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Central banks need a bigger and bolder mandate

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In the wake of the global financial crisis, there is an emerging consensus that the framework underpinning central banking, known as inflation targeting, is too narrow. The crisis is a stark reminder that a monetary policy framework focused on price stability will also affect financial stability through its impact on asset prices, commodity prices, credit, leverage, capital flows, and exchange rates.

Moreover, the effects are not limited to one country. One country's monetary policy can spill over to other countries through cross-border capital flows, with important consequences for financial stability there too. So, it is time to update central banks' mandates and operations. Specifically, they should be updated to make financial stability an explicit objective of central banks, along with price stability. In particular, monetary policy should be recognised as a legitimate element of the macroprudential supervisor's toolkit.

This means that when rapid credit growth, or other indicators of financial excess, accompany asset price increases, the authorities should employ stress tests to evaluate the effects of the changes on asset prices, economic activity, and financial stability. Instead of seeking to identify bubbles, they should simply ask whether a change in current financing conditions could be disruptive for the economy.

Where the answer is Yes, they should lean against the wind using a combination of levers, including monetary policy when necessary. If this results in periods when, in the interests of financial stability, the central bank misses its inflation target, then so be it. Such is the nature of a "dual mandate" that prioritises not just price stability, but also financial stability.

An expanded mandate requires central banks to change the way they deal with the public and politicians. Neither group will be happy, for example, if the central bank curbs credit growth in the interest of financial stability, causing asset prices to fall. The bank must clearly articulate its assessment of the risks and the rationale for its policy actions. More transparency and better communication are crucial if the central bank is to defend its independence as its mandate expands. It needs to be explicit about how it seeks to balance the objectives of price stability, output stability and financial stability.

Central banks traditionally do little to internalise the spillover effects of their policies on other countries. They underinvest in financial stability at the global level. In large economies, domestic political authorities should let considerations of these external effects play an explicit role in the monetary policy framework. Central banks in these countries should pay more attention to their collective policy stance and its global implications.

To this end, a small group of systemically-significant central banks should meet regularly. This group would assess the implications of their policies for global liquidity, leverage, and exposures. It would also discuss the appropriateness of their joint monetary and credit policies for maintaining global price, output and financial stability.

The committee should issue a periodic report, evaluating and justifying their policies from the global perspective, pointing out areas of dissent or inconsistency. This should be submitted to the Group of 20 nations and released with a public presentation. The requirement to issue periodic public reports can help central bankers identify and air the inconsistencies in their policies.

Large countries may not yet be ready for their central banks to accept global responsibilities, especially while they are preoccupied with tackling slow domestic growth. But we must prepare for the future. The proposed reports would initiate a broader discussion of how to alter the mandates of large central banks, to minimise adverse repercussions from their policies, even while their responsibilities continue to be domestic.

The world has been rethinking bank regulation to make economies more stable. Unless it also rethinks central banking, the job will be half done.

**This article is based on “Rethinking Central Banking”, a Brookings Institution report.*

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