Central Banks and Macroprudential Policies:
Who Does What?

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Trying to Narrow Down the Issue

- Policies directed to more traditional concerns
- Two sources of systemic instability in the financial sector; the cross section and time dimensions
- Three solutions; prevention, management, resolution
- Six cells in the matrix; who does what?
- Today, focus only on crisis prevention and crisis management due to "procyclicality"
- Governments should deal with cross section issues and also crisis resolution

The Problem is Domestic "Procyclicality" Leading to Macro Instability

- The current crisis has its roots in excessive credit and debt creation
- Lessons from economic history
- Lessons from the history of economic thought
- Neither price (monetary) nor financial stability ensures satisfactory macroeconomic performance
- Need to address the underlying roots of the problem, not just its symptoms

The Solution is Crisis Prevention

- The "lean versus clean" debate
- How best to "lean"?
- The shortcomings of monetary instruments
- The shortcomings of macroprudential instruments
- The need for coordinated tightening during upturns?

But Inevitably Crisis Management as Well

- Complex systems always fail; be prepared
- The need for coordinated easing during downturns?
- The Borio- Goodhart controversy; confidence is key
- A fatal disconnect; monetary policy on the accelerator and regulatory policy on the brake
- Why? Two silos and two sets of false beliefs
- Implications? Risks have risen and policy options have declined

Which Domestic Institutional Framework Best Serves Financial Stability?

- Various models for allocating macroprudential functions across and within institutions
- Criteria for choice; how the imperatives of “should and would” determine who “could” do what
- These criteria put central banks at the core
- But threaten the “independence” of central banks

Making the Domestic Framework Operational: the "Should" Problem

- Need full acceptance of a new analytical framework; one pillar (the "gap") is not enough
- Need to identify emerging risks; alternative approaches and associated data requirements
- Need to identify which instruments are available
- Need to calibrate the available instruments
- Why this criterion should favor a central bank model in "booms" if not "busts"

Making the Domestic Framework Operational: the "Would" Problem

- Impediments to action in the real world
- How those impediments might be removed; transparency and accountability
- How explicit rules might help resolve both the "should" and "would" problems
- But what if the rules are wrong?
- Why this criterion should favor central banks

Making the Domestic Framework Operational: the “Could” Problem

- More arguments favoring central bank model
- Need for legislation or, at least, an MOU
- Mandate: for longer term price stability and/or financial stability?
- Powers: “the buck stops here”?
- Accountability: necessary but ever harder?
- Governor-Board model or Committee model?

Is it a Problem that this Domestic Model Threatens Central Bank "Independence"?

- A broader mandate with less accountability could be dangerous
- But "independence" has always been oversold
- And is, in any event, already threatened
- National circumstances matter; avoid the straw that breaks the camel's back?
- The work of central bankers will be less "neat" than in the past

International Dimensions of Macro Instability

- Global integration of financial markets is a reality; capital flows, international banks and Bloomberg
- Spillovers a threat to "independent" domestic policies. Leakages imply domestic responses less effective.
- Need to roll back globalization to limit both spillovers and leakages?
- Need for a new international monetary system to limit spillovers and global crisis?

Or A Need for Still More Radical Solutions?

- Should domestic capital requirements be both much higher and simpler?
- Should we rely less on regulation and more on self and market discipline?
- Should we institute "narrow money" and abolish safety nets and regulation?

Concluding Comments

- We have been on a bad path; crisis resolution has not been achieved
- Our highest priority should be thinking about managing the next phase of the current crisis
- Yet thinking about crisis prevention also has merit; a time for institutional reform?
- Good luck to policymakers:

THEY WILL NEED IT