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THE CENTRAL BANKING REVOLUTION

A generation's inflation-busting orthodoxy has been turned on its head by the financial crisis. What now?

BY PAUL CARREL, MARK FELSENTHAL, PEDRO DA COSTA, DAVID MILLIKEN AND ALAN WHEATLEY
FRANKFURT/WASHINGTON, MARCH 24

On a warm, Lisbon day last May, Jean-Claude Trichet, the ice-cool president of the European Central Bank, was asked whether the bank would consider buying euro zone governments' bonds in the open market. "I would say we did not discuss this option," Trichet told a news conference after a meeting of the ECB's Governing Council. Four days later, the ECB announced that it would start buying bonds.

Trichet's U-turn was part of an emergency package with euro zone leaders to stave off a crisis of confidence in the single currency. By reaching for its "nuclear option", the ECB had also helped rewrite the manual of modern central banking.

That's happened a lot over the past three years. Since the early days of the financial crisis in 2008, the European Central Bank, the U.S. Federal Reserve and the Bank of England have all been forced to adopt policies that just a few years ago they would have dismissed as preposterous. And the Bank of Japan responded to the Sendai earthquake and tsunami by doubling its own asset-purchase programme, to keep the banking system of the world's third-largest economy on an even keel.

For a generation, the accepted orthodoxy

PAST ORDER: U.S. Federal Reserve Chairman Ben Bernanke listens to questions about the inflation rate during his testimony before the Joint Economic Committee on Capitol Hill in Washington in this 2006 photo. **REUTERS/JIM YOUNG**

has been to focus on taming inflation. Financial stability has taken something of a back seat. Now, whether mandated to do so or not, western central banks have bought up sovereign debt to sustain the financial system, printed money by the truckload to stimulate their economies, sacrificed some of their independence to coordinate monetary policy more closely with fiscal decisions, and contemplated new ways of preventing asset bubbles.

Some -- such as Bank of England Governor Mervyn King -- have joined wider political protests at commercial banks that are still behaving as if they are "too big to fail", and as if being bailed out is just a hazard of business.

In the measured world of central banking, it amounts to nothing short of a revolution. Otmar Issing, one of the euro's founding fathers and a career-long monetarist hawk, told Reuters that in buying government bonds the ECB had "crossed the Rubicon". The question now for the ECB -- and for its counterparts in Britain, the United States and elsewhere -- is what they'll find on the other side.

EXTRAORDINARY CIRCUMSTANCES

DON KOHN, A FORMER vice-chairman of the Federal Reserve, realised central banking was changing forever at a routine meeting of his peers in Basel, Switzerland, in March 2008. The shockwaves from the U.S. subprime mortgage meltdown had begun rocking banks around the world and Kohn, a 38-year veteran of the U.S. central bank, listened as one speaker after another described the fast-deteriorating economic conditions.

"It was terrible," Kohn said. "One of the people at the meeting used the phrase, 'It's time to think about the unthinkable'."

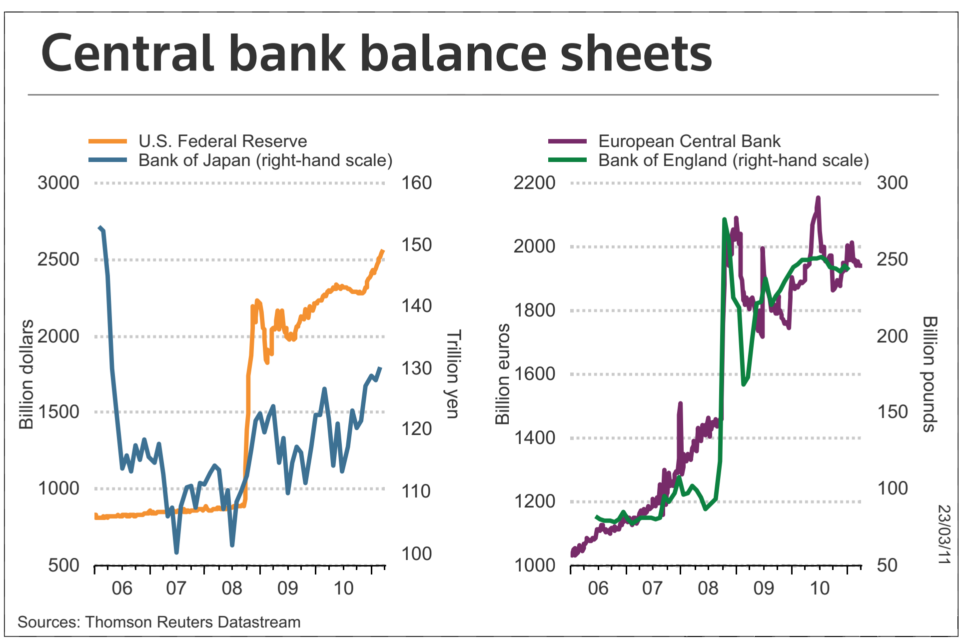
Kohn left the meeting early to return to Washington, but the line stuck in his head. He would use it a few days later to justify his support for a Federal Reserve decision to spend $29 billion to help J.P. Morgan buy investment bank Bear Stearns, which was teetering on the edge of bankruptcy.

That financial meltdown caused a credit crunch that triggered a severe recession and, in countries such as Greece, a sovereign debt crisis. After slashing interest rates practically to zero, central banks desperate to prevent a new global depression had no choice but to expand the volume of credit, rather than its price, by reaching for the money-printing solution known as "Quantitative Easing" (QE). In the eyes of critics, Federal Reserve Chairman Ben Bernanke was living up to his nickname of "Helicopter Ben" -- a reference to a speech that he gave in 2002 in which he took a leaf out of the book of the renowned monetarist economist Milton Friedman and argued that the government ultimately had the capacity to quash deflation simply by printing money and dropping it from helicopters.

Until that point, the Fed was a lender of last resort for deposit-taking banks. By invoking obscure legislation from the Great Depression, it also became a backstop for practically any institution whose collapse could threaten the financial system. Kohn and others at the Bear Stearns meeting had just done the unthinkable.

"When the secretary of the (Fed) Board was reading off the proposals ... my heart was racing," Randall Kroszner, a Fed governor at the time, says of the decision.

An academic economist from the conservative, free market-oriented University of Chicago, Kroszner was instinctively against intervention. At the same time, he knew that a decision by the Fed to stay above the fray would trigger financial panic. Before the meeting Kroszner had chatted with Bernanke, another scholar of economic history, about a historic parallel in which financier J.P. Morgan -- the person, not the company -- opted against stepping in to save the Knickerbocker



Reuters graphic/Scott Barber

Trust, precipitating a financial panic in the first decade of the 20th century.

"I couldn't believe that we were faced with these questions, and I couldn't believe that I could support them," Kroszner told Reuters in February. "In these extraordinary circumstances, it was very risky to just say no."

By the time the $600 billion second round of quantitative easing wraps up in June, the central bank will have spent a staggering $2.3 trillion – more than 15 percent of GDP -- buying bonds. It has also created new lending windows to channel funds to financial institutions and investors and expanded its financial safety net for everything from money market mutual funds to asset-backed securities and commercial paper.

The Fed argues that its loans have been repaid without any cost to taxpayers, and that the beginning of a recovery in the U.S. economy and the fading of the threat of deflation, which gnawed at Bernanke, justify its bold improvisation. But some experts, including a number of Fed officials themselves, believe the central bank is paying a big price. Some critics say the Fed's open-ended provision of next-to-free money is encouraging more reckless risk-taking by banks and speculators. Others say the Fed has exceeded its remit and encroached on the turf of politicians. Some Republicans, in particular, want to curtail the Fed's powers.

The United States has not been alone. In Britain, the Bank of England has run its own programme of quantitative easing, spending 200 billion pounds (about 14 percent of GDP) mostly on UK government securities, and has introduced a scheme for financial institutions to swap mortgage-backed securities for UK Treasury bills. The ECB took three main steps: adjusting its money market operations to offer unlimited amounts of funds, lowering standards on the collateral it accepts in such operations, and buying bonds. The bond buying, though amounting to 1.5 percent of euro zone GDP, is less radical than the Fed's because the bank absorbs back the money that its purchases release. But its initiative is still highly controversial.

Issing, the ECB's chief economist from 1998 to 2006, calls the bond-buying dangerous. But he also concedes that the problems of the past few years have required extreme measures. "It is difficult to justify within the context of the independence of the central bank," says Issing. "But, on the other hand, the ECB was the only actor who could master the situation. What matters now is that it finalises this programme and gets out."

NEW RULES

CENTRAL BANKS HAVE historically often been subordinated to governments, but the high inflation and slow growth that

DOUBLE VISION: Buying bonds is difficult to justify by an independent ECB. Jean-Claude Trichet, the ECB's president, addresses the media during his monthly news conference in, August 2010. **REUTERS/KAI PFAFFENBACH**

IN CHINA, A BID FOR INFLUENCE

Zhou Xiaochuan, governor of the People's Bank of China. REUTERS/NIR ELIAS

BY KEVIN YAO
BEIJING

Not a central bank in the conventional Western mould, the People's Bank of China has nevertheless emerged as a powerful player in steering the world's second-largest economy as the decade-long term of its governor, Zhou Xiaochuan, draws to a close.

On the world stage, Zhou is beating the drum for the dollar to be dethroned as the world's dominant currency. At home, the Chinese central bank chief isn't sitting idle either.

The central bank was pivotal in forging a consensus within the Communist Party leadership that led to the landmark revaluation of the yuan in 2005; similarly, analysts say the central bank was the driving force behind Beijing's decision last June to end a two-year peg to the dollar introduced to help China weather the global financial crisis.

The central bank has modernised China's domestic bond and money markets, introducing a flurry of short-term instruments to help it control money supply and guide market expectations.

The bank, which constantly has to fend off attempts by other state agencies to encroach on its turf, has also taken steps to keep a tighter grip on bank lending. Traders and investors around the world now hang on its every word and deed, even though, ironically, Zhou can only dream of the powers enjoyed by his foreign counterparts such as Ben Bernanke and Jean-Claude Trichet.

"The People's Bank of China is playing a more and more important role in the economy, although it's a fact that it still enjoys little operational independence," said Qing Wang, China economist at Morgan Stanley in Hong Kong.

Unlike Western central banks, the PBOC does not have the final word on adjusting interest rates or the value of the yuan. The basic course of monetary and currency policy is set by the State Council, China's cabinet, or by the Communist Party's ruling Politburo.

followed the oil price shocks of the 1970s ushered in a relatively simple orthodoxy: their goal should be to keep inflation in check. Maintaining a slow and steady pace of price rises became the overriding aim of central bank policy, and independence from political pressures came to be seen as a pre-requisite for achieving this. Starting with New Zealand in 1989, central banks in more than 50 countries adopted explicit, public targets for inflation.

Western governments claimed this was responsible for the Great Moderation, a two-decade period of relatively stable growth in developed economies. It still has many proponents, but the credit crisis has made a mockery of that overriding simplicity, exposing serious flaws in how central banks defined their mission and operated. One flaw: they did little to prevent the build-up of the asset bubbles that triggered the financial crisis, such as the boom in U.S. subprime mortgages. Another: the obsession with inflation blinded them to dangerous trends in banking. After all, what is the point of keeping inflation low if lax lending and feckless financial supervision threaten to tip the economy into the abyss?

"The problem was not that the Fed lacked instructions to avoid a crisis," says James Hamilton, a professor of economics at the University of California, San Diego and visiting scholar at the central bank on multiple occasions. "The problem was that the Fed lacked the foresight to see the crisis developing."

Fed Chairman Bernanke doubts central banks can know for sure that an asset bubble has formed until after the event, and feels monetary policy is too blunt a tool to arrest any worrisome developments. At the same time Bernanke, former vice-chairman Kohn and others agree that the central bank might be able to employ broader tools to prevent asset prices from getting too frothy. For example, the Fed regulates margin requirements for buying equities with borrowed funds; it could use these to rein in a galloping stock market.

"The simplicities of extreme inflation targeting -- which said if you meet your inflation target and keep inflation stable the rest of the economy would look after itself -- have been blown apart," Sir John Gieve, who was deputy governor at the Bank of England from 2006 to 2009, told Reuters. "The Bank's objectives have become a lot more complicated. Some people have been quicker to realise this than others. If you talk to the Japanese, they would say they have been doing this for a while."

ANY ANSWERS?

COULD THE FED and its counterparts in Britain and Europe learn from Asian central banks, many of which limit the proportion of deposits that banks can extend as loans? Should they insist that a home buyer make a sizeable deposit when taking out a mortgage -- a practice that might have tempered the U.S. housing bubble? Central banks in some emerging economies outside Asia already appear to be adopting such methods – known as 'macroprudential' steps – to complement traditional interest rate policy. Turkey has been raising commercial banks' reserve ratios while simultaneously cutting interest rates, and

Zhou made headlines in March 2009 by proposing to replace the dollar eventually as the world's main reserve currency with a beefed-up version of the the Special Drawing Right (SDR), the International Monetary Fund's unit of account. The idea may be premature, but Zhou is spearheading a programme to boost the use of the yuan in trade and investment to ensure the currency becomes a major component of the SDR.

The quest for policy clout has sparked some turf battles.

The PBOC was recently at odds with the National Development and Reform Commission, the powerful planning agency, on targets for bank lending and inflation.

On the currency front, the central bank has been wrangling with Commerce Ministry, a staunch defender of Chinese exporters, over the pace of yuan appreciation. Zhou wants a stronger yuan to help curb inflation; exporters, not surprisingly, are opposed.

The PBOC has only a short history as a true central bank. Until 1983, it was also engaged in deposit-taking. The enactment of the Law of the People's Bank of China in 1995 formalised its central banking powers. It was also responsible for financial supervision until the China Banking Regulatory Commission was set up in 2003.

Foreign central bankers speak highly of the PBOC's technocrats. "Compared with other major central banks, the People's Bank of China is less independent, but it's increased professionalism means more of its proposals will be endorsed by the leadership," said an analyst at a state-owned bank who declined to be named.

Zhou, a well-trained economist and keen tennis player, has promoted a number of influential Chinese scholars to senior positions to beef up the central bank's management.

Among them, deputy governor Yi Gang, who has a PhD in economics from the University of Illinois, is tasked with managing the country's $2.85 trillion foreign exchange reserves.

Yi and China Construction Bank Chairman Guo Shuqing are among the candidates to succeed Zhou, 63, who is due to retire next year.

(Editing by Alan Wheatley)

REUTERS INSIDER

Former Bank of England Deputy Governor Sir John Gieve, central bank veteran Bill White of the OECD and other experts examine the urgency needed to wean banks off their addiction to cheap central bank liquidity, how to do it and what the consequences are if it doesn't happen.

Click for the video:

http://link.reuters.com/xyh68r

Brazil signalled this month it would rely more on credit curbs and less on rate increases to fight inflation.

Or should they look closer to home, for example to the central banks of Australia and Canada? Both are inflation-targeters, but they sailed through the global crisis without having to resort to extreme measures. A history of conservative banking regulation in those countries meant they never faced severe credit problems.

"Prior to the crisis a lot more people were of the view that if it's not broke don't fix it," said Dean Croushore, professor of economics at the University of Richmond in Virginia and a former economist at the Philadelphia Federal Reserve. "Policymakers didn't react, particularly with respect to housing. Maybe being a bit more proactive is a good thing."

Then again, some Republican lawmakers want the Fed, which has a dual mandate to keep inflation low and maximise employment, to focus exclusively on the first task. They contend that monetary policy is not the right tool to create jobs. Buying up bonds and bailing out failing firms does indeed blur the boundaries between monetary and fiscal policy. Critically, it also suggests that supposedly autonomous central banks are doing the bidding of politicians.

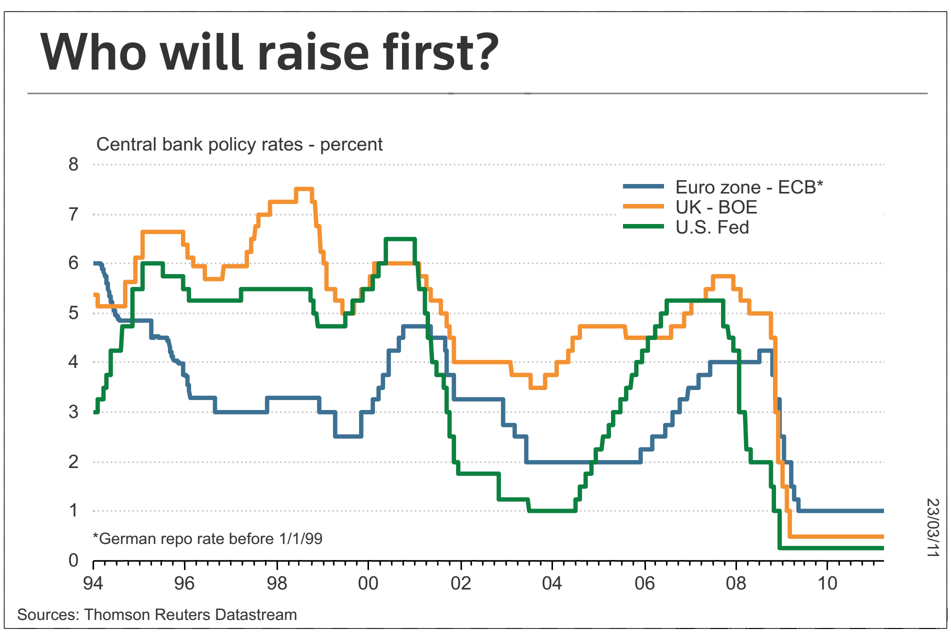
"Things cannot change in a measured way," said European Central Bank policy maker Axel Weber earlier this month. He is also head of Germany's Bundesbank, but last month he stood down as a candidate to succeed Trichet at the ECB. His outspoken opposition to the bank's bond-buying underlined the rift between the traditional approach to central banking and the political expediency born of the crisis. "There will have to be fundamental change ... If institutions are too big to fail, they are too big to exist," Weber said, echoing comments by King at the Bank of England.

MORE INTRUSIVE

THE SHIFT IS ALREADY happening. "Bond investors are not facing a future change; they are living through a change," said Gieve, the former Bank of England deputy governor. Inflation remains very important, and I have no doubt my colleagues at the Bank of England take it very seriously ... But they are also aware of the need to stabilise the financial system. They need to get the economy on a sustainable growth track. "

Of course the Fed has never operated in a vacuum. Greenspan swiftly cut interest rates after the Black Monday stock market crash in October 1987 and again in September 1998, after the Fed had to organise a $3.5 billion rescue of LTCM, a big hedge fund. But some experts, including Stephen Roach, Morgan Stanley's non-executive chairman in Asia, have long argued that an explicit financial stability mandate would force the Fed -- and other banks -- to pay closer attention to looming bubbles and weak links in the system rather than simply mopping the mess up later.

Legislators are giving central banks more powers to keep an eye on financial -- as distinct from monetary or economic -- trends. Academics have also broadened their reach in that direction, with the Federal Reserve's prominent Jackson Hole conference last summer featuring a paper arguing that policymakers should pay closer attention to financial variables in their



Reuters graphic/Scott Barber

REUTERS

BRAVE NEW WORLD

Bank of England Governor Mervyn King in Manchester, northern England, September 2010. REUTERS/DARREN STAPLES

BY HUW JONES
LONDON

The world's first recorded bank panic dates back to Rome in AD 33, yet the intervening centuries don't seem to have given top central bankers much to go on when it comes to detecting how local risks and asset bubbles become systemic, threatening the world economy.

Everyone agrees the authorities need a macroprudential or "bird's eye view" of the risks, but no one knows how to get it, partly because even the experts can't agree on what systemic risks are. "Systemic risk is an elusive concept," said the Bank for International Settlements this month. "It can have significant economic consequences and is quantitatively important, yet there is no clear consensus on how it should be measured." Some central bankers admit privately it may be impossible to detect all bubbles.

That's hardly encouraging, since addressing the problem is a core element in the changes western central banks have been called on to make. But this hasn't stopped bankers from trying: fast-evolving new approaches are being foisted on an unwitting public, even as central bankers themselves aren't entirely sure how things will work.

So far, all have created bodies with reassuring names: the United States has a Financial Stability Oversight Council, the EU has a European Systemic Risk Board, and Britain's Financial Policy Committee is already up and running -- albeit in interim form after it was set up this year. It has taken months to get this far, a sign of how much it is still a work in progress.

The committee, which must wait until 2012 for the legislation needed to firm up its legal foundations, has an agreed objective. Its broad remit is to ensure the financial system stays resilient in the face of booms and busts, and any actions it takes must not frustrate economic growth over the medium to long term.

Also decided is that the committee is based at the Bank of England and chaired by the Bank's governor, Mervyn King, turning him into one of the world's most powerful central bankers in terms

HOW MANY SHALL WE ORDER? Critics say not only the Fed, but also the government, made mistakes. Treasury Secretary Timothy Geithner, left, and Fed Chairman Bernanke leave a ceremony to debut the new design for the US$100 note in Washington, April 2010. **REUTERS//JIM YOUNG**

macroeconomic assessments.

That's exactly the direction things are headed. Since the beginning of this year, ECB boss Trichet has chaired something called the European Systemic Risk Board (ESRB) -- a body designed to take a bird's eye view of Europe's financial system and flag up emerging problems so the relevant authorities can act. In Britain, the government has decided to disband the Financial Services Authority and give the Bank of England the job of preventing any build-up of risk in the financial system, on top of its monetary policy role. And in the United States, newly enacted legislation gives the Fed a leading role in financial regulation as part of the Financial Stability Oversight Council.

"From a regulatory standpoint, we'll be more aware and more intrusive in monitoring institutions that are systemically critical," Dallas Fed President Richard Fisher told Reuters in an interview.

POLITICS, OF COURSE

WITH THOSE EXPANDED roles comes a greater need for central banks to explain their actions to citizens, markets and politicians alike. Investors will no longer be able to anticipate how policy makers will act just by tracking inflationary trends as they did for a generation before the Great Financial Crisis.

Bernanke made it a priority from the start of his tenure in 2006 to improve communications. He didn't have to do much to improve upon his oracular and sometimes opaque predecessor, Alan Greenspan, who famously said, "if I turn out to be particularly clear, you've probably misunderstood what I've said."

But the crisis exposed the Fed to withering fire. "It's hard to maintain mystique when there have manifestly been a series of policy errors, not just at the Fed but in many branches of government," says Maurice Obstfeld, a professor of economics at the University of California at Berkeley.

Even harder, when the big central banks themselves have yet to work out how they will implement their new powers. The new rules in the United States, for instance, give regulators more leeway to wind down global financial institutions deemed too large to fail in case they touch off a catastrophic domino effect as loans are called in. But how that will work in practice remains to be seen.

"At the end of the day it comes down to whether or not the too-big-to-fail resolution mechanisms are robust. There's still some thinking to be done on that," David Altig, research director at the Atlanta Fed and a professor at the University of Chicago's Booth School of Business, said in a telephone interview. To judge by comments by Weber and King, that's a big, unanswered, politically charged question. The BoE chief has been vocal in complaining that the concept of "too important to fail" has not been addressed, and that bankers continue to be driven by incentives to load up on risk.

Then there's the fact that deciding which firm should live and which not is an intensely political process. Look no further than the furore over the U.S. authorities' decision to bail out insurer AIG and car maker GM, but to let investment bank Lehman Brothers go to the wall months after arranging a rescue of Bear Stearns.

With an expanded awareness of their mandates, wouldn't central banks be forced to

of responsibilities. It will meet at least four times a year with publication of its deliberations and decisions. Members include King's senior colleagues and four outsiders. It will intervene in two ways: call for actual rule changes or issue recommendations, which markets will interpret as warnings. Or it will aim to "take away the punchbowl" in regulatory parlance, to ensure credit is curbed before the financial party gets out of hand.

The committee is expected to spend much of its time issuing policy recommendations to other bodies, such as the planned new Financial Conduct Authority (which will partly replace the Financial Services Authority next year) or the new Prudential Regulation Authority, which adds another new responsibility for the Bank of England in the supervision of major banks and insurers. It could, for example, call for banks to reduce their short-term liabilities, with a deadline.

That all sounds simple enough, but some of the new committee's tactics are far from from agreed. It will be given its own set of tools or "directive powers", but what these will be is still up for debate.

Some, like FSA Chairman Adair Turner, say the new committee could be allowed to cap the proportion of a property's value that banks can lend, to cool overheated property markets. Many central banks in Asia limit the proportion of deposits that banks can extend as loans.

Others argue the committee's role cannot include managing the credit cycle -- for an unelected body to tell households how much they can borrow would be a politically fraught endeavour, these central bankers say. The aim is not to stop over-borrowing, they argue, but to stop it from undermining the financial system. A better approach would be to slap extra capital charges on those banks that are willing to lend a higher share.

There's plenty of time to tackle the details. Between now and the end of 2012, the committee and the government will refine its remit and tools. "That remit is likely to be more a matter of words than a single number like the inflation target, but it is the right approach to seek to set this out as explicitly as possible," says Bank of England Chief Cashier Andrew Bailey.

Even if those details are agreed, they may mask a political minefield. For instance, the committee wants the government to say where the trade-off would lie between preserving the stability of the financial system and threatening broader economic growth by, say, curbing consumer demand.

The committee's European counterpart is in a similar situation: its chairman Jean-Claude Trichet said this month macroprudential regulation is a new discipline with no template, and the tools needed may take until the middle of this decade to hone.

And, of course, the British committee's effectiveness will depend entirely on good links and perhaps even coordinated steps with its counterparts in the United States and EU. This may not be easy in practice, because even regulators are human.

(Editing by Sara Ledwith)

take into account such dilemmas when they are setting interest rates?

"It's a risk, but one has to be aware of the risk and to avoid it," says Issing, the former ECB chief economist. "It's macroeconomic supervision; it's not micro control of individual banks. But if the European Systemic Risk Board identifies systemic risk, it must be solved with tools of regulation and not by lax monetary policy."

A FACT OF LIFE

IN TRUTH, CENTRAL BANKING, by its nature, has always been an intensely political enterprise. To pretend otherwise is naive. War, revolution, depression and calamity have always subjugated central banks to political necessity, and most are still state-owned. Like a country's highest court, a central bank cannot -- no matter how vaunted its independence -- be unaware of the political and social mood. The Fed chairman and the U.S. Treasury secretary worked hand in glove during the financial crisis and have the freedom to discuss a range of topics when they meet informally every week.

The political nature of central banking was brought home last month when Weber decided to stand down early. He had judged that he did not have enough political support from the 17 members of the euro zone, and his relationship with German chancellor Angela Merkel was also rocky. He will hand over to Jens Weidmann, Merkel's economic adviser. Critics of the appointment -- and there is no shortage of them in a country that likes its central bankers tough and independent -- worry that Weidmann will weaken the Bundesbank's statutory freedom from political influence.

That misses the point completely, says David Marsh, co-chair of the Official Monetary and Financial Institutions Forum, which brings together central banks, sovereign wealth funds and investors. Marsh says the launch of the euro in 1999 was a political act itself, one that has already led to a much more politicised regime of monetary management.

"The interplay with governments -- whatever the statutes say about the supreme independence of the European Central Bank -- is a fact of life," he says. "The mistakes and miscalculations of the last 12 years show how monetary union has to be part of a more united political system in Europe. That is not loss of independence. That is political and economic reality."

It is against this backdrop that Trichet's apparent conversion on the road from Lisbon to Brussels last May must be seen.

Niels Thygesen, a member of the committee that prepared the outline of European Economic and Monetary Union in 1988-9, says the euro zone debt crisis forced the ECB to show some flexibility by agreeing to the bond-buying programme. "It is a departure relative to the original vision for the European Central Bank, which was supposed to be a bit isolated from dialogue with the political world," he says. "On the other hand, I never thought that was quite a tenable situation."

NO EASY ANSWERS: QE hasn't done it for Japan. Bank of Japan Governor Masaaki Shirakawa at the start of the meeting of G20 finance ministers and central bank governors in Paris February 2011.
REUTERS/BENOIT TESSIER

> *"THE GOVERNMENT TENDS TO BLAME EVERYTHING ON THE BANK OF JAPAN. "*

Thygesen, now a professor at the University of Copenhagen, said he did not particularly like the idea but acknowledged that the ECB might in fact have gained some clout by agreeing to the bond-buying plan. Trichet helped rally euro zone leaders into arranging standby funds and loan guarantees that could be tapped by governments in the currency bloc shut out of credit markets -- relieving the ECB of some of the burden of crisis management.

"It was part of a bargain and I'm sure Mr Trichet bargained very hard and in a way successfully," says Thygesen. "The ECB has stood up well and gained substantial respect for its political clout in bringing about actions on the part of governments, which otherwise might not have taken place."

LESSONS FROM JAPAN

IT DOESN'T ALWAYS WORK out that way. Just ask the Bank of Japan.

The BOJ embarked on quantitative easing as far back as 2001. But a decade on, it has still failed to decisively banish the quasi-stagnation and deflation that has dogged Japan's economy since the early 1990s. Only once in the past decade, in 2008, has Japan experienced inflation of more than 1 percent -- the central bank's benchmark for price stability.

When the global crisis hit, the BOJ revived a 2002 scheme to buy shares from banks and took a range of other unorthodox steps to support corporate financing. But its actions failed to placate critics who view it as too timid. Senior figures in the ruling party and opposition parties talk of watering down the BOJ's independence and forcing it to adopt a rigid inflation target.

"The government tends to blame everything on the BOJ," Kazumasa Iwata, a former BOJ deputy governor, told Reuters.

Makoto Utsumi, a former vice finance minister for international affairs, defended the bank's current set-up, saying it would be "absurd" and "unthinkable" for a developed country like Japan to make its central bank a handmaiden of the government.

The bank's prompt response to the devastating March 11 earthquake and tsunami has since earned it widespread plaudits. The BOJ poured cash into the banking system, doubled its purchases of an array of financial assets and intervened in the foreign exchange market in coordination with the central banks of other rich nations to halt a surge in the yen that was hurting Japan's exporting companies.

Charles Goodhart, a professor at the London School of Economics who was on the Bank of England's Monetary Policy Committee from 1997 to 2000, believes a measure of central bank independence can be preserved, even if cooperation with ministers is needed to keep the banking system stable. "I think trying to maintain the independent role of the central bank in interest rate setting remains a very good idea," he told Reuters. "When it comes to financial stability issues, at any rate under certain circumstances and at certain times, there will have to be a greater involvement of the government."

How to achieve that balance is the subject of a whole other debate. "None of this is going to be quite in the separate boxes it has been in the past," says Gieve, the former Bank of England deputy governor. "If you have inappropriate monetary policy, all the macroprudential instruments in the world will find it very difficult to push water up hill."

IMPORTING INFLATION

AS IF THE POLITICAL dimension was not enough of a headache, central bank rate-setters seem to be finding it harder to nail down the sources of the inflation they are tasked to fight. One reason is globalisation.

Central banks have traditionally turned a blind eye to a one-off rise in prices stemming from, say, an increase in consumption taxes, a sharp drop in the exchange rate that boosts import costs or, as now, a spike in oil. As long as the price jolt does not change inflationary expectations or worm its way into the broader economy by prompting workers to ask for higher wages, policy makers have usually felt comfortable in keeping their eye on underlying cost pressures at home.

That remains the consensus, as demonstrated by the Bank of England, which has failed to keep inflation down to its 2 percent target for much of the past five years.

But in a world of integrated supply chains, can inflationary impulses be neatly attributed to either domestic or international forces? Does it now make sense, as some analysts argue, to estimate how much spare capacity there is globally, not locally?

The answers to those questions will have huge implications for monetary policy.

Lorenzo Bini Smaghi, one of six members of the ECB's Executive, has warned that sharper rises in the prices of commodities and goods imported from emerging economies will push up euro zone inflation unless domestic prices are controlled. "A permanent and repeated increase in the prices of imported products will tend to impact on inflation in the advanced countries, including the euro area," he said in Bologna in January.

St. Louis Fed President James Bullard admits the United States could not consider its own inflation outlook in complete isolation from the rest of the world. "Perhaps global inflation will drive U.S. prices higher or cause other problems," he told a business breakfast in Kentucky in February.

The ties that bind global banks and the ease with which capital flows across borders mean that central banks have to be more aware than ever of the international consequences of their policy actions. Because the dollar is the dominant world currency, the Fed came under widespread fire for its second round of bond buying. Critics in China and Brazil among others charged that dollars newly minted by the Fed would wash up on their shores, stoking inflation and pumping up asset prices.

"How do we conduct monetary policy in a globalised context?" asks Richard Fisher, the Dallas Fed president. "How do we regulate and supervise and develop our peripheral vision for those that we don't supervise in a formal way, in a globalised context? Not easy."

Structural shifts in the world economy also raise questions about how long central banks should give themselves to hit their inflation goals -- further blurring the picture for investors.

"The central bank always has the choice of the time horizon over which it hits its inflation target," Thygesen, the Copenhagen professor, said. "As the Bank of England is now learning, it may have to extend that horizon somewhat in particularly difficult circumstances. There may be good reasons for doing it, but that is where the element of discretion lies."

The Bank of England expects inflation to remain above target this year before falling back in 2012. The ECB, which seeks medium-term price stability, is resigned to inflation remaining above its target of just below 2 percent for most of 2011. In the last 12 months, it stood at 2.3 percent.

It all adds up to a significant shift in the environment in which central banks operate. Policy-making is a whole lot more complicated. With a broader mandate for keeping the banking system safe comes increased political scrutiny. With fast-expanding export economies like China becoming price setters instead of price takers, offshore inflation and disinflation are of growing importance. If the rise in oil prices is due to increased demand from developing nations, for instance, can Western central banks still play down ever-higher energy bills as transient?

That all means it will become tougher for central banks to preserve their most precious asset, credibility.

"Look at the '90s and the early years of this century -- central banks were at the peak of their reputation worldwide, and I was already saying at that time that we know from experience that the risk is highest when you are on top," Issing says. "Central banks have to take care to restore their reputation, if it has been lost. I think this is a difficult situation for central banks worldwide."

(Paul Carrel reported from Frankfurt, David Milliken from London and Mark Felsenthal and Pedro Nicolaci da Costa from Washington; Additional reporting by Rie Ishiguro in Tokyo; Writing by Alan Wheatley; Editing by Simon Robinson and Sara Ledwith)

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COVER PHOTO: Two protesters from the 'Put People First' action group perform hand stands to protest during the G20 Finance Ministers meeting in St Andrews, Scotland, November 2009.
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