

Comment on Orphanides
Athanasios, 'Is Monetary Policy
Overburdened?'

BIS, June 20, 2014

The only game in town?



But what game?

Inflation targeting

- Originates with Don Brash in New Zealand
- Spreads to other major CBs, including ECB but also implicitly the Fed
- Good because by anchoring inflation expectations and building central banks' credibility, 'enhanced their flexibility to respond promptly and aggressively' in the crisis

But what game?

Not just inflation targeting; also

1. Full employment and associated indicators of real economic activity;
2. Fiscal sustainability, facilitating the repair of public sector balance sheets over time;
3. Financial stability, especially facilitating the repair of bank balance sheets.

Reasons not to abandon IT

1. Loss of credibility could impair future crisis management capability
2. Asking central banks to deliver full employment reduces pressure on politicians to enact fiscal policy or structural reform
3. Relying on real economy measures like the output gap is practically difficult
4. Moral hazard as CBs become responsible for public and bank balance sheet problems

A historian's critique

Ascendancy of inflation targeting was a more complex process than the author implies

- Not clear that the Fed was targeting only or even primarily inflation after 1987
- We can't separate rise of IT from the rise of CBI – central bank independence
- CBI has always been contingent on the requirements of the state

Origins of central banks

- Private entities given privileges in return for providing public goods e.g. Bank of England (1694)
 - War finance in return for monopoly on joint stock banking and banknote issue
 - Convertibility of notes into gold (targeting a gold price)
 - Pivotal role in inter-bank transactions, money market
 - Debate on relationship between reserves and note circulation

What Bagehot really said

- Lender of last resort: 'Very large loans at very high rates ... to prevent the greatest number of applications by persons who do not require it'
- But also 'a wise *apprehensiveness*'
- The size of the reserve should *not* be specified by some automatic rule
- Discount rate should not be determined by a simple rule

Why Bagehot opposed targets

- 'No certain or fixed proportion of its liabilities can in the present times be laid down as that which the Bank ought to keep in reserve.'
- CB should target nothing more precise than an 'apprehension minimum', which 'no abstract argument, and no mathematical computation will teach to us':
- 'Credit is an opinion ... The state of credit ... can only be known by trial and inquiry.'

Lessons of the Depression

- War reveals contingent nature of Bagehot's order, restoring CBs to role of government financing vehicles
- Restoration of gold standard ends post-war inflation but creates a transmission mechanism for depression
- Federal Reserve Board makes multiple errors of policy, turning recession into massive banking crisis and 'Great Contraction'
- CBs subordinated to state in World War II

Lessons of the Great Inflation

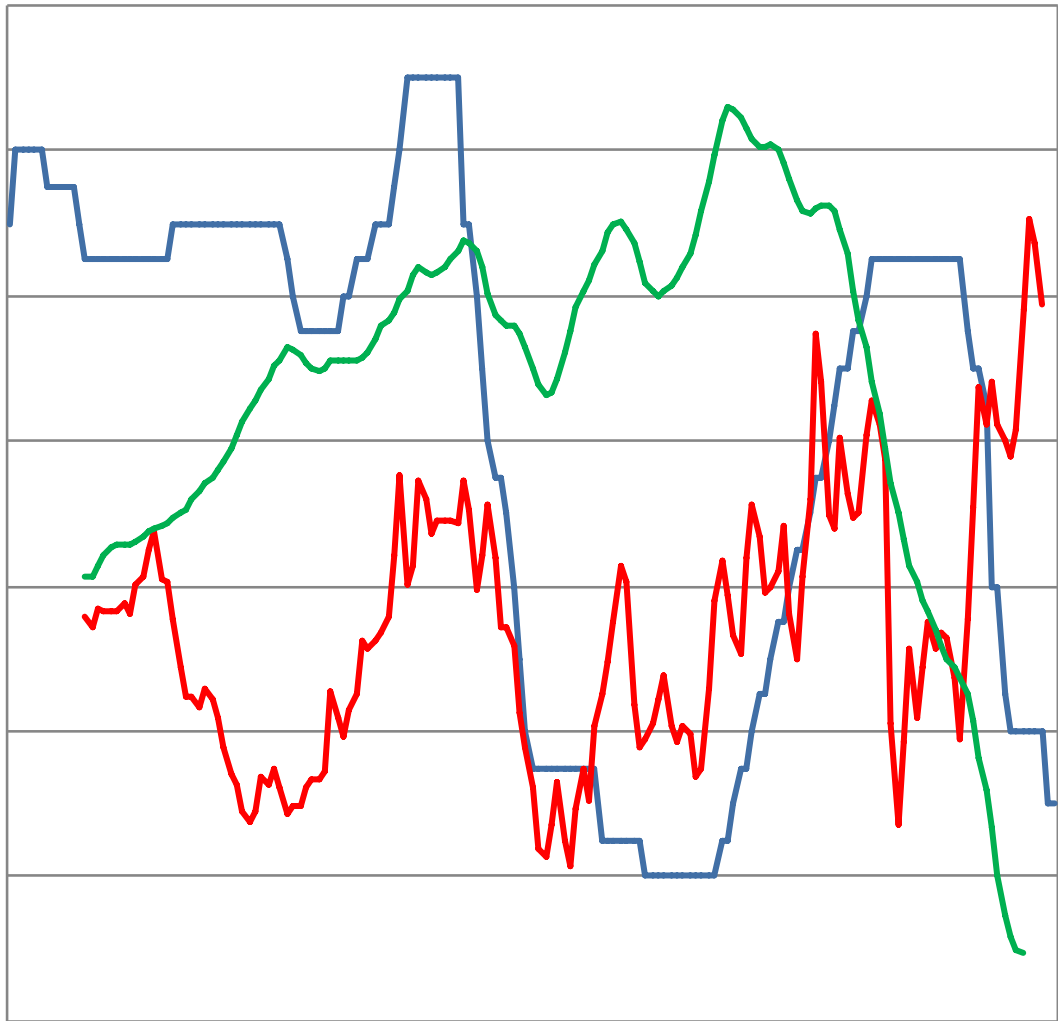
1. Central banks should now make price stability their paramount, if not sole, objective ... BUT ALSO:
2. They should do this by targeting the growth of the money supply
3. They should be made more independent from governmental pressure

What actually happened

- UK monetarists had to abandon targeting aggregates because of effects of financial liberalization – hence shadowing DM, joining ERM
- Monetary policy always worked in association with fiscal and structural reform
- CB independence remained contingent (e.g. Bundesbank after 1989)
- Fed never truly embraced IT: After 1987, the Greenspan 'put' as implicit policy

The Fed 'put'

- October 20, 1987
 - Greenspan ready 'to serve as a source of liquidity to support the economic and financial system'
- Failure to lean against 'irrational exuberance'
 - Fed funds rate cut 1995-1997, 1998, 2001-2003
- Refusal to act preemptively against housing bubble (1999 Jackson Hole)
- Celebrating the 'great moderation' (2004)
- Blaming the conundrum on global 'savings glut' (2005)



cities were
rising at 12-18%

The end of CBI

- Japan: appointment of Kuroda to implement 'Abenomics'
- UK: appointment of Carney to mitigate fiscal austerity
- US: Obama fires Bernanke on Charlie Rose
- ECB: Germans seek to undermine OMT, postpone banking union

Conclusion

- The issue is not whether or not inflation targets are to be joined by additional targets.
- The issue is whether or not the era of central bank independence is coming to an end.
- If so, we'll look back on the idea of central banks as the 'only game in town' as hubris comparable with the idea of a 'great moderation' – to be followed equally quickly by nemesis.