What Should Central Banks Do?

Comments on Charles Goodhart's "The Changing Role of Central Banks*

Randall S. Kroszner

Booth School of Business
University of Chicago
and

National Bureau of Economic Research

*Presented at the BIS Annual Research Conference, June 2010, Lucerne, Switzerland .
Contact: randy.kroszner@chicagobooth.edu

We have come to expect insightful, witty, and provocative analysis of fundamental issues from Charles Goodhart, and this paper does not disappoint. The paper begins with an overview of how the roles of central banks have evolved as markets and institutions have changed from the mid-nineteenth century to the present. This deep historical understanding provides the foundation for analyzing what tasks are appropriate for central banks today in light of the recent financial crisis.

Charles foresees an era that will more closely resemble the roughly half-century of “more intrusive regulation, greater government involvement, and less reliance on market mechanisms” that followed the Great Depression than the quarter-century of the “triumph of markets” that preceded the financial crisis. He sees much more interaction between the central bank and various activities of government, e.g., finance ministries, competition authorities, resolution authorities, etc., but holds out hope that the operational independence of the central bank over monetary policy can remain. Intriguingly, he argues that if this independence cannot be maintained then policy makers should consider farming out interest-rate setting to a group of independent experts who might well be “a coven of Druids casting runes over the entrails of a chicken.” Provocative indeed!

For Charles, the “essence of Central Banking lies in its power to create liquidity by manipulating its own balance sheet.” While I very much agree that the lender of last resort and liquidity creation functions are at the heart of what central banks can and should do, I see a much closer connection to interest-rating setting. A key channel through which central banks affect short-term interest rates is through open market operations, that is, actions that affect their balance sheets. Charles discusses how liquidity provision could be undertaken independent of interest-rate setting and in many settings it might be possible to do this. If we consider the extraordinary liquidity provision that central banks have undertaken in response to the crisis, however, it seems difficult to see how central banks could have flooded markets with liquidity without significant downward pressure on the levels of short-term interest rates. At least some coordination between interest-rate setting and liquidity provision in these circumstances seems crucial since the supply of liquidity would likely overrule the pronouncements of the Druids.

The recent crisis and Charles’ thought historical examples indeed underscore the unique power of using the balance sheet in response to crises. The success of implicit or explicit inflation targeting in the quarter century prior to the recent crisis led many to forget or under-appreciate the role of balance sheet manipulation in central banking. The ability to use the balance sheet to provide liquidity thus gives the central bank a fundamentally important role in financial stability (see, for example, Kroszner and Melick forthcoming)

Defining precisely the central bank’s responsibility for financial stability is, however, less straightforward than it might seem. I believe that there are two views of the central bank’s role with respect to financial stability: as a fire extinguisher or also as a smoke detector.

The “fire extinguisher” role is the classic one that central banks have played as lenders of last resort and liquidity creators in times of financial stress and tumult. This role emphasizes that central banks should stand ready to act as the flames begin to appear. The central bank can then douse them with liquidity to prevent the flames spreading from one institution or market to another in order to avoid a system-wide conflagration.

The “smoke detector” or “macro-prudential” role emphasizes that the central bank has a fundamental responsibility to act early to prevent the tinder from igniting into flames in the first place. Being proactive in monitoring individual institutions and interconnected markets for signs

of froth and fragility is what macro-prudential policy should focus upon. The macro-prudential role certainly does not conflict with the more traditional "fire extinguisher" role, but it requires a much expanded set of authorities and activities on the part of the central bank.

Policy-makers in many countries see a larger smoke-detector role for central banks as a way to reduce the likelihood of future crises, and I think that it is inevitable that central banks will take on more of a macro-prudential role in the post-crisis era. It is important, however, for policy makers and market participants not to have an excess sense of comfort about what macro-prudential policy can achieve. While expanding the toolkit is valuable, I would caution that macro-prudential supervision and regulation involves significant challenges to implement as an effective smoke detector and involves political risks for the central bank. Excessive faith in macro-prudential policy to stop the buildup of risk concentrations and froth in markets could lead to reduced market discipline and forms of moral hazard. I will briefly mention three challenges for macro-prudential policy.

The first key challenge concerns data and measurement. What will be the metrics or indicators of systemic risk to trigger macro-prudential action? Following the financial and currency crises in emerging markets in the 1980s and 1990s, academics and researchers at institutions such as the IMF and World Bank tried to develop "early warning" systems to better anticipate where and under what circumstances a crisis might occur. This exercise has proved to be extremely difficult, and there are no generally accepted crisis warning indicators that would allow authorities to act sufficiently far in advance to avoid one.

Much research is now being undertaken on these issues in the more micro setting of financial firms and markets. I certainly applaud this effort but still believe it is quite early to make commitments about the power of such metrics and indicators to predict trouble. New markets and instruments, for example, pose particularly vexing problems because, by their very nature, they would have short data trails by which risks could be assessed.

Even if a reasonable set of indicators can be developed, there is a second challenge that is more theoretical in nature. How strong of a foundation can financial economics provide to supervisors and regulators that an asset is "overpriced" or a risk premium is "too low"? As I believe Larry Summers emphasized many years ago, financial economics and markets are extremely good for ensuring that a 24 ounce bottle of ketchup is priced at twice as much as a 12 ounce bottle but not quite as helpful for determining what an ounce of ketchup should be worth. Assumptions about preferences, etc. are needed and reasonable people could disagree.

Without a straightforward and theoretically grounded way to argue that a risk is not properly being taken into account in market pricing, a supervisor or regulator is open to the criticism of being arbitrary and attempting to substitute her judgment for those of market participants who are putting their own money on the line. It can be difficult to for the supervisor or regulator to "prove" the case. Unfortunately, this also opens the way for political judgments and pressures to determine what is and is not considered "arbitrary."

The third challenge concerns the political-economy dynamic. Will a central bank's independence be challenged if it is actively engaged in macro-prudential policymaking? Charles emphasizes this point when he suggests that it may be that "the combination of operational independence to set interest rates and liquidity management together with prospective macro-prudential regulation just vests too much power in a non-elected body."

Consider the case of housing. The US and many other countries have numerous government programs and policies that encourage home ownership, ranging from reductions in down payments to subsidies to securitization (in the US, for example, through the GSEs). If a

central bank becomes concerned about "frothiness" in housing, how easy would it be to adopt policies that reduce loan to value ratios, restrict securitization, raise capital requirements, or otherwise increase the costs of mortgages? The unelected body of the central bank could be portrayed as trying to overrule public policies explicitly adopted by an elected body. This certainly could put the central bank in the political cross hairs. Effective macro-prudential policies thus may involve risks for central bank independence.

To conclude, Charles has written a thoughtful paper about fundamental issues of what central banks have done and what central banks should do. I very much agree with Charles that the ability to manipulate the balance sheet is central to central banking. In this comment, I have touched on only two other roles, interest rate setting and macro-prudential policy. Charles analyzes many other issues in his wide ranging paper that I am certain will stimulate debate on the proper roles for central banks for many years to come.

Reference

Kroszner, Randall S. and William Melick, "The Response of the Federal Reserve to the Recent Banking and Financial Crisis," forthcoming in An Ocean Apart? Comparing Transatlantic Response to the Financial Crisis, Adam Posen et al. editors, Peterson Institution for International Economics, 2010.