What Should Central Banks Do?

A comment on "The Changing Role of Central Banks" by Charles Goodhart

Randall S. Kroszner
Norman R. Bobins Professor of Economics
The University of Chicago
Booth School of Business

Intro

- As we have come to expect of Charles, witty and insightful analysis of a fundamental issue
- Underscores importance of the value of economic history as a foundation for the assessment of “new” roles
  - Delighted that at least half of the papers emphasize history
- Will be able to focus on only a few of the many important points raised
  - Excellent to set the stage for the conference

Four Epochs

- 1) Victorian Era: unified but flawed “real bills” theory of price and financial stability

- 2) Government Control: distrust of competition, restrictions on capital flows, interest rates, activities of intermediaries

Four Epochs (con't)

- 3) Innovation and Arbitrage: from eurodollar market to CDOs, rise of wholesale funding
  - Target inflation and let markets work
  - Focus on K, less emphasis on liquidity (arbitrage)
  - CP and ABCP, greater competition for funds so more reliance on external sources; rise of MMMFs as ways to avoid reg; reg incentives driving originate to distribute and securitization
  - Regulatory arbitrage driving the "shadowy" interconnections and innovations

Four Epochs

- 4) What does the future hold?
  - Should inflation targeting change? NO
    - But do Taylor Rule – like behaviors provide excess incentives to risk-taking?
  - What role in financial stability?
  - *"essence of Central Banking lies in its power to create liquidity, by manipulating its own balance sheet"*
    - Emphasis on LLR, no need to set interest rates
  - But perhaps LLR provides incentives to innovate instruments with tail risk, since Central Bank gets stuck with it so how to address this problem?

Central Bank as LLR

- Central bank is on the hook to do lending in a crisis so it must have knowledge and expertise to evaluate rapidly in crisis circumstances borrowers and collateral
  - Some supervisory role is crucial
  - Helps to avoid BOE-Northern Rock episodes

Central Bank as Financial Stability Regulator?

- But do we turn the fire extinguisher into a smoke detector to provide an early warning about fires?
  - Unsuccessful search for early warning signals for int'l financial crises and unlikely to do better here
  - Must be cautious about limits of macro-prudential supervision

Bank Tax

- Two-part tariff, low basic rate and time/risk varying
  - Effectively similar to a time-varying capital charge since the tax will affect the cost of capital
  - Could they simply push activities off balance sheet or elsewhere into the shadows, a rerun of Basel I?
    - Complicate resolution? Undermine living wills?
  - Are they at the bank or holding company level?
    - Perhaps driving rapid growth of Canadian or Australia subsidiaries or affiliates?

Bank Tax (con't)

- Do the proceeds go to general revenues or a protection fund?
  - Explicit moral hazard? What is the purpose?
- Who will decide and how much and quickly will they change?
  - Fiscal vs macro-prudential
- Do taxes lead to rise in the crisis (and make banks even less viable) or do they go down in a crisis and anger the public?

Sanctions and Enforcement

- Where the rubber hits the road
- Rules are only as good as enforcement and monitoring but strong incentives to evade
  - Crucial distinction between supervision and regulation
- FDICIA right in principle but didn't work in practice
  - Politically difficult to clamp down real estate
    - OFHEO, RIP; Commercial Real Estate "guidelines"
  - Weak supervisors at home (OTS, RIP) or abroad

Resolution

- Since central banks are on the hook, playing some role in resolution is crucial
- Living wills extremely valuable but only if they are clear and credible
  - Most effective with simple organizational structures
  - Taxes and tax avoidance complicate this

Resolution (con't)

- Reducing uncertainty about contract enforcement
  - Proposals in US Congress tend to increase contract uncertainty, e.g., violate priority in bankruptcy
    - The int'l data clearly say that lack of rule of law reduces willingness to invest
    - This is precisely the pull-back we saw in the fall of 2008

So What Should Central Banks Do?

- Lender of last resort (LLR)
  - Very much agree that this is the "essence"
- An interest-rate-setting role
  - Natural but not necessary complement to LLR
- A supervisory and regulatory role with teeth
  - No need to be exclusive (and can never be given globalization of markets/institutions)
  - But councils/int'l bodies must avoid the "Graeae" problem
    - One eye and one tooth!

What *Shouldn't* Central Banks Do?

- Debt monetization
  - But open to a role in debt management
- Consistent credit allocation
  - Distributional consequences of the balance sheet
- Industrial policy
- Competition policy?
- Consumer protection?
  - Is it best to delegate to an agency that does not consider safety & soundness and growth?

So What Should Central Banks Do?

- Broader financial stability mandate?
  - Difficult balance of responsibility and authority
  - Difficulties and dangers of drawing the line between systemically-important and other institutions and markets
    - Incentives for risks to migrate into the “shadows” just beyond the border
  - Be careful what you wish for
    - Potential compromises to independence, political pressure not to intervene to in certain markets (e.g., real estate)
    - Incentive to innovate tail risks