Comments on “Minimizing Monetary Policy” by Peter Stella

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This is a very interesting paper about the role of central banks conducting monetary policy and financial stability. The analysis is made from the perspective of the balance sheet of central banks, and who better to analyze this issue than Peter Stella, one of the main authorities on the topic. The paper looks for ways to strengthen the independence of central banks when dealing with periods of serious financial distress.

The paper distinguishes monetary policy from central banking activities. It argues that the difference between the two widens in times of financial upheaval. During a crisis, the central bank can be subject to political and fiscal pressure to expand its balance sheet. The author suggests that when this happens central banks are actually conducting fiscal policy, which jeopardizes their independence. Independence of central bank and of monetary policy is essential in order to achieve price stability. However, sometimes it is difficult to distinguish if the central bank board is taking fiscal or monetary decisions.

The recent financial crisis has shown monetary authorities taking actions that are normally under the scope of the government. Non-conventional policies—for example, those carried out by the Fed—have allocated resources to particular sectors. The purchase of risky assets from the housing sector can be construed as being non-neutral and affecting the allocation of resources. In principle, it should fall under the scope of fiscal policy. However, when central banks have to pursue financial stability, intervening in some dysfunctional segments of financial markets may be warranted.

Therefore, during a crisis, the line between monetary and fiscal policies becomes blurred. Hence, I am not sure that this limit can be clearly defined on an *ex-ante* basis. This makes it difficult to think of institutions that can have well-defined roles regarding price and financial stability.

Central bank autonomy may be affected by political pressures for one of two reasons. The first risk is the temptation to create seigniorage beyond what would be consistent with inflation targeting. In countries with central banks with positive net worth, where profits are distributed to the government, seigniorage is the main source of dividends. During a crisis, the central bank could face fiscal pressures to deviate from the goal of price stability in order to obtain more resources. This is especially important in developing countries (Stella, 2009). A commitment to an inflation target, where deviations are explicitly informed to the public and so is the strategy to achieve the target, can mitigate this risk. The second risk is related to budget: whereas the Treasury is restricted by budgetary concerns, the central bank is not. However, this adds

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flexibility during periods of turmoil, and hence, rather than a risk it may turn out to be an advantage.

In my comments I will focus first on the role of central banks regarding price and financial stability. Then, I will discuss the proposal advanced by Stella on creating and institution, different from the central bank, in charge of market intervention during critical times. Finally, in the light of the Chilean experience, I will discuss ways to ensure independence even in periods of financial stress. I will conclude with some final thoughts.

On Central Banks, Financial Stability and Monetary Policy

This paper proposes the creation of a market intervention entity, to which I will refer with greater detail in the next section. It would be in charge of dealing with financial crises separately from monetary activities. The idea would be to split the balance sheet of the central bank between this agency and a central bank in charge of monetary policy. In order to deal with regular monetary policy the central bank needs only a small amount of capital, and indeed, from here comes the idea of "minimizing monetary policy". This could render monetary policy more effectiveness and independence.

This agency would be the lender of last resort (LOLR), and the central bank would conduct normal liquidity management. However, in a world where central banks set the short term interest rate, they have to manage liquidity. The LOLR role of a central bank is a natural extension of the liquidity provision to times of financial upheaval.

Non-conventional policies applied in many countries to deal with the zero lower bound of interest rates were fully coherent with both price and financial stability. In Chile we implemented foreign exchange rate swap lines, broadened the range of collateral for open market operations, issued 1-year repos at the lowest monetary policy rate, and provided other special liquidity facilities. There was no need for a special agency to deal with these operations whose main purpose was to ensure that low rates would remain low for an extended period of time, affecting the entire yield curve. This is the natural form to increase the monetary stimulus when the monetary policy interest rate cannot be reduced any further. Therefore, large expansions of the balance sheet of central banks can help to conduct monetary policy consistently with price and financial stability.

The advantage of allowing the central bank to conduct non-conventional policies and be an effective LOLR in times of crisis is that it can react quickly and is better equipped than government agencies. Of course, there is an important issue in how to finance the losses, and this cost should be borne by the fiscal authority and the form to do it should be determined *ex-ante*.

Finally, the idea of minimizing monetary policy drove foreign exchange reserves out of the central bank. Exchange rate misalignments can be a serious source of financial instability, stemming from a currency crisis and weak banking systems. However, exchange rate management should be conducted by the central bank. First, when monetary policy sets the interest rate, the exchange rate must be flexible because of the well-known impossible trinity. However, central banks can intervene on an exceptional basis. In particular, when there are signs of bubbles or misalignments that can threaten financial stability. However, the intervention must be done in full concordance with the inflation outlook; otherwise there will be a loss of credibility of the inflation anchor. The one that can best make that call is the central bank, and hence it should run exchange rate policies. The exchange rate is also subject to significant political pressures, which is an additional reason for it to be conducted by an independent institution that pursues price and financial stability, the two channels through which the exchange rate affects the economy as a whole.

The Market Liquidity Maintenance (MLM) Corporation

The paper proposes the creation of an agency that would be in charge of helping stabilize financial markets in times of financial disruption. Such an agency would operate only during financial crises, and hence it would have few activities during normal times. This agency would intervene by having the authority to rapidly expand its balance sheet by having pre-approved powers to issue government-backed debt. While we know that this is part of what was needed to deal with the recent financial crisis, we still wonder whether the right lesson is that we need to institutionalize this type of assistance.

What I think is the main lesson from the crisis is that we need to focus on limiting the exposure of critical intermediaries to asset price fluctuations, so there is no need for intervention. The problem with focusing on creating the institution to stabilize markets is that it induces serious moral hazard problems. This agency is providing insurance against extreme events in asset markets, so private agents will increase their exposure under the certainty that in a crisis somebody will take appropriate care. In addition, this also creates moral hazard for regulators and policymakers who also benefit from this insurance and hence they can overlook financial vulnerabilities. Therefore, this proposal could be creating two-way moral hazard.

However, it could be argued that authorities may be forced to act anyway, so they better be prepared. But even so, it is an open question whether the costs of a slower intervention are larger than the benefits of being ambiguous about intervening a market —and therefore inducing a more cautious behavior of market participants. The concept of MLM goes against this ambiguity.

It seems that in a constantly changing financial environment it is difficult to implement a credible, well-specified set of rules for intervention. Instead, there must be room to assess each situation in its own merit and therefore have some discretionary powers.

Finally, the next crisis will most likely hit in areas that are not well prepared to face disruptions. Indeed, a key factor behind the recent financial crisis was regulatory arbitrage. Financial innovation occurred to reduce the regulatory burden, with the resulting increase in vulnerability. Therefore, it is unlikely that activities of the MLM Corporation will cover all contingencies and, hence, crisis management will always require some improvisation and quick, original policy responses.

Strengthening and Safeguarding Central Bank Independence

The law as well as the practice of central banks can ensure independence of monetary policy decisions. In this part I will comment on ways to safeguard central bank independence in the light of the Chilean experience.

The Central Bank of Chile's autonomy is ruled in a constitutional law, which requires a special quorum to be amended. This law forbids the Central Bank from directly or indirectly lend to the government. Indeed, the central bank cannot buy government debt, even in the secondary market, and to allow government debt as collateral for monetary operations it has to be done under very strict conditions. If the borrower fails to comply with its obligations, the regulation passed by the Central Bank prevents the Central Bank to acquire such collateral and it establishes a procedure to sell those instruments in the stock market at a fair value. Open market operations in Chile are done with the Central Bank's own debt.

Regarding financial stability, section 36 of the Central Bank law, entitled "the authority to maintain the stability of the financial sector", establishes that in case of emergency (temporary cash emergency) the Central Bank can provide credit to the banking entities for up to 90 days, and can also acquire instruments of their credit and investment portfolios. This period can be extended by the majority of board members, upon prior opinion of the banking regulator. This provides a wide scope for dealing promptly with financial distress.

As for monetary policy, the Central Bank has adopted an inflation target of 3%, with a tolerance range of ±1 percentage point and a policy horizon of two years. There are four monetary policy reports every year and they include detailed discussion on the achievement of the target as well as forecasts of inflation and growth. This communication reinforces the commitment to price stability, especially when models and most inputs in the forecast are transparently presented.

Regarding the relationship between the Central Bank and public finances, the bank has to transfer 90% of its profits to the government provided its net worth amounts to about 2% of GDP. Since the early 1990s and as a result of the appreciation of the peso, accumulation of reserves, and mostly the cost of the financial crisis of the early 1980s, this limit has never been reached, so there have no been transfers to the government (Restrepo et al., 2009). Having negative net worth has some problems, since there could be limits to the bank fulfilling its role as lender of last resort, the need to ask the government for capitalization, which may hinder independence, and subordinating monetary policy to fiscal policy. However, they have not been serious problems in Chile given its strong fiscal position. On the other hand, central banks with high levels of net worth may not just be subjected to pressures on the transfers of seigniorage to the government, but also to the transfer of reserves, as has been the experience of other emerging markets.

Final Remarks: Crisis Prevention vs. Crisis Management

I have to conclude with two observations and one conclusion:

First, a crisis is a rare event. For example, according to Glick and Hutchinson (2001), a banking crisis happens once every twenty years in most countries. Currency crises are somewhat more frequent, happening once every ten years. Crises have become slightly more frequent, but still during the 1990s they took place on average once every fourteen years (see also Bordo et al., 2001).

Second, the financial crisis was appropriately handled, though poorly anticipated. The initial shock, in terms of lost wealth, was not very different from that of the Great Depression, and certainly it is possible to argue that the shock was even larger. By looking at the performance of the global economy at the onset of the crisis, the picture did not look that different from that of the 1930s (Eichengreen and O'Rourke, 2010). However, towards mid-2009 the world economy showed the first signs of recovery and there was, fortunately, a "decoupling" with respect the crisis of the 1930s. This was the result of stabilizing the financial system, putting in place strong monetary and fiscal expansions, and, particularly in emerging markets, allowing the exchange rate to float.

Therefore, in my view, the first task must be to reduce the probability of a crisis happening again. There is the need to improve the resolution mechanisms of a crisis. But the top priority must be crisis prevention, and it is perhaps where we have the largest gap with ideal policies. Crisis prevention requires setting up appropriate incentives for the private sector to manage risk and to avoid excessive exposure to financial fragilities. Authorities have to improve regulation, availability of information and tools to monitor financial stability. Incentives are central, and this requires being very clear about moral hazard. Indeed, resolution mechanisms could be a serious source of moral hazard, and, hence, all proposals must be carefully examined regarding these distortions.

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