deep global integration and fiat money. His place in monetary history is however secure, one way or the other.

The writer is a civil servant. These views are personal