

Additional Pressures on Central Banks

In this chapter we describe how central banks are coming under additional pressures in the post-financial-crisis environment. While some of these additional pressures are not entirely new, they threaten to force central banks onto risky terrain.

We highlight two sets of pressures: (a) the consequences of high public and private debts; and (b) the perceived dangers of currency appreciation and overvaluation.

While manifestations of these pressures are already evident in individual countries, it is important to understand them as part of a broader global picture. We do so in the next two sections, which look at the consequences of high public and private debts in the advanced economies and at worries about currency misalignments and overvaluation in emerging markets, respectively. Following this *positive* analysis (which asks what kinds of new pressures central banks will find themselves subject to), we turn in the concluding section to the *normative* dimension (the question of how central banks should respond).

Central Banks and the Debt Overhang

High levels of public debt are likely to be the most enduring legacy of the 2007-2009 financial crises

for the United States and other industrial economies. For many if not most advanced countries, concerns about those debt burdens will shape policy choices for years. Fiscal adjustment is painful in the short run, which makes it politically difficult to deliver. Debt restructuring, for its part, leaves a damaging stigma and is also often associated with deep recessions.

Importantly, debt overhangs are not limited to the public sector, as was the case following World War II, but include a high degree of leverage in the private sector, especially in the financial industry and among households.²² The surge in domestic bank credit that occurred in most advanced economies in 1997-2007 has barely begun to unwind. The build-up in external leverage was even greater, with Iceland and Ireland recording gross external debt positions in excess of ten times their respective GDPs. The debt overhang and associated problems are common to most advanced economies.

An unsustainable path for the public debt ultimately needs to be addressed. In some countries this will require an extended period of primary budget surpluses. In others it will require debt restructuring. The authorities will of course be reluctant to term their actions restructuring; they will prefer the pretense that they are finding uniquely

²² See Reinhart and Reinhart (2010).