Discussion by Charles Bean, Deputy Governor for Monetary Policy, Bank of England of "Is Monetary Policy Overburdened?" by Athanasios Orphanides 12th Annual BIS Conference, Luzern, 21-22 June 2013

Athanasios Orphanides asks "Is monetary policy overburdened?" His answer is Yes. He will be pleased to know that so is mine. While there is much in the paper I agree with, however, there are aspects of his argument where my perspective is somewhat different. In particular, he frequently identifies the singular mission of the central bank as maintaining price stability. I think this is too narrow a perspective, particularly in respect of financial stability. I shall come back to this at the end.

Athanasios focuses on three factors contributing to the overburdening of monetary policy, namely concerns about: growth and unemployment; fiscal sustainability; and financial stability. Starting with the first, Athanasios accepts that there is a short-run trade-off between activity and inflation, but argues that attempts to exploit it to achieve higher growth and lower unemployment for a while may simply end up compromising the central bank's ability to achieve low and stable inflation over the longer run.

Inflation targeting, as actually practiced by the Bank of England and other inflation-targeting central banks, recognises this by aiming to achieve the target level of inflation in the medium term, but accepting temporary deviations from target (especially in face of cost shocks) in order to avoid excessive output volatility. This closely resembles the optimal policy in analyses of monetary policy in simple New Keynesian macroeconomic models, such as those of Lars Svensson and Mike Woodford.

Such "flexible" inflation targeting appeared to have been amazingly successful during the period of the Great Moderation: inflation was low and stable, while output growth was unusually steady. That in turned raised the expectations of politicians and public as to what could be expected from monetary policy. To a degree, we were victims of own success.

As a result of the financial crisis and the associated recession, matters have now gone to the other extreme, with a substantial, though uncertain, margin of spare capacity still persisting in the affected economies. Demand is likely to remain subdued for some time to come, reflecting in part the drawn-out nature of the process of balance sheet repair. In addition, the limited room for fiscal action means that monetary policy is often seen as the only show in town. But that is at a time when the combination of untried unconventional policies of uncertain effectiveness is coupled with weaker policy pass-through on account of impaired bank balance sheets and excessive private debts. So there is something of a gulf between expectations and what is achievable.

Now analyses of optimal monetary policy (under discretion) suggest that the inflation gap should be proportional to the output gap, so that inflation should be above the target when there is spare capacity and *vice versa*. Given the persistent spare capacity at the present time therefore, a central bank should be willing to accept a correspondingly persistent overshoot of its target – at least providing that it does not threaten the credibility of the regime.

Athanasios suggests that central banks should ignore society's output objective and focus just on hitting the inflation target, leaving it to structural reforms to generate lower unemployment. While I agree that, in the long run, monetary policy is powerless to affect things such as the average growth rate or the average rate of unemployment, I don't think central banks can simply say that it is therefore all someone else's problem. If we do, then we risk losing democratic legitimacy and having our power to set monetary policy circumscribed. But we should explain the limitations of monetary policy and argue the case for other actions too.

Let me now turn to monetary policy and fiscal sustainability, where Athanasios presents two arguments. First, he suggests that the large-scale bond purchases by some central banks mean that the corresponding governments will be loath to see monetary policy normalised. Of course, this is not a particular feature of bond purchases, it would equally be true if policy rates are unusually low. And there is no doubt that tensions with governments will be heightened as central banks move towards the exit – a sort of "weak fiscal dominance". But do we really think that central banks shouldn't have supported recovery in this way because of worries about the pressures they might come under during the exit phase? Again, I think that would risk central banks losing their democratic legitimacy.

Athanasios does suggest that a solution is to buy foreign, rather than domestic, bonds, citing Switzerland as an example. But the action of the SNB was justifiable only because the Swiss Franc was subject to extreme upward pressure and the SNB had few domestic bonds to buy. But in most cases, buying foreign bonds would be seen as a blatant attempt to depreciate the exchange rate, shifting the burden of adjustment abroad. Such a beggar-my-neighbour policy would be totally unacceptable to trading partners and risks protectionism.

Athanasios second argument is that undertaking monetary support reduces the incentives for the fiscal authorities to take the necessary, though difficult, actions. This is a real issue, illustrated several times during the euro-area crisis: each time the European Central Bank steps in with a major initiative, governments slow down on taking the necessary fiscal and structural measures. But surely the right response cannot be to keep policy tight just to discipline governments. Isn't it better to build in the right incentives in other ways, such as the conditionality in the ECB's Outright Monetary Transactions facility?

There is, though, another fiscal aspect that Athanasios doesn't discuss, and that is the prominent role in some jurisdictions of the central bank as a "fiscal policeman". Central banks certainly have a legitimate concern in ensuring debt sustainability and avoiding fiscal dominance. But when a central bank opines on the detailed structure of government spending and taxes, it is moving into political territory, and may thereby risk losing public support. In some countries, the central bank may be the only body with the credibility to play such a role. But, in my view, it is one that it should take on only reluctantly.

Finally, let me turn to monetary policy and financial stability. Here Athanasios sometimes seems to make a category error in equating the mission of central banks with that of achieving price stability. To my mind, that ignores the centrality of maintaining financial stability. Central bank money is the ultimate settlement asset and acting as a lender of last resort to illiquid but solvent financial institutions is surely <u>the</u> defining role of a central bank. Setting monetary policy does not need to be in central bank, but being the lender of last resort does.

But in any case, the real issue is not whether the central bank is responsible for maintaining financial stability as well as price stability, but rather how they are managed and interrelations between them. I take the view that monetary policy is ill-suited to be the primary instrument for preventing the build-up of financial imbalances – the collateral cost to the real economy is usually too great. Instead, supervisory and macro-prudential policies should be the first and second lines of defence. But macro-prudential policies are relatively untried and there will also be times that the financial imbalances are building outside the boundary of the regulated sector. In that case, it may be necessary to direct monetary policy in part to the financial stability objective, accepting the short-term consequences for activity and inflation.

In the new framework at the Bank of England, we manage the monetary policy/financial stability nexus by having two committees with overlapping membership: the Monetary Policy Committee targets price stability and subject to that supports the government's policies for growth and employment; and the Financial Policy Committee targets financial stability and to that also supports the government's policies for growth and employment. Moreover, each is enjoined to have regard to the actions of the other.

Finally, Athanasios frets about potential losses to the central bank's balance sheet as a result of liquidity support actions. Here the solution seems straightforward. Central banks should lend only to institutions that are solvent and viable, against collateral they can risk manage by taking a suitably prudent haircut. If they go beyond that and take credit risk on to the consolidated public sector balance sheet to any significant degree, then that should only be with explicit consent of the fiscal authorities and under an indemnity. It surely has to be for democratically elected politicians to commit public funds, not the central bank.