

Whither Central Banks?

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<http://e105.org/e266>

I agree with Alan on all points

- Central banks have been evolving for hundreds of years

And I think we all believe they will remain important for the foreseeable future

- Vital Question: Where should we be going?
- How did we get to where we are today?

The key driver of evolution

- Economies are inherently prone to various finance-related stresses, breakdowns, and crises.
- Societies have evolved many mechanisms for preventing, resolving, and mopping up after crises
mechanisms scattered across many institutions
- Modern central banks arose in this ongoing process

Types of crisis

- **Liquidity crises**

(bank panics)

- **Government funding crises**

(often war related)

- **International imbalance crises**

(exchange rate, trade, external indebtedness)

Modern central banking history

- 1870-1930: gold standard
- 1944–1971: Bretton-Woods
- 1995 to 2007: inflation targeting
- 2016: What's next (this conference)

Aside: International monetary systems

- Alan did not talk much about central banks as part of an international monetary system
- In the gold standard and Bretton Woods eras the international system was the key
- Supreme objective: reduce the likelihood of international political, economic, and military crises flowing from unsustainable international imbalances

A caricature of 1900 vs. 2000

- 1900: Central banks had two overriding purposes financial stability, stability of external value of the currency
- 2000: low, stable domestic inflation is overriding goal

A caricature of 1900 vs. 2000

- 1900: Central banks had two overriding purposes financial stability, stability of value of the currency

domestic inflation rate an afterthought, left to wander

- 2000: low, stable domestic inflation is overriding goal

value of the currency left to wander; financial stability in the background

Post-crisis: 2 returning questions

- What responsibilities should a central bank have for financial stability?
(beyond a narrow lend of last resort role)
- Does domestic inflation targeting deliver a coherent and healthy international monetary system?

More pointedly

- Suppose you are a small, relatively healthy economy at the edge of a large economy that is struggling with low inflation and other problems
- Will fairly single-minded pursuit of your domestic inflation target deliver the most desirable outcomes?

Switzerland? Sweden?

Some speculation

- Economists can write models to support either answer
- We can be most sure about longer-run issues
- The transition from here to the long run can be long and painful

Finally,

- The costs and benefits of different approaches to these issues facing, e.g., Sweden will fall on very different segments of the population
 - ... inherently political, raises some independence issues

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Quick summary, historical evolution of central banks

Central banking essentials:

- So long as the government offers liabilities in a fiat currency, some entity must manage the internal and/or external value of that currency.

important questions about internal vs. external value

- Economies need a backstop provider of liquidity

important questions about any additional financial stability roles

Ancillary responsibilities

- In virtue of its core roles, the central bank has expertise that may make it a reasonable place to lodge other aspects of oversight, regulation, maintenance of the financial plumbing.
- The main question here seem to be whether endowing the central bank with too many responsibilities may compromise its pursuit of the essentials.

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Alan's friendly amendment: independence

Central bank semi-independence

- Standard argument is that independence is key to safeguarding the value of the currency
- Experts often give a sugar-coated version of this point

I think Alan followed the norm in polite conversation

The sugar coated version

- Democratic political systems may be ‘short-sighted’ at times
- If the folks in charge were thinking clearly, they would accept that the *right* value of the currency (the right nominal anchor) is a technical matter

Hand it over to technical experts.

Less polite/American perspective

- Especially in times of stress, monetary policy decisions are inherently political

That is, they involve complex balancing of different interests in society.

- Society sets up institutions intended nudge decisions on those political matters in a desired direction.

away from some crude majoritarian outcome

Founding of the Fed's FOMC

- **Senator Aldrich:**

No government yet has been found strong enough to resist the pressure for [inflating the money supply] in times of real or imagined stress.

Founding of the Fed's FOMC

- The solution FOMC was created with two opposing groups in carefully balanced proportion
- Representative Steagall:
[Under the bill adopted, voting on the FOMC] will stand 5 to 7, giving the people of the country as contradistinguished from private banking interests control by a vote of 7 to 5.
- Note: the Senate had proposed 3 to 2

Founding of the Fed's FOMC

- In 'normal times' monetary policy may masquerade as a technical background issue
- But un-normal times can persist for a decade or more
- Should not pretend that monetary policy is purely technical or that it is mere short-sightedness that we are worried about

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The reasons for insulation from democratic forces (semi-independence) are strongest at those un-normal times when policy may be most political

Further evolution: Improving central bank

- Central bank laws around the world are now being re-thought
- This is as it should be
- We may soon settle into a new orthodoxy for a time

Beware of experts

- I think the community of experts is guilty of oversimplifying and excess focus on the last crisis.
- The swing from the gold standard to inflation targeting (polar opposites) is really quite striking

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My hope is that we observe the lessons of history and that this conference is part of further real progress for the good of all.

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