Comments on Stella

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- 1. Stella’s starting point: Current crisis reopened debate about Central Bank Independence

- 2. Delegation: Monetary Policy vs Financial Policy
  - CBI is really about monetary policy independence (formal/informal inflation targeting)
  - Rogoff and Walsh Independent Central Bankers are Monetary Policy Agencies
  - This Says NOTHING about optimal framework for crisis management

- 2. Blurring the lines between monetary policy and financial policy:
  - Credit Policy (Portfolio Choices by Central Bank)
  - Funding Policy (High Powered Money or Debt? When interest Rates=0%?)
  - Risk Exposure (Monetary Policy is Risk-free, Financial Policy isn't)
- 3. Implications for Governance and Balance-sheets
  - Monetary Policy:
    - Operational Independence
    - No Exposure: Small Capital and Balance-sheet
  - Financial Policy:
    - Partial Independence (amounts to ex post fiscal transfers, subsidies etc)
    - Exposure: Large Capital and Balance-sheets

- 4. Blueprint
  - a split Between Minimal Monetary Authority (MMA) and Market Liquidity Maintenance Corporation (MLM)
  - Transition:
    - Can Be (Has Been?) Done
    - Losses of MLM would be Controlled/Financed by Congress/Executive
    - Hybrid Governance Structure for MLM (neither monetary, nor fiscal)
- 5. Conclusions
  - One can only protect monetary policy independence…
  - …by recognizing that central banking should not be independent, separating it from monetary policy…
  - … and endowing it with alternative/innovative governance structure(s)

I organize my reflections under three Headings/Concerns with Historical Flavour

My starting point: “The MLM’s objectives and operations would be similar to those undertaken by central banks under the gold standard era -- before the advent of modern monetary policy”

But: “Gold Standard” Central Banks Did Combine:

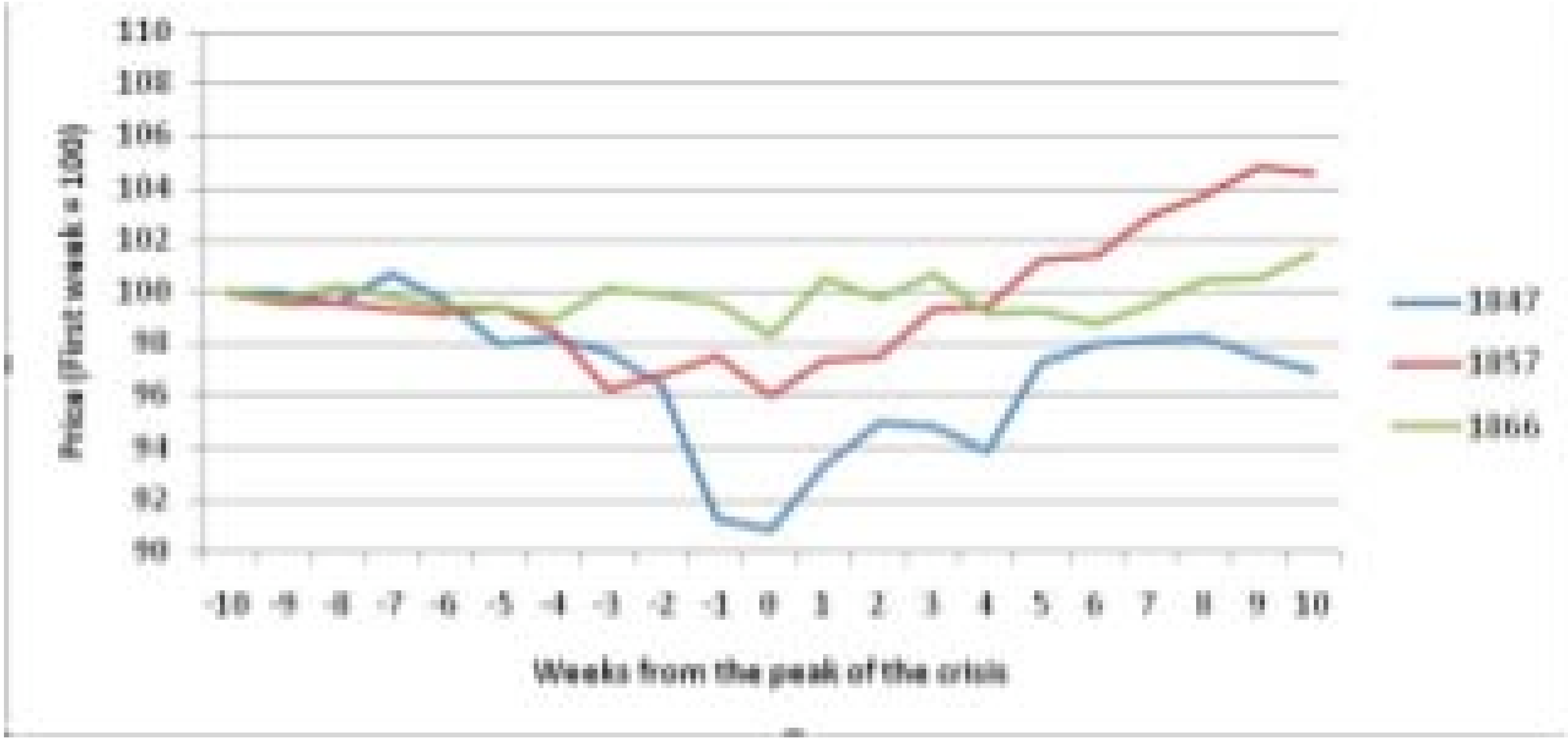
- A monetary policy function delegated to an independent agency (Gold Peg, in the Case of England, Encapsulated in Peel Act of 1844)
- A system of More or Less Formalized Contingency Plans (suspension of Peel Act -- which ruled over gold convertibility) during crises

- 1. Operational Issues
  - Can one Separate the Mezzanine Level of Monetary Policy from the Sub-prime Level of Financial Risks?
    - Other Risks than “Financial”: Example of Foreign Exchange Reserves (Bank of Netherlands, Bank of France faced massive losses from Sterling Devaluation in 1931)
    - Problem of Competition Among Agencies: The Operations of the MLM may counteract those of the Monetary Authority
      - When MLM and MMA co-existed for a while, (Russia, Austria-Hungary) some merger was eventually implemented after a period always described as frustrating (technically, the monetary authority had to cope with another institution performing de facto open market operations).

Cont'd

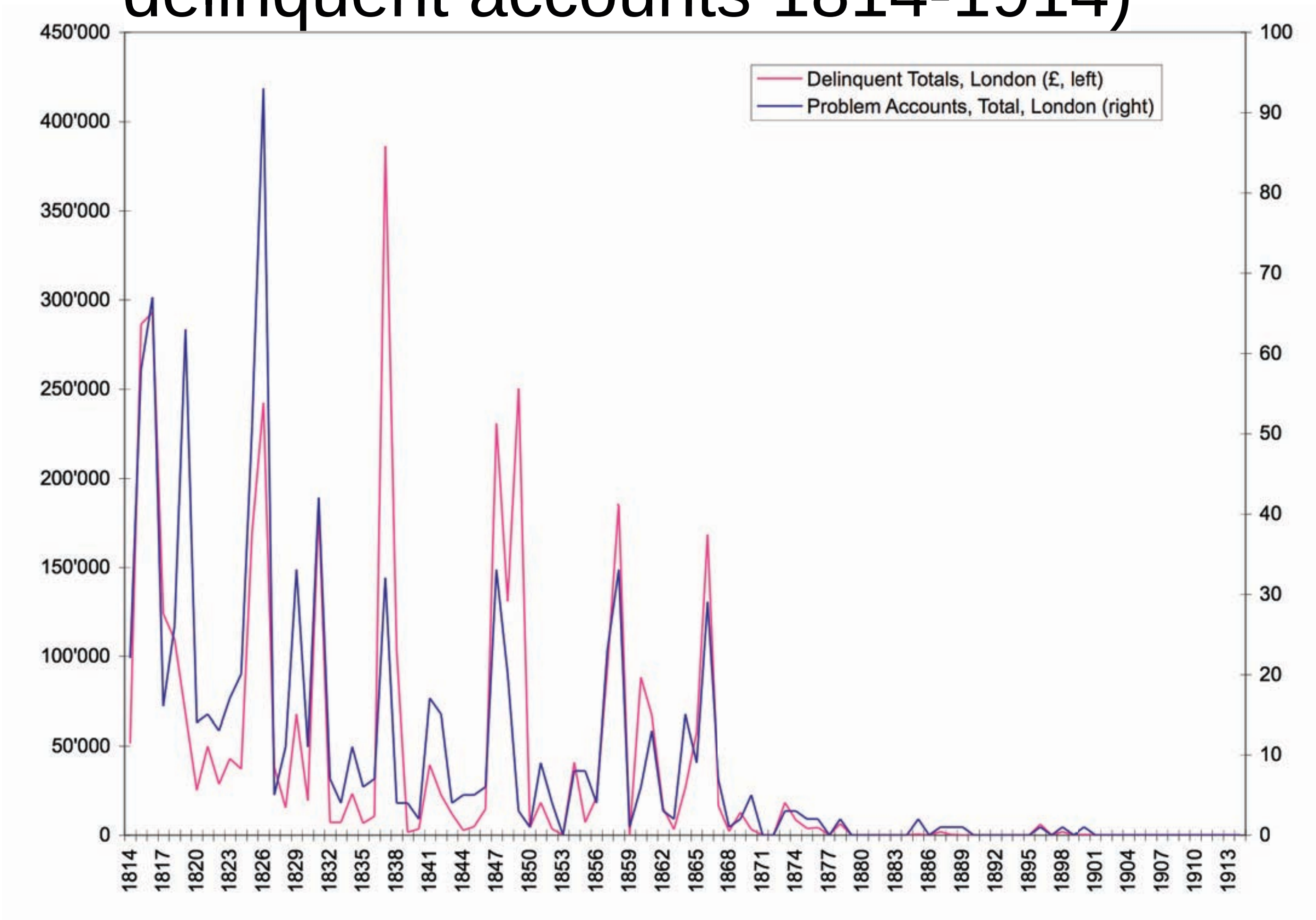
- Dealing with Bubbles: One Agency To Prick Them, another to Clean up the Mess?
- Historically, Some Central Banks were Created to Mop Up Government Debt (Kind of MLM): they Inevitably Ended up Being Put at the Center of the Banking System (England, Scandinavia)
- Experience of the "Independent Treasury" in the US
- "Liquidity" is a Judgement Call (decided by MLM?) and then used by MMA?

Price of British Consols (Treasuries) in Three Crises

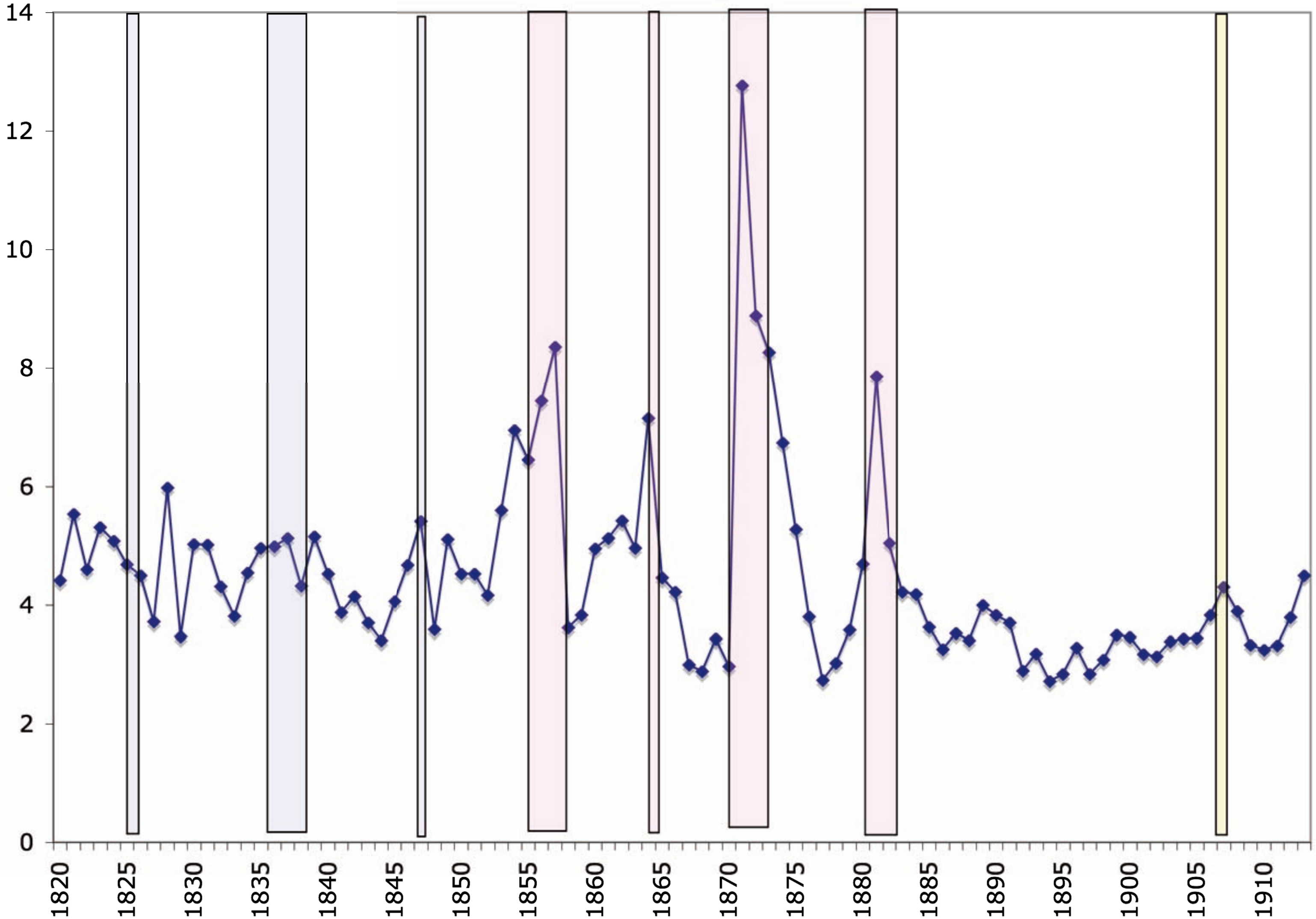


- 2. Inter-temporal Issues
  - Bank of England was a combination of MMA (Gold Standard) and MLM (“Bagehot rules”) but the question is why were the two tied?
  - At first, it was thought that this spelt the end of Peel’s Act -- but it did not and turned out to be a complement to it (Bordo-Kydland, Gold Standard as contingent rule)
  - Credibility of Monetary Policy arises From Its Ability to Supervise Crisis Operation

- 3. Moral Hazard
  - Peter's Proposal Takes for Granted that Crisis Lending Creates Exposure (BoE delinquent accounts 1814-1914)



Central Bank Dividends and Crises in France



- The Proposal would Somehow Acknowledge that there will be other Crises (that, we know) that will lead again to bail out and will have political implications
  - This crisis was of an extent and nature that led to fiscal implications. What we want is to reduce likelihood of such problems in the future. What does the proposal do about that?
  - Why not working towards solution that enable central banks to make time consistent pledges of no bail out?
  - We have made central banks independent from the government, it may be time to make them independent from the banking system?