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Conference Paper

Reassessing central banking

Session Handouts, Global Economic Symposium 2010 (GES), 27-29 September 2010, Istanbul, Turkey

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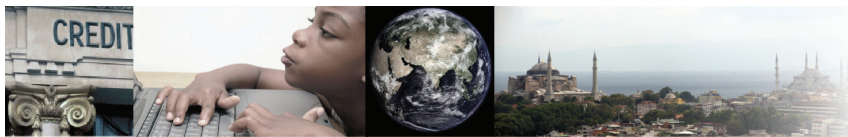
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The Global Economy

Reassessing Central Banking

The Challenges

During the past decades, a broad consensus among economists and policy makers has emerged that inflation targeting by central banks leads to very good macroeconomic outcomes.

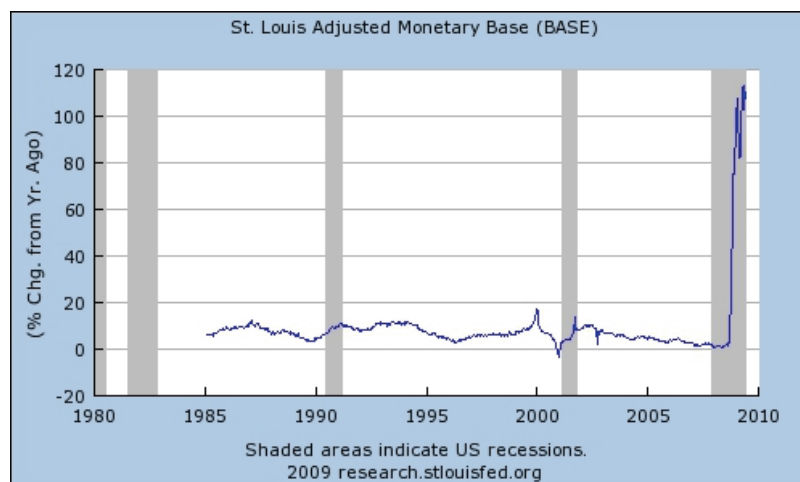
The “Great Recession” has casted doubt on this conventional wisdom. Many policymakers and analysts blame the loose monetary policy stance of the Federal Reserve to be one of the main causes for the meltdown of the financial system and the “Great Recession.”



Before the financial crisis, most central banks focused on low and stable consumer price inflation and used short-term interest rates as the main tool to implement their inflation target. Monetary aggregates and the supervision of other prices (e.g., asset prices) usually played a minor role in the actual conduct of monetary policy. Although most central bank tackled the issue of systematic risk and banking, most of them did not treat price stability and banking supervision as comprehensive issues. Quite frequently, central banks had de facto iron walls between the respective departments or they shared the responsibilities for banking supervision with other government bodies.

- Will central banking be the same after the “Great Recession” as it was before?
- Should monetary policy react to housing markets and asset price bubbles?
- Are two or more pillars better than one?
- Are central banks the best banking supervisors?
- What are potential tensions between monetary policy and banking supervision?
- Are quantitative easing and other unconventional policies adequate instruments during (great) recessions?

These and other related issues will be the focus of the session “Reassessing Central Banking.” The session will bring together academic economists, central bankers and economists from major banks. They are meant to come up with new perspectives for central banking in order to promote future economic and financial stability.





Proposed Solutions

Edward Lazear

Professor of Human Resources Management and Economics, Graduate School of Business, Stanford University

Reassessing central banking: The central bank and the government

At last year's advisory board meeting, I argued that it would serve the GES best if panel members focused on their areas of expertise and did not venture into other areas that might be more timely or popular. My research area is general microeconomics and personnel economics in particular—not monetary economics. My credentials for discussing central banking derive solely from my background as chief economic advisor to the President of the United States during the financial crisis. As such, I will focus my remarks on aspects of central bank behavior that interact with that of national governments, and in particular, with the executive. Again, sticking to my comparative advantage, most of my discussion will focus on the United States and the Federal Reserve.

I preface my comments with praise for the overall behavior of the Fed during the crisis. One can always point to actions that were taken that should not have been, and others that were not have taken that should have been, but the Fed receives high marks for its behavior throughout the financial crisis period.

The central bank as an agent of fiscal policy

Certainly in the US, the Federal Reserve's role has been defined as that of effecting monetary policy. Fiscal policy is clearly in the realm of Congress and the President. During crises, the distinction becomes blurred. This may not be the best policy in either the short run or in the long run. Two specifics follow.

The emergency role of central banks

The exigent circumstances clause of the Federal Reserve Act states:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank.

The clause is sufficiently general that some have argued it would permit the Federal Reserve to execute almost any bailout during crisis periods. The Fed's interpretation was somewhat different and caused some confusion in the market.

A common confusion is the belief that the Fed assisted in the merger of Bear Stearns with JP Morgan, but refused to do the same for Lehman Brothers. Although an inaccurate characterization of that which occurred, it remains true that just a couple of days later, the Fed acted to prevent the total collapse of AIG and all of its derivative liabilities. Why? What authority allowed the Fed to act in Bear Stearns and AIG, but not in Lehman Brothers?

The exigent circumstances authority is too vague and empowering. It should be constrained such that the Central bank must make an argument, with evidence, that failing to use the authority to discount for non-bank entities would, with high probability, cause major repercussions in the real economy. As such, it should be used in the rarest of circumstances, if



ever. I do not believe that the Bear Stearns action would have risen to that standard. Most bailouts should be in the purview of Treasury or finance ministries and should be granted explicitly by legislative bodies in advance of crises. The “failure to have resources and authority” should not be an excuse to dump the responsibility on the monetary authority. The TARP assistance done through Treasury, which was given to Bank of America in its acquisition of Merrill Lynch in December, 2008, was the appropriate way to handle such transactions.

Bad incentives for the executive branch

Having the Federal Reserve available for exigent (or other) lending is not only an inappropriate use of the central bank, but undermines the relationship between the executive and legislative branches. In the US, when the administration can end-run Congress by obtaining funding from the Fed, a dangerous precedent is set and one that is inappropriate, at least in the context of the US Constitution. The President and his appointed representatives should not be able to engage in fiscal policy that has not been approved by Congress. To the extent that Fed lending facilitates this, it creates a channel of government that was neither contemplated nor appropriate.

The central bank and legislative bodies

The chief central banker, by virtue of the data collected by the central bank, has a tremendous amount of information that may be of value to legislators. As such, legislative bodies may call bank chairs to testify. The Fed chairman is called on to do this frequently.

This is a dangerous pattern, especially when it leaks into providing specific advice to Congress and aid in drafting legislation. This undermines the credibility of the Fed as the sole and independent monetary authority and undercuts the administration in its role as a leader in proposing fiscal policy.

The role of the central bank should be one of providing information, not advice to legislative bodies. The central bank’s role precludes assistance in drafting legislation.

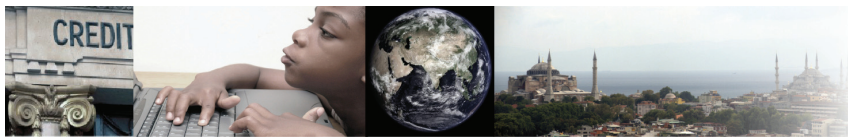
Additional central bank responsibilities

More regulatory authority

It is natural that the central bank regulates those entities to whom it must lend in last resort. How broad should the central bank’s regulatory authority extend? I believe that the central bank should have more, not less authority, in regulating financial institutions.

It is highly optimistic to believe that we can regulate and thereby control systemic risk. For example, the recent financial regulatory reform bill in the United States would not have prevented (nor even lessened to any significant degree) the last financial crisis, let alone future ones that will come from unanticipated directions. But some regulation is necessary and the question is who should do it.

Because the central bank should regulate a large part of the financial sector, namely banks, it is also beneficial to have its regulatory authority extended to cover non-bank financial institutions that engage in shadow banking. Although hedge funds were not at the center of the financial crisis, investment banks and conduits of commercial banks played a major role. The failure of other financial institutions like GMAC, not to mention Fannie Mae and Freddie Mac, had implications for the economy as a whole. In order to prevent agencies from producing conflicting regulations that may induce leakage (where systemically risky activity bleeds from the tightly regulated sector to the less regulated sector), I would prefer that the power to regulate bank-like activities move from other agencies (e.g., like the Securities and Exchange Commission and Federal Deposit Insurance Corporation) to the central bank.



Systemic risk oversight

During the last administration, there existed an institution known as the President's Working Group on Financial Markets. The Fed chairman was a member of that group, the role of which was to anticipate and make recommendations to prevent systemic risk and other problems that might arise in the financial sector. Unfortunately, like other government bodies, private sector agents, and academic economists, the group neither anticipated nor prevented the financial crisis from occurring.

In the legislation just passed, another systemic regulator is created, which has as its members not only many of the same positions, like Fed chair, but some of the same individuals as well. I am not sanguine that the newly named group will do much to prevent what its predecessor did not.

What is the solution? I believe we should be less confident that we have the foresight and ability to regulated systemic crises out of existence, either through central banks or other bodies. Instead, we should favor a lighter regulatory environment in the interest of higher growth coupled with more ex post fixes than we would choose in a perfect world. Popping bubbles, attempting to manipulate asset prices, and other actions of this sort not only take the central bank beyond its knowledge, but put it in the position of causing rather than reacting to crises. The Fed should stick to its role of addressing inflation and employment through the use of monetary policy. Regulating monetary institutions and quasi-monetary institutions is part of this. But it is unreasonable to expect the Fed to be clairvoyant about systemic risk. Consequently, the Fed's role should remain limited to that which it knows how to do, namely engage in monetary policy and set the terms by which their member financial institutions and others mentioned above operate.

Facilities

Sometimes, central banks can play an important role when markets freeze up. While I have concern anytime the Fed launches a new facility, when the complete breakdown of a market threatens the financial system, Fed intervention is warranted. Such was the case in the commercial paper market in 2008. However, the Fed should not engage in policies that change prices in an economy simply because those prices have implications for economic activity. The most important example of this is massive intervention in mortgage markets with the explicit goal of lowering mortgage rates. This is fiscal policy and should be the role of government—not the Fed. If Congress and the President in their collective wisdom decide that subsidies for housing are appropriate (as they did recently), then so be it. But monetary policy does not extend to attempting to alter the relative prices of housing, auto, commercial credit, or other assets in the economy. Quantitative easing that works through extending influence over longer-term Treasuries than is traditional less clear-cut.

Christian Merkl

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The central banks in small open economies should include the exchange rate in their objective function.

Central banks in small open economies should openly recognize that exchange rate stability is part of their objective function. This does not imply that inflation targeting should be abandoned. Indeed, at least in the short term, imperfect capital mobility endows central banks with a second instrument in the form of reserve accumulation and sterilized intervention. This tool can help control the external target while domestic objectives are left to the policy rate.



Central banks primary objective must remain the maintenance of price stability; it shall not focus on asset prices.

Because monetary policy works with a lag, policymakers' response to changes in inflation and other economic variables should depend on whether those changes are expected to be temporary or longer-lasting. When that point is taken into account, policy during that period—though certainly accommodative—does not appear to have been inappropriate, given the state of the economy and policymakers' medium-term objectives. House prices began to rise in the late 1990s, and although the most rapid price increases occurred when short-term interest rates were at their lowest levels, the magnitude of house price gains seems too large to be readily explainable by the stance of monetary policy alone. Moreover, cross-country evidence shows no significant relationship between monetary policies and the pace of house price increases.

Although central banks may be charged with additional tasks in the aftermath of the crisis, their primary objective must remain the maintenance of price stability. We can not allow any conflicts of interest to arise. The high-level expert group headed by Jacques de Larosière, former Governor of the Bank of France and Managing Director of the IMF, has identified a number of weaknesses in the supervisory framework both inside and outside Europe that contributed to the build-up of the current crisis. One of the group's proposals is to give the ECB more responsibility for so-called macro-prudential supervision. This means supervision that aims to limit the risk of distress in the financial system as a whole, but does not extend to supervision of individual financial institutions.

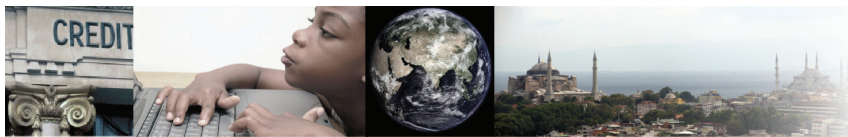
A central bank has no instruments to target successfully asset prices and creating a macroeconomic disaster by pricking a bubble would ruin the standing of a central bank. (The role of a central bank as a regulator and supervisor is a separate issue.)

A monetary policymaking strategy that monitors money and credit continuously and crosschecks the results against other analyses guarantees the symmetry of policy in expansions and contractions.

A monetary policymaking strategy that monitors money and credit continuously and crosschecks the results against other analyses guarantees the symmetry of policy in expansions and contractions. "Ultimately, this cross-check leads to a better assessment of the correctness of the policy stance. Early indications that a process of surging equity or house prices in the euro area might be interacting with conditions of abundant liquidity would lead to heightened vigilance." There are many examples of the application of "vigilance." "Monetary developments, therefore, require careful monitoring, especially in the light of the strengthening of economic activity and, in particular, of strong asset price dynamics, especially in housing markets."

Macro-prudential supervision should also avoid leading to an excessive burden of regulation. The legal principle *non bis in idem* applies to regulation: The financial sector can not be regulated twice.

Any well-functioning macro-supervisory framework needs the support of market participants, because a rigorous monitoring of systemic risks will require continuous market intelligence. Contact with market participants will be essential for detecting important trends, such as growing financial imbalances, convergence of business models, similarities in investment strategies and innovations in financial instruments—to name just a few. It will be of immense value to establish a structured dialogue with the financial industry to this end. Anecdotal evidence will be of little relevance if there is no possibility to drill down to the sources of risk on the basis of well-founded information and a regular dialogue with market participants. I understand that there may be concerns that this will impose an additional reporting burden on the industry. In my view, this should not happen. To the extent that macro-prudential oversight requires micro-prudential data, the latter should be available from supervisors, and full



confidentiality will be ensured. Any additional reporting would be exceptional. Macro-prudential supervision should also avoid leading to an excessive burden of regulation. The legal principle *non bis in idem* applies to regulation: The financial sector can not be regulated twice. The aim of macro-prudential supervision is to provide better regulation—and if possible much better, not in quantity but in quality.

During (great) recessions quantitative easing and other unconventional policies are adequate instruments.

Direct effects of money on demand and inflation, (real balance and portfolio-balance effects) still remain active at zero-interest rate floor. The effect of an increase in the monetary base is smaller than in normal times and estimates are rather imprecise. May justify pre-emptive interest rate reduction and aggressive quantitative easing.

At the same time, balance sheet policies raise a number of challenges for central banks. As central banks move away from the simplicity and well-rehearsed routine of interest rate policy, they face much trickier calibration and communication issues. As they substitute for private sector intermediation, they may favor some borrowers over others, tilting the level playing field, and could risk making the private sector unduly dependent on public support. As they purchase government debt, they come under pressure to coordinate with the public sector debt management operations. And as their balance sheets expand and they take on more financial risks, central banks risk seeing their operational independence and anti-inflation credentials come under threat in the longer term. As a result, questions about coordination, operational independence and division of responsibilities with the government loom large. These costs suggest that unconventional monetary policies should best be seen as special tools for special circumstances. The costs also point to the need for appropriate governance arrangements, designed to limit the risk that the central bank anti-inflation priorities are undermined in the medium term. And they put a premium on early exits, as soon as economic conditions permit.

Central banks should take simple rules more seriously.

Usually monetary policy is conducted via open market operations but with an operating target for the money market rate. Taylor-rule style monetary policy may be reformulated as a rule in terms of the monetary base. When rate is at zero-interest rate floor, central bank can continue with direct purchases of assets (government debt, private sector debt) and/or longer-term operations in the money market.

It's awfully hard to claim that Fed policy had no role in the housing boom and collapse that triggered the financial crisis, AND, central banks should take simple rules more seriously. Deviations ought to be systematic and well explained. **Do not** rely too much on forecasts, particularly if those measures may be revised substantially. AND NO, it is not yet self-evident that central banks should respond to asset prices directly over and above output and inflation. AND, it is not necessary to fix exchange rates or return to the gold standard. Central banks should remain independent and in charge of interest rate policy, with more weight given to simple rules than sophisticated discretion.

Domestic Price Stability: A successful consensus. External Stability: Limited understanding and unhelpful volatility in practice. C. Systemic Financial Stability: Some functions firmly maintained and well-functioning; but problems of organizing and coordinating responsibilities for financial supervision and crisis management remain.

Should the inflation target be raised?

The inflation tax is clearly distortionary, but so are the other, alternative, taxes. Many of the distortions from inflation come from a tax system that is not inflation neutral, for example, from nominal tax brackets or from the deductibility of nominal interest payments. These could be corrected, allowing for a higher optimal inflation rate. If higher inflation is associated with



higher inflation volatility, indexed bonds can protect investors from inflation risk. Other distortions, such as the lower holdings of real money balances and a greater dispersion of relative prices, are more difficult to correct (the empirical evidence is, however, that their effects on output are difficult to discern, so long as inflation remains in the single digits). Perhaps more important is the risk that higher inflation rates may induce changes in the structure of the economy (such as the widespread use of wage indexation) that magnify inflation shocks and reduce the effectiveness of policy action. But the question remains whether these costs are outweighed by the potential benefits in terms of avoiding the zero interest rate bound.

In addition to tempering debt problems, a short burst of moderate inflation would reduce the real (inflation-adjusted) value of residential real estate, making it easier for that market to stabilize. Absent significant inflation, nominal house prices probably need to fall another 15% in the US, and more in Spain, the UK and many other countries. If inflation rises, nominal house prices do not need to fall as much.

On the other side, there are various costs emanating from higher inflation:

- a) Relative-price distortions: Not all prices inflate at the same rate, and so inflation generates some relative-price distortions which lead to resource misallocation. The higher the inflation rate, the greater these distortions.
- b) Stability of inflation expectations: It is much more difficult to have stable inflation expectations at higher levels than at lower ones. In turn, the higher the inflation rate, the larger the danger, that inflation continues to move up ever further.
- c) Unexpected inflation: Empirically inflation is also much more volatile at higher rates than at lower rates. In turn, unexpected inflation tends to become a significant problem, the higher the inflation target is. Unexpected inflation also leads to significant resource misallocation.

Suzan Sabancı Dinçer

Chairman and Executive Board Member, Akbank

Will central banking be the same after the “Great Recession” as it was before?

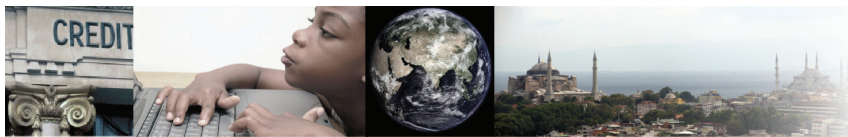
Prior to the financial crisis, the main focus of most central banks’ was to achieve and maintain price stability.

However, in advanced countries lower inflation and stable macro-economic environment proved inadequate to restore financial stability. Insufficient supervisory framework aggravated the build-up of the current financial crisis.

In Turkey, the example I know best, the issue did not present itself this way. The Central Bank took a lead in restoring confidence to the market after the 2001 self-generated crisis. Banks were subject to tight regulation. The financial system was not over-leveraged. Our Central Bank was focused on the fight with inflation. Mortgages were in their infancy and certainly not securitized. There was no asset price bubble.

Of course, Turkey has been affected by events outside its borders. And as we look to the future, we realize there are no grounds for complacency. We feel we have been warned and we are vigilant.

Central banks should now be given more responsibility to identify early potential risks and warnings to the financial system (rise in the degree of leverage, asset price dynamics etc) as a whole to secure financial stability: “Macro-prudential” supervision. It is a systemic surveillance and does not involve individual financial institutions.



The surveillance will involve a regular public reporting of all relevant macroeconomic and financial information regarding systemic risks.

Should monetary policy react to housing markets and asset price bubbles?

Although central banks in general have not targeted asset prices, the current crisis created an imperative that asset price developments should be closely monitored.

The central bank should monitor and prevent the emergence of asset price bubbles through a pre-emptive policy tightening in order to secure the stability of the financial system.

In this case, “leaning against the wind” policy, where the central bank takes cautious approach by adopting a tighter policy to prevent the emergence of the asset bubble seems to be realistic under present crisis conditions.

The crash of an asset price bubble threatens the stability of the banking system. As a lender of last resort; central banks should be involved in the supervision of the financial system.

Are two or more pillars better than one?

There is a need for a harmony of pillars: Price stability, asset prices, liquidity, exchange rates, all need to be managed in synchronization.

All these variables complement each other to secure financial stability.

Are central banks the best banking supervisors?

Central banks are the ultimate lenders of last resort. They bear the burden in case of problems in the system as we experienced during the current crisis. Therefore, it is optimal that they are involved in supervision of the system as well. They are naturally the guardians of financial stability.

Monetary policy and policies for financial stability are complementary. Monetary policies conducted through interest rates decisions, liquidity management etc. affect the financial sector and financial stability, and financial stability makes it easier for a central bank to conduct monetary policy.

In the case of Turkey, CBRT can be responsible for the supervision of financial markets and system wide risks overseeing the health and stability of the overall financial system, whereas BRSA can remain as the supervisor for the banking sector.

The banking sector regulation and supervision should be indeed conducted by a separate entity as it needs a different expertise to safeguard the rights of depositors, to ensure that banks to operate in a healthy and efficient manner and to ensure efficient functioning of the credit system.

What are potential tensions between monetary policy and banking supervision?

Conflict of priorities can arise when monetary policy and financial sector supervision are carried out jointly rather than by separate agencies.

Monetary policy decisions have consequences on financial stability. Conflict between monetary policy objectives and supervision might arise in times of economic-financial stress.

Would a central bank begin monetary tightening early to prevent asset bubbles while risking economic growth? Or would a central bank be reluctant to tighten monetary policy due to its possible adverse effects on the financial sector?

Central banks carry the burden of being lender of last resort, but as supervisors they will work closely with financial institutions and there is a risk that their independent perspective may somewhat be diluted.



Are quantitative easing and other unconventional policies adequate instruments during (great) recessions?

Unconventional measures undertaken during the crisis were essential to help the global economy recover. As this was an unprecedented crisis it is only normal that measures to fight the problems were unconventional too; it is important that supportive measures during crises be adaptive to current problems.

However, only quantitative easing through sharp cuts in interest rates or liquidity injections is not adequate during a crisis of such an extent; public sector policies with large fiscal stimulus packages should supplement monetary policy. Fiscal packages have a more direct effect on the real economy, whereas monetary policies are more directly related to the financial sector.

Jürgen Stark

Member of the Executive Board, European Central Bank

With their bold and decisive action in response to the financial crisis, central banks played a key role in sustaining financial intermediation, reducing systemic risks, and ultimately restoring financial market stability. In addition to extraordinary policy rate cuts in response to receding inflationary pressures and risks in an environment in which the financial crisis had significantly weakened the outlook for economic activity, many central banks have taken a number of non-standard measures to support the functioning of financial markets and thereby the economy.

Specifically, between October 2008 and May 2009, i.e., within a period of only seven months, the ECB lowered its main refinancing rate by 325 basis points to a historically low level of 1 per cent. In addition, dysfunctional markets had weakened the ability of monetary policy to influence the outlook for price stability through interest rate decisions alone. Consequently, the ECB has adopted a number of non-standard measures that were nevertheless fully consistent with the principles of sound monetary policy geared towards price stability over the medium term. First, the Governing Council of the ECB decided to enhance its credit support to the euro area economy, thereby fostering financing conditions against the background of the euro area's primarily bank-based financial system. [The successful implementation of these measures was particularly supported by the Eurosystem's operational framework that proved robust and flexible as circumstances worsened and that had served the ECB well in almost a decade before the financial turmoil.] Second, the Governing Council introduced a Securities Markets Programme (SMP) with a view to ensuring depth and liquidity in those market segments which are dysfunctional and to restore and maintain an appropriate functioning of the monetary policy transmission mechanism. Overall, all the non-standard measures taken by the Eurosystem in response to continued acute tensions in financial markets proved powerful to resist deflationary risks even at very low levels of policy rates and in the face of major negative shocks.

To be clear: The unprecedented measures taken by the Eurosystem represent a response to extraordinary circumstances in a context of exceptionally high uncertainty and instability in financial markets. In these circumstances, the low level of the key ECB interest rates has been appropriate. At the same time, the extremely low level of the key ECB interest rates needs to be adjusted timely. Maintaining very low interest rates for too long implies the risk of hampered activity in money markets and diminished profitability on the part of banks and insurance companies. It also reduces incentives for banks, firms and households to repair their balance sheets, as bad loans and other troubled assets can be refinanced very easily. In addition, there is the risk of abating fiscal consolidation efforts ultimately complicating the task of monetary policy. It is therefore important to ensure that policy rates do not remain at very low levels for longer than is necessary, as this would entail the danger of significantly distorting financial market participants' perceptions, thereby fostering excessive risk-taking (moral hazard), with adverse impact on asset prices and financial stability.



The challenge for central banks now is to tailor the exit from extraordinary monetary easing in an environment of still prevailing uncertainty. In this regard, the ECB's enhanced credit support measures and the SMP are by construction of a temporary nature. This allows a natural phasing out once the overall situation strengthens. The guiding post for timing and sequencing of the exit from monetary accommodation was and will remain the outlook for medium-term risks to price stability. This is the objective central banks have to focus on. Given that central banks ultimately have only one instrument, this is the only goal they can credibly achieve. We must therefore be take care not to overburden them with a multiplicity of goals.

The ECB's money pillar provides an important element for maintaining price stability over the medium term. Monetary analysis helps identifying underlying trends in consumer prices which would take years to be revealed by economic analysis. There is overwhelming consensus on the empirically robust long-run relationship between money and prices. Extracting the money trend helps identifying the long-term underlying trend in prices. By so doing, monetary analysis reinforces the medium-term orientation of monetary policy.

Introducing money and, notably, credit considerations in the monetary policy strategy, and using these for the Governing Council's overall assessment of the risks to price stability over the medium term, represents a reinforcing strategic mechanism that encourages a leaning-against-the-wind attitude in the face of unsustainable financial trends. Since financial imbalances are empirically associated with strong dynamics in money and credit aggregates, central banks can mimic leaning-against-the-wind policies, while avoiding the pitfalls of directly responding to asset prices, by giving monetary analysis due weight in their strategies. Importantly, resisting pro-cyclical tendencies inherent to financial systems essentially aims at maintaining price stability over long horizons.

In pursuing an effective leaning-against-the-wind policy approach, central banks contribute to financial stability, without compromising on their price stability objective. In this respect, they can mitigate, but will never be able to fully contain systemic risk. Effective regulatory and supervisory policies are the first line of defense against systemic risk. Hence, successful regulatory and supervisory reforms, as currently pursued globally, will be key for ensuring future financial stability. In this context, the creation of the ESRB as the new macro-prudential supervisory body in the EU will be an important advance in the EU economic governance framework.

The ECB's two-pillar monetary policy strategy has proven its merits compared to textbook inflation targeting approaches, whose intellectual foundations rest on the canonical version of the New Keynesian model. In this model money has been considered redundant for the monetary transmission mechanism, and monetary policy is prescribed to focus on stabilizing inflation over relatively short horizons. Since the conduct of monetary policy is primarily based on inflation and output gap forecasts as summary statistics, longer term risks to price stability that can at times emanate from unsustainable financial sector developments are typically not taken into account or even overlooked. Indeed, the developments in the run-up to the global financial crisis have shown that low and stable inflation rates may well be consistent with the build-up of financial imbalances, which, in turn, can create serious risks to price stability down the line.

Durmuş Yılmaz

Governor, Central Bank of the Republic of Turkey

The recent financial and economic turbulence has led to a dramatic shift in conventional macroeconomic thinking, and central banking was not an exception. In fact central banks usually go over major transformation in the aftermath of each major crisis episodes. Think of the Great Depression that redefined the role of the Federal Reserve in the United States or the turmoil in the 1970s that put inflation fighting front and center. It is likely that the next era in



central banking will be shaped by the discussions on the relation and conflicts of price stability and financial stability. The role of central banks in regulation and supervision of financial markets to avert next crisis will also be at the center stage in the post-crisis period.

It is also quite natural that drastic times call for drastic actions, especially for central banks. Prior to the global financial crisis, central banks used to conduct their operations through conventional banks mainly using government bonds for liquidity management. However the financial crisis led the central banks employ so called “unconventional policy tools” such as corporate bonds, asset backed securities and mortgages in their operational policy implementations. In the meantime, corporations and non-bank financial institutions have joined the conventional banks as the counterparties of central banks in market transactions. As these pragmatic policies have proved vital in keeping the financial system from imploding during the crisis, the vital question in this context is whether the innovative policies we have seen in the last year will lead to longer-term changes in central banking. Whether central banks will maintain and protect their growing influence in the financial markets due to extraordinary actions during the crisis will be the main issue that we are facing in the coming period.

Of course, overextended and overleveraged financial sector entails higher degree of coordination and cooperation between central banks and supervisory bodies. At this juncture, the expertise of central bank in markets, institutions and macro analysis demands central banks taking a leading role in financial stability. In most countries central bank involvement in financial stability is required by law due to its lender of last resort function. Although separate supervisory bodies function well in normal times, in times of distress it is the central banks to take action and interact with the banks.

Central banks currently have the sole instrument of interest rates in shaping their policies. As the “Tinbergen Rule” suggests this one instrument could be deployed to solve only one equation, which in this case, is price stability. So the difficulties in achieving price stability and financial stability simultaneously necessitate a second policy tool for central banks: regulatory and supervisory powers. Note that central banks already possess a wide range of tools to regulate the financial system (such as reserve requirements) and to supervise the health of the sector. However, in many countries there are other independent agencies with far reaching authority and functions to ensure confidence and stability in financial markets, make credit system operate effectively, protect rights and benefits of savers and improve financial sector. Asking central banks to deliver financial stability would naturally necessitate transfer of these powers as well.

Arming central banks with a broad range of regulatory and supervisory powers is not straightforward. First, monetary policy actions to achieve price stability could jeopardize financial stability in some cases due to the mandate creep. If a conflict arises between the two, which role should the central bank assume? Striking a balance between a large set of objectives carries the risk of delivering unsatisfactory results in all areas, setting aside enormous communication problems that make central banks look incoherent.

Second, combining the lender of last resort power with supervisory role carries the risk of time inconsistency problem. Setting macro prudential regulations and claiming an unwavering commitment may be illusionary, when a financial crisis breaks out and central banks are asked to open their purse to float the system with liquidity.

Last but not the least, there is the issue of political interference. As the former American president F.D. Roosevelt once said: “Great power involves great responsibility.” If you delegate an institution so much power and authority, how can you justify its independence in a democratic society that cherish political accountability? It is quite ironic that central banks are likely to lose at least some of their insulation from politics, as they become more dominant and influential in the economy.



All in all I am not totally convinced that creating a financial tsar, i.e., a super large, all encompassing central bank is the right answer. Actions taken in times of distress may not always be the optimal choice after normalization.