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Inflation targeting twenty years on

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Programme committee

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Dinner speech
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These are extraordinary times for Central Banks. The wish that Central Bankers might become seen as useful, but boring, technocrats, rather like dentists, seems all too far from realisation. Let me start by reminding you that all the really serious financial crises have occurred in the aftermaths of periods of great economic success, and at times when inflation was not a serious issue, for example USA in 1929, Japan in 1990/91, most everywhere in 2007/8; before then in the 19th century crises often followed over-expansion on the basis of great technological break-throughs, canals and railways, which had the effect of lowering prices. There are, indeed, good reasons, as Hy Minsky pointed out, why crises should follow overconfidence, as nemesis follows hubris.

The point of this, however, is to emphasize that successful control of inflation does not carry with it any assuredness of limiting, or even much mitigating, asset price bubbles and busts. And this would I fear remain so even if housing prices were to be correctly included in the inflation index, as should be done.

Achieving low and stable inflation remains the priority, but it cannot be the be-all and end-all of a Central Bank's remit. This realisation has led to two different proposals. The first is to adjust Central Bank reaction functions so as to have them lean against the wind of asset price bubbles and busts. The second is to find and employ additional instruments in order to dampen asset price fluctuations, and to maintain financial stability. In my view the latter, if it can be done, would be far preferable.

The present constitutional position whereby the Central Bank uses its operational independence to hit a medium term inflation target, mandated by government, is simple, straight-forward and allows for clarity and accountability. It would muddy the waters, involving discretionary trade-offs, to have the Central Bank try to hit two, largely orthogonal, targets with a single instrument. Especially in the current context with half the people fearing deflation, and half fearing inflation, there is more need than ever for Central Banks to commit to a fixed inflation target.

Central Banks already have one instrument for achieving financial stability, in the form of liquidity provision. They were taken largely unawares by the scale and extent of the continuing need for liquidity from August 2007 onwards, and have been forced into unprecedented innovation since then. There must now be a rethink about how to charge banks, and other financial intermediaries, in advance for the liquidity insurance function that

Central Banks fulfil; such a charge, whether it take the form of a direct payment premium, an additional capital requirement, or whatever, should also serve as a counterweight to the incentive to run a large maturity mismatch.

But some additional regulatory controls over liquidity, though desirable, will not be sufficient. Generalised problems with liquidity almost always go hand in hand with concerns about solvency, as in 2007. If you could assume that I can certainly repay you, you would always lend to me unsecured at a risk free rate, an invalid assumption that alas is incorporated into most macro-economic DSGE models. Instead liquidity and solvency issues are, almost invariably, intertwined. Indeed liquidity only really has a rationale and meaning, when solvency is a potential problem. But, whereas Central Banks can provide liquidity, they cannot recapitalise banks or other systemic financial intermediaries by themselves. That can only be done through the Minister of Finance picking the fairly deep pockets of the taxpayer. That means that financial stability issues have to be decided and carried out jointly by the Central Bank, the Treasury and by whichever institution is responsible for day-to-day supervision of the systemic financial institutions.

I see no sensible alternative to the adoption, or continuation, of some kind of tripartite committee, though I would rather have it normally headed by the Central Bank governor than by a politician or Treasury civil servant. Quite where this need for fiscal/monetary cooperation on financial stability issues leaves the euro-zone, except in rather obvious difficulties, remains to be seen. The problem with the operation of the Tripartite Committee in the UK, and its counterparts elsewhere, was not its structure and procedures, though no doubt these could be improved, but in the lack of counter-cyclical instruments, in the form, for example, of time and state varying controls over capital requirements and mortgage

lending. And even more important, where such requirements might have been applied in principle under the rubric of Pillar 2 of Basel II, there was no keenness in practice to do so. Regulators and supervisors will always have to operate against the desires of the market, of the politicians and of the institutions, since “taking away the punch bowl when the party is just getting going” wins no popularity prizes, and therefore Central Bank regulators must have their backbones stiffened by rules and ex ante commitments, but I have banged this particular drum often enough before now.

But if there must be cooperation between the fiscal and the monetary authorities on financial stability issues, where does this leave the independence of the Central Bank? In principle that does not worry me. An institution can carry out separate tasks, in which one set of such tasks is done independently, via a Monetary Policy Committee with its attendant staff, and another set of tasks jointly via a Financial Stability Committee, with its own staff. The MPC consists of specialised internal and external Central Bank appointees. The FSC is wider with a tripartite membership. Thus we normally separate pure monetary policy, in which the Central Bank has had independence delegated to it, from financial stability where decisions need to be taken jointly between the monetary and fiscal authorities.

But something of a spanner has recently been thrown into the workings of this separability theorem in the guise of the recent adoption of quantitative easing. This latter involves enormous fluctuations in the size of the Central Bank’s own balance sheet, and puts the Central Bank in a position where it can make either huge profits or massive losses. In short the Central Bank’s balance sheet has become risky, and Central Banks do not themselves have sufficient capital to absorb such risks. At a time when the private sector is being asked to mark-to-market all such assets that are not being held to maturity, there are

some interesting questions to be asked about the accounting principles being employed in Central Banks and in Ministries of Finance. After all, if one of the virtues of quantitative easing is its relatively flexible reversability, we can hardly assume that all the assets being bought by Central Banks are to be held to maturity, can we?

One can hardly deny that quantitative easing, QE, drives a horse and cart through the thesis of the separation of fiscal and monetary policies. In a sense this has already been recognised in a pragmatic way in the UK; we British tend to pride ourselves on being pragmatic in contrast to theoretical or ideological. Anyhow the Governor has agreed with the Chancellor the main modalities of QE, that is the overall amount and the strategy of how and on what classes of assets the total funds may be spent, though the initiative has, I believe, come from the Governor and the MPC, and the Chancellor has effectively indemnified the Bank against the risk of loss, and he, and the Treasury, then leave the MPC to get on with the application. The government has to be involved in setting the strategy; leaving operational tactics for an independent Central Bank. How far does that diminish the effective operational independence of the Bank of England? In my own view, hardly at all.

But can such a division of duties work so smoothly elsewhere, for example in the USA where the separation of powers leaves Congress with control over fiscal policy, or in Europe where M. Trichet has no euro-fiscal counterpart? Does QE by the Fed represent, in part, a form of fiscal operation which has, for the time being at any rate, bypassed Congress. There are some in the USA who consider that QE raises some ticklish questions about the constitutional relationships between the Fed, the Treasury and Congress. For the moment this may be swept under the crisis carpet, but can it be so for long? The same is true in the Euro-zone. Could the Governing Council just decide off their own bat to, shall we say, treble the

size of the ECB's balance sheet? What would happen if the member state governments were unhappy with this decision, as Angela Merkel would undoubtedly be?

There are some who will seize on the adoption of QE to argue that the separation of monetary policy, carried out by an independent Central Bank, from fiscal policy was from the start a dubious idea, and that the two policies should always have remained coordinated, and under the control of the Treasury. I have heard a senior retired British Treasury civil servant muse along such lines.

Moreover, the kind of additional instruments that I and others have been proposing, in order to allow the Financial Stability Committees of Central Banks to do their job effectively, such as time and state varying capital requirements, constraints on mortgage lending, etc., will, I believe, require supporting legislation, since they must be backed by appropriate sanctions, and sanctions need legal under-pinning. So it is quite likely that there will need to be further legislation, virtually everywhere, both to reinforce Central Bank powers to implement financial stability and, perhaps, to sort out the constitutional difficulties that QE has exposed.

To conclude, the years 1993-2006 were in many ways a Golden Age. One aspect in which this was so for Central Banks was that it seemed that their constitutional and functional role had been largely and successfully clarified. One feature of the current crisis in general, and the adoption of QE in particular, has been to put this role back under review. We will see.