Central Banking: What Have We Learned Since 2007?

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The Global Financial Crisis started in August 2007 when interbank lending markets froze and when the payment system was endangered for the first time since the 1930s. As US real estate prices peaked in 2005, with interest rates rising, it was inevitable that a crisis would arise following all that had been going on in the US with the previous bonanza in home mortgages, securitization and product derivatives. However, until September 2008, central bank and government officials were still telling the public that the 'fundamentals' were 'sound', while private forecasters, as late as October 2008, were still predicting reasonable economic growth. Obviously, except for a few Cassandra and a few knowledgeable observers, nobody really knew how unstable and fragile an economy based on an unregulated financial system could become.

Our analysis takes as point of departure a Minskyan view of the economy with an emphasis on the inherent tendency of an unregulated financial system towards instability. While adopting a Minskyan framework, the paper's focus will be, however, on the evolution in the understanding of monetary theory among some practitioners at central banks. Central bankers were relatively quick in grasping that the textbook description of monetary creation, based on the fractional reserve system and money multiplier, was entirely wrong and had to be dismissed. Otherwise, it was felt that market participants would take the wrong decisions since they would be based on an inappropriate model of the economy and hence on the wrong expectations.

There was already a consensus before the financial crisis that, in normal times, all central banks try to achieve their policy targets by relying on changes in nominal and real interest rates as control variable. What was not clear, however, was that money and credit were purely endogenous variables, which were not determined by the amount of reserves created by the central bank. While some features of this reality came to be endorsed early in the crisis, for instance when central banks and in particular the Fed adopted a floor system to set interest rates, other features were not fully understood, which gave rise to the exercises of quantitative easing – the so-called extraordinary measures – which have been tried in a number of countries and which have illustrated the limits of central banking and the inappropriateness of textbook monetary theory.

In much the same way, the Eurozone crisis also gave rise to a new understanding of how financial markets function, via the "Draghi effect", albeit much too late. It is now recognized, even by Nobel-prize winners, that countries can run as large a public debt as they wish as long as financial markets know that the central bank will back its government, thereby highlighting the importance of the particular institutions in place.

The Minskyan view of the economy, based on the endogenous money and credit approach, offers a rather pessimistic outlook about the likely results of efforts to make marginal modifications to the regulatory structure. In our view, much more radical changes are required, that would safeguard the payment system, which is a clear instance of a public good. These more radical changes will be outlined in the paper.