Comments on Charles Goodhart's paper "The changing role of central banks"

Stanley Fischer[1]

As expected, Charles Goodhart has written an interesting and challenging paper, which starts with the historical background of central banking, and then discusses a key set of issues that face all central banks at present and that will continue to face us in the months and years ahead.

As I read the paper, I recalled a line of Paul Samuelson's about what one expects from a paper: "It's not whether it's right or wrong that matters, it's whether it gives you a good run for your money" – meaning that a good paper is one that makes you think hard about things you believe or think you know. This paper succeeds splendidly in that regard.

I. Historical section

The historical background on central banking is well worth reading. It includes a few teasers, such as the mystery line "… the Bagehot rule for acting as Lender of Last Resort, which is … all too often misinterpreted." (p 3) In discussion with Charles after the session at the conference, I learned that the misinterpretation concerns lending at a penalty rate.

Many interpret Bagehot as requiring the lender of last resort to lend at a penalty rate relative to the market rate during the crisis. Goodhart's interpretation is that Bagehot's recommendation was that the lender of last resort should lend at a penalty rate relative to the normal market rate, ie relative to the market rate that the central bank expects will obtain after the crisis has been dealt with. Whether or not this is exactly what Bagehot meant, the advice is clearly logical.

This section also includes a persuasive answer to the question we must all have asked ourselves at some time: "How come there were so few financial crises or bank failures in the period after World War II, up to the early 1970s?" The relevant sentence is:

> "This was ***not*** due to any exertion of effort by central banks to maintain systemic stability; instead the controlled, constrained financial system was just a safe, but dull, place." (p 8)

No doubt there were times during the last few years when many central bankers would have preferred to be in a safe but dull place.

II. The future role of the central bank

This second section of the paper is the heart of the paper from the viewpoint of this conference. It is based on Goodhart's general view, "But, absent wars, it is the shifting

[1] Governor, Bank of Israel. This is an edited version of remarks delivered at the Annual BIS Research Conference, Luzern, 24 June 2010.

balance between the central bank's monetary policy (stable prices) and its financial stability role that usually generates most interest."

I will take up six issues that Charles deals with in this section of the paper.

1. *Who sets the interest rate?* Throughout the paper Charles de-emphasizes the centrality of the central bank's function of setting the interest rate. He seems to argue that it is of little consequence whether the central bank or the treasury sets the interest rate; ie he regards the post-World War II UK arrangement up to 1992, in which the Treasury set the interest rate, as being consistent with the normal functioning of a central bank.

Goodhart notes that it is sometimes asked whether an institution that sets the interest rate and manages liquidity should also be given the task of managing financial stability. Rather, he says, the question should be whether an institution that manages liquidity and financial stability should also be given the authority to set the interest rate.

This question is followed by a lengthy discussion of whether there could or should be a separate organisation to set the interest rate. Since the interest rate decision has to be followed by market actions to make the decision operational, I find the distinction between the organisation that sets the interest rate and the organisation that manages liquidity puzzling, unless the following is an example.

In most central banks the monetary policy committee makes the interest rate decision. It does not have to decide what actions need to be taken to make the interest rate effective. That is left to its markets department, or the open market desk, or whomever it is that carries out market operations. One *could* say that the institution that makes the interest rate decision is the monetary policy committee and that the institution that manages liquidity is the open market desk – but that does not seem to be a useful way of thinking of the issue.

Possibly the issue that Charles is pursuing is whether the lender of last resort – the institution that controls the balance sheet of the organisation that can create liabilities that are accepted as money – should also set the interest rate. One can point to the UK arrangement post-World War II as an example of a separation of these two functions, but it is not a particularly happy one – and we should not be indifferent between having the interest rate set by an independent central bank or having it set by a treasury, which by definition is political.

In any case, one suspects by the end of this section that we have been sent on an intellectual wild goose chase, for Charles concludes: "One ***could*** imagine a completely separate body whose sole function would be to determine the official interest rate, but I rather doubt whether this would be the most sensible approach."

I take this as meaning that the paper comes out in favour of the financial stability function being placed in the central bank, which should also set the interest rate and manage liquidity. I agree.

2. *Managing the corridor system:* Charles suggests the interest rate corridor can be managed so that liquidity policy and interest rate policy could be varied in a largely independent fashion. That could indeed be the case, but then one has to ask what purpose the central bank interest rate is serving. A related but somewhat weaker point – that the central bank can gain a little extra flexibility in monetary policy by varying the width of the corridor, and/or by making it asymmetric – is evident from the actions taken by several central banks during the global financial crisis.

3. *The fiscal consequences of central bank actions:* Almost every action the central bank undertakes has fiscal consequences, for example, when the central bank raises the interest rate, the government's interest bill rises. The central bank's profits are also affected by its monetary policy decisions, and since the profits are typically eventually transferred to the government, this too has fiscal consequences. These are inconvenient facts that make central bank independence all the more necessary.

There is one puzzling statement in this section of the paper: "A central bank can only provide liquidity; it cannot provide capital." This appears to be wrong. A central bank can provide capital to a bank by making it a low-interest loan, or by taking an ownership share. Whether these actions are wise, or permitted by law, is a separate issue.

4. *Taxing banks:* The paper argues that the central bank needs to be involved in this issue. It is not clear why, though presumably the bank regulator, who should have some responsibility for the stability of the banking system, should typically be consulted when governments decide to impose special taxes on banks.

5. *Debt management:* The paper suggests that the central bank should manage the national debt. The Bank of England used to do that, but it is not at all clear that the suggestion is a good one. The national debt is issued by the treasury, and can – and probably should – be managed either by the treasury, in consultation with the central bank, or by a separate debt office that should also manage the debt in consultation with the central bank.

6. *Concentration of power:* Charles asks "if the central bank is both central bank and financial stability authority, whether it isn't reaching the acceptable limit for a non-elected body within a democratic society".

This point needs to be taken seriously. It can be dealt with, as is planned in the UK under the new arrangements due to be implemented over the coming two years, by having separate decision-making bodies for monetary policy and for financial stability respectively. There can be greater government representation on the financial stability committee than in the monetary policy committee. In addition, this issue can be dealt with by moving conduct of business supervision out of the central bank and placing it in another institution, under separate control – this is the twin peaks model.

III. Final comment

Charles concludes that "The idea of the central bank as an independent institution will be set aside." This is a fittingly provocative remark with which to end a provocative paper, but it is not clear what it means.

One interpretation is that even an independent central bank needs to get used to the idea of working cooperatively with the government in those areas that are of mutual concern, while jealously guarding its independent right to make key decisions according to the authority granted it under the law. If not, the benefits of having a central bank that can take a longer term and apolitical view of what is good for the economy and take actions in support of that view will be lost – and that would be a costly mistake.