Restoring Central Banks After the Crisis

Re-Examining Central Bank Orthodoxy for Unorthodox Times:
Inaugural Meeting of the Global Society of Fellows of the Global Interdependence Center

Banque de France

Paris, France

March 26, 2012

Charles I. Plosser

President and CEO
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

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

Restoring Central Banks After the Crisis

Re-Examining Central Bank Orthodoxy for Unorthodox Times: Inaugural Meeting of the Global Society of Fellows of the Global Interdependence Center

Banque de France
Paris, France

March 26, 2012

Charles I. Plosser
President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

Introduction

I am delighted to be here today in this beautiful city and to have the honor to serve on such a distinguished panel with friends and colleagues. David Kotok has been the guiding force behind the GIC conferences over the past several years. He and his team at the GIC never fail to gather an interesting and knowledgeable group of people to discuss important topics on truly global issues. So, I want to thank him and the GIC for their efforts and contributions. I also want to thank our hosts, Christian Noyer and the Banque de France.

I am going to take a little different tack on the subject matter of this gathering. Rather than focus on what new orthodoxy we should take away from the financial crisis, I want to argue that we need to restore some of the old orthodoxy. David did suggest that he wanted to have a conversation on important issues, so I intend to be somewhat provocative in an effort to stimulate such conversation. As usual, I want to stress that my views are my own and not necessarily those of my colleagues in the Federal Reserve System.

I will focus my remarks on two related topics that have emerged as a consequence of the crisis. The first is the relation between monetary policy and fiscal policy. The second topic involves the role of a central bank's balance sheet as a policy tool. These are issues that I believe are of fundamental importance to the role of central banks in our economies.

The Relationship Between Monetary and Fiscal Policies

Let me begin by sharing some thoughts on the appropriate relationship between monetary and fiscal policies. In the wake of the financial crisis and the ensuing recession, many countries around the world responded with a significant increase in government spending. Some of this increase came about through what economists call automatic stabilizers. But there has also been a dramatic expansion in budget deficits attributable to deliberate efforts to apply fiscal stimulus to improve economic outcomes. This expansion in government spending has been very significant in the U.S., but it has also occurred in other countries. So what does this have to do with monetary policy? Well, it turns out, a great deal. It is widely understood that governments can finance expenditures through taxation, debt — that is, future taxes — or printing money. In this sense, monetary policy and fiscal policy are intertwined through the government budget constraint.

For good reasons, though, societies have converged toward arrangements that provide a fair degree of separation between the functions of central banks and those of their fiscal authorities. For example, in a world of fiat currency, central banks are generally assigned the responsibility for establishing and maintaining the value or purchasing power of the nation's unit of account. Yet, that task can be undermined, or completely subverted, if fiscal authorities set their budgets in a manner that ultimately requires the central bank to finance government expenditures with significant amounts of seigniorage in lieu of current or future tax revenue.[*]

The ability of a central bank to maintain price stability can also be undermined when the central bank itself ventures into the realm of fiscal policy. History teaches us that unless governments are constrained institutionally or constitutionally, they often resort to the printing press to try to escape what appear to be intractable budget problems. And the budget problems faced by many governments today are, indeed, challenging. But history also teaches us that resorting to the printing press in lieu of making tough fiscal choices is a recipe for creating substantial inflation and, in some cases, hyperinflation.

Awareness of these long-term consequences of excessive money creation is the reason that over the past 60 years, country after country has moved to establish and maintain independent central banks — that is, central banks that have the ability to make monetary policy decisions free from short-run political interference. Without the protections afforded by independence, the temptation of governments to exploit the printing press to avoid fiscal discipline is often just too great. Thus, it is simply good governance and wise economic policy to maintain a healthy separation between those responsible for tax and spending policy and those responsible for money creation.

It is equally important for central banks that have been granted independence to be constrained from using their own authority to engage in activities that more appropriately belong to the fiscal authorities or the private sector. In other words, with independence comes responsibility and accountability. Central banks that breach their boundaries risk their legitimacy, credibility, and ultimately, their independence. Given the benefits of central bank independence, that could prove costly to society in the long run.

There are a number of approaches to placing limits on independent central banks so that the boundaries between monetary policy and fiscal policy remain clear.

First, the central bank can be given a narrow mandate, such as price stability. In fact, this has been a prominent trend during the last 25 years. Many major central banks now have price stability as their sole or primary mandate.

Second, the central bank can be restricted as to the type of assets it can hold on its balance sheet. This limits its ability to engage in credit policies or resource allocations that rightfully belong under the purview of the fiscal authorities or the private marketplace.

---

[*] See Thomas Sargent and Neil Wallace, "Some Unpleasant Monetarist Arithmetic," Federal Reserve Bank of Minneapolis *Quarterly Review*, 5 (Fall 1981), pp 1-17.

And third, the central bank can conduct monetary policy in a systematic or rule-like manner, which limits the scope of discretionary actions that might cross the boundaries between monetary and fiscal policies. Milton Friedman's famous k-percent money growth rule is one example, as are Taylor-type rules for the setting of the interest rate instrument.

Unfortunately, over the past few years, the combination of a financial crisis and sustained fiscal imbalances has led to a breakdown in the institutional framework and the previously accepted barriers between monetary and fiscal policies. The pressure has come from both sides. Governments are pushing central banks to exceed their monetary boundaries, and central banks are stepping into areas not previously viewed as appropriate for an independent central bank.

Let me offer a couple of examples to illustrate these pressures. First, despite the well-known benefits of price stability, there are calls in many countries to abandon this commitment and create higher inflation to devalue outstanding nominal government and private debt. That is, some suggest that we should attempt to use inflation to solve the debt overhang problem. Such policies are intended to redistribute losses on nominal debt from the borrowers to the lenders. Using inflation as a backdoor to such fiscal choices is bad policy, in my view.

Pressure on central banks is also showing up through other channels. In some circles, it has become fashionable to invoke lender-of-last-resort arguments as a rationale for central banks to lend to "insolvent" organizations, either failing businesses or, in some cases, failing governments. Such arguments go beyond the well-accepted principles established by Walter Bagehot, who wrote in his 1873 classic *Lombard Street* that central bankers could limit systemic risk in a banking crisis by "lending freely at a penalty rate against good collateral." Central bankers have abandoned this basic Bagehot principle in the last few years but have not replaced it with a clear alternative. Indeed, actions were often confusing and unpredictable and lacked a coherent framework. I believe that central banks need to think hard about how and when they exercise this important role. We need to have a well-articulated and systematic approach to such actions. Otherwise, our actions will exacerbate moral hazard and encourage excessive risk-taking, thus sowing the seeds for the next crisis. Unfortunately, neither financial reform nor central banks have adequately addressed this dilemma.

Breaching the boundaries is not confined to the fiscal authorities asking central banks to do their heavy lifting. The Fed and other central banks have undertaken other actions that have blurred the distinction between monetary policy and fiscal policy, such as adopting credit policies that favor some industries or asset classes relative to others. Such steps were taken with the sincere belief that they were absolutely necessary to address the challenges posed by the financial crisis.

The clearest examples can be seen when the Federal Reserve established credit facilities to support markets for commercial paper and asset-backed securities. Most notable has been the effort by the Fed to support the housing market through its purchases of mortgage-backed securities. These credit allocations have not only breached the traditional boundaries between fiscal and monetary policy, they have generated pointed public criticisms of the Fed.

Once a central bank ventures into fiscal policy, it is likely to find itself under increasing pressure from the private sector, financial markets, or the government to use its balance sheet to substitute for other fiscal decisions. Such actions by a central bank can create their own form of moral hazard, as markets and governments come to see central banks as instruments of fiscal policy, thus undermining incentives for fiscal discipline. This pressure can threaten the central bank's independence in conducting monetary policy and thereby undermine monetary policy's effectiveness in achieving its mandate.

In my view, this blurring of the boundaries between monetary and fiscal policies is fraught with risks. As I said, these boundaries arose for good reason, and we ignore their breach at our peril. I believe we must seek ways to restore the boundaries.

The Central Bank's Balance-Sheet Policy

Another related issue facing central banks arises from the degree to which central banks have expanded their balance sheets. There are two dimensions to this issue. One is the composition of the balance sheet. In the U.S., for example, the balance sheet of the Federal Reserve has changed from one made up almost entirely of short-term U.S. Treasury securities to one that is mostly long-term Treasuries, plus significant quantities of long-term mortgage-backed securities. This concentration of housing-related securities is problematic because it is a form of credit allocation and thus violates the monetary/fiscal policy boundaries I just mentioned.

The second aspect is the overall size of the balance sheet. Many central banks expanded their balance sheets in an effort to ease monetary policy after their usual policy instrument – an interest rate — had reached the zero lower bound. Do central bankers anticipate that their balance sheets will shrink to more normal levels as they move away from the zero lower bound? Is it desirable to do so? Or should monetary policy now be seen as having another tool, even in normal times? Some have suggested that central banks adopt a regime in which the monetary policy rate is the interest rate on reserves rather than a market interest rate, such as the federal funds rate. This would then permit the central bank to manage its balance sheet separately from its monetary instrument, freeing it to respond to liquidity demands of the financial system without altering the stance of monetary policy. In principle, this would take pressure off central banks to shrink their balance sheets from the current high levels and simply rely on raising the interest rate on reserves to tighten monetary policy.

The alternative is to return to a more traditional operating regime in which the central bank sets a target for a market interest rate, such as the federal funds rate in the U.S., above the interest rate on reserves. Implementing this regime would require a smaller balance sheet.

I am very skeptical of an operating regime that gives central banks a new tool without boundaries or constraints. Without an understanding, or even a theory, as to how the balance sheet should or can be manipulated, we open the door to giving vast new discretionary abilities to our central banks. This violates the principle of drawing clear boundaries between monetary policy and fiscal policy. When markets or governments come to believe that a central bank can freely expand its balance sheet without directly impacting the stance of monetary policy, I believe that various political and private interests will come forward with a long list of good causes, or rescues, for which such funds could or should be used.

Economic theory and practice teach us that monetary policy works best when it is clear about its objectives and systematic in its approach to achieving those objectives. Granting vast amounts of discretion to our central banks in the expectation that they can cure our economic ills or substitute for our lack of fiscal discipline is a dangerous road to follow.

In June, the Federal Reserve's Open Market Committee outlined some principles that would guide its exit from this period of extraordinary monetary accommodation. In my view, those principles represented an important first step in the FOMC's attempt to restore the boundaries between monetary and fiscal policies. In particular, the FOMC clearly stated its desire to return to an operating environment in which the federal funds rate is the primary instrument of monetary policy. To achieve that objective, the Fed will have to shrink its balance sheet to a more normal level. I interpret this as saying that our balance sheet should not be viewed as a new independent instrument of monetary policy in normal times.   The exit principles also indicated the Committee's desire to return the Fed's balance sheet to an all-Treasuries portfolio.   This re-establishes the idea that the Fed should not use its balance sheet to actively engage in credit allocations.

In other speeches, I have outlined a framework that I have termed a "new accord" between the Federal Reserve and the Treasury. It would enable the central bank to act in emergencies when requested by the Treasury or the fiscal authorities, but it would be clear up front that any non-Treasury assets that accrued on the central bank's balance sheet would be swapped for government securities within a specified period of time. This would ensure that fiscal policy decisions remain under the purview of the fiscal authorities, not the central bank.

Summary

To summarize, it is important for governments to maintain independent central banks so that they are better able to achieve their mandates. It is also sound policy to limit the discretionary ability of central banks to engage in policies that fundamentally belong to fiscal authorities or private markets. Establishing and maintaining clear boundaries between monetary and fiscal policies protects the independence of the central bank and its ability to carry out its core mandate — maintaining price stability. Clear boundaries and resisting the use of the balance sheet as a new policy tool would also improve fiscal discipline by making it more difficult for the fiscal authorities to resort to the printing press as a solution to unsustainable budget policies.