Rethinking Central Banking

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Prior Consensus

- No permanent tradeoff between inflation and unemployment.
- High and volatile inflation hurts growth.
- Inflation disproportionately hurts the poor.

$\Rightarrow$ Flexible inflation targeting

$\Rightarrow$ Central bank independence

Flexible Inflation Targeting

- Aim to stabilize inflation at target but also minimize output gap
- Flexible exchange rates
  - Intervention and reserve accumulation unnecessary because interest rates and flexible exchange rates smooth out demand shocks
- "Own house in order" also achieves global macroeconomic stability.
  - National stability=> Global stability
- Tinbergen principle
  - Interest rates to tackle aggregate demand, supervisory measures to tackle financial stability

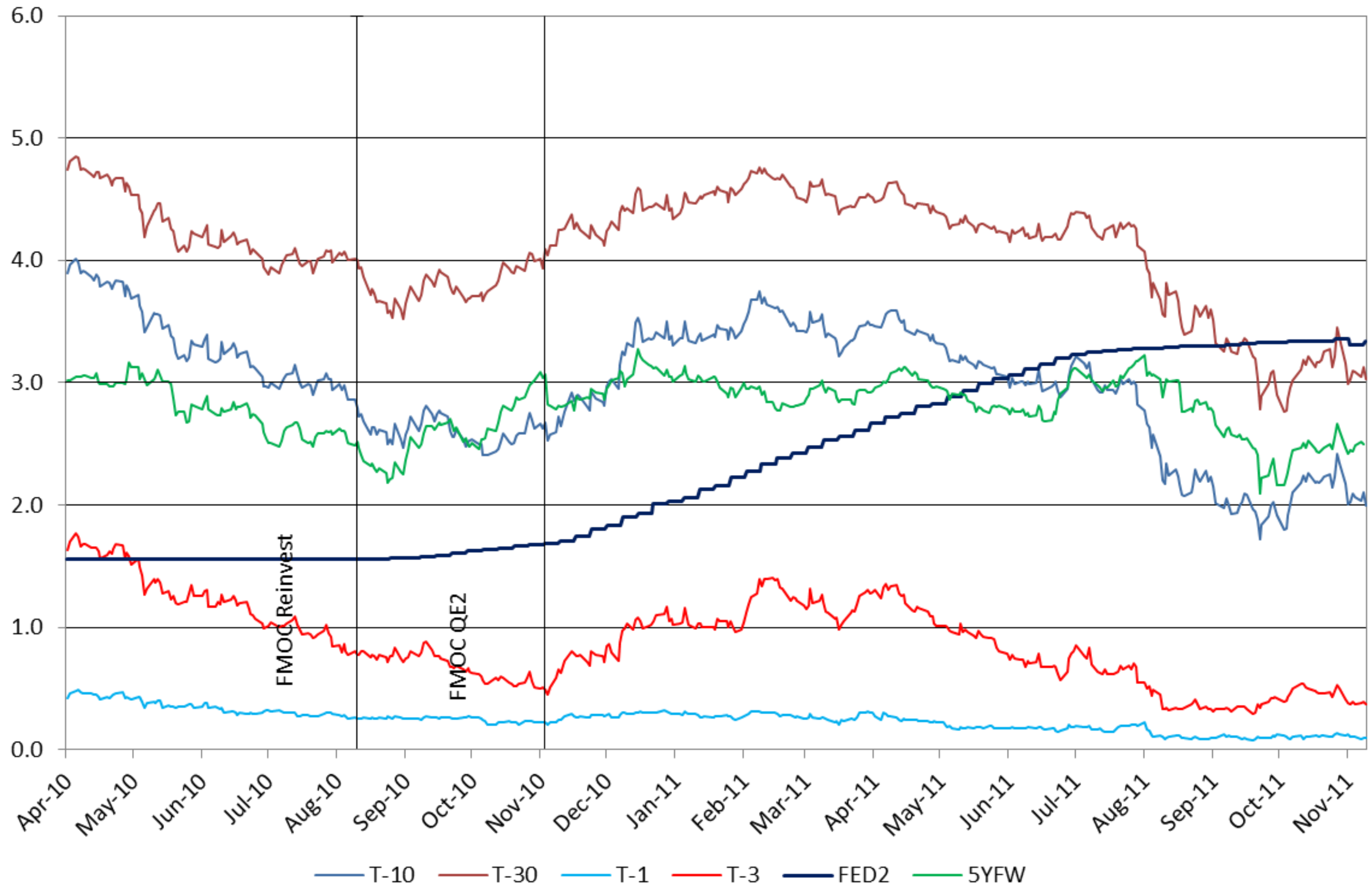
Breakdown

- Financial sector risk built up even while inflation remained low.
  - Asset price bubbles: Pricking stock bubbles vs credit bubbles
  - Asymmetric intervention
- Different de facto policy regimes: floaters and fixers
  - Inflation targeting and exchange rate targeting: Incompatibility in a time of low growth
- Spillovers through:
  - Commodity prices
    - Each central bank takes commodity prices as exogenous
  - Cross border capital flows
    - Exchange rate intervention to prevent overshooting

Added complications

- Political pressure to support debt issuance and growth when high debt loads and low growth in industrial countries
- Unconventional monetary policies at zero bound.
    - When local lending is limited, credit is likely to spillover abroad.

QE 2 and Operation Twist



What should be done?

- Make financial stability an explicit goal
  - Interest rate policy also a legitimate tool to ensure financial stability – sometimes undershoot target in the interest of financial stability
  - Lean against wind => bubble hunting?
  - Macro prudential measures: flexible until we learn
    - DTI, LTV, countercyclical capital, liquidity, levy on non-core
    - Instruments tackling too big to fail
- Unified responsibility for stability with central bank: can better evaluate trade-offs between various tools

What should be done?

- Capital controls – for macro-prudential reasons rather than to affect exchange rate
  - Affect form of capital flow (limited effect)
- Get countries to internalize consequences of their monetary policy stances
  - International committee of systemically important central bankers reporting to G-20 on the collective stance
  - Recognize incompatibilities
  - Eventually enshrined in mandate

What should be done?

- Limit the level of exchange rate intervention, but recognize that when many countries intervene, there are serious incompatibilities.

What is difficult to address.

- Pressures on central banking at a time of high debt and low growth
  - Do unconventional mechanisms satisfy the public’s and government’s need for action even while doing little damage?