THE GLOBAL INVESTOR SUMMIT ROME 2024

The Subtle Art of Central Banking: A View From The Inside

In an unsettled global economy, central banks are being asked to shoulder ever more responsibility. Dual mandates are swelling into triple and even quadruple mandates, presenting policymakers with at times competing priorities.

At its recent Global Investor Summit in Rome, Bank of America convened a panel of central bankers, finance ministers and world-renowned experts, chaired by Claudio Irigoyen, global head of Economics Research, BofA Global Research, to share their insights into the lessons central banks can learn from the past, and where they should go next at this critical juncture.

Rome, Italy

A full plate

As Bank of America's research team has pointed out, 2023 was a year that defied expectations in multiple ways: recessions that weren't, rate cuts that never came, equity and bond markets that over and underperformed. This unpredictability compounds the complexities faced by policymakers as they seek a way forward that will stand the tests of time and hindsight.

Irigoyen framed the problem in terms of the breadth of challenges central banks are now being asked to consider, even as they seek to engineer a soft landing while beset by global conflicts and their externalities, the aftermath of the COVID-19 pandemic and mixed signals from major economies.

"We're asking central banks to deal with price stability, climate change, inequality – is it too much?" he asked the panelists.

In response, they noted that many of the tools available to central bankers are effective only some of the time. This is because monetary policy is asymmetric – it can be very effective in fighting inflation, but much less effective in bringing economies out of recession.

In addition, panelists stressed the need for cooperation between fiscal policy and monetary policy – something Irigoyen pointed out was less and less in evidence. The audience in Rome heard convincing arguments that such cooperation is required to unlock the full macro-prudential toolkit necessary to see off the risk of stagflation, enabling tactics from intervention in forex markets to more extreme solutions such as capital controls.

Lessons from Japan

The eminent economist Simon Kuznets once quipped that there are four types of economy: developed, undeveloped, Argentina and Japan. That last country continues to occupy the minds of policymakers given Japan's long experience with deflation and recent emergence from it – an experience that will be particularly relevant to other economies facing, or soon to face, similar demographic and growth challenges.

One panelist was Tsutomu Watanabe, professor of economics at the Graduate School of Economics of the University of Tokyo, who has closely tracked Japan's return to inflation over the previous two years, and its deployment of unconventional monetary policies in pursuit of this goal.

The professor made the point that deflation in Japan was intractable for decades because it had become embedded in society, with lower prices reinforcing consumer expectations of even lower prices to come. He urged central banks and governments to do everything they can to prevent these kind of sentiments from crystallising. And in a prediction that was proven correct just days later, he told the panel that **"Japan's new interest rate will be near zero."**

A question of neutrality

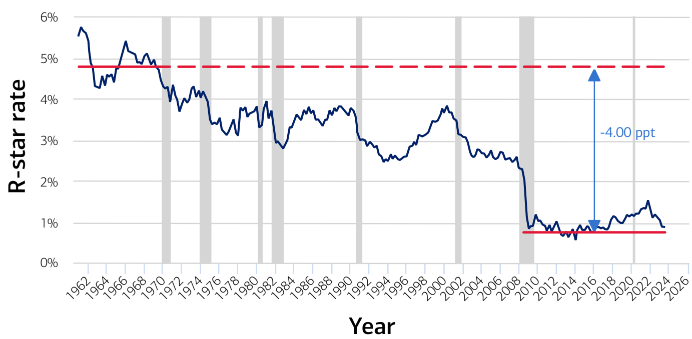
Another key topic for the panel at the Global Investor Summit in Rome was that of neutral or natural interest rates, or R-star: the real policy rate of interest that eliminates inflationary or deflationary pressures, per Maurice Obstfeld's definition[1]. Specifically, the expert panels considered which factors are most important in estimating R-star, given that its level can only be inferred rather than directly measured and that methodologies surrounding it continue to evolve.

Debate has flourished since the pandemic over whether the neutral rate of interest has risen or fallen. In January 2024 in-depth research from Bank of America's U.S. economists concluded that R-star had increased since the pandemic to sit at around 40 basis points in real terms, in line with the Federal Reserve's assumptions.

Panelists noted that calculating the neutral rate of interest across different markets had been made more difficult by still ambiguous emerging forces such as the impact of artificial intelligence on the labour market. Factors like these are likely to impact countries differently depending on their technological sophistication and differing demographic pathways.

The panel discussed the future of the global financial system, and whether international tensions could impact the mix of currencies in which international trade is conducted, particularly among emerging markets.

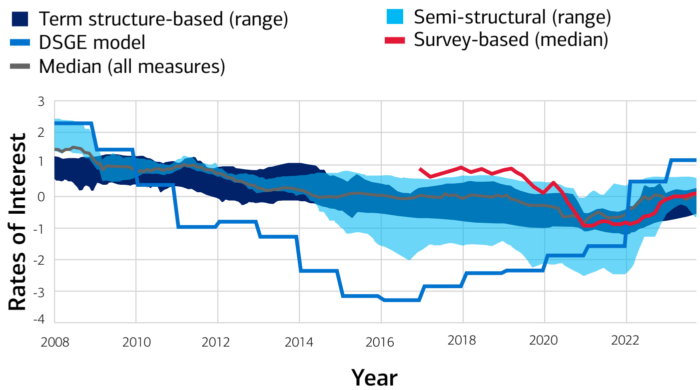
R-Star (neutral rate of interest)



Note: Gray bars indicate recessions
Source: Holston-Laubach-Williams model,
Federal Reserve Bank of New York

Real natural rates of interest in the euro zone

(percentages per annum)



Source: European Central Bank

What the session, and indeed the wider Global Investor Summit, reinforced was that the factors and choices confronting central banks are complex. As the global economy enters a new era of technological change, and more and more states grapple with the consequences of aging and declining populations, the experiences of once-outliers like Japan are going to become relevant to many more policymakers around the world.

How they respond will have profound consequences for how economies adapt to a period of at times difficult and at other times promising transformation.

To learn more about Bank of America's international business, please get in touch with your relationship manager or **click here.**

[1] Natural and Neutral Real Interest Rates: Past and Future, Maurice Obstfeld

[2] Reuters: Neutral rate debate resurfaces as US economy refuses to crack