



Why are central banks necessary?

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May I alter the title a bit?



Why are *somewhat* **independent** central banks necessary?

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Why are *somewhat* **independent** central banks necessary?

because political governments
could do the job(s)

May I alter the title a bit?



Why are *somewhat* **independent** central banks necessary?

because CBI is
not absolute

because political governments
could do the job(s)

With these amendments, my answer is yes.

The four classic functions of a central bank

1. Monetary policy proper
2. Lender of last resort
3. Supervisor/regulator of banks/FIs
4. Guardian/operator of the payments system



The four classic functions of a central bank

(**M** denotes “natural monopoly”)



1. Monetary policy proper **M**
2. Lender of last resort **M**
3. Supervisor/regulator of banks/FIs
4. Guardian/operator of the payments system

Competition is thinkable in 3 and 4. Is it also advisable?

1. Monetary policy proper



- Broader than just “providing a nominal anchor”
- Pre-crisis consensus was moving toward: control an overnight interest rate to achieve an inflation target
- Now it’s much broader:
 - More instruments (e.g., QE, forward guidance,...)
 - More goals? (e.g., financial stability, not employment?)
- Remember the main argument for CBI: Politicians with *short* time horizons will inflate *too much*.
 - But what if inflation is *too low*?
 - Success in *raising* inflation looks muted so far.
 - But what if the CB “inherits” the markets’ *short* time horizon?

2. Lender of last resort



- Possible *only* by an institution that can “print money”
- Must be handled with care (moral hazard, inflation)
- A rarely mentioned paradox: LOLR loans are apt to be highly political/politicized. Yet the function is assigned to non-political technocrats.
 - Maybe it should be “safe, legal, and rare.”

3. Supervisor and/or regulator



- This is (at least) a 3 x 3 x 3 classification.
 - Supervisor, regulator, or both?
 - Just banks, all FIs, or something in between (e.g., SIFIs)?
 - Microprudential, macroprudential, or both?
- The CB can have “competitors” in most cells.
- So there is lots of room for cross-country differences.
 - In the US, the Fed...:
 - has competitors in sup and reg
 - has (primary) responsibility for all SIFIs—banks or not
 - shares macroprudential sup & reg, but has no macroprudential weapons!



4. Payments system

- CB may not run it, but can/should supervise it.
 - Financial “plumbing” needs to be more reliable than cable TV.
- CBs have had some competition in providing means of payment for centuries.
- Now in danger of losing their monopoly on currency?
 - Rogoff: Currency is a nuisance—or worse.

5. Other functions



- Advising governments on “technical” matters.
 - It’s easy to get drawn into political decisions
 - Watch out that “advice” doesn’t become reciprocal.
- Issue its own debt securities
 - To finance what?
 - Interest-bearing reserves are close to CB bills.
- Development banking
 - Common in emerging markets
- “Helicopter drops” of money
 - Not possible in most countries.



But in a crisis...

1. Conventional monetary policy is slow-acting and may quickly get exhausted.
 - Normal macro goals take a back seat to financial stability and “plumbing” issues.
2. CB may need to play LOLR role “early and often.”
3. Supervisory information may become critical.
 - Think Northern Rock, Bear, Lehman, AIG, stress tests,...
4. Payments issues may assume huge importance.

And furthermore...



- The CB's normal *long* time horizon gets *very short*.
 - The long time horizon is one main argument for CBI.
- The goals of the CB and the political government probably converge (financial stability).
- Is CBI still *desirable* in a crisis?
 - Overt conflict between the CB and the Treasury/Ministry could be disastrous.
 - But what if the “crisis” goes on and on?
- Is CBI even *possible* in a crisis?
 - Close consultation and cooperation is necessary.

My final answer



Q: Are *somewhat independent* central banks necessary?

A: Yes, but except in a crisis, central banks are probably wise to stick to their knitting.