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Central banks must co-ordinate policy

By William Rhodes

After moving in parallel steps, they are now starting to diverge, warns William Rhodes

Not since 2008 has there been a greater need for policy co-ordination among major central banks to harmonise monetary and bank regulatory policies. Back then, the financial crisis forced swift co-ordinated responses by the US Federal Reserve and the European Central Bank, followed by the Chinese authorities, which prevented a global depression.

Now, new storms are likely. Recent financial market developments triggered by emergency central bank actions in Argentina, Turkey, India and South Africa, but reflecting broader concerns about interest rate trends, may prove to be just a foretaste of things to come. The risks are rising of a prolonged period of exceptionally volatile and disruptive cross-border financial flows that could create financial market turmoil and undermine the fragile revival of growth now being seen in many economies.

In 2013, key central banks were moving in parallel. They were pumping out liquidity, holding interest rates down and shouldering the lion's share of responsibility for stimulating growth. But now divergence, rather than cohesion, is emerging. Traders may win, while everyone else may lose.

Making matters worse is the rising fragmentation of the international bank regulatory system, which creates increasing opportunities for regulatory arbitrage. Banking authorities have still not put in place agreed approaches to resolution; the Volcker rule may or may not be applied in different ways in key jurisdictions; capital ratios differ significantly from one jurisdiction to another; and, there have been repeated failures to agree on international accounting standards.

Under these circumstances banks will underperform in providing lending for productive investments that are now essential for reducing unemployment and securing growth in many economies.

Ideally, intensified efforts at policy co-ordination by central banks should take place alongside a broader palette of co-operative policy actions led by Group of 20 governments, including measures to revive slumbering world trade growth. But the next G20 summit is not until November, and a great deal needs to be done before then if the world's economy is to not face serious problems.

The key goal for all actions needs to be the core objective set at the 2009 G20 summit of forging co-operative policies to restore and sustain significant economic growth. The lead must be taken now by the central banks at a time when underlying pressures are pushing them in different directions.

There continues to be uncertainty about the course of the Fed's policy. The most probable prospect is for a substantial slowing of the Fed's bond purchases over the next six to nine months.

Despite the disappointing recent unemployment data, the pressures for accelerated tapering are likely to mount as the economy shows increasing signs of growing at 3 per cent plus this year.

The ECB, by contrast, confronts lacklustre growth across most of the eurozone, with some 20m unemployed and rising risks of deflation – inflation in January was just 0.7 per cent. Further monetary policy easing by the ECB is the likely response. Meanwhile, domestic economic conditions provide the Bank of Japan with no reason to change its current easy money course and indeed it may be pressed to ease still further. In the UK, though, a strengthening domestic economy has already given rise to some speculation that the Bank of England may actually raise rates.

The Chinese authorities, for their part, face pressures to stimulate the economy to boost domestic consumption as a result of recent important Communist Party decisions. But, they must also

confront three financial problems: excessive borrowing by municipal and provincial governments and state-owned enterprises, rapid growth of the shadow banking sector, and rising levels of non-performing loans at the major commercial banks.

While the Chinese need to be concerned with cooling the tempo of new bank loan expansion, many other countries are challenged by the weakness of bank lending to productive, employment generating investments.

The banks are in large measure constrained by regulatory uncertainties. The banking authorities deserve credit for strengthening banking supervision, but they have failed to put in place the level playing field the G20 called for in 2009.

It is easy to apportion blame for the fragmentation in regulation, but the fact is that as the 2008 crisis recedes in memory, so the compelling need to ensure co-operative and co-ordinated economic policies between the major economies declines in political importance. This trend needs to be reversed.

Right now the central banks must take the lead, but the ultimate responsibility should weigh on the shoulders of G20 summit leaders who will be held to account if their inaction compounds economic difficulties.

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