Central banking, monetary stability and financial stability

EDITORIAL: CENTRAL BANKING, MONETARY STABILITY AND FINANCIAL STABILITY

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Introduction

Central banks seem to have been with us for ever, and to be almost everywhere. Very few countries do not possess a central bank, and these are, with a notable exceptional case, small countries which use the currency of some other larger state.[1] But they are actually a fairly modern phenomenon. Sweden's central bank emerged from Stockholms Banco, founded in 1656; and the Bank of England was founded in 1694. But neither of these was founded as a central bank. They developed the core central banking functions only in the nineteenth century.[2]

These core central bank functions are set out as follows in a just published history of Sweden's central bank (which is now known as the Riksbank): 'The primary functions of a modern central bank are to maintain the value of money and safeguard the stability of payment systems' (Wetterberg, 2009).

All modern central banks are expected to carry out these two tasks, and some, notably the US Federal Reserve, have other goals in addition to these. The central banks which have their tasks precisely defined are in general those which had their constitutions revised in the past two decades. Most of these were modelled to a considerable extent on the constitution of the Reserve Bank of New Zealand. That central bank was founded in 1934 (and then was closely modelled on the Bank of England), but was given a revised constitution in 1989. This gave the Reserve Bank a precisely defined mandate to achieve an inflation target, and also gave it responsibility for supervising the banking system of New Zealand with the objective of maintaining the stability of the system as a whole, though emphatically not that of any individual institution. The Bank of England, with its dual responsibilities for monetary and financial stability, mirrors this very closely. Indeed, the only notable difference between the two institutions, until some recent revisions to the constitution of the Bank of England noted below, was that in Britain monetary policy is set by a committee, and in New Zealand it is set by the Governor alone.

That structure, and others very like it, seemed satisfactory. It was associated with something over a decade of low inflation, strong growth, and financial sector stability, over a large part of the world. But things have gone wrong recently. The objective of this collection of papers is not primarily to consider yet again what has gone wrong. Although it is too early to write the definitive history of the recent crisis, there is already much useful material available.[3] This collection turns to the question of 'What next?'. What changes might make the banking system more stable?

Overview

The papers readily divide into seven groups. Two papers, by Roland Vaubel and by Pedro Schwartz and Juan Castañeda respectively, consider whether we need central banks, and re-examine the arguments for their being private institutions if they exist at all. Two, by Robert Hetzel and by Roland Vaubel, examine the current situation – how it arose, and what is being done about it. Such analysis is of course an essential part of thinking about the kind of institutional reform that might reduce the risk of problems in the future. One paper, by Robert Miller, examines the current crisis in an historical context and from an Austrian perspective, one invaluable for opening minds to new ideas. Steve Ambler examines the benefits of the price level, rather than the inflation rate, as a target. Then David Mayes considers a matter that was much discussed in one of the Treasury Select Committee reports mentioned above, *The Run on the Rock*: should the central bank be involved in supervision and regulation? Then Charles Blankart and Erik Fasten consider the role of the state in the resolution of financial crises. Last comes a

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completely different kind of paper, by John McFall, explaining the role and work of the Treasury Select Committee of the UK's House of Commons. That Committee has played a major role in the UK in gathering information on the crisis, analysing it, and making proposals to reduce the dangers of such episodes in the future. John McFall is the Chairman of that Committee, and has been at the centre of these deliberations.

In short, these papers review whether we need the institution of a central bank at all, the nature of current problems, and how to change institutional design if the institutions are to survive and to serve economies as was intended by those who guided the evolution of the world's two first central banks, the Bank of England and Sweden's Riksbank. This brief introduction draws out some points from these papers, places them in the context of other discussions, and in conclusion examines an issue that is plainly regarded as too difficult even for heads of government to contemplate.

The main points

Roland Vaubel, in a characteristically succinct and elegant paper, acknowledges the traditional arguments for there being central banks – the arguments include the traditional centralisation of reserves claim, but go beyond that and include the possibly lower cost of guaranteeing stability that a state-backed central bank may have, and their role as a 'provider of insurance' for commercial banks. But as Vaubel argues, none of these traditional arguments appears to justify the present situation of the central bank of every country being a monopoly. This paper thus questions the design of the very foundations of modern banking systems. Pedro Schwartz and Juan Castañeda do likewise. Observing, in an argument related to that of the subsequent paper by Blankart and Fasten, that central banks and fiscal authorities are now combined in consequence of the recent financial disturbances, they go on to argue that to break this link is essential for the long-run integrity of the currency, and that this is best done by privatising central banks. Only then would they, could they, be truly and usefully independently.

These two papers are in the line of a tradition with which Bagehot certainly sympathised, and which has been extended in more recent years by, most notably, Hayek (1976) and White (1995), and, less recent but notable nonetheless, Smith (1936, reprinted 1990).

Robert Hetzel gives a most useful overview of developments in the USA as a prelude to his diagnosis of what went wrong. He concludes that far from the current economic and financial difficulties being purely the fault of free markets, the problems originated in vacillating approaches to the control of inflation. This vacillation caused our present problems. Hetzel sets out clearly the kind of policy that could work, identifying it with one of its first post-World War II proponents, William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve from 1951 to 1970:

> 'According to Martin's own characterisation as "lean against the wind", the Fed raises the funds rate in a measured, persistent way in response to sustained increases in resource utilisation rates (decreases in the unemployment rate), and conversely for sustained decreases in resource utilisation rates. Martin imposed discipline on the resulting period-by-period funds rate changes through the imperative that they be consistent with maintenance of the expectation of price stability read from the behaviour of bond rates.'

This approach was largely followed by Paul Volker, and for a good part of his tenure by Alan Greenspan; but departure from it confused both real and financial markets, and so started our present difficulties.

In his second contribution to this collection, Roland Vaubel considers international and domestic causes and cures for our difficulties. There is almost perfect complementarity between his paper and that which precedes it, for Hetzel focuses on monetary policy as directed towards price stability, while Vaubel primarily considers how best to maintain financial stability, the other traditional function of a central bank. He concludes that there were regulatory failures, and argues compellingly that these will not be remedied by centralisation and internationalisation of regulation. These policies will make matters worse, by weakening democratic accountability, reducing competition, and increasing scope for politically motivated short-term meddling. Currently fashionable panaceas are shown by Vaubel to merit only a polite dismissal.

Turning next to Robert Miller, it is notable how what some view as an old-fashioned, deservedly defunct, explanation of economic fluctuations both fits rather well with the arguments of Hetzel (and, in so far as there is overlap, with those of Vaubel) and contributes to our understanding of what got us here and how to get out of our difficulties. The initial contrast made in the paper, between the views of Milton Friedman and Anna Schwartz (1963) and the 'Austrian' approach rapidly emerges, in the careful discussion which follows, as too sharp. Indeed, the problems which the 'Austrian' analysis identifies as caused by too easy money are exactly those identified by Robert Hetzel in his paper, and the concerns over present monetary expansion expressed by Robert Miller are also those of Hetzel. The different approaches add depth and robustness to each other's conclusions and recommendations.

Steve Ambler's paper deals with what at first glance might appear a narrow and technocratic issue, whether the central bank should under its monetary policy mandate target a stable price level or a stable (and low) inflation rate. But the issues are neither modest nor narrowly technocratic. The argument for stability in the value of money is that it much improves the functioning of the price system and thus the efficiency of the allocation of resources. Changes in relative prices, important for supply and for demand decisions, are not obscured by unpredictable changes in the value of the money in which prices are measured. This matters not just day-to-day, but long into the future, for the more stable are prices the more straightforward it is for individuals to enter into the kind of long-term contracts that are helpful in the allocation of long-lived resources, such as natural resources and major investment projects. It is not too much to claim that one of the most important things governments can do to protect the environment is to ensure stability in the value of money. As Ambler points out, a price level target makes the task much more straightforward, particularly over long horizons when an inflation target, particularly one which allows inflation to be within a range, can permit really quite substantial movements

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of the price level. Further, and often forgotten, a price-level target makes monetary policy in a time of low inflation, and perhaps incipient deflation, more effective. The argument is, as Ambler observes, straightforward.

> 'A negative inflation shock under PT [price level targeting] is, if the regime is credible, expected to be followed by inflation that is higher than average in order to bring the price level back to its predetermined path. This means that the bank's target interest rate has to be reduced by less to achieve a given reduction in the real interest rate than under IT [inflation targeting]. For this reason, monetary policy has more leverage to stimulate aggregate demand under PT.'

Ambler's proposal, although somewhat less radical than some others in this collection, would nevertheless produce major benefits.

David Mayes takes up the common post-crisis cry that central banks should once again become closely involved in banking supervision. There is something in that cry, for, certainly in the UK, problems seemed to be more difficult to handle because of weakness in the mechanisms by which the FSA has kept the central bank informed on the state of various institutions. So far as one can tell from the outside, when Northern Rock got into difficulties, this came to the Bank, to use the phrase used by the journalist Hartley Withers writing in 1914, just as did the outbreak of World War I to financial markets, 'like a bolt from the blue'.

But much more important, Mayes argues, is that there was no way in most countries outside the USA of dealing with banks when they were in trouble but before they were on the point of collapse. There was no orderly resolution regime for banks. This was troublesome because the inevitably slow processes of a normal corporate bankruptcy are unsuited for institutions with multitudinous interlocking contracts with other parties, and where people keep the money they use for their day-to-day spending. Having such a procedure not only allows orderly closure with disruption minimised, but, David Mayes emphasises, makes clear to all financial institutions that they are not so big that the taxpayer will protect them from their own folly or even their own misfortune. This will increase caution in the future.

Charles Blankart and Erik Fasten, using a theory of the state, provide a political analysis which underpins this. They set out three possible theories, and conclude that the 'contractual theory' is most useful in analysing and responding to present difficulties, for it explains how banks are regulated in return for the state underpinning them. What has gone wrong is that the regulation was not adequate. Prompt closure will, as David Mayes argues, help promote sensible behaviour of these regulated institutions. But they also advocate various regulatory changes further to advance stability, and conclude by raising an issue which leads to the concluding observations of this introduction. What can be done by nations acting individually when banks are international?

A concluding concern

Central banks can cope when an international bank is in difficulties. For however international a bank may be, when it is doing business it needs national currencies, and these can be supplied by national central banks. These currencies are not supplied unconditionally and without suitable collateral, but there is no need to discuss those matters here. For present purposes that central banks can supply the currency is enough.

But they cannot supply capital. Central banks are just too small to be able to take on a failing institution, and then recapitalise it and sell it on or follow whatever procedure is needed to ensure an orderly resolution. This is for governments. But which government? The governments of the countries in which the banks do business, the home country's government, or what? This was a problem that had been raised before but was forced on everyone's attention by the problems ensuing on the difficulties of Iceland's banks. That country was just too small to manage the orderly resolution of such large banks.

As has been argued by David Mayes (Mayes and Wood, forthcoming, 2009) it is implausible that every country could undertake to manage the failure of its banks. An alternative would be international agreement to pool resources. That, however, would not only be open to all the objections to international 'solutions' identified in Roland Vaubel's second paper in this collection, but is wildly unlikely to come about and even less likely to be adhered to were the resources called on to any significant extent. This is an important matter – but one totally ignored in the recent G20 discussions. Some problems are apparently too hard to face.

Since bank failures are inevitable, that conclusion is not an optimistic one. But that said, this introduction can end more optimistically. Every one of the papers in this collection offers clear and shrewd diagnosis, and thought-provoking and valuable proposals. Even if the more radical proposals are for the moment not acceptable, reasoned rejection of them would entail careful thought, and that would surely lead to improvements in our banking and central banking structures. Some of these proposals may appear politically impossible at the moment. But as the history of the UK alone shows, few sensible proposals remain politically impossible for ever. Out of our present difficulties much good may eventually come.

1. The exceptional case is of course created by the euro. It is a currency without a country, and the countries which use the euro are countries which do not have central banks which are central banks in the full sense of the term. This raises complex and deep issues well outside the scope of this short introduction; a most useful guide to them can be found in two papers by Charles Goodhart (1998, 2003).
2. It is generally but certainly not universally agreed that the Bank of England developed them first, having done so by the end of 1866.
3. Two excellent sources are two reports of the Treasury Select Committee of the House of Commons (2008, 2009). Full references to these can be found at the end of this introduction. Gillian Tett's (2009) book is also very useful.

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