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## **Central banks in the driving seat**

by Michael Heise

It looks as though the central banks in the industrial countries are set to keep their interest rates close to zero for some time yet. Last week the European Central Bank announced that it would continue to provide the banks with unlimited liquidity. The US Fed stands ready to step up its quantitative easing again and just a few days ago the Bank of Japan pumped a further EUR 100bn in long-term liquidity into the banking system. This is hardly the desired "return to normality".

Western central banks point out that, with inflation rates low and inflation expectations heading firmly south, there was no acute threat to price levels on the horizon. Indeed, Japan's headache is more one of deflation. In addition, it would be risky if monetary policy were to start reversing its accommodative policy at the same time as fiscal consolidation was getting under way. Favorable interest-rate and liquidity conditions are highly welcome, especially in Europe where in some cases government austerity packages are dousing demand appreciably. This all makes perfect sense. But things get more problematic if monetary policy is again supposed to fine tune the economy. This can be observed in the US right now where – in the face of sliding sentiment indicators – the Fed is once again being expected to avert a sharper slowdown in the economy. However, this is practically impossible as monetary policy does not have an immediate effect; it has scant influence on new orders or production in the coming months. If one nonetheless takes such short-term indicators as the yardstick for monetary policy action, an overdose is almost inevitable: The dosage of the monetary policy medicine is too high because the short-term cure fails to materialize.

Even in volatile times monetary policy has to keep its eye on medium-term developments and act accordingly.

Certainly, we are not yet seeing the self-sustained upswing which would warrant an immediate withdrawal of the intensive care monetary policy is currently providing. But this could arrive more quickly than the still depressed sentiment in some quarters might suggest. It is by no means complete pie-in-the-sky that labor markets in the industrial countries might firm up in the coming months, credit demand pick up as a sign of rising investment activity and more stable banks again, and that medium-term inflation expectations start to move up. Following the massive stimulants doled out to the economy by monetary and fiscal policy in 2009 and 2010, an ongoing economic recovery would not be a surprise but par for the course. Monetary policymakers have to look into the future, supported by experience and theory. Staring only at the current indicators means you are flying blind, as we saw in the many doomsday scenarios in early 2009.