Will Traditional Monetary Policy Suffice for Current Global Financial Challenges?

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Outline of Issues

Monetary policy, as it is currently understood, can be said to rest on three pillars: the institutional environment that defines the place of the central bank within government, the manner in which monetary policy is conducted, that is, the monetary policy regime, and the monetary authority's role in ensuring financial system stability.

While most policymakers and analysts recognize the importance of central bank independence, there is as yet no widespread consensus in the profession about the extent to which it contributes to inflation, nor even how to precisely define it. In academic circles, central bank independence has been downplayed as of late as poorly linked to inflation records around the world. When the relationship between the central bank and the government is defined along several dimensions, not on a unique summary measure of the degree of central bank independence, the importance of institutional factors in determining inflation can be highlighted. Indeed, it is the multi-faceted relationship between the government and the central bank that leads to a new focus on governance principles of central banking. The core principles include: a clear statement outlining the ultimate responsibility for the conduct of monetary policy, explicit procedures to resolve conflicts between the central bank and government, a precise definition of the scope of central bank responsibilities, and transparent appointments procedures. Once these core principles are properly defined, a clear picture emerges of the relationship between central bank independence and inflation.

Monetary policies have evolved since the Bretton Woods system essentially mandated a form of fixed exchange rates through the adoption in several countries of monetary targets during the 1980s. Both regimes failed to contain inflation over the long-term. Since the early 1990s, however, inflation targeting has become increasingly popular around the world. In spite of the apparent success of inflation targeting, sceptics remain. Yet, this type of monetary strategy has now outlasted both the Bretton Woods and monetary targeting regimes. Moreover, it is increasingly becoming evident that inflation targeting owes its success in large part to its ability to anchor inflationary expectations. Nevertheless, there is considerable variation in how inflation targeting is delivered around the world and the evidence suggests that while this monetary policy strategy is robust, especially in the industrial world, it remains a relatively more fragile monetary policy strategy in emerging markets.

With the apparent success at delivering relatively low inflation globally, central banks have turned their attention to the possibility of ensuring financial system stability. In spite of the benign inflationary environment, the regular occurrence of financial crises has created stresses in a wide variety of countries. The US sub-prime problem, so-called, is the latest such crisis while the Asian crisis of 1997-98 remains fresh in the minds of all policymakers. Not surprisingly, central banks have turned their attention to the dangers that lurk behind 'financial imbalances' world wide, and how monetary policy can contribute to mitigating these. Although seemingly a logical extension to the inflation control problem, efforts at containing financial crises must acknowledge the dearth of analytical approaches to the problem. We simply do not have anything approaching a consensus theory of financial system stability. Therefore, attempts to increase emphasis on financial system stability as an additional goal of central banks must not only face the question whether the existing toolkit of monetary policy is capable of delivering the desired outcome, even if we can agree on a theoretical framework, but whether the relationship between the central bank and the supervisory authorities is sufficiently well structured or defined to prevent crises from erupting in future. For the time being at least, and until the analytical apparatus is capable of delivering useful predictions, central banks ought to ‘stick to their knitting’.