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THE LIMITS TO CENTRAL BANK'S OBJECTIVES – THE POLICY PERSPECTIVE

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Basis for Central Bank's independence

➢ **The high inflation of the 1970s & 1980s led academics and policy makers to agree on a set of principles which made price stability the cornerstone of monetary policy:**

- There is no permanent trade-off between inflation and unemployment.
- High and volatile inflation depresses growth
- Inflation disproportionately harms the poorest segments of society

➢ However, it was recognized that **the actions to achieve price stability could be very unpopular.** Therefore, the pursuit of price stability could be made more **credible and effective by granting Central Banks independence.**

➢ Many Central Banks achieved independence in the 1990s.

The Bundesbank an example to follow

- A very important example of the merits of central bank independence was the German Bundesbank and the success of the German economic model and performance.

- In fact, during the negotiations of the Maastricht Treaty on European Monetary Union, the model of independence represented by the Bundesbank was taken as the reference for the European Central Bank (ECB) and the European System of Central Banks (ESCB).

General Consensus about Monetary Policy Strategy

➢ At the same time **a general consensus** was reached **about most elements of a successful monetary policy strategy:**

- Macroeconomic stability was achieved through rule-based monetary policy, delegated to an independent central bank with implicit or explicit inflation target and little role for discretionary fiscal policy.
- The central bank controlled the short-term interest rate, which affected the real economy through long-term interest rates, inflation expectations and asset prices.
- Credit channel of monetary policy was deemed weak.

➢ As a consequence **price stability was sufficient for macroeconomic stability.** So there had to be a clear separation between monetary policy and regulation and supervision. This led Central Banks to adopt a micro-prudential approach to regulation and supervision

First disagreements about the Consensus appear by the early 2000s

- **By the early 2000s, Monetary policy was perceived as being highly successful** and credited with achieving low inflation & low variability of inflation and output. This period has been named the "Great Moderation".

- However, a group of economists (Claudio Borio, William White, Raghuram Rajan, etc.) argued that the **prevalent framework might be ignoring the risks associated with the build-up of financial imbalances**, which could eventually result in financial instability with serious macroeconomic consequences.

- Contrary to the general consensus, low and stable inflation in the short term is no guarantee of lasting price stability. Accommodative monetary conditions could contribute to an underpricing of risk and unsustainable increases in credit and asset prices without rising consumer price inflation.

- This problem could be addressed by extending policy horizons **beyond the two years** typical of inflation targeting regimes

The "Great Recession" put into question the General Consensus

- The most severe economic contraction since the **Great Depression put into question this general consensus.**
- Although it is still premature to identify the new paradigm that will emerge, the two areas within Central Banks where more changes are occurring are:
  - The conduct of monetary policy, with many **unconventional measures**.
  - The development of **macroprudential policies**.
- **Initially,** all central banks reacted using **conventional monetary policies:**
  - **Reduced interest rates aggressively**, reaching values very close to zero, to prevent the disinflationary process from translating into deflation.
  - Faced with the emergency of blocked interbank markets, **provided a generous monetary base** to meet the gross needs of banks.

Non-conventional monetary policies

➢ **When the crisis worsened**, Central Banks applied **non-conventional monetary policies** in three forms:

- **Forward guidance:** The FED has taken this strategy furthest, due to its dual mandate, by linking low interest rates to future unemployment. The ECB adopted an explicit forward guidance formula on 4th July 2013.

- **Changing the size and composition** of Central Banks' balance sheet have been the policies more used since 2008.

➢ **These divergences in non-conventional tools** reflect specific characteristics of the respective financial systems and institutional frameworks and differing perceptions and assessments of the risks that may be assumed by central banks. The US strategy involved a greater blurring between policies, which the ECB, as the central bank of 17 countries with full sovereignty in other policy areas, cannot assume.

Macroprudential policy

➢ A main lesson from the crisis is that **price stability without financial stability does not guarantee macroeconomic stability**.

➢ Macroprudential policies are a **new set of instruments** to stabilize the financial system and minimize the impact that its tensions might have on the real economy. Established around two dimensions:

- **Cross sectional dimension** or how risk is distributed in the financial system at a point in time. To reinforce its overall resilience requires imposing tighter standards for systemic individual institutions.
- **Time dimension** or how aggregate risk evolves over time. It requires instruments, like dynamic provisions, that dampen the inherent procyclicality of the financial system.

➢ **Spanish** introduction of **dynamic provisions** (2000) are a pioneering case.

➢ **Macroprudential and monetary policies interact** in practice**,** which has important implications for institutional design.

The challenges ahead for Central Bank's independence

- Non-conventional monetary policies contributed to stabilize financial markets and set the stage for subsequent economic recovery.

- But retaining them for too long may have adverse implications for the functioning of financial markets and inflation. This could compromise the hard-earned confidence in the ability and determination of central banks to keep inflation in check and risk. As a consequence, **the timing and manner of the unwinding** of these measures may have important **consequences for Central Bank's independence**.

- The expansion of central banks responsibilities has made **independence much harder to define**. These new responsibilities have blurred the separation between Central Banks and national governments. As a consequence **safeguards are needed**