

The Changing Role of Central Banks

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Historical Introduction

Three main functional roles:

- i) Price stability
- ii) Financial stability (and development)
- iii) Support State in crisis (war)
Constrain misuse of State powers in normal times

Balance between functions shifts over time.

Identify three stable epochs, with confused inter-regnums between them.

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|----|----------------------------------|---|
| 1. | 1840s → 1914
1914 → 1933 | Victorian era
Inter-regnum |
| 2. | 1933 → 1971/72
1971/72 → 1979 | Decades of Government Control
Inter-regnum |
| 3. | 1980 → 2007
2007 → Current | Triumph of the Markets
Inter-regnum |
| 4. | The Future | ? |

Victorian Era

In praise of the Real Bills doctrine

Learning to use OMO to make official rate effective

Independence from Government and quasi-automatic market mechanisms

Decades of Government Control

Lessons of 1929-33 was to suppress competition.

Safe but dull

Controls and cartelisation, over-riding of weak market mechanisms

No independence; so what did it do?

- (i) Advice on policy (less effective than Treasury)
- (ii) Administer controls
- (iii) Manage markets (fx, bond, money market)

Triumph of the Markets

IT and international competition, Euro-dollar market
Collapse of Bretton Woods, inflation

Targetry: Money, fx, inflation

Capital was constraint on bank expansion
But no self-control, so regulation

Such regulation failed (too procyclical)

The Future Role of the Central Bank?

- Price stability does not guarantee financial stability (Minsky)
- Cannot achieve two objectives with one instrument
- So develop macro-prudential regulation/supervision
- What will be role of Central Banks in this?

A. The Essence of Central Banking

- This lies in liquidity management, not setting interest rates
- “A Central Bank is a bank, not a study group”

B. Interactions with Government

- (i) A bank tax
- (ii) Sanctions
- (iii) Debt management
- (iv) Bank resolution
- (v) Interest rate setting

C. Inter-connection with other Regulators/Supervisors

D. Structural Development in the Financial Sector

E. Conclusions

What does closer involvement of Central Banks with Governments mean for the interest-rate setting function?