Comments on Peter Stella, "Minimizing Monetary Policy", Marc Flandreau, Graduate Institute, Geneva, BIS Annual Conference, Lucerne, June 25, 2010

Peter Stella's paper is both intriguing and ambitious. It makes a useful contribution to the ongoing discussion on organizational and central bank design issues raised by the Sub-prime crisis. His starting point is that the crisis reopened debate about Central Bank Independence. In the past 30 years an emerging consensus has held that monetary policy is better conducted if delegated to an independent body. This independence takes the form of the delegation of monetary policy targets (either formal or informal) to an unelected bureaucracy. The theoretical contributions of Rogoff and later Walsh, among others, have provided a rationale to central bank independence. The intuition is that the conflicts of interest of the independent monetary authority are not quite the same as those of central bankers and as such provided for superior monetary policy performance. However, Stella emphasizes, this says nothing about the optimal framework for crisis management. He argues that a case should be made that financial policy (or the central bank's attitude towards the financial system and crisis lending) is distinct from monetary policy. As a result, central bank independence should be revisited with this distinction in mind.

The current financial crisis, he argues, has seen a blurring of lines between monetary and financial policy. This has become apparent at three levels: first credit policy (the portfolio choices of central bank – in short their buying of sub-prime or government debt); next, funding policy (the creation of ad hoc vehicles to hold distressed instruments and funded by government debt at a time when interest rates are nearing zero is not very different from their funding by high powered money or debt?; and last risk exposure (monetary policy is risk-free while financial policy isn't, but recent central bank moves have pushed them into a territory where they would bear significant exposures).

This situation, according to Stella, provides a rationalization for identifying different Governance and Balance-sheets set up for monetary and financial policy. Monetary policy is best conducted with operational independence and involves little or no exposure. As a result it can be dealt with little capital, a slim balance-sheet and large operational independence. Financial policy however, because it does involve risk ex ante and transfers ex post, is part of fiscal policy and should involve a large balance-sheet, a large capital to cushion potential losses, and limited independence.

These transactions lead Stella to formulate a blueprint for central bank reform – in practice a split between a Minimal Monetary Authority (MMA) and a Market Liquidity Maintenance Corporation (MLM). The first would be in charge of monetary policy, while the second would take care of financial policy. He suggests that this is feasible because more sweeping reforms have been done in the past (think of New Deal). He also emphasizes that this would put the Parliament in the driver's seat to control and fund MLM, which would be endowed with a hybrid governance structure that would be neither monetary nor fiscal. Stella's conclusion is that one can only protect *monetary policy independence* by recognizing that *central banking* is not monetary policy, that it should not be independent, and that it should be endowed with an alternative and innovative governance structure.

Since Stella alludes in several occasions to historical precedents and also draws on history to make claims on the feasibility of his scheme, my comments will seek to expand on this and provide a historical perspective on the proposal. At one stage Stella argues that "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". His intuition is that 19th century central banks were in charge of implementing a simple monetary policy rule (gold convertibility – or the maintenance of the Gold Standard) and were thus "minimal" in this sense. However, a more complete representation would recognize that "Gold Standard Era" central banks did combine: A monetary policy function delegated to an independent agency (for instance in the case of England, the gold peg was encapsulated in the so-called Peel Act of 1844) and a more or less formalized contingency plan (which took the form of a suspension of Peel Act during crises such as 1847, 1857, 1866…). Suspension of the Peel Act also altered some fundamental aspects of the "normal" way monetary policy was conducted, including provisions for the way profits would be booked etc. The question I raise therefore is why was it that

earlier designers found it preferable to endow the same agency with different goals rather create a separate agency?

One possibility is operational issues in the separation of monetary and financial policy: Can one Separate the Mezzanine Level of Monetary Policy from the Sub-prime Level of Financial Risks? For one thing there does exist other risks than financial ones. While it is reasonable to argue that the conduct of monetary policy involves "less risks" than financial policy, history suggests that "monetary policy" can be exposed to serious risks. The example of foreign exchange reserves is a very relevant one. The sterling crisis in 1931 had the effect of inflicting massive losses to the Bank of France and the Bank of the Netherlands (the Bank of France was technically bankrupt) and led to a Treasury supported recapitalization of the Bank of France followed by the transfer of foreign reserve management to the French Treasury. Today, the control of the Chinese executive over China's foreign exchange reserves is obvious.

At another level, history suggests that when MLM and MMA co-existed for a while with a Treasury agency taking an active role in money markets generally in relation with crisis management, some merger was eventually implemented after a period always described as frustrating. Technically, the monetary authorities had to cope with another institution performing de facto open market operations. The US experience with the "Independent Treasury" in the 19th century, which was an attempt to grow crisis management functions in a system that was prevented from having a central bank is a reminder that it may be that independence is required in crisis management, just as it is in monetary policy and perhaps even more.

I am not sure either how the two agencies would divide roles when it comes to bubbles. Would one agency (in charge of monetary policy) prick them while the other would to clean up the mess? Or would the bubble be entirely dealt with by the MLM (on account that bubble bursting would involve redistributive conflicts) – in which case wouldn't the minimal monetary authority be somewhat sidelined, to say the least.

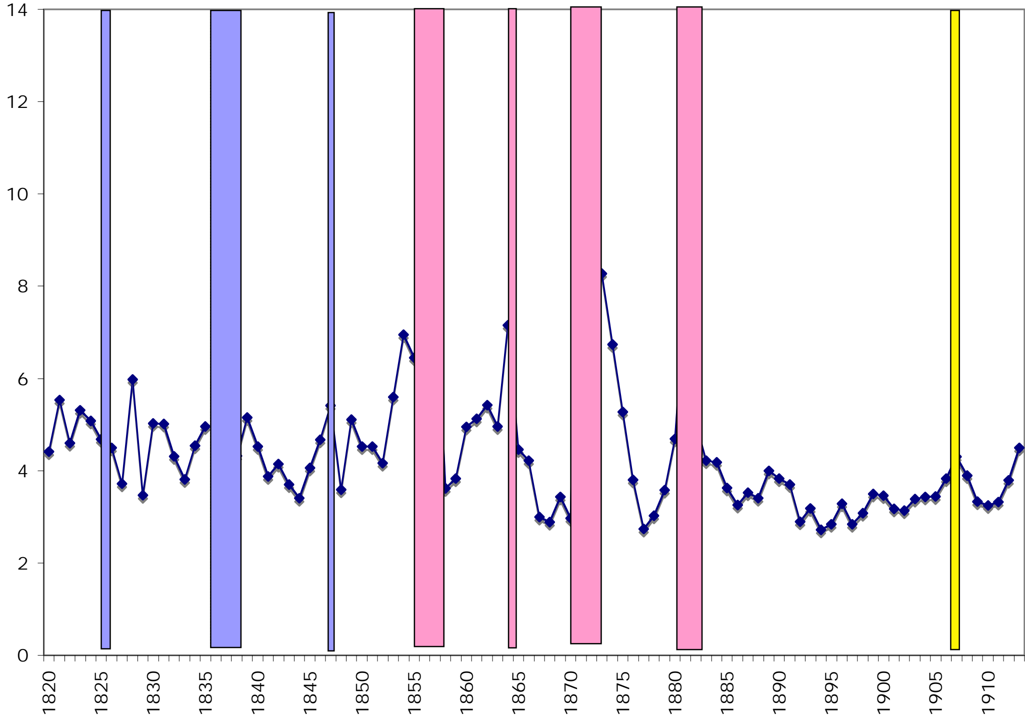
Finally, I note that historically, several central banks were created to mop up government debt and deal with the financial problems resulting from inadequate monetary policy and yet they inevitably ended up being put at the center of the banking system. Could this just be a coincidence? My understanding is that a central part of this is that the identification of "liquidity" has implication for both crisis management (what can be brought to the central bank then) and monetary policy (what banks as a result routinely hold in their books). The Bank of England offers a good illustration of this. It was a combination of MMA (Gold Standard) and MLM ("Bagehot rules"). It's ability to perform adequate monetary policy functions, I claim was tied to its ability to supervise crisis lending *and vice versa*.

Another aspect of Stella's suggestion to separate monetary policy from financial policy is the notion that crisis lending creates exposure. While such a view is implied by popular expressions such as "bailing out" or "rescuing banks", it may be misleading. Bignon, Flandreau and Ugolini (2010) cover the experience of the 19th century and show that the emergence of modern lending of last resort was accompanied by a *reduction* of Bank of England losses during crises. This may be explained by a two factors. First, crisis lending needs not be loss making. In fact, the central bank is lending using the cash it produces and can thus buy good assets at distress prices. The recent profits posted by the US Treasury on its purchases of US bank stocks are an illustration of this. A case could be made that sound liquidity support is profit making (see also Flandreau 2007 for a discussion of this matter in historical perspective and the chart below showing Bank of France dividends rising in crises). Second, generous crisis lending can be accompanied by prophylactic measures aimed at minimizing central bank exposure (collateral, haircuts, etc.). I am therefore not quite convinced that, because of its redistributive implications, central banking belongs to fiscal policy.

My general impression is that the main lesson from the sub-prime crisis is that it led to a sequence of events that created fiscal commitments over and beyond what was anticipated or desirable. The biggest commitments were the result of the operation of automatic stabilizers, however, and thus wholly happening in the realm of fiscal policy – and not monetary policy. What we want now is to limit the probability and occurrence of similar problems in the future. "Fiscalizing" a body in charge

of crisis management may not be the best way to go. After all, whatever policy leverage governments had over central banks was used to involve them into the crisis in ways that future historians will have to assess. As a result, central banks became captive of a banking system whose failures they had not been able to monitor. In the past, we have made central banks independent from the government. It may be time to make them independent from the banking system?

Figure 1. Dividends and Crises at the Bank of France



Source: Flandreau (2007)