

Central banking and Monetary Policy: What Will Be the Post-Crisis New Normal?

Report on a conference jointly organised by SUERF and BAFFI CAREFIN Centre (Bocconi University)
Milan, 14 April 2016
Sponsored by Intesa Sanpaolo

Conference Report

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Central Bankers are currently facing big challenges in designing and implementing monetary policy, as well as with safeguarding financial stability, with the world economy still in the process of digesting the legacy of the crisis. The crisis has changed central banking in many ways: by shifting the focus of monetary policy from fighting too high inflation towards fighting too low inflation; by prompting new “experimental” non-conventional measures, which risk to cause large, long-lasting market distortions and imbalances and which also have more far-reaching distributional consequences than “normal, conventional” monetary policy; and by broadening central banks’ responsibilities particularly in the direction of safeguarding banking stability and financial stability at large.

This raises several questions for the future: How long will ultra-easy monetary policies last? What are post-crisis growth trajectories, and how will the natural rate of interest rates evolve? How could an exit from ultra-easy monetary policy and a return towards higher nominal interest rates be eventually managed smoothly? Does ultra-easy monetary policy itself affect the economy in a lasting and structural way? Is the pre-crisis economic paradigm governing monetary policy still valid? If not, in what ways should it be adjusted? Are there any reasonable and practical alternatives? Against this background and given the larger post-crisis range of central banks’ responsibilities: is the current institutional set-up governing central banks and their relationship to government, Parliament and the financial system still appropriate? What adaptations might be considered? Would they bring an improvement or, on the

contrary, a set-back to the unsuccessful policy approaches of the 1960s and 1970s?

To discuss these issues, on 14 April 2016 the Baffi Carefin Centre (Bocconi University) hosted a SUERF Conference.

The conference was opened by **Andrea Sironi**, Rector of the Bocconi University, **Donato Masciandaro**, Baffi Carefin President and Department Head, Bocconi University and SUERF, and by **Urs Birchler**, SUERF President and Professor of Banking, University of Zürich.

The first speech was by **Fabio Panetta**, Deputy Governor, Banca d’Italia and Member of the Supervisory Board, SSM (ECB) on the topic of “Monetary Policy and Central Banking: What We Learned”. He gave a comprehensive diagnosis of current central banks’ policies. Also in the light of the crisis experience, there is no reason to challenge central banks’ primary objective of price stability. But central banks should not allow inflation to fall too low below their target for too long, because of the risk of debt deflation spirals and the risk of a de-anchoring of inflation expectations. The current low level of real equilibrium interest rates and the very low level of inflation in the euro area challenges monetary policy in the sense that the zero lower bound of interest rates has been reached. However, recent practice and also theory shows that nominal interest rates can fall below zero. Furthermore, central banks can also achieve further monetary expansion through enlarging the quantity of the money supply. The ECB’s Expanded Asset Purchase Programme (APP) has so far been quite effective in stimulating demand and preventing inflation from falling even further. But monetary policy should not be the only game in town:



fiscal policy should also play its role in adding stimulus. For sure, financial stability repercussions of expansionary policies must be monitored closely, financial stability also requires economic growth. The credit cycle in the euro area is still in a negative phase, there is no excessive risk taking. Prudential authorities, while closely monitoring developments, should not act prematurely as excessive restrictions might, by hampering the recovery, increase, rather than decrease, financial stability risks. Regarding the future, central banks' approach to "never say never" will continue to apply in the future.

An important topic was central bank **transparency and communication** in the post-crisis world. **Petra Geraats**, University of Cambridge, gave an overview of "Transparency of monetary policy in the post-crisis world". Central banks' increased range of tasks make transparency and communication more important but also more complicated. Communication in the guise of forward guidance is taking on the role of a separate policy instrument. Forward guidance may take several forms: qualitative or quantitative, time-dependent or state-contingent (or a combination), it can relate to various variables. Experience has shown that it can be very powerful. Also for large-scale asset purchase programs, announcement effects were quite important, emphasizing the role of communication. Despite all benefits, transparency should not be taken too far. E.g. it should not lead to postponement of necessary decision just because they were not pre-announced. A monetary policy transparency index compiled and currently being updated by the author for over 100 central banks for the post-crisis period captures five aspects of monetary policy making: objectives, economic data and models, procedures including the strategy, minutes and voting, the explanation of policy decisions and operational aspects including the transmission of monetary policy.

Bilin Neyapti, Bilkent University, argued that the crisis was among other things triggered by lack of an effective institutional framework to prevent and deal with financial crises. Spread responsibilities and thus lack of accountability among various institutions led to slow recognition of the building up of risks. The crisis thus led to a rethinking of the roles of central banks, the state and financial institutions in achieving macroeconomic

stability. But the issue is by no means resolved, neither in academia nor in policy. Effective macro-prudential supervision requires effective accountability.

Sylvester Eijffinger, President Tilburg University Society, Professor of Economics and CEPR, drew parallels of the institutional status of modern monetary authorities and highest-level courts; he used this insight to translate empirical methods used to study deliberations of courts to the study of central bank committee voting behaviour. Employing spatial voting models, he used voting records to estimate the latent preferences of policy makers in various central banks. For the Bank of England, he found no evidence that internal MPC members are systematically more dovish than external ones, but the preferences of internals are more clustered. By contrast, he interpreted the remarkable differences between internal and external members at the Hungarian central bank as an indication of highly politicized appointments. For the Fed, he found that Board members are on average more dovish than the Fed President but little evidence on the existence of a political appointment channel. He generally found no or only modest evidence for systematic differences according to Board members' career backgrounds.

Alessandro Riboni, Ecole Polytechnique Paris, pointed out that various authors may mean different things when distinguishing between "hawks" and "doves". Apart from favouring or disliking "activism" or the propensity to vote for high versus low interest rates, in the monetary economics literature hawkishness or dovishness refers to the relative weight a policy maker attaches to inflation versus output or employment stabilization. Comparing his own reaction-function based assessment of hawkishness with the one of Eijffinger et al, he found that results coincide only partly. Furthermore, particular voting procedures may influence voting behaviour; according to previous research by the author, in practice major central banks' policy committees operate on the basis of a consensus model, which coincides with results from experimental economics. Finally, he asked what committee members in their voting behaviour actually maximize: public welfare in the sense of the best possible monetary policy decision, or maximization of their personal reputation; some research in this field indicates

that external committee members tend to hold more extreme views and that anti-herding behaviour may reflect career considerations.

The following three papers took **historical perspectives**, in order to gain insights for central banking nowadays. **Michael Bordo**, Board of Governors Professor of Economics, Rutgers University, gave a paper on “Central bank credibility: insights from an historical and quantitative exploration”. The paper examined the empirical determinants and the historical evolution of central bank credibility using both historical narrative and empirics for a group of 16 countries, both advanced and emerging. The key determinants of credibility are the monetary regime and institutional factors such as the central bank’s mandate, its independence and its governance. He showed that the evolution of credibility went through a pendulum where credibility was high under the classical gold standard before 1914, then it was lost and not regained until the 1980s. The advent of inflation targeting further enhanced central bank credibility. The financial crisis, central banks’ massive discretionary interventions in financial markets, and their increased focus on financial stability, including macro-prudential supervision, have mixed monetary with fiscal policy and threatened independence. QE may become problematic for central bank credibility if inflation ensues. Financial crises can damage central bank credibility.

Tommaso Monacelli, Bocconi University, pointed out that central banks’ forward guidance at the zero lower bound also hinges on the “credibility” of the central bank’s commitment to a future “inflationary boom”. Such announcement can be expected to suffer from time inconsistency, particularly for “conservative” central banks, for whom it is difficult to “commit to being irresponsible” if they pursued inflation targeting successfully before. An understanding of financial fragility requires non-linear models, in which financial fragility accumulates slowly in normal times (such as the “Great Moderation”) but then it takes relatively small shocks to trigger deep recessions. This understanding should form the foundation for macro-prudential policies. History also tells us a lot about the evolution of **central bank governance and design**. **Forest Capie**, Professor,

Cass Business School, City University, London, and **Geoffrey Wood**, Professor, University of Buckingham, offered a comparative history and analysis of governance in the Bank of England and the Reserve Bank of New Zealand. They show that discretionary monetary policy aiming to achieve a broad set of objectives under the Government’s control was – apart from war times - experimented with only during a relatively short time in the second half of the 20th century. This experiment led to high inflation. By contrast, external anchors such as in particular a metal standard or also an external exchange rate anchor provided an effective tool for the preservation of the value of money in the long term. Without such anchor, monetary policy needs to be guided by a very clear price stability objective, and the central bank needs to have the instruments necessary to pursue its statutory objective, in order to avoid erosion of the value of money. Safeguarding financial stability should be the central bank’s competence, not least because the necessary information and know how is more easily pooled at this institution and there are synergies with central banks’ function as lender of last resort. What is to be avoided by all means is a lack of clarity on responsibilities among various government bodies and lack of accountability. As it cannot be taken for granted that the government uses its delegated power in the long-term interest of the electorate, central banks need to be granted independence; however, independence itself is subject to change, unless it is protected by high barriers against change in constitutional law.

Charles Goodhart, Emeritus Professor, London School of Economics, supplements this analysis with a vivid account of how governance in the Bank of England changed over time as a result of historical developments (such as the post-WW I period), the appearance of outstanding personalities as well as group dynamics within the Bank of England, without changes in formal laws requiring such change. The result was that the nature of decision making varied between the extremes of committee decisions and concentration of power in a single person, i.e. the governor.

Martin Melecky and **Anca Maria Podpiera**, Lead Economist and Consultant, respectively, at the World Bank, talked about “**Central bank design and banking**



supervision". They recalled that before the crisis, there was a general tendency to unify prudential supervision in special agencies outside the central bank; since the crisis, in many countries prudential supervision has again been re-integrated into the central bank. The authors show empirically that countries with deeper financial markets and countries that undergo rapid financial deepening can benefit from having banking supervision in the central bank in terms of safeguarding financial stability. They also interpret their results as suggesting that policy makers benefit from detailed knowledge of the microstructure of the financial system for safeguarding systemic financial stability.

Like in other public and private sector institutions, the topic of gender diversity in top management is gaining in importance. **Davide Romelli**, Bocconi University, presented preliminary results from a paper on "Gender and monetary policymaking: trends, drivers and effects". They built an index of gender representation in central bank boards for 112 countries as of 2015. They find that central banks with certain governance structures such as higher independence or lesser involvement in banking supervision are associated with larger women participation in central bank boards. Regarding monetary policy decisions, the economic literature so far has investigated e.g. the link between "dovishness" and gender, the link between inflation performance and gender composition of boards, or also aspects of gender impact on risk behavior. The authors find that women are best represented in central bank boards in Caribbean, North America and Africa; Europe and Asia achieve only moderate scores. Women representation is inversely related to countries' income level, with low-income countries showing the by far highest score. Roman Catholic countries have by far the lowest women representation, Eastern orthodox and other Christian religions have the highest scores. The authors also find that gender diversity is inversely related with inflation and money growth: thus, the presence of women in central bank boards seems to be associated with more hawkish monetary policy.

Aleksandra Maslowska-Jokinen, University of Turku, proposed several avenues for a further refinement of this research. First, it is not clear whether the research

addresses risk aversion or inflation aversion. Furthermore, various explanatory variables might interact, and some seeming explanatory factors might actually in turn be driven by other factors, such as political cycles. Women might also be elected into central bank boards for "swing voter" characteristics. She also noted that some countries with particularly high women shares in monetary policy boards are found in countries with quite unfavourable corruption and democracy ranks. Therefore, she urged to conduct robustness checks to verify the empirical findings, e.g. by looking at different time periods for the data.

The distributional effects of ultra-easy monetary have gained increasing attention recently. It was also a recurring theme at the conference. According to **Bilin Neyapti**, expansionary policies in response to the crisis have contributed to inequality; also macro-prudential policy should take distributional consequences more into account. **Fabio Panetta** pointed out that the impact of non-conventional monetary policies on inequality must be considered in a general equilibrium framework, which also takes into account the positive employment effects for workers; while the rich benefited from financial gains triggered by central bank asset purchases, the poor benefited from cheaper debt and jobs, which overall led to a decrease in inequality in Italy. **Jan-Egbert Sturm**, KOF Swiss Economic Institute, ETH Zürich, revisited the question on how liberalization of the financial sector is related to income inequality. Contrary to previous research, they find that both financial development and financial liberalization are associated with increases in income inequality. The effect is stronger if financial development is higher. This needs, however, not necessarily be bad for the poor to the extent that finance may promote economic development and thus raise overall living standards. **Pierre Siklos**, Professor, WLU Canada, pointed out that the results from the quite limited number of available theoretical and empirical studies on this issue are not directly comparable, as they use different theoretical frameworks, define financial development differently, and define and date financial crises differently. Also, important social policy elements of financial systems, such as deposit insurance provisions, are neglected. More generally, Siklos opines that post-crisis ultra-easy

monetary policies distort markets substantially and generate huge redistribution from lenders to borrowers. Overall, to conclude, conference participants shared the view that reconsidering the pre-crisis central banking model would imply considerable risks, which are difficult to gage at this point in time and may be underestimated. How to hedge this risk is a fundamental issue that must be considered to understand not only

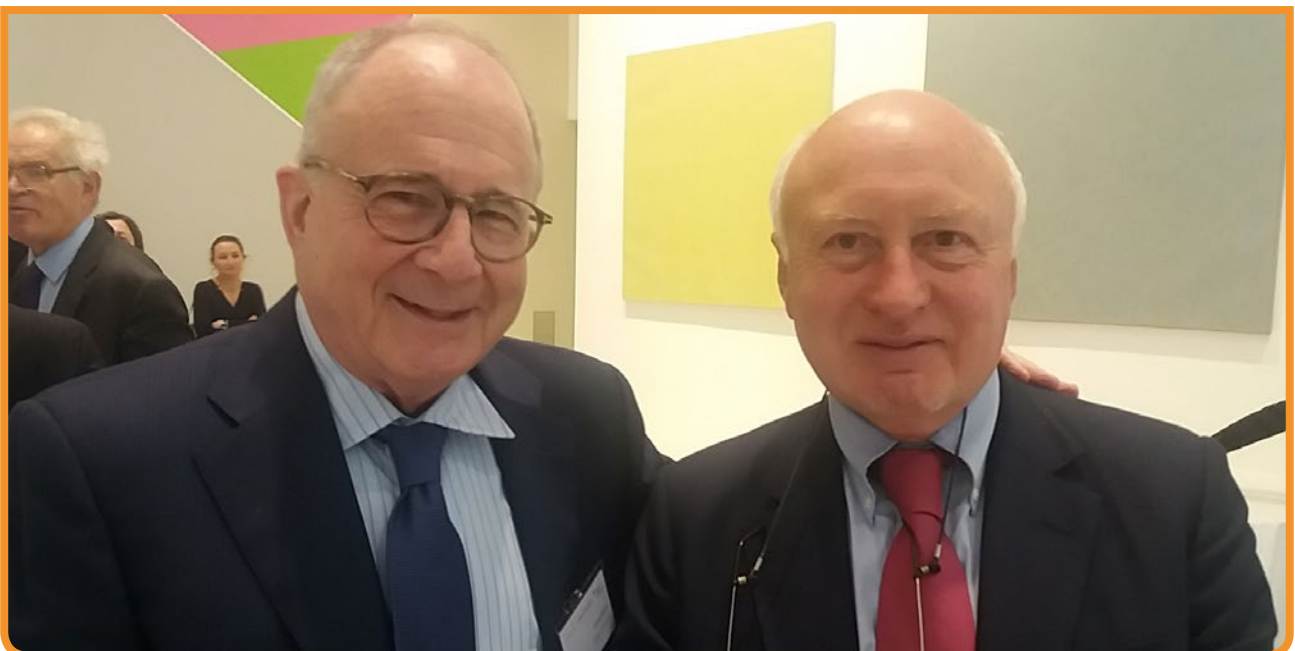
what will be the economics of “post-crisis” monetary policy, but also which political economy drivers motivate initiatives to reforms of central bank governance. Central bankers are sailing in uncharted waters. While not offering answers to these complex and potentially far-reaching questions, the conference at least highlighted where the deeper issues and risks may linger beneath the surface.



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Sylvester Eijffinger, Petra Geraats



Michael Bordo, Geoffrey Wood

The conference report and the conference presentations are available online at:

www.suerf.org/milan2016