Timid central bankers have failed to convince sceptical audiences

***The Economist*, Free Exchange, Feb 20th 2016**

Making credible regime change

IS THE job of central bankers more like that of technicians, carefully turning knobs as they fine-tune the economy, or magicians, manipulating the audience into the suspension of disbelief? Most of the time it is the former. Monetary maestros nudge interest rates up and down with meticulous precision. Yet in extreme cases—such as when economies become trapped in a low-growth rut—central bankers must try to conjure up a change in the public's economic outlook. Just as uncertain magicians often fail to pull off their tricks, so central banks are finding their audiences in an ever-more sceptical mood.

Economists have long acknowledged the role of mass psychology in business cycles. In 1936 John Maynard Keynes described the "animal spirits" that could drive swings in spending or investment. The power of an abrupt change in market beliefs came sharply into focus in the early 1980s, when many economies were struggling to clamp down on stubbornly high inflation. Economists at the time worried that using interest rates to rein in inflation would be enormously costly. Because the public had come to expect high inflation, they reckoned, growth-crushing rate rises would be needed to force down prices and create new consumer expectations. A common estimate at the time had it that reducing America's inflation rate by just one percentage point would cause economic damage of nearly 10% of GDP.

Thomas Sargent, a winner of the Nobel prize for economics, questioned this logic. In a paper published in 1982 he pointed out that historical episodes of hyperinflation did not end slowly, as central banks subjected economies to grinding recessions, but almost overnight. An abrupt but credible "regime change" in policy could realign popular expectations almost instantaneously, he reasoned. If people believed a government's promise to halt inflation, and immediately began behaving as if the promise were credible, then in principle the adjustment could occur quickly.

In a paper published in 1990 Peter Temin, of the Massachusetts Institute of Technology, and Barrie Wigmore, of Goldman Sachs, argued that Mr Sargent's regime-change hypothesis might just as easily apply in reverse to an economy stuck in a slump. They analysed the American economy in the 1930s. Franklin Roosevelt's programme of expansion—which included a departure from the gold standard, devaluation of the dollar, and a boost to government spending—was instrumental in bringing America out of depression, they allowed. But the turnaround in America's fortunes occurred remarkably quickly, before those policies had time to work. As Christina Romer, an economist at the University of California, Berkeley, noted in 2013, the change in expectations in America happened almost immediately on Roosevelt's arrival. Equity prices jumped by 70% between March 1933 and June of that year. An analysis of market expectations of inflation concluded that traders anticipated deflation of 7% at the beginning of 1933, but inflation of 6% by the end of the year.

Messrs Temin and Wigmore credit Roosevelt with transforming the public's beliefs about how the economy would perform in future. During his campaign and after his inauguration, Roosevelt repeatedly pledged to raise prices in the deflation-stricken economy. The choice to leave the gold standard—the centre of monetary orthodoxy at the time—was a powerful signal that the break with the past would be complete.

When, in 1999, Japan became the first big economy to sink into a world of zero interest rates since the 1930s, economists spotted the parallel. Japan risked becoming stuck in a liquidity trap, they pointed out. When an economy is weak, a dose of bad news can cause people to revise down their expectations