SPEECH

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■ The framework of modern central banking

Thank you for inviting me to this conference on reforming the State Bank of Vietnam. I imagine that one reason why I have been invited here is that the central bank I represent, Sveriges Riksbank in Sweden, just over a decade ago was in a situation which resembles the one the State Bank of Vietnam is experiencing now. At that time we had reached a situation where there were strong reasons – if not imperative ones – for reconsidering the way in which we used to think about monetary policy. It became clear that a reform of monetary policy and its framework was both desirable and necessary.

Of course, Sweden is by no means the only country where monetary policy has undergone major changes in recent times. The view of how best to conduct monetary policy has changed fairly radically over the past twenty years and this has been reflected in a more or less worldwide reform process.

What I hope to be able to contribute here today – as an introduction to the discussions – is to provide an overall picture of the ideas that formed the basis for this process and to describe what are today considered to be the guiding principles for a modern central bank, according to established research and practical experiences.

What objectives should a central bank have?

The most fundamental question to ask when one is on the point of reforming the monetary policy framework is, of course, what the objective of monetary policy should be. On a very general level the objective of monetary policy can be said to be to create an environment where the economy can develop in the best possible manner. However, this definition is too general to be of any great practical use, although it excludes some tasks that are sometimes imposed on central banks.

To obtain a more operational definition, it is necessary to take the discussion one step further and ask the question of *how* monetary policy can contribute to favourable economic development. On a fundamental plane, one could say that the central bank's main task should be to ensure that the payment system in the economy functions efficiently. This means in simple terms that payments and financial transactions can be made easily and smoothly and entail as little risk as possible. Many scholars also regard this as the main reason why central banks were originally founded.[1]

An economy's payment system can be regarded as a sort of infrastructure in roughly the same way as the country's communications network or energy supply system. It also essentially fulfils the same purpose, i.e. to ensure that the flows essential to the economy – in this case the flow of money – functions properly.

However, ensuring that the payment system functions efficiently is also a fairly general definition that requires further precision. To become more specific, it is necessary to define what characterises an efficient payment system. I intend to discuss two characteristics here that I perceive to be the most central – price stability and financial stability.

Price stability

An important component of an efficient payment system is that economic agents have confidence that the value of the means of payment will remain stable over time, that is in practice that inflation will be low and stable. One usually expresses this as there being a nominal anchor that prevents inflation and inflation expectations from drifting off. If households and companies are confident that the general price level will not change very much, they are better able to plan for the future and need not put effort into finding ways of protecting themselves against inflation, but can focus on more productive activities.

Another argument for keeping inflation low focuses on the role of price formation as a signalling system. When inflation is low and stable it is easier for economic agents to distinguish changes in relative prices and to adjust their decisions regarding consumption, saving, work and investment accordingly. High and fluctuating inflation, on the other hand, disrupts the signalling function of the pricing system and can more easily lead to bad economic decisions. In an environment with low inflation, the price system can do a better job in allocating resources to uses where they will do most good. In a broader sense, one could see an efficient pricing system as part of an efficient payment system – it ensures that the transactions made are based on the best information possible.

Price stability can also be justified for reasons not immediately connected with the efficiency of the payment system, such as the fact that high and fluctuating inflation tends to give rise to undesirable distribution effects. For instance, inflation appears to hit poor people hardest as the rich usually have better opportunities to protect themselves, or even to benefit, from the effects of inflation.[2] This could be because, for instance, poor people often have no other opportunity than to retain a large part of their limited assets in the form of money or because they are to a greater extent than the rich dependent on public subsidies that are not fully indexed.

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[1] See, for instance, Santomero, A.M., S. Viotti and A. Vredin, (2001), "Challenges for Central Banking: An Introduction", in Santomero, A.M., S. Viotti and A. Vredin (ed.), *Challenges for Central Banking*, Kluwer Academic Publishers.

[2] See Easterly, W. and S. Fischer, (2001), "Inflation and the Poor", *Journal of Money, Credit, and Banking* 33, 2 (part 1), 160-178. For a more detailed account of the advantages of low, stable inflation, see for instance King, M., (2002), "The Inflation Target Ten Years On", Speech at the London School of Economics, November 19.

Keeping inflation low and stable is currently the most obvious – and definitely the most noticed – task for modern central banks. The reason for the focus on price stability is of course the negative experiences of the high and fluctuating inflation many countries experienced in the 1970s and 1980s. During this period one could say that the central banks' original task of guaranteeing the value of the means of payment was neglected as other tasks, primarily affecting demand in the economy, were perceived as more important and more interesting for monetary policy. The consequence was that the nominal anchor was relinquished and to establish it again proved to require considerable effort.

Let me before I discuss the other important component of an efficient payment system – financial stability – say something about the most common approaches to attaining price stability. There are currently two predominant means of trying to ensure that inflation remains at a low and stable level. One is to tie one's own currency to the currency of a country with a long tradition of low and stable inflation. The fixed exchange rate thus becomes an intermediate target through which one hopes to attain the ultimate target – price stability. The other means is to allow the exchange rate to float and to give the central bank the task of acting more directly to attain low, stable inflation – what is known as inflation targeting.

The changeover in monetary policy made by Sweden at the beginning of the 1990s meant that we switched from the first method, fixing the exchange rate, to the second, targeting inflation. The reason was quite simply that the fixed exchange rate had not functioned very well as a means of keeping down inflation and establishing a nominal anchor in the economy. For a couple of decades we had failed to keep price and wage increases in check. However, a fixed exchange rate relationship is not, of course, compatible with an inflation rate that systematically exceeds that in the country to which the exchange rate is tied – sooner or later the exchange rate relationship must collapse. The rapid increases in wages and prices also repeatedly came into collision with the fixed exchange rate and the result was that the Swedish currency was devaluated on several occasions from the mid-1970s onwards. The economy was thus characterised by "boom-bust-cycles" with alternate strong acceleration and sudden braking.

However, the fact that the fixed exchange rate did not work as a nominal anchor in Sweden does not mean that it could not function well in other countries; it has unquestionably done so in many cases. So let me therefore move on and mention some general advantages and disadvantages of the two methods.[3]

Perhaps the foremost advantage of having a fixed exchange rate regime as a means of keeping inflation under control is that it makes the task of monetary policy simple and straightforward: it shall set the key rate in a way that enables the exchange rate relationship to be maintained. This task is also easy for the general public to understand.

At the same time, it may be a disadvantage that monetary policy is tied to this single task. It cannot then be used to subdue domestic disruptions that have no equivalent in the country to which the currency is tied – the anchor country. At the same time, disruptions in the anchor country will immediately affect the targeting country as interest rate adjustments in the anchor country will lead to corresponding interest rate adjustments in the targeting country. If, for instance,

[3] A more detailed discussion of the advantages and disadvantages of these and other monetary policy regimes can be found in, for instance, Mishkin, F.S., (1999), "International Experiences with Different Monetary Policy Regimes", *Journal of Monetary Economics* 43, 579-605.

the interest rate in the anchor country is raised because demand in that country is increasing, the interest rate in the targeting country must also be increased in order to maintain the exchange rate relationship, even if the country is in a recession. A fixed exchange rate regime thus means that it is not possible to conduct an independent monetary policy. The task of keeping the economy in balance and of steering inflation more directly cannot thus rest with the central bank. A fixed exchange rate relationship can also be exposed to speculative attacks if it is not entirely credible. This was the case with the Swedish krona and several other European currencies at the beginning of the 1990s.

With regard to inflation targeting, I am of course somewhat biased and for obvious reasons find it easier to point to advantages than disadvantages. One advantage is that a central bank which conducts inflation targeting is not tied to maintaining a particular exchange rate relationship, but can be more directly aimed at focussing on what is happening in the domestic economy. Another, partly related advantage – which I believe has been very important in Sweden's case – is that inflation targeting means that one specific authority is given a clear responsibility for maintaining price stability. During the 1970s and 1980s it was not entirely clear where the responsibility for this lay in Sweden. One could say that the responsibility in practice had been delegated to the social partners, but that the total economic policy tended at the same time to be so expansionary that it became difficult to maintain wage and price increases at reasonable levels. A further advantage of inflation targeting is that the task of monetary policy, in the same way as with a fixed exchange rate regime, is easy for the general public to understand.

If I am to try to find a disadvantage with inflation targeting, it could be that it is more difficult from a purely operational point of view for a central bank to steer inflation towards a particular level than to maintain a particular exchange rate relationship. Inflation targeting is thus much more demanding than a fixed exchange rate regime with regard to the central bank's analytical work and its ability to communicate its policy. Whether this is something that should be regarded as a disadvantage or not is of course a question of judgement. For the Riksbank, the transition to inflation targeting heralded the start of a fairly comprehensive increase in competence in the field of economics. The number of PhD economists at the Riksbank has risen sharply in recent years and our research in areas related to monetary policy has expanded considerably.

Financial stability

Let me now move on to the other central component of an efficient payment system. This concerns the stability in the financial system; particularly in the financial institutions that supply payment services, i.e. primarily the banks. Financial stability is currently regarded, parallel to the price stability target, as the main task of a modern central bank.

The financial system has essentially three main tasks: converting savings into financing, managing risk and providing efficient channels of payment. Let me give a basic example. A bank receives savings from households which it then lends to other households or to companies that need to invest. Banks are specialists at valuing, monitoring and managing credit risks in the households and companies to which they lend. The bank therefore contributes to ensuring that the mediation of capital in the economy functions efficiently; it is sufficient that borrowers can convince the bank of their creditworthiness, they do not need to convince each individual saver. Similarly, savers do not have to assess the creditworthiness of every borrower; it is enough to be satisfied of the bank's solvency. The banks can also supply payment services for households and companies by using the existing financial infrastructure, such as accounts and various routines for transferring funds between financial institutions.

As these functions are central to an efficient economy, it is evident that major problems can arise if financial stability is upset. This is aptly illustrated by, for instance, the crises in South East Asia at the end of the 1990s and by the bank crisis that Sweden and other countries suffered at the beginning of that same decade.

While the target of maintaining price stability is relatively straightforward and intuitive, it is more difficult to specify the task of promoting financial stability. This task has also been formulated in slightly different ways in different central banks' regulations. For instance, the Bank of England's charter says that it is "responsible for the overall stability of the financial system as a whole", while the corresponding task in the regulations for Sweden's Riksbank has been expressed in a more indirect manner: "to promote the efficiency and safety of the payment system".[4]

One strategy for maintaining financial stability can briefly be described as consisting of three different parts: a clear regulatory framework, an efficient day-to-day prudential supervision and oversight and a preparedness to act strongly and quickly in a crisis. Exactly what role is played by the central bank in this strategy is also something that varies from country to country.

Many central banks contribute in different ways to the formulation of the regulatory framework for the financial system, for instance, by giving their views on proposed bills and by participating in committees where domestic and international legislation is formulated. With regard to the day-to-day prudential supervision and oversight, one solution that is applied in Sweden and other countries is that the supervision of the financial sector is delegated to a special, independent authority with the power to apply sanctions. In other countries the supervision work is done by the central bank itself. In the cases where supervision is delegated to an independent authority, the central bank usually has an oversight role that entails regularly monitoring and analysing developments in the financial sector and presenting its views of the risks in the financial system. Ever since the bank crisis at the beginning of the 1990s, this has been perceived as a very important task in Sweden; in fact, it could be argued that the bank crisis was allowed to arise partly because no authority previously had the specific task of monitoring the overall financial stability. The Riksbank now publishes a twice-yearly report analysing the stability of the Swedish financial system. In a crisis situation, the central bank plays a very important role. It may then need to go in and act as lender of last resort, that is, to grant emergency liquidity assistance (ELA) to banks and financial companies if this is considered necessary to prevent the financial system from collapsing.

The two objectives of price stability and financial stability are related to each other in different ways, in addition to both being important components of an

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[4] See, for instance, Oosterloo, S. and J. de Haan, (2003), "A Survey of Institutional Frameworks for Financial Stability", Occasional Studies Vol.I/No. 4, De Nederlandsche Bank, for an overview of how the task of promoting financial stability is dealt with in different central banks' regulations and in practice.

efficient payment system. The stability of the financial system is of course a necessary condition for a policy aimed at price stability, as the latter is fairly meaningless if the country is threatened with economic collapse. The financial stability objective can therefore in one sense be said to be superior to the objective of price stability.

At the same time, it is very probable that price stability in the long run promotes financial stability, for instance, by making the price system function better and thereby reducing the risk of bad investments. However, price stability is no guarantee of stability in the financial system, which is illustrated, for instance, by the problems in the Japanese banks at the beginning of the 1990s. There is thus no reason for central banks to focus solely on the price stability objective and thereby assume that financial stability will follow automatically – both objectives are important.

Other objectives than price stability and financial stability?

Are there any other objectives than price stability and financial stability that may be suitable for a modern central bank?

Many countries also have objectives for developments in the real economy written into the regulatory framework governing the central bank's activities. For instance, in the US legislation it says that the Federal Reserve shall promote "maximum employment", while the British legislation says that the Bank of England shall support "the economic policy of Her Majesty's Government, including its objectives for growth and employment". In Sweden there is no specific objective for real economic developments written into the law, but it is nevertheless considered to be understood that the Riksbank – as an authority under the Riksdag, the Swedish parliament – shall support the objectives of economic policy with the aim of attaining sustainable growth and a high level of employment.

Exactly how the objectives are worded thus varies considerably between countries, often depending on the fact that changes and modifications have gradually been made to regulations originally written much earlier. I dare to claim nevertheless that the essence of modern central banks' wording of their objectives is the same. It is a question of monetary policy, as I said earlier, being first and foremost aimed at ensuring there is a credible nominal anchor in the economy. As long as this nominal anchor does not risk coming loose, monetary policy can be aimed at stabilising the real economy. I shall return to this shortly and for now merely emphasise that the key word here is *stabilise* the real economy and nothing else.

It may be interesting to note in this context that the experiences from the period of low, stable inflation have meant that price stability is now increasingly perceived as both an *objective* in itself and as a *means* of achieving other macroeconomic objectives.[5]

There are many indications that price stability has beneficial effects on *efficiency* and *growth* in the economy. The reasons can be those I just mentioned, i.e. that the price system functions better as a signalling mechanism in a low inflation

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[5] See, for instance, Bernanke, B.S., (2006), "The Benefits of Price Stability", Remarks at The Center for Economic Policy Studies and on the occasion of the 75th Anniversary of the Woodrow Wilson School of Public and International Affairs, Princeton University, February 24.

environment and that households and companies can spend more time on productive activities instead of trying to protect themselves against inflation. Essentially it is a question of price stability being a necessary condition for an efficient payment system, as I said earlier.

In addition, the period of low and stable inflation has also been characterised in many countries by less *fluctuations* in growth in the real economy than was previously the case. The differences compared with developments during the inflationist and unstable 1970s, often entitled "The Great Inflation", have been so notable that this development has been awarded its own title in academic research – "The Great Moderation".[6] Although the reasons for the greater real economic stability are not entirely clear; there are hypotheses that economies have undergone various types of structural changes which have subdued the fluctuations – such as improved stock management among companies and financial innovations – or that the shocks to the economies have quite simply been smaller than during the 1970s. However, it is most likely that a better monetary policy has played some role in the increased real economic stability.

We have thus established what a central bank's primary tasks should be: to maintain price stability, to promote stability in the financial system and – as long as the nominal anchor formed by the price stability target is not threatened – to try to stabilise the real economy. There may nevertheless be reason to provide an example of what is *not* an appropriate objective for a central bank.

As I have tried to emphasise, the real economic objectives that central banks have entail *stabilising* real quantities such as production and employment. By stabilising I mean that one tries to reduce the fluctuations around the long-term trend. However, it is important to realise that this long-term trend development is not something that monetary policy can directly influence. For example, a country's long-term growth is determined by developments in the quantity of labour and real capital and technological progress. The best that monetary policy can do is, as I have already observed, to indirectly contribute to favourable economic developments by ensuring that inflation is kept low and stable and that financial stability is good.

Although it might be tempting, it is therefore meaningless – and often counter-productive or even damaging – to give the central bank the task of "creating" growth or employment. If one tries to affect growth and employment by systematically keeping interest rates low and increasing liquidity in the economy, or by allowing public sector projects to be financed directly by the central bank, the profits will be only short term. Inflation will rise in a way that will sooner or later become difficult to control – the nominal anchor will loosen – while developments in the real economy risk being poorer than they would have been otherwise. I believe that it is correct to claim that a lack of insight and excessive optimism regarding the role monetary policy can play in long-term real economic growth was one important reason why inflation was so high during the 1970s.

The value of independence

How can one then construct a framework for monetary policy that provides the central bank with the best possible conditions to carry out its tasks? Here I intend

[6] See, for instance, Bernanke, B.S., (2004), "The Great Moderation", Remarks at the Meetings of the Eastern Economic Association, Washington, DC, February 20.

to be fairly brief as this is something that will be discussed in more detail in the next contribution to this conference. Let me just note that there is currently general agreement that the central bank should be given the opportunity to work independent of the political system in order to attain the objective of price stability. It has been observed that if monetary policy is conducted at arm's length from party politics, there is greater confidence in the price stability objective. This is linked to the fact that there has often been a tendency for politicians to use monetary policy for more short-term purposes which have conflicted with the long-term price stability objective and which have often entailed loosening the nominal anchor.

Making the central bank independent is probably the element of the past decades' monetary reform process that has triggered the most debate and has been perceived as the most controversial. It is probably natural for politicians to feel uncomfortable giving the central bank increased independence as it unavoidably means that they give up some of their decision-making powers, and moreover in a field perceived to be central. I assume that this is one explanation why, for instance, it took Sweden until 1999 before there was sufficient political support to grant the Riksbank increased formal independence and to confirm by law the price stability objective, despite the fact that these reforms had been proposed when the inflation target was introduced in 1993.

However, the concern among politicians over making central banks independent is quite unwarranted. The independence does not, of course, mean that the central bank is free to conduct any monetary policy they wish; it only means that it should be able to use the means at its disposal to meet the objectives set by the political system without outside intervention. This is usually expressed as the central bank being instrument independent but not goal independent. The delegation of powers should be regarded as a means for politicians to ensure that the long-term aim of the monetary policy that they endeavour to achieve – but have difficulty guaranteeing – can become a reality. Furthermore, a natural consequence of the independence is that the central bank shall be accountable for its actions and that monetary policy shall be conducted in a transparent manner.[7]

It is interesting to note that, despite fairly substantial initial doubts, people have afterwards been very satisfied with the reforms implemented. Monetary policy therefore appears to have essentially delivered what was hoped for and I am not aware of any country where making the central bank more independent has been regretted.

Conclusion

Let me round off. I began by saying that the State Bank of Vietnam is currently in a situation similar to that of the Swedish Riksbank just over a decade ago. However, it is also the case that the conditions are different in certain respects. One difference is that the Swedish credit and money markets had been deregulated completely during the 1980s and early 1990s. This meant, for instance, that the central government issued bonds, through public auctions and at predetermined times, and actively attempted to promote the development of a secondary market. Thus, there was already a clear channel through which

[7] For a detailed discussion of "central bank transparency", see, for instance, Chapter 1 of Blinder, A.S., (2004), *The Quiet Revolution – Central Banking Goes Modern*, Yale University Press.

monetary policy could have an effect. Another difference was that we in Sweden had the support of a long tradition of comprehensive production of public statistics that made our work easier. These are factors that, as I understand it, do not apply to the same extent here in Vietnam, at least not yet.

Vietnam has thus – like all countries – its own special conditions that may need to be taken into account and may make it difficult to formulate monetary policy as an exact blueprint of the system in another country.[8] However, I would like to say nevertheless that the principles which guide monetary policy in modern central banks, and which I have described here, are so general that they should be able to act as guiding stars for monetary policy reform work anywhere in the world.

Essentially it is a question of giving the central bank carefully specified – and realistic – objectives, granting it independence in its endeavours to meet the objectives and ensuring that it carries out its work in a transparent manner and is accountable for its actions.

It is my conviction that reforms based on these principles will be beneficial to Vietnam, too.

Thank you.

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[8] It can be noted, for instance, that Camen, U. and H. Genberg, (2005), "An Inflation Targeting Regime for Vietnam", paper prepared for the VERCON First Annual Conference, Hanoi, May 24, draw the conclusion that the conditions for introducing "full fledged inflation targeting" have not yet been fulfilled in Vietnam.