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Rethinking central banking

Barry Eichengreen Eswar Prasad Raghuram Rajan

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Central banks have massively broadened their remit in recent crisis-laden years, but the standard analytic framework – 'flexible inflation targeting' – has not changed. This column argues that it is time to properly flesh out an alternative framework. Financial stability should be an explicit mandate of central banks, and international coordination among central banks should be boosted by forming a small group of systemically significant central banks that regularly meets and issues reports to the G20 on their financial-stability policies.

In the wake of the global financial crisis, there is an emerging consensus that the framework underpinning modern central banking – known as flexible inflation targeting – needs to be rethought.

- A monetary policy framework focusing on price stability and output growth will also affect financial stability through its impact on asset valuations, commodity prices, credit, leverage, capital flows, and exchange rates.
- One country's monetary policy can spill over to other countries, especially when central banks follow inconsistent frameworks, with cross-border capital flows serving as the transmission channel.

All this suggests that the conventional framework for central banking is inadequate (*eg* Dalla Pellegrina *et al* 2010). It is too narrow to meet domestic and global needs, as we argue in Eichengreen *et al* (2011).

Consensus on dissatisfaction; disagreement on solutions

There may now be broad consensus on this general point, but there is still little agreement about the particulars of the new framework. It is time to move beyond dissatisfaction with the prevailing framework and properly flesh out an alternative. In our view and that of our colleagues (listed below), that alternative should have the following elements:

- Financial stability should be an explicit mandate of central banks.

Other micro- and macroprudential policies should be deployed first, wherever possible, in the pursuit of financial stability, but monetary policy should be regarded a legitimate part of the macroprudential supervisors' toolkit.

- When rapid credit growth or other indicators of financial excess accompany asset price increases, the authorities should employ stress tests to measure the effects of changes in credit conditions on asset prices, economic activity, and financial stability.

Instead of seeking to identify bubbles, the authorities should simply ask whether current financing conditions are raising the likelihood of sharp reversals in asset prices that are disruptive to economic activity.

- Where the answer to the aforementioned question is yes, central bankers should then lean against the wind using a combination of the tools at their disposal, turning first to non-monetary micro- and macroprudential tools, but also to monetary policy tools when necessary.

If this results in periods when, in the interests of financial stability, the central bank sets policies that could result in deviations from its inflation target, then so be it.

- Responsibility for the maintenance of financial stability can be assigned either to the central bank or to a self-standing financial supervisory authority. But in both setups, close coordination between the central bank and other agencies that contribute to ensuring the stability of financial conditions is essential.

This is particularly important when policymakers have to evaluate the tradeoffs between the use of monetary tools and prudential measures and make decisions on the appropriate mix.

- Central banks already require substantial operational independence in order to pursue their mandates. They will require even greater independence when a financial-stability objective is added to those mandates.

They will, in turn, have to establish the legitimacy of their actions in circumstances where the nature of threats to financial stability is poorly understood.

The public and its elected representatives may not be happy, for example, if the central bank curbs credit growth in the interest of financial stability, causing asset prices to fall. This makes it important for the central bank to clearly communicate its assessment of the risks and the rationale for its policy actions. It needs to explain how it seeks to balance the objectives of price stability, output stability, and financial stability.

Better communication and greater clarity on how the central bank will be held accountable for its broader mandate are necessary to defend central bank independence. Independence is politically viable only with accountability, and the best way to enhance accountability is for central banks to become more transparent and forthright about their objectives and tactics.

- The spillover effects of a central bank's policies in other countries are a legitimate concern.

At present, central banks do little to internalise these effects. Admittedly, they may have difficulty in justifying actions taken in the effort to do so to domestic political authorities.

This tension points to the need for further changes in prevailing policy framework. Specifically, domestic political authorities should be persuaded to allow such considerations to play an explicit role in the central bank's monetary policy framework in large economies. Large-country central banks should pay more attention to their collective policy stance and its global implications. Where appropriate, they should consider coordinated action to help stabilise the global economy in times of stress.

A small group of central banks to lead the change

We realise that these recommendations are unlikely to be implemented in isolation. We therefore propose that:

- A small group of systemically significant central banks, perhaps called the International Monetary Policy Committee, should meet regularly under the auspices of the Committee on the Global Financial System of the Bank for International Settlements (BIS).

- This group would discuss and assess the implications of their policies for global liquidity, leverage, and exposures, and the appropriateness of their joint money and credit policies from the point of view of global price, output, and financial stability.

Although central bank governors already meet regularly at the BIS, we recommend a substantial upgrade for our proposed committee from the current informal and closed-door format.

Communication of central bank actions is important at the global level, just as it is for a domestic audience. In some ways, it is more important, since the global spillovers and coordination can be discussed explicitly. For this reason:

- The committee should periodically issue a report assessing and justifying their policies from this global perspective, pointing out areas of dissent or inconsistency.
- The report should be submitted to the G20 and released more broadly with a formal public presentation.

Possible objections

Central bankers will of course insist they have no control over one another. Some will claim that such matters are already discussed informally at the BIS meetings or formally at the G20 meetings. However, the current BIS format is not conducive to accountability, and the current G20 format gives precedence to heads of government and finance ministers, not central bank governors. The discussion that takes place at the margins of the G20 meetings is informal. For these reasons, a separate forum is needed. The need to issue periodic public reports can help central bankers identify and publicly air the inconsistencies in their policies. With time, this should encourage them to internalise some of the external consequences of their policies.

The kind of report we have in mind can inform a broader discussion of how the mandates of large central banks can be altered so as to minimise the adverse spillover effects of their policies, even while their responsibilities continue to be domestic. It would have the ancillary benefit of stimulating research on the definition, determinants, and means of control of global liquidity, a notion that is still an abstract and ill-defined concept in policy discussions.

Some will question whether the world in fact needs yet another international committee of central bankers to issue yet another periodic report. But if monetary policymakers are to take seriously not just the pursuit of low inflation but also global economic and financial stability, extending to real-financial interactions and the cross-border repercussions of national policies, then we would insist that the case for such a committee and such a report is compelling.

Editor's Note: "Rethinking Central Banking," published by the Brookings Institution, is the first annual report of the Committee for International Economic Policy and Reform (CIEPR), comprised of Barry Eichengreen, Mohamed El-Erian, Arminio Fraga, Takatoshi Ito, Jean Pisani-Ferry, Eswar Prasad, Raghuram Rajan, Maria Ramos, Carmen Reinhart, Helene Rey, Dani Rodrik, Kenneth Rogoff, Hyun Song Shin, Andres Velasco, Beatrice Weder di Mauro and Yongding Yu.

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