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It May Be Harder for Central Banks to Manage Recoveries than Economic Downturns?

Recent statements from the U.S. Federal Reserve may seem puzzling to some and downright annoying to others. What comes through rather clearly, however, is that the Fed is not quite sure how to handle the economic recovery. And it is not alone. In Europe, there is an emerging division between those who think that the liquidity support offered by the European Central Bank (ECB) has run its course and those who believe more stimulus is needed.

Central banks were indispensable actors in preventing the pandemic's deep global recession from turning into something far worse. Now the trick is deciding when to "turn the tap off."

In the case of the United States, the Fed has been clear that it intends to continue with its Quantitative Easing (QE) or bond-buying program until such time as it is convinced that the recovery is on firm footing (presumably, influenced by unemployment rates) and that inflationary expectations are not moved by temporary increases in inflation. Both measures are subject to errors and, some would say, even misinterpretation.

Professor Larry Summers, former U.S. treasury secretary, has been one of those criticizing the Fed for its complacency, its failure to respond to the inflation uptick, and its seeming indifference to large increases in government spending. We addressed these particular concerns in previous *Economic Viewpoints.*

What is new in this debate is a recent statement from Federal Reserve board members who are concerned with rising housing prices. Eric Rosengren, president of the Boston Fed, has gone so far as to raise the troubling specter of a boom-and-bust cycle in the real estate market. But surely, if this is a potential problem, the continued purchase of mortgage-backed securities

(MBSs) and the entire $120 billion per month program of bond purchases are part of it.

The housing crisis of 2008 was fueled by excessive liquidity and below normal interest rates. If the rise in real estate prices is a preoccupation, then announcing a scheduled phaseout of QE is a necessary antidote.

In Europe, Jens Weidmann, president of the Deutsche Bundesbank, the German central bank, has signaled again that he believes it is high time to curb the European Central Bank's QE program in the face of rising inflationary indictors. The inflation risks may be exaggerated—especially by the Bundesbank, which has a strong antipathy to any hint of price increases—but there are other reasons to consider Weidmann's point of view.

Although Germany's tough budget rules were temporarily suspended, allowing for increased spending due to the COVID-19 pandemic, that will change in 2023 and it will be anticipated in 2022. For that reason, a delay in reversing the ECB's policy on QE will increase the likelihood that monetary tightening will coincide with the inevitable restoration of tight fiscal rules in Germany. This would be unfortunate timing for Europe.

There is also the possibility of miscalculation in some European financial capitals where the pandemic has led to what the OECD has identified as a major concern: so-called "zombie lending." This phenomenon of continued provision of liquidity to unprofitable, and often large, firms implies that the real level of non-performing loans is actually considerably higher than reported levels. Again, continuing with status-quo policies may make eventual adjustments harder to undertake.

Returning to the U.S. panorama, the notion that the Fed should add another $1.44 trillion year-on-year of liquidity into the financial markets is not without risk. With low interest rates and excessive liquidity, the search for yield often leads to poor financial outcomes or, in the worst cases, to actual crises.

Moreover, should the uptick in inflation be more than temporary, the cumulative shock of monetary tightening could prove much more severe than a gradual phase-out of the now unnecessary QE.

One thing is clear. Managing the withdrawal of liquidity from the system is much harder than its initial injection.