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Whither central banking?

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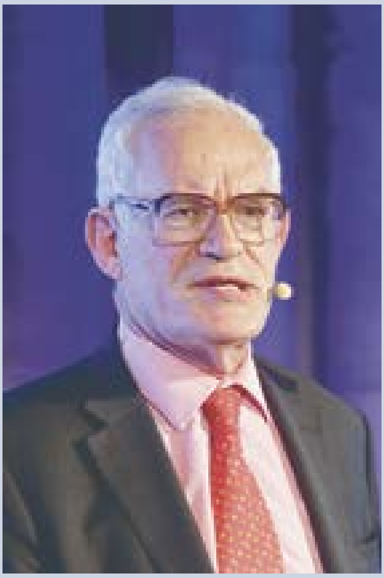

Whither central banking?

The history of central banking can be divided into periods of consensus about the roles and function of central banks, interspersed with periods of uncertainty, often following a crisis, in which central banks are searching for a new consensus. The time line is roughly as follows:

Table 1

History of central banks has swung between periods of consensus and uncertainty

	Consensus	Uncertainty
1873–1914	Gold standard, real bills doctrine, lender of last resort (LLR)	
1914–1933		Breakdown of gold standard, breakdown of real bills doctrine, unemployment and inflation
1934–1970	Fiscal (Keynesian) dominance, central bank subject to finance ministry, financial repression, interest rates used for balance of payments, otherwise low	
1971–1990		Stagflation, monetarism vs. Keynesianism, liberalisation and financial crises
1990–2007	Independent central banks, inflation targets, Great Moderation	
2008 to present		Great Financial Crisis (GFC), financial instability, deflation

Source: Author's compilation.

As shown in table 1, it is obvious that we are in the middle of a period of major uncertainty about the appropriate role and functions of central banks. Some conclusions have, however, been fairly clearly drawn from the Great Financial Crisis (GFC), including the assertion that the previous ideas were erroneous, as follows:

Table 2

Generally accepted myths pre-2007

(i) Price stability, plus Basel capital adequacy ratios, would guarantee solvency.
(ii) With solvency thus guaranteed, liquidity will always be available via wholesale markets.
(iii) That maturity mismatch in the banking system can be ignored.

Source: Author's compilation.

But there are many uncertainties left:

1 The structure of the banking system

There is a historical regularity here. After each crisis, and in each period of uncertainty, there is a search for rules that might have prevented the prior crisis. In each case there is a move towards the more radical proposals, but the actual outcome is a compromise.

Table 3

Crises and Reactions

Date	Crisis	Radical proposal	Compromise outcome
Early 1800s	Suspension of gold standard	Ricardo's currency board	Bank Charter Act 1844
1929–1933	Collapse of U.S. banking system	Chicago Plan	Glass-Steagall Act
1970s	Stagflation	Monetarism	Pragmatic monetarism
Now	Collapse of banking systems	Narrow banking	Ring-fencing and …?

Source: Author's compilation.

2 The ability of macroprudential instruments to maintain financial stability

The following queries remain:

Table 4

Some queries about the use of macroprudential instruments

(i) Are they intended to protect the economy from banks, or banks from the economy? What is their main purpose?
(ii) Will they be used aggressively enough (Brainard caution)?
(iii) What is the dividing line between macroprudential and other policies, e.g. fiscal?
(iv) Since the dividing lines are fuzzier, who is responsible for controls?
(v) How does one distinguish between sustainable and unsustainable financial developments, and how can one communicate that distinction to both politicians and public, both of whom enjoy being in a boom period?

Source: Author's compilation.

3 Do we need to rethink monetary policy?

Table 5

Some queries about current monetary policies

Question	Answer
A higher target?	No.
Lean vs. clean?	Try macroprudential instruments first.
Why so ineffective?	Weakness of banking sector.
How to communicate?	Base forward guidance on states, not dates. But even states are unpredictable.
What if another downturn happens?	Helicopter money? Negative interest rates?

Source: Author's compilation.

4 The technology of banking

Perhaps the main uncertainty is the rapidly changing technology of banking (and central banks). Banking is based on transactions and information technologies. Both of these are rapidly changing. Underlying queries relate to:

Table 6

Some queries about technology

(i) Efficiency and state security vs. privacy and liberalism.
(ii) Blockchain ledger transactions.
(iii) Speed vs. equality of opportunity. High-frequency trading and frequent auctions.

Source: Author's compilation.

5 Where are central banks now?

Let us contrast the state of central banks in the Great Moderation (GM) with that now following the Great Financial Crisis (GFC).

Table 7

Contrast in the role of central banks

	Focus	Instruments	Confidence	Independence
GM	Narrow: Price stability	Single: Interest rates	High	Undoubted
GFC	Broader: Price stability Financial stability	Many: Interest rates Unconventional monetary policy (UMP) Macroprudential policy Stress tests Resolution	Groping	At some risk

Source: Author's compilation.

6 So whither central banking?

Central banks have now been awarded, and/or have assumed, far more power than previously, but have much less confidence about how to use such powers. An unstable condition?

The future cannot – perhaps fortunately – be forecast.