

The Limits of Central Banking

Presented to the Council on Foreign Relations

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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Introduction

Today I want to discuss the importance of thinking realistically about the central bank's capabilities as we look beyond the current turmoil to the future of the Federal Reserve's responsibilities for monetary policy and financial stability. The financial turmoil of the past year and the consequent restructuring in the marketplace have prompted calls for the Fed to assume expanded responsibilities. Some envision the Fed's becoming the supervisor and regulator of a broad array of financial firms in order to ensure financial stability.

Yet, before we seek to dramatically expand the Fed's responsibilities, I believe it is important to recognize that there are limits to what central banking can do, and this has implications for what central banking should do.

The Fed needs to be accountable for meeting its goals. Yet, we must take care to set reasonable expectations for what a central bank can achieve. We must recognize that over-promising can erode the credibility of a central bank's commitment to meet any of its goals, whether for monetary policy or financial stability. My comments today will touch on both of these central bank responsibilities.

What Monetary Policy Can and Cannot Do

Let me start with monetary policy. Much of the public discussion of the Federal Reserve's monetary policy seems to assume that the Fed's job is to stabilize the economy against macroeconomic shocks — such as a sharp rise in the price of oil or a sharp drop in the housing market. The impression one gets is that, if the Fed were simply quicker or smarter or given more regulatory powers by Congress, we could always counteract the adverse effects of these shocks and easily achieve monetary policy's dual mandate to keep the economy growing with full

employment and little or no inflation.

However, I see two problems with this view. First, it fails to recognize the difference between what the Fed can do in the long run and what it might be able to do in the short run. Second, it assumes the Fed has the ability to stabilize the economy against the adverse effects of almost all macroeconomic shocks. On both counts, this view seriously overstates the true capability of the Fed or any central bank in modern market economies.

In truth, the only thing that sound monetary policy can affect in the long run is the rate of inflation. Changes in monetary policy can affect real economic activity, such as the unemployment rate or output growth, but only temporarily and with considerable uncertainty as to timing and magnitude. Consider the case where economic activity is slowing or declining. If we increase the money supply to lower interest rates or to keep them low, we may temporarily boost economic activity because it may take a while for prices to respond to the additional amount of money in circulation. The temporary boost occurs with a so-called “long and variable” lag. Indeed, the effect of lower interest rates on economic activity may not be felt for nine to 18 months. Eventually, though, prices will rise, the purchasing power of money will erode, and the boost to economic activity will fade away. Moreover, the effect on the real economy can be completely offset if inflation expectations rise in reaction to the accommodation. That is why we place considerable stress on our credibility and commitment to keep inflation low and stable.

The task is further complicated when one realizes that all sorts of shocks are simultaneously buffeting the economy. Shocks can occur to specific sectors or specific regions. Some may be large and some may be small. Some may be positive and boost economic growth, while others may be detrimental to growth. If monetary policy responded to one shock in an attempt to offset its possible effects, it may aggravate the effects of another shock.

Thus, monetary policy’s ability to neutralize the impact of shocks is actually quite limited. Successfully implementing such an economic stabilization policy requires predicting the state of the economy more than a year from now with a high degree of accuracy — including

anticipating the nature, timing, and likely impact of future shocks. The truth is that economists simply do not possess the knowledge to make forecasts with such accuracy. Attempts to stabilize the economy will, more likely than not, end up providing stimulus when none is needed, or vice versa. Indeed, aggressive attempts at stabilization can, in fact, increase volatility rather than reduce it.

In many cases the effects of shocks to the economy simply have to play out over time, so that markets eventually adjust to a new equilibrium. For example, monetary policy cannot keep the prices of gasoline and home heating oil at the low levels they were when crude oil was \$30 a barrel. And monetary policy cannot reverse the sharp declines in housing prices over the past year. Monetary policy simply cannot eliminate the need for households or businesses to make real adjustments when such shocks occur.

This doesn't mean monetary policy should be unresponsive to changes in broad economic conditions. The best strategy is to set our policy instrument — the federal funds rate — consistent with controlling inflation over the intermediate term. This implies that the target federal funds rate will vary with the overall outlook for the economy. By keeping inflation stable when shocks occur, monetary policy can foster the conditions that enable households and businesses to make the necessary adjustments to return the economy to its sustainable growth path — although depending on the nature of the shock, this new growth path may be lower, higher, or the same as its previous growth path. But monetary policy itself does not determine this sustainable path.

For example, if an adverse productivity shock results in a substantial reduction in the outlook for economic growth, then real, or inflation-adjusted, interest rates tend to fall. As long as inflation is at an acceptable level, the appropriate monetary policy is to reduce the federal funds rate to facilitate the adjustment to lower real interest rates. Failure to do so could result in a misallocation of resources, a steadily declining rate of inflation, and, perhaps, even deflation.

Conversely, when the outlook for future economic growth is revised upward, real market interest rates will tend to rise. Provided that inflation is at an acceptable level, we would want to

facilitate this adjustment by raising the federal funds rate. Failure to do so would again result in a misallocation of resources and, in this case, a steadily rising rate of inflation.

In both cases, I view changes in the Fed's target interest rate as responding to economic conditions in order to keep inflation low and stable. Monetary policy is not "trading off" more inflation for less unemployment in order to stabilize the economy against an adverse shock, nor is it "trading off" more unemployment for less inflation when there is a favorable shock to the economy. The empirical support for such a trade-off is tenuous at best, and the empirical support for the view that central banks can favorably exploit such a potential trade-off is even weaker.

Asking monetary policy to attempt to offset the effects of adverse shocks to the economy is unlikely to work, and it will surely exact a toll in terms of higher inflation. This is particularly troublesome, since it would undercut the hard-earned credibility of the Fed's commitment to control inflation. This loss of credibility could lead to more variability in the public's expectations about future inflation. As we saw in the late 1970s and early 1980s, such an unanchoring of inflation expectations makes it more difficult and costly to reduce inflation when it is too high. This, in turn, would also make it harder to achieve maximum sustainable growth, the other part of our dual mandate, since high and variable inflation makes adjustments in labor and product markets more costly.

This is not a new concern. In his presidential address to the American Economic Association over 40 years ago, Milton Friedman cautioned the economics profession:

*"...we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making."*¹

This caution is well worth remembering as it is still relevant today.

Of course, Friedman also recognized that some shocks might require a response — in particular,

¹ Milton Friedman, "The Role of Monetary Policy," *American Economic Review*, 58:1 (March 1968), pp. 1-17.

those that, in his words, “offer a ‘clear and present danger.’” In my view, shocks that put the stability of the financial system at significant risk require a response. Indeed, over the past year, the Federal Reserve has aggressively eased monetary policy and employed innovative liquidity tools to help mitigate the effects of the financial turmoil.

Financial Stability, Regulation, and the Fed’s Role

The widespread effects of this financial turmoil have focused attention on the role of central banks in supporting financial stability.

The Fed, as lender of last resort, has undertaken several liquidity measures intended to address extreme financial stress to forestall contagion and mitigate systemic risk. One role financial intermediaries perform is bearing and managing the liquidity risk that arises from funding long-term assets with short-term liabilities. Businesses are able to get funding for projects that may not pay off until sometime in the future, and financial intermediaries are able to meet savers’ withdrawals of funds with retained earnings or by selling off liquid assets. In most cases, this maturity transformation works fine.

However, if depositors and other liability holders suddenly demand large withdrawals, an intermediary may be forced to sell long-term assets at prices below their value if they were held to maturity. The intermediary’s illiquidity problem could turn into a solvency problem, eventually leading to the intermediary’s failure. Such failures have the potential to cascade throughout counterparties, ultimately leading to a major breakdown of borrowing and lending in the economy. In times of crisis, such as the situation we have found ourselves in this past year, the Fed must act as lender of last resort to provide liquidity.

Since the summer of 2007, we have set up various channels through which financial institutions can borrow from the Fed against a wide range of collateral. This has provided direct liquidity to financial institutions, thereby helping to meet our responsibility for ensuring financial stability. I want to stress that the Fed has sought to ensure that solvent institutions facing temporary liquidity problems remain solvent. The intention was not to prop up insolvent institutions. Similarly, I want to emphasize that, although the Fed has played a role in the resolution of

systemically important financial firms, the intention has been to protect the orderly functioning of the money market and thus to stem systemic risk to the broader economy — not to address the solvency issues of individual institutions.

Our preference is to allow market forces to handle any required restructuring in the financial services industry. However, in some cases this is not possible when the risks to financial stability are too high.

Regardless of our intentions, we need to recognize that by taking these actions, we create expectations about future interventions and who will have access to central bank lending. These expectations, in turn, can create moral hazard by influencing firms' risk management incentives and the types of financial contracts they write, which may ultimately increase the probability and severity of future financial crises.

Going forward, just as we should avoid setting unrealistic expectations for monetary policy, we should also avoid encouraging unrealistic expectations about what the Fed can do to combat financial instability. As I have argued, in times of financial crisis, a central bank should act as the lender of last resort by lending freely at a penalty rate against good collateral. Yet, recent experience suggests we need to clarify what the Fed can and cannot be expected to do in today's complex financial environment.

The events of the past year underscore the importance of carefully assessing the current financial regulatory structure. Regulatory reforms should aim to lower the chances of financial crisis in the first place, for example, by setting capital and liquidity standards that encourage firms to appropriately manage risk. We should consider market structures, clearing mechanisms, and resolution procedures that will reduce the systemic fallout from failures of financial firms. Indeed, it would be desirable to be in an environment where no firm was too big, or too interconnected, to fail.

Yet regulatory reforms must recognize that modern financial systems will never be immune to financial problems. Encouraging the belief that any system of financial regulation and

supervision can prevent all types of financial instability would be a mistake. Instead, our goal should be to lower the probability of a financial crisis and the costs imposed from any troubled financial institution.

As we move forward with regulatory reforms, we must carefully consider the role the Fed should play and our responsibilities for promoting financial stability.

The Fed has learned much over the past two decades about how to conduct monetary policy more effectively. I believe the general principles for sound monetary policy are just as applicable to our responsibilities for promoting financial stability and fulfilling our role as lender of last resort.

In conducting monetary policy, we have learned that clearly stating our policy objectives; taking a systematic approach to achieving these objectives; and committing to this systematic approach over time, even when it seems expedient to abandon it, can deliver better growth and inflation outcomes. In addition, as my colleague here on the podium, Alan Blinder, has stressed, central bankers must be as transparent as possible and communicate their views on monetary policy clearly to the public, to whom we must be accountable.²

I believe that these principles should also apply to our lending policies. In particular, I believe that the central bank should clearly state objectives and set boundaries for its lending that it can credibly commit to follow. Clarifying the criteria on which the central bank will intervene in markets or extend its credit facilities is not only essential but critical. Intervening too often or expanding too broadly the set of institutions that have regular access to the central bank's credit facilities can create moral hazard, distort the market mechanism for allocating credit, and thereby increase the probability and severity of a future financial crisis. Thus, a too liberal lending policy would undermine our lending policy's intended goal of financial stability. Of course, announcing the central bank's criteria *ex ante* does not commit it to act as stated in every case, but it does raise the costs of deviating from the criteria.

Experience has also shown that when a central bank can conduct its monetary policy

² Alan Blinder, *Central Banking in Theory and Practice*, The MIT Press, Cambridge, MA, 1998.

independently of the fiscal authority and political influence, it can achieve better outcomes because it is able to take a longer-term perspective in pursuing its objectives. This principle of central bank independence is crucial.

In setting our lending policies we must avoid taking actions that stray into the realm of allocating credit across sectors of the economy, which in my view is appropriately the purview of the market. But if government must intervene, it should be the responsibility of the fiscal authority. Expanding the types of assets on the Fed's balance sheet from Treasury securities to a wider array of assets, including loans to a wider variety of institutions, as we have done over the past year in pursuit of financial stability, does raise concerns in my mind, in part because it increases the number of entities that may seek to influence Fed policies. The Fed needs to operate independently from these pressures and resist them when they arise so that its policies benefit society at large over the longer term and not any particular constituencies in the near term.

Another consideration in setting the Fed's financial stability and regulatory responsibilities is how they interact with our monetary policy goals. Expanding the Fed's regulatory responsibilities too broadly increases the chances that there will be short-run conflicts between our monetary policy goals and our supervisory and regulatory goals. It is particularly important that any such expansion not undermine the credibility of our commitment to price stability. For example, it would be a mistake for the central bank to pursue an inflationary monetary policy in order to temporarily alleviate funding pressure on financial institutions. While financial institutions might be better off in the short run, higher inflation would hurt them as well as the rest of the economy in the long run.

As we consider the Fed's financial stability and regulatory responsibilities, we must also be careful not to compromise the Fed's independence. Nor should we undertake tasks that would undermine our ability to meet our dual-mandate objectives of ensuring price stability and fostering sustainable economic growth.

Conclusion

To sum up, the past year has been a challenging time for the U.S. economy and for policymakers. The Fed responded to the deteriorating economic outlook and continued stresses in financial markets with its monetary policy and liquidity facilities. Restructuring is occurring in the financial services industry, and it is clear that when some normality returns to the markets — which eventually it surely will — some type of regulatory reform will be needed.

Some people may think expanding the Federal Reserve's regulatory and supervisory authority would prevent the types of financial crises we have been experiencing this year. Yet, I have tried to raise some cautionary flags about going beyond the limits of what a central bank can and should do. A modern financial system cannot be immune to all financial stress. Setting up expectations that the Fed will surely be unable to fulfill would undermine our ability to achieve our primary monetary policy and financial stability objectives. Regulatory reforms should aim to reduce the probability and economic severity of future periods of instability but should not be expected to eliminate them entirely.

As legislators consider regulatory reforms, they should avoid giving the Fed new missions or goals that conflict with the one goal that is uniquely the responsibility of a central bank — price stability. No other institution is charged with this objective, and no other institution can deliver it.