Credibility on the line

Many will wonder if central banks know what they are doing, forecasts **Zanny Minton Beddoes**

For the past five years the rich world's central bankers have been seen as the saviours of the world economy. Their willingness to slash interest rates, buy bonds and embrace "unconventional" policies helped to prevent the financial crisis causing a depression, and has underwritten the recovery. Even as politicians dragged economies down with premature fiscal austerity, competent central bankers propped growth up.

In 2014 the reputational tables will turn. In most places the recovery will strengthen; politicians, particularly in Europe, will make fewer obvious macroeconomic mistakes. But the central bankers will be under fire. By the end of 2014 there will be growing debate about whether the technocrats know what they are doing, both in monetary policy and in their newly expanded roles as financial supervisors. Credibility, the currency of effective central banking, will be in shorter supply.

Not by Yellen alone

Fed-led into uncertainty

The debate over monetary policy will centre on America's Federal Reserve, both because its decisions have big effects on the rest of the world and because the Fed faces a particularly tricky set of tasks. It will be under new leadership. Assuming the Senate confirms her nomination, Janet Yellen, the current vice-chairman, will succeed Ben Bernanke in the top job on February 1st. Ms Yellen's priorities are well known. She is more worried about the lack of growth than any threat of inflation. She is leery of scaling back too fast the Fed's "quantitative easing" (printing money to buy bonds), and is keen to expand "forward guidance", setting out expectations for the Fed's future actions. But Ms Yellen will not run policy alone. Up to five new Fed governors (out of seven) may be appointed in 2014. A different, more hawkish group of regional Fed presidents will have a vote.

Such big changes in the Fed's complexion will make it harder to discern the central bank's priorities. All the more so because the economy will send mixed signals about whether it needs more or less monetary stimulus. Growth will accelerate modestly in 2014, and the jobless rate will fall. But in other respects the labour market will remain feeble, and inflation will start and end the year well below the Fed's target of 2%. For all the worries that bond-buying would lead to out-of-control price rises, the main monetary trend of 2014 will be uncomfortably low inflation.

This mixed performance will fuel the argument about how far and fast to slow the pace of bond purchases. It will also bring changes in forward guidance. The Fed could supplement its promise to keep short-term rates unchanged until the jobless rate falls at least to 6.5% with a promise not to raise rates until inflation reaches its 2% target.

The central bankers will be under fire

The combination of new people and continuing debate makes experimentation inevitable. But it could have unfortunate side-effects. Uncertainty about the Fed's plans will rise, causing volatility in financial markets and leaving the central bank less effective at influencing monetary conditions. That, in turn, will raise doubts about both the central bankers' competence and their tool-kit.

Versions of this problem will bedevil other rich-world central banks. The Bank of England will tinker with its own forward guidance, which was introduced in August 2013. That did little to influence long-term interest rates, a poor record that will not improve in 2014. Even with massive bond-buying, the Bank of Japan will struggle to convince investors that it can meet its promise of raising inflation to at least 2% by spring 2015, particularly as Japan's economy will be squeezed by a higher consumption tax.

By itself, the denting of confidence in central bankers' monetary skills will not be too serious. Yet that will not be their only concern. Their regulatory responsibilities will bring controversy too.

The Bank of England will need to rein in surging property prices even as they underpin Britain's recovery in 2014. The European Central Bank (ECB) will take responsibility for supervising the euro area's biggest banks. The hope is that a balance-sheet review from the ECB will oblige banks to scrub bad assets and raise capital, helping to spur the recovery. But Europe's politicians have failed to agree on what to do if the capital holes turn out to be too large for banks or their governments to cope with. If the ECB is tough, it may reignite the crisis; if it conducts a soft review, it will weaken its own credibility. Expect a fudge.

Central banks will not shift from being saviours to incompetents in one year. But the gap between outsize expectations and the central bankers' ability to deliver will start to show. ■

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