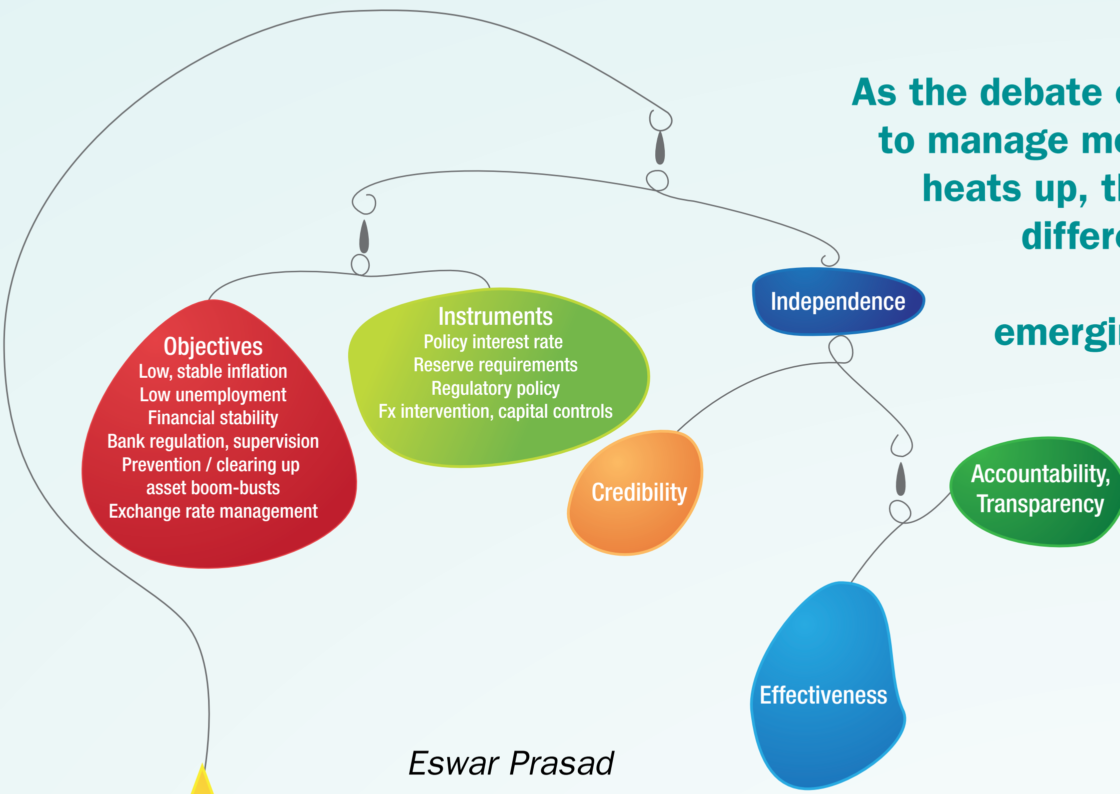
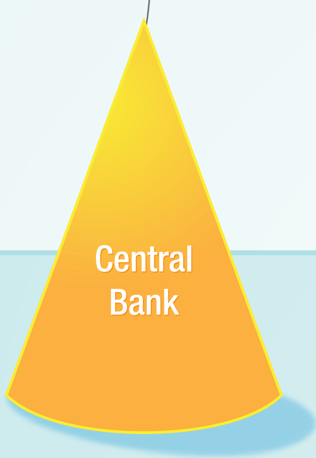
After the Fall

As the debate over how best to manage monetary policy heats up, the once-sharp difference between advanced and emerging economies is blurring





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As the world economy ponders the lessons from the receding global crisis, a fierce debate has erupted about central banking concepts thought to have been long settled (Goodfriend, 2007). The appropriate role and mandate of central banks has come under scrutiny around the world.

Globalization has made both advanced and emerging market economies more exposed to external shocks, as their rising openness to trade and financial flows creates wider channels for cross-country spillovers of shocks. These forces have also increased the burden on monetary policy. It is much harder now for a central bank to use instruments such as interest rate changes to attain domestic objectives; as capital sloshes around the globe it can create many difficulties in managing monetary policy, especially in economies with shallow financial systems. And yet, monetary policy is gaining importance as a first line of defense against external shocks and breakdowns in the financial system, because it can be far more nimble than other macroeconomic policy tools.

This has generated a rich debate: what the right framework is for monetary policy, what the scope of a central bank's objectives should be, and what the optimal degree of central bank independence is. Even as clarity about optimal monetary frameworks has diminished, a remarkable outcome of the crisis has been a convergence in the nature of the debates about central banking in economies at different stages of economic and institutional development.

Emerging market central banks have been considered as lagging behind those in advanced economies—in terms of the rigor of their operating frameworks and also their sophistication and transparency. But central banks in emerging markets have come out of the crisis looking a lot better than their advanced economy counterparts. Less-sophisticated financial markets and much greater regulatory prudence proved to be an advantage. Consequently, some interesting twists have come up in the debates about suitable monetary and regulatory policies for emerging markets (Gill, Kanbur, and Prasad, 2009). At the outset, it is worth reviewing some general principles that are relevant for all types of economies.

Targeting inflation targeting

Over the past two decades, inflation targeting—in either explicit or implicit form—has become the monetary policy framework of choice for most advanced economies. A number of emerging market central banks have also adopted frameworks in which their priority is to maintain inflation at a target level or within a specified range. Many others had been moving toward such a system. Inflation targeting has had a good track record of delivering price stability and anchoring inflation expectations, which has proven valuable in emerging markets, where high inflation is especially pernicious because it hits the poor disproportionately hard.

But inflation targeting has come under sharp attack in the aftermath of the global financial crisis. Central bankers in developed economies are being pilloried for focusing too much on price stability, ignoring asset market bubbles, and failing to prevent the worst crisis seen for a generation.

Meanwhile, although many emerging markets weathered the crisis relatively well, central banks in that group that target inflation also face pressure to abandon the framework. Critics argue that targeting inflation could be damaging to these economies if it means disregarding sharp exchange rate fluctuations and boom-bust cycles in equity and housing markets.

Indeed, a more sweeping argument by some emerging market central bankers is that low inflation is neither necessary nor sufficient for financial stability. That enormous financial market stresses built up in many advanced economies during a time of low inflation and stable growth forces one to take this view seriously.

Asset market bubbles

Price bubbles in housing and equity markets can have destructive effects on financial markets and the economy when they pop, as they eventually do. This reality seems to legitimize the argument that central banks cannot ignore asset price bubbles and that a narrow framework that restricts central banks from taking preemptive actions against bubbles is doomed to failure. But there is a major problem—it is difficult to detect such bubbles in real time and far from obvious that monetary policy is the right tool to prick these bubbles before they become large.

The purist view on monetary policy is that as long as central bankers have the right macroeconomic model for inflation, asset bubbles should be incorporated into the inflation-targeting framework. Asset booms increase the financial wealth of households and firms, causing them to feel richer and spend more. That should translate into rising aggregate demand that would increase inflation that in turn would trigger a policy response. In other words, central banks would automatically head off asset bubbles by taking monetary policy actions to counter their inflationary impact. Yet, even if central banks had the right model, asset prices could boom rapidly and cause destructive busts before their aggregate demand implications became apparent.

A compromise position is that bubbles fueled by loose monetary policy—perhaps, for example, the housing boom in the United States—should be brought to heel by monetary policy, while others—such as the equity price boom in the technology sector in the early 2000s—should be dealt with using regulatory policies or be allowed to run their course. This approach faces its own set of problems because of the difficulty in detecting and heading off bubbles, let alone divining their causes. Even now it remains a matter of contention whether the proximate cause of the housing boom and subsequent bust in the United States was lax monetary policy or weak regulation.

However this debate is resolved, in the aftermath of the crisis it will be difficult for central banks to ignore asset prices, even if they do not target them in any formal way. Indeed, an explicit financial stability mandate will require central banks to manage asset prices. After all, in the recent crisis, the fall in U.S. house prices ultimately brought the entire financial system to its knees. Some central bankers even contend that preserving financial stability is so closely related to the standard goals of monetary policy that it is impossible to separate the two functions (Blinder, 2010).

This aspect of "mandate creep" for central banks could create complications. Consider the notion of using regulatory tools to manage asset bubbles and ensure financial stability, while using interest rate policy to manage inflation. This can create tension when the financial well-being of the financial institutions for which the central bank is responsible might be affected by interest rate policy. For instance, low policy interest rates are good for bank profits because they give banks access to cheap money, but low rates could cause a surge in inflation expectations and fuel asset price bubbles.

There is a bigger risk to this particular aspect of mandate creep. Although it is tempting to include asset prices in the monetary policy framework, it is dangerous to ask central banks to manage asset market outcomes without clear criteria and without knowing how monetary policy actions influence asset prices. These are uncharted waters, but the practice of central banking clearly cannot be put on hold pending a theoretical resolution of these issues.

Objectives and instruments

In the midst of a crisis, monetary policy has to be pragmatic and use all available tools. Indeed, the decisive and massive liquidity interventions by central banks around the world played an important role in keeping financial systems from imploding during the recent crisis. This still leaves open the question of which monetary policy framework is right for more normal times. Which framework will contribute to macroeconomic and financial stability, reduce business cycle fluctuations, and create room for monetary policy to respond aggressively to adverse external shocks?

The conventional view, grounded in academic work and practical experience, is that monetary policy effectively has a single instrument—usually the policy interest rate—and that this can at most be used to attain one objective, such as low and stable inflation. A more nuanced version is that most central banks in fact have two instruments—a monetary policy instrument and regulatory authority. The former should be used to manage inflation, while the latter prevents imbalances from building up in the financial system. But even this limited set of objectives creates tensions. For instance, as already noted, what is good for the financial system in times of stress—low interest rates and abundant liquidity—may not always be good for managing inflation outcomes.

Such tensions are heightened in emerging markets, where central banks have traditionally been responsible for a broad array of social and economic goals in addition to price and financial stability. For instance, the mantra that a stable and transparent monetary policy focused mainly on one objective is best in the long run comes up against the harsh practical reality that surges in capital inflows and the resulting exchange rate appreciation can have permanent pernicious consequences for export-market shares and hurt the central bank's legitimacy. As a result, ancillary objectives such as exchange rate management already complicate the conduct of monetary policy in these economies. Instruments such as capital controls have limited effectiveness and create problems of their own.

A different perspective is that, in emerging markets, central banks ultimately end up being held responsible for a large set of objectives. One option is to try to embrace all these objectives, with all the risks that entails, because the alternative is to be blamed in any event if something goes wrong with any of those objectives. On the other hand, it can be equally argued that facing multiple objectives makes it more essential for a central bank to set and communicate a more limited set of goals that it can hope to deliver effectively.

If a central bank does take on multiple mandates, it can create unrealistic expectations about what it can and cannot do with the tools at its disposal. Indeed, there is a temptation to ascribe omnipotence to monetary policy, an attribute that some emerging market central bankers find forced on them. But this burden may be too much to bear and doomed to eventual failure, especially in economies with weak institutional structures, limited regulatory capacity, and high levels of fiscal deficits and public debt. Even in the absence of these constraints, monetary policy by itself cannot influence an economy's long-term growth potential or shift the unemployment rate for an extended period.

A more circumscribed view is that monetary policy can best contribute to macroeconomic and financial stability by maintaining low and stable inflation. This framework, if it operates well, defines the limits of monetary policy and provides a clear standard of accountability. The tensions among these varying perspectives feed into the debate about central bank independence.

Does independence matter?

Central bank independence is under assault around the world. In the United States, Congress is threatening to put the Federal Reserve Board under tighter surveillance even while giving it a broader mandate to manage large and systemically important financial institutions. In other countries, the crisis has served as cover for politicians to try to rein in central banks. In Argentina, the President fired the central bank president for not agreeing to use foreign exchange reserves to pay part of the country's debt obligations.

These developments are taking place against the prevailing notion that central bank independence is an unalloyed virtue because it allows the institution to focus on what it does best, without political or other constraints, and helps build credibility for the central bank in managing inflation expectations. This credibility comes in handy during tough times because it gives the central bank room to employ extraordinary measures without inflation expectations getting out of hand. An example is the relatively modest inflation expectations in the United States, despite the massive amount of liquidity injected by the Federal Reserve during 2008–09 and the rapidly rising level of public debt. At least so far, markets seem convinced that the Fed will not let inflation get out of hand.

The concept of central bank independence is complex, however. The conventional notion is that an independent central bank with a narrow but well-defined objective such as maintaining low and stable inflation has the best chance of being effective and transparent, making it less subject to political interference. Even central banks that have a clearly defined single objective in the form of an inflation target have only operational independence to achieve that target. The government determines the target itself and the consequences of missing it. Indeed, if the government was not involved in setting it, the target would lack broader public legitimacy.

Even such a narrow objective could be difficult to deliver if the government runs a profligate fiscal policy, racking up large budget deficits. Furthermore, if central banks are made responsible for financial market stability and avoidance of asset price bubbles, they must be given more instruments than a policy interest rate (or, in some cases, a reserve requirement). There is however, deep tension between central banks having multiple objectives—even if they have a corresponding number of instruments—and the operational independence needed to achieve the inflation target. Broader objectives invariably mean more political interference and reduced credibility in maintaining low inflation.

These complications are heightened in emerging markets. In many of these economies, central banks are among the most well-managed and trusted public institutions, which makes it tempting to give them more responsibilities. But taking on more responsibilities could make them less effective at the one thing they have proven good at—controlling inflation.

The real conundrum is that a narrower set of objectives could also result in central bank independence being threatened if it looks as if the central bank is not concerned about other objectives such as growth and employment. Central bankers in some emerging markets implicitly argue that what little independence they have already hangs by a thread, which could be severed if, for instance, the central bank does nothing about rapid exchange rate appreciation that hurts exporters or asset bubbles that can inflict considerable pain when they pop.

The classic retort is that the central bank can best contribute to high growth and financial stability by providing a stable macroeconomic environment through price stability. Given developments during the recent crisis, this argument has come to sound dogmatic and almost untenable. Indeed, this is one area where there seems to be a rising disconnect between the theory of central banking and its practice.

Many alternatives

Despite the rising prominence of inflation targeting, there remains a wide range of alternatives in the practice of central banking. At one end of the spectrum are formal inflation-targeting central banks such as those in Canada, New Zealand, and Thailand. The U.S. Federal Reserve has a formal dual mandate of fostering growth and price stability, but is widely seen as having an inflation objective as its main priority. At the other end of the spectrum is the Reserve Bank of India, whose Governor, Duvvuri Subbarao, explicitly bills it as a full-service central bank that has multiple objectives—with low and stable inflation not necessarily the dominant priority. A number of central banks, including the People's Bank of China, have one form or another of an exchange rate target, effectively importing monetary policy from abroad.

Theoretical models have had a much narrower range. For instance, models of inflation-targeting frameworks have focused largely on strict targeting or a flexible form that has the central bank putting some weight on the output gap, which measures the degree of slack in an economy. There is little research making explicit connections between price stability and financial stability or indicating how asset prices might be incorporated into a broader monetary framework.

Even in a narrow context, academic research is only beginning to grapple with the particular challenges facing emerging markets. For instance, the question of which price index an inflation-targeting central bank should aim at takes on a very different hue in low- and middle-income economies. In these economies, food expenditures account for nearly half of total household expenditures, and a large proportion of the population works in a cash economy with little access to the formal financial system (Anand and Prasad, forthcoming). It is untenable for central banks in these economies to target just core inflation, which excludes volatile food and energy prices—even though classical theoretical models suggest core inflation is the proper target. Broader questions about the right level of inflation that should be targeted in emerging markets or the trade-offs between higher inflation and stronger currency exchange rates also remain unresolved (Blanchard, Dell'Ariccia, and Mauro, 2010).

The net result is that, even as academics (including the author) call for more robust monetary policy frameworks that are better grounded in analysis, they have not provided frameworks that come close to dealing with the complex practical challenges that emerging market central bankers face.

Keeping things normal

Central bankers have shown their ability to respond effectively to crises. The core issue is not crisis response, however, but rather which monetary policy framework will reduce the probability of crises in the first place. Here the answers are less clear. Interestingly, virtually every economy that had an explicit—or implicit—inflation-targeting regime in place before the crisis has more or less indicated its intention to stick with that framework, perhaps because it has a good record of delivering price stability.

A number of questions remain about how inflation targeting can be adapted to the postcrisis world. A more fundamental issue, though, is whether the approach even provides a baseline framework that can be adapted to the circumstances of specific countries.

Is inflation targeting a framework that liberates central banks to do what they can do effectively and set realistic expectations for what monetary policy can achieve? Or is it a straitjacket that causes central banks to ignore financial market and macroeconomic developments that ultimately can pose big risks?

Pragmatism is an excellent operating rule in desperate times, but does not provide a framework for stability in normal times. Operating without a framework offers flexibility and adaptability, but at the cost of weakening the anchor for inflation expectations. It also risks limiting central banks' ability to build up credibility that could come in handy in times of macroeconomic and financial stress.

Inflation targeting still seems the most defensible framework, and blaming it for regulatory failures that caused a near financial collapse may result in throwing out the bathtub, along with the baby and the bathwater. Striking a balance between these perspectives will not be easy. Central bankers and academics alike have some hard thinking ahead of them. ■

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