ISSN : 1287-4558

Analyses Économiques vol. XI-01 (April 2011)

The Newsletter of the French Council of Economic Analysis

The CAE is an independent, non partisan advisory body reporting to the French Prime Minister, whose members belong to the academic community, as well as to the business and government sectors. Reports issued by the Council represent the views of their authors only, not those of the CAE (which does not take policy positions) or of the French government. The reports, which are published together with comments by discussants and background papers, can be downloaded free of charge from our website www.cae.gouv.fr. Each issue of this newsletter, which is released by the Council's permanent staff, focuses on a particular report.

Central Banks and Financial Stability

Report by Jean-Paul Betbèze, Christian Bordes, Jézabel Couppey-Soubeyran and Dominique Plihon

EDITORIAL

Central banks were responsive and pragmatic overall in the face of the global crisis. They lowered their key rates, generously provided the required liquidity and practised 'unconventional' policies.

This report makes use of a questionnaire sent to central bankers, economists as well as supervisors. The key question concerns the relationship between two objectives: monetary stability and financial stability. Two contrasting interpretations proposed in the report clarify the terms of the debate.

The first approach advocates a separation between monetary policy and macro-prudential policy with separate entities responsible for monetary stability and financial stability. The second approach calls for change and integration of monetary policy and macro-prudential policy, with both assigned to the same institution if possible, and for better coordination between the related goals. The two approaches share some recommendations, but are essentially very different.

Christian de Boissieu
Executive Chairman of the CAE

This report discusses required changes to the tasks of central banks in response to the financial crisis we just weathered. Central banks must draw lessons from the crisis. The most significant lesson is that they did not pay sufficient attention to financial stability. The authors of this report all agree on this. The report, however, offers two approaches (the first advocated by Christian Bordes and, the second by Jean-Paul Betbèze, Jézabel Couppey-Soubeyran and Dominique Plihon) which differ on how to carry out coordination of monetary and financial stability policy. The differences mainly lie at two levels. Firstly, in terms of the principle of separation that the first approach upholds between these two policies, whereas the second approach recommends abandoning this separation. Secondly, in terms of the governance based on independence, transparency and accountability that the first approach seeks to preserve as much as possible, whereas the second approach envisions necessary changes at this level too. The report is based on a survey in the form of a questionnaire distributed to economists and central bankers. Each approach led to a set of recommendations.

This report was discussed in the presence of the Minister for the Economy, Finance and Industry on March 7, 2011. This letter, published under the responsibility of the permanent unit of CAE, summarises the authors' main conclusions.

Central banks and the crisis

The recent financial crisis, whose impact on the real economy was severe, inevitably prompted a reflection on the regulation governing the banking and financial sector as a whole. Central banks are the heart of this regulation, through monetary policy that they set in motion and financial stability policy to which they contribute. If their emergency measures and battery of unorthodox measures, in the opinion of most economists, helped to curb the deflationary spiral into which the crisis threatened to pull Western economies, their inadequate preventive action, even their responsibility in triggering the crisis, remain subjects of debate. There are three contentions on the matter. The first relieves them of any responsibility, by attributing the crisis to a lack of supervision of the financial system. The second holds them strongly accountable; after closely supporting the recommendations of the canonical model in the eighties and nineties (notably by conducting monetary policy according to a rule), central banks drifted away, if not pulled away completely, from these recommendations starting from 2002-2003 (with key rates regularly below those recommended by the Taylor rule). The third underscores the paradox of credibility, credibility inherited from the previous period of non-inflationary growth. According to this argument, the successes achieved in safeguarding monetary stability, combined with lower volatility of price increases and economic activity, contributed to reducing the cost of risk. In this environment, financial players were encouraged to take excessive risks, which weakened them. Central banks

certainly issued warning signs, but they did not act to defuse financial tensions. While recognising the multiple factors at the root of the crisis, the authors of the report point specifically to the insufficient attention paid by central banks to financial stability and promote the idea that we need to change the concept of central banking. To accomplish this, they agree on the need for coordination between monetary policy and overall financial stability policy or so-called *macro-prudential* policy. But they differ on how this coordination is to be carried out.

Questioning of the principle of separation

Christian Bordes recognises that the crisis has shattered the idea of the separation between monetary policy geared solely toward maintaining price stability over the medium term and liquidity management designed to ensure financial stability strictly speaking, at least the proper functioning of the money market. However, he supports continued separation between monetary and overall financial stability policy that is macro-prudential policy. Linking the two, in his view, must be based on a well-established economic principle that available instruments should be paired with the objectives for which they are most effective (Canadian economist Robert Mundell's assignment rule): achieving price stability for monetary policy, financial stability for macro-prudential policy, assigned to two distinct authorities; the Central Bank, of course, for monetary stability and another independent authority for financial stability.

Jean-Paul Betbèze, Jézabel Couppey-Soubeyran and Dominique Plihon defend another form of coordination. From their perspective, the coordination must not be limited to monetary policy and liquidity management, but must be extended to macro-prudential policy. They highlight the dangers of the principle of separating monetary stability and financial stability, in a broad sense. Monetary policy in 1990-2000 painstakingly complied with the principle of separation. Major central banks focused on their goal for monetary stability and accordingly also sought to contribute to financial stability. The links between monetary stability and financial stability proved far more complex than they expected. As illustrated by the paradox of credibility popularised in the work of Claudio Borio at the Bank for International Settlements (BIS), monetary stability reinforced by the credibility of central banks may sow the seeds of financial instability. The period of great moderation in the 2000s, characterised by low and stable inflation, of which central banks were not only craftsmen but to which they undeniably contributed, favoured lesser aversion to risk, accordingly leading a large number of economic agents, particularly banks, to take excessive risks. The channels through which flowed the corresponding effects of the monetary policy were then largely ignored or underestimated. The credit channel was considered to be weak, even obsolete. Banks' risk-taking channel, meanwhile, appeared most recently in the academic literature. Thus, it is through these two channels that the low interest rates of the early 2000s contributed to financial instability. From now on, these channels should be subject to increased monitoring. Because monetary stability does not guarantee financial stability, central banks must give equal importance to these two goals. And because these two goals may conflict, they cannot be achieved using interest rates alone. The interest rate cannot do everything. Here, it is not an enhanced Taylor rule that is being proposed but a wide array of macro-prudential instruments available to the Central Bank which appears as the authority best positioned to undertake responsibility for macro-prudential policy.

The authors of both approaches in the report agree on the principle that there is no unique model for coordination between monetary and prudential policy. Micro-prudential policy does not necessarily come within the purview of central banks. And even when it is recommended in the second interpretation of the survey that they also accept responsibility for macro-prudential policy, this does not necessarily imply that they also take on micro-prudential policy. Entrusting both micro- and macro-prudential supervision to central banks may, in effect, present several drawbacks: excessive concentration of power, risk of red tape, lower efficiency with respect to the mass of information to process, etc. This may also increase the weight of sectoral supervisory regimes that are yet less suited to the integration of banking and financial activities. The reason is that even if the Central Bank may appear as a natural supervisor for banks, it is not the same for other financial intermediaries: the Central Bank is very rarely the sole supervisor when it is involved in prudential supervision. In the end, it is important that when the Central Bank is not micro-supervisor, it is in close and permanent contact with the supervisor(s). It is this lack of relationship that made it much more difficult to manage the financial crisis in the United Kingdom, for example.

Central bank governance

Although central banking cannot remain unchanged after the crisis, nevertheless some of these principles must be maintained, particularly those that characterise its governance. In this regard, Christian Bordes argues that an «independent, transparent and accountable» central bank model must be preserved. For this reason he considers too ambitious any coordination that would involve assigning responsibility for monetary policy and macro-prudential policy to a single authority or committee. In effect, he believes that this may reduce the efficiency of monetary policy by making it difficult for the Central Bank to exercise autonomy, by undermining the transparency of its actions and seriously impeding their control. Under these conditions, he argues that the most realistic response is to hold to the principle of instrument allocation set out above: each instrument must be assigned to achieving the objective for which it is the most efficient.

When calling for coordination of monetary and macro-prudential policy within the Central Bank, Jean-Paul Betbèze, Jézabel Couppey-Soubeyran and Dominique Plihon highlight the risks and difficulties entailed in terms of governance. Larger roles will mean more powers for central banks. More powers will mean more accountability, explanations and transparency. And finally, the latter will mean more cooperation and sharing of information with other authorities in charge of financial stability. All of this while fending off regulatory capture risks from both public and private players, which implies that central banks exercise their independence with respect to all players, public and private.

An international survey sent to economists and central bankers

To probe the state of the debate around the evolving roles of central banks, the authors of the report developed a questionnaire. This type of survey has become commonplace, particularly within central banks.

Divided into six major themes, fifty-five questions were asked to address the different dimensions (organisational, instrumental, strategic, theoretical basis, etc.) of central banking, including:

• First, *Great Moderation and financial instability*: questions relating to the macroeconomic environment of monetary policy before the crisis as well as the possible origins of the financial imbalances observed during this period;

• *Institutional design of central banking*: questions relating to the institutional framework of central banking and seeking to identify changes caused by the crisis (opportunities for reform, questioning of the principle of separation, etc.);

• *Financial stability*: questions relating to the involvement of central banks in terms of financial

stability and expected developments in this area;

• *Monetary policy: transmission channels/strategies/instruments*: questions concerning the possible the accommodation of monetary policy currently under discussion (raising the inflation target, price level instead of inflation targeting, etc.);

• *International dimension*: coordination issues at the international level between the major central banks are addressed;

• Finally, *Economics/science and art of central banking*: questions about the respective roles of art and science in central banking before and after the crisis.

The questionnaire was sent to around 200 recipients (academics, central bankers and supervisors) of which 46 responded: 15 central bankers (responding supervisors were too few to form a separate category of participants) and 31 academics from around the world (a total of 16 countries plus the euro zone represented by the European Central Bank). Central bankers were naturally well distributed among the 16 countries because a person generally responded on behalf of their institution (except for two in Japan). French (12), American (10) and British (4) economists are the most represented among questionnaire participants. The answers are presented with graphical illustrations, for all participants and by category (central bankers and academics), accompanied by an explanatory comment. A number of these illustrations are also included in the main text of the report. The two proposed interpretations offer two different uses of the questionnaire.

The questionnaire is instructive on the issues that bring together central bankers and economists as well as those that separate them. According to the vast majority (91%), the 'Great Mode-ration' of 1990-2000 led to an underestimation of risks. The importance of the risk-taking channel, however, is recognised only by 54% of central bankers (versus 63% of economists). About half of participants (economists as well as central bankers) said that the Great Moderation has ended. The two categories of participants are, however, much more divided on the question of whether we are entering an era of greater financial instability. Optimists, central bankers are only 38% in agreement with this assessment versus 70% of economists.

90% of economists and central bankers believe that the crisis has changed both the objectives and instruments of central banks. A large majority of both groups believes that the goal of monetary stability must be complemented by an objective of financial stability. Involvement of central banks in the macro-prudential supervision also held broad support. However, when it comes to considering new instruments or a change in objectives more concretely, divisions emerge: only 8% of central bankers are, for example, prepared to revise their strategy for targeting inflation, versus 79% of economists. 85% of central bankers are not in favour of replacing the targeting of inflation by the targeting of a general price level, while 29% of economists would be in favour. Central bankers are also proving very hostile to an increase in the inflation target to facilitate the exit from the crisis (8% in favour, versus 39% of economists), probably because of the risks entailed by this strategy would undermine their credibility. 77% of central bankers deem it necessary that interest rates react to credit and asset bubbles (versus 57% of economists). Yet paradoxically, they are less convinced than economists that monetary policy can counter credit cycles (50% of central bankers versus 75% of economists). In another paradox, although they are not worried about the incoherence between national monetary policy strategies or a global monetary mess, most central banks (82%) responded that they must consider the impact of their policy on global liquidity, and coordinate their interventions on the foreign exchange market (78% versus 61% of economists), and as a lender of last resort (92% versus 80% of economists). The end of the questionnaire is also instructive as to the supporting role that economics can still play in the conduct of monetary policy: confident, 70% of central bankers continue to view their task as an «art backed by science»; more cautious, 60% of economists estimate that the conduct of monetary policy is a mere art!

The report's main recommendations

The report is filled with recommendations for both analysing central banking and contributing to its development.

Recommendations from the first interpretation

The first part of the report, which argues for the idea of accommodating central banking around the principle of optimal allocation of monetary and macro-prudential policy instruments, supports the following proposals:

• governance of central banks' actions must remain organised around the independence-accountability-transparency triptych;

• monetary/macro-prudential policy architecture must be built on the principle of instrument allocation (the Mundell assignment rule): each policy is assigned to completing the objective for which it is the most appropriate;

• monetary policy must remain primarily biased towards price stability, while macro-prudential policy must address financial stability;

• pushing the deadline chosen to reach the price increase target should enable better consideration of financial stability, though this does not mean it would be easy to do;

• monetary policy remains an effective tool for stabilising economic activity in major economies;

• in the event of higher commodity and basic good prices, coordination of major central banks' actions is desirable;

• a higher inflation target in order to facilitate the stabilisation of economic activity is a proposal that merits closer attention, especially for a monetary union. In the United States, where there is no official target, the adoption of the targeting of a general price level would strengthen the nominal anchor;

• coordination of monetary policy and macro-prudential policy, according to Mundell's principle, should at least enable, if not avoid, the emergence of a bubble fuelled by a credit boom;

• in this framework, monetary policy must give priority to the maintenance of price stability and be conducted in accordance with the principles of a basic Taylor rule. The macro-prudential policy must be designed to ensure financial stability and also be based mainly on the application of a rule, the enforcement of a counter-cyclical capital ratio, for example;

• the monetary policies pursued by major central banks have implications for international liquidity, capital flows and international commodities and basic good markets. This reinforces the need for international coordination of monetary policies to avoid the development of financial imbalances in the global economy.

Recommendations from the second interpretation

The second part of the report, which calls for abandoning the principle of separation and for coordination of monetary policy and macro-prudential policy within the Central Bank, supports other proposals:

• inflation is the result of a complex set of monetary and structural factors related to globalisation, as the Great Moderation illustrated;

• monetary and financial stability are tied by complex relationships, with two, sometimes conflicting, meanings, which can lead to conflicting goals. Financial stability has, in effect, paradoxically suffered from the credibility of central banks;

• the tasks of central banks must include financial stability, which implies ending the principle of separation between the two objectives. The strict application of

this principle during the recent crisis hindered the effectiveness of central banks' actions;

- financial instability takes on different forms according to the time period and country, rendering its definition and measurement complex. But this is not a reason to prevent central banks from tackling financial instability;
- banking and financial channels for monetary policy were underestimated, both by economists and central bankers. The risk-taking channel was acknowledged much later;
- credit continues to play a major role, that securitisation contributed to underestimating, in the financing of the economy and in the genesis of financial crises;
- macro-prudential policy must become the main weapon against financial instability, and the Central Bank a major player in this policy. Macro-prudential thus represents the link that has been missing up until now between monetary policy and micro-prudential supervision;
- a broadened range of instruments available to central banks and supervisory authorities is necessary to simultaneously achieve the objectives of monetary and financial stability;
- among the macro-prudential instruments, emphasis is placed on credit regulation instruments, such as the loan to value ratio, that need to be expanded and strengthened as well as on a progressive system of reserve requirements on credits whose objective is to prevent excessive credit;
- the recent crisis revealed the limits of the solutions to systemic entity failures. Identification and monitoring of these entities are needed. A policy of preventive action may be considered. These special measures will fall under the responsibility of central banks, as part of their macro-prudential supervision;
- the macro-prudential involvement of central banks will not require them to assume the role of micro-prudential supervisor where they are not responsible for this. There is no single model for organising supervision. However, the central bank will work closely with supervisory authorities. From this perspective, the French choice of a prudential supervisor that remains close to the Central Bank is satisfactory;
- several provisions may be considered to enable this proximity between central banks and prudential supervisors: a common information network (similar to that provided by US Dodd-Frank law), shared governance, the consultation of an independent financial consumer protection authority or even participation in meetings of the steering committees of authorities responsible for financial stability;
- given their expanded powers and responsibilities relating to financial stability, central banks must be more accountable and develop a culture of greater information sharing and cooperation with other authorities and civil society, in order to maintain or even adapt their independence vis-à-vis political and economic authorities.

Additional findings

Three additional findings were made in this report. The first, by Michel Aglietta, seriously challenges the doctrine of inflation targeting and argues for a broadened monetary policy that includes an objective of financial stability, more sensitive to excess credit and soaring asset prices. The second, prepared by Charles Goodhart, offers a comprehensive analysis of macro-prudential policy instruments. The third is based on an interview that Tommaso Padoa-Schioppa gave to the authors in June 2010. It addressed a theme that was particular dear to him: the governance of international institutions and, especially, the oversight committees within which decisions are made on a principle of cooperation that requires full consensus. He pleaded for another kind of governance, based on the principle of joint decisions made by majority if necessary and binding for everyone. Tommaso Padoa-Schioppa died suddenly in December 2010. This report is dedicated to him.

Comments

Jean-Pierre Vesperini places the origin of the recent financial crisis much more on international monetary imbalances and, more particularly, in the accumulation of foreign exchange reserves of emerging countries, than in errors of monetary policy. In this regard, he doubts that accommodations or changes at the central banking level alone can be a sufficient bulwark against future crises.

According to ***Daniel Cohen***, the argument proposed by the report is essentially to decide what new and necessary compromises have emerged between macroeconomic regulation, simply inflation and that of asset prices. Are stable regulations modelled on the Taylor rule required? Should central banks be given a certain discretionary power, and if so which power? To these questions, he answers that some margin of discretion should be left to central banks and that these banks should use several instruments as the interest rate alone is insufficient. If there is a bubble, Daniel Cohen is not sure that monetary authorities should act alone. He advocates the use of fiscal policy (by influencing the personal investment rate, for example). The central banking of the future will avoid the bias of both Keynesian monetary policy and the Greenspan Put which stoked financial instability.

La documentation Française
113 rue de Grenelle 75007 PARIS [France] Ph.: (33-0)1 42 75 53 00 – Fax: (33-0)1 42 75 51 27
Publisher: Christian de Boissieu – Editor: Pierre Joly – Electronic Publishing: Christine Carl