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Central bankers have collectively lost the plot. They must raise interest rates or face their doom

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The twilight of monetary policy CREDIT: MATT CARDY/GETTY IMAGES

It was May 6 1997, and the forlorn Tory survivors of Labour's landslide election victory five days earlier had to make our first collective decision. On that day, the new Chancellor, Gordon Brown, announced that henceforth the Bank of England would have operational independence from governments.

We decided not to demur. In private, we had considered doing the same thing ourselves. The idea that central banks should be free of political pressures and the electoral cycle as they set interest rates had become a prevailing one across the world – with good reason after the many wild swings in inflation and interest rates over previous decades.

Ever since, the Bank, like its counterparts such as the US Federal Reserve and the European Central Bank, has been setting interest rates as it wishes to achieve a sustained, low rate of inflation. But such central banks are now in deep trouble, perhaps deeper than they realise. Eight years after the global financial crisis they are still pursuing

emergency policies that are becoming steadily more unpopular and counter-productive. Unless they change course soon, they will find their independence increasingly under attack.

Theresa May warned in her conference speech about low interest rates fuelling inequality. Donald Trump rages against the chair of the Fed, Janet Yellen. Germans are restive about the lax monetary policy of the ECB. What has gone wrong?

In 2008 the central banks reacted to a massive crisis they had completely failed to foresee by cutting rates to record lows and embarking on “quantitative easing” – pumping trillions of dollars into their economies by buying up the assets of commercial banks. The trouble is that eight years later they are, to varying degrees, still doing it. Like doctors keeping their patients on a drip many years after an operation, they are losing credibility and producing very dangerous side effects.

There are at least 10 serious drawbacks to this – all of which can be accepted for a short period but become either politically explosive or economically unwise if continued indefinitely.

1. Savers find it impossible to earn a worthwhile return, which drives them into riskier assets thus causing the price of houses and shares to be inflated ever higher.
2. Higher asset prices make people who own them much richer, while leaving out many others, seriously exacerbating social and political divides and fuelling the anger behind “populist” campaigns.
3. Pension funds have poor returns and therefore suffer huge deficits, causing businesses to have to put more money into them rather than use it for expansion.
4. Banks find it harder to run a viable business, contributing to the banking crisis now visibly widespread in Italy and Germany in particular.
5. Those people who are able to save more do so, because they need a bigger pot of savings to get an equivalent return, so low interest rates cause those people to spend less, not more.
6. Companies have an incentive to use borrowed money to buy back shares – which they are doing on a big scale – rather than spend the money on new and productive investments.
7. Central banks are starting to buy up corporate bonds, not just government bonds, to keep the system inflated – so they are acquiring risky assets themselves and giving preference to some companies over others.
8. “Zombie companies”, which can only stay in business because they can borrow so cheaply, are kept going even though they would not normally be successful – dragging down long-term productivity.
9. Pumping up the prices of stock markets and houses without an underlying improvement in economic performance becomes ever more difficult to unwind and ultimately threatens an almighty crash whenever it does come to an end – wiping out business and home buyers who got used to ultra-low rates for too long.
10. People are not stupid; when they see emergency measures going on for nearly a decade it undermines their confidence in authorities, who they think have lost the plot.

I am not an economist but I have come to the conclusion that central banks collectively have now indeed lost the plot. The whole point of their independence was that they could be brave enough to make people confront reality. Yet in reality they are blowing up a

bubble of make-believe money to avoid immediate pain, except for penalising the poor and the prudent.

Earlier this year I put this view to the top staff at the central bank of a major Far East economy, thinking they might set my mind at rest and explain why everything made sense. But, far more alarmingly, they said they agreed with me: their problem was that no single authority can opt out of these policies because they might cause a recession for their own country unless there was a global, co-ordinated move gently to raise interest rates.

The policies of any one central bank may well be perfectly rational, including the recent decisions of the Bank of England after the referendum. But so is a decision by any one sheep to run with the flock when in danger. The trouble is that the whole flock might be heading for a cliff.

Some central bankers would mount a strong defence of their approach. They would explain that there is a global glut of savings, so interest rates are in any case kept low by market forces. This is true, but it does not mean those rates have to be driven to zero, or even below zero now in some places, by the authorities.

They would also say that their mandate is to keep inflation low and positive and that's it. All these other effects that I have mentioned are not their business, because they are not political leaders. They are just doing a technical job.

I have bad news for them. The accumulating effects of loose monetary policy globally are intensely political. When pension funds renege on promises, or inequality widens further, or savers become desperate, huge public and political anger is gong to burst over the heads of the world's central banks.

The only way out is for the US Fed to summon the courage to lead the way to higher interest rates, and others to follow slowly but surely. If they fail to do so, the era of their much-vaunted independence will come, possibly quite dramatically, to its end.