

# Policy Brief

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## The End of Monetary Dominance? How Crises Can Influence Monetary Policy Decisions and Institutions

Pierre L. Siklos

Has the global financial crisis made monetary policy more powerful, or it has exposed its limitations? For the most part, the answer is the former, at least today, but the outlook may not be so rosy. When the former British Prime Minister, Harold Macmillan, was asked what were the greatest challenges he faced, he replied: "Events, my dear boy, events." We have certainly witnessed in the last year a series of events that are challenging policy makers as well as their beliefs about how monetary policy ought to be conducted in future. Indeed, these same events may come to haunt the monetary authorities, and we may well see a return to a period when monetary policy was subservient to a fiscal policy that steps in, ostensibly to impose order on an apparently unruly private sector. Central banks, among other players, appear to have unwittingly put in place the conditions necessary for what we can now confidently call the perfect storm of 2008. There were several observers who predicted that a train wreck was looming on the horizon. Indeed, perhaps most stunning of all, the Bank for International Settlements (BIS), created from the ashes of World War I and which quickly became the forum for central bank cooperation, a role it continues to fill to this day, had repeatedly warned about the troubles that lay ahead. "...these facts also suggest that the magnitude of the problems yet to be faced could be much greater than many now perceive" (BIS Annual Report, 2008: 9). The failure of central banks to act on these warnings may come back to haunt them in the near future.

What began in the summer of 2007 as the "subprime crisis" has, in the space of one year turned into a global financial calamity and, quite possibly, the worst financial crisis in over a century. The media have constantly bombarded the public, pointing out, perhaps in an attempt to reassure the public, that the current Chairman of the US Federal Reserve, Ben Bernanke, is a student of the Great Depression. The past would not be permitted to repeat itself.<sup>1</sup> Less frequently heard are questions about whether the Great Depression is the proper backdrop for the current set of predicaments facing policy makers. While there are some loose parallels with the cataclysmic events of the late 1920s, such as the run up in asset prices, the eventual failure of parts of the banking system, the key difference is that recent monetary policy has been excessively loose for several years.<sup>2</sup>



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Arguably, the most important lesson from policy making in the years culminating in the Great Depression is that it was the sheer hubris of policy makers, especially in the United States, who believed that the successful pre-emptive strike of a boom of the early 1920s through monetary policy decisions, meant that any subsequent boom or bust could be dealt with by asking monetary policy to act decisively or preemptively.<sup>3</sup> We now know, however, that inside the US Federal Reserve (see Meltzer, 2003), the prevailing ideology meant that the US Fed tightened rather than loosened policy as a response to rising stock prices. As in so many examples of this kind from history, policy makers are most likely to commit egregious errors when they adhere to a faulty, outdated or, possibly misinterpreted, ideology, leaving aside good judgment. That ideology, called the real bills doctrine, consisted of believing that monetary policy should prevent inflation and that it ought to be backed by the proper securities whose demand would be influenced by the needs of trade. By the time officials had realized their mistake, it was too late. The US economy unraveled and the ensuing Depression spread around the world.

While the economic shock went global it also tends to be forgotten that some countries weathered the storm that was unleashed by the actions of a single central bank. It is notable that these countries had one policy in common, namely a floating exchange rate (Choudhri and Kochin, 1980). It is worth bearing this in mind as policy makers reconsider the current worldview about how financial systems ought to be regulated and linked to each other in a globalized world. I return to this issue later in this paper. Another lesson that is worth highlighting is that the Great Depression culminated in a reversal of fortunes for central banks. Personalities such as Benjamin Strong of the US Federal Reserve, Halmar Schacht of the German Reichsbank, and Montagu Norman of the Bank of England, who dominated the policy making agenda during the 1920s, left the scene. Monetary policy would soon be emasculated by a resurgent fiscal policy assisted by a compliant central bank. Just as a series of crises have historically led to the creation of central banks in the first place, not only to help finance expensive wars, but to maintain the necessary financial stability that was periodically interrupted by shortages of liquidity or excesses in the banking system, it was the failure of central banks given considerable de facto autonomy in another time of crisis that would serve as the trigger for the end of monetary dominance. These same forces that were present then may well resurface once politicians catch their breath and take a look back at the events that led up to the ongoing financial crisis. They may well reach the conclusion that central banks failed to live up to their promise not only to deliver low and stable inflation but may also reject the “consensus” view that such an environment is most conducive to promoting financial system stability. For example, just last month, Jean-Claude Trichet, President of the European Central Bank, argued that “The primary goal of a central banker, and certainly of the ECB [European Central Bank] is to maintain price stability..., which is a necessary condition for financial stability, if not a sufficient condition” (Trichet, 2008). These pronouncements may very well fall on deaf ears if the economic environment continues to rapidly deteriorate. It is important to recall that the creation of a central bank gave governments a rapid “reaction force” in times of financial stability while an arm’s length relationship provided a shield, at least in theory but not always in practice,

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against excessive inflation when irresponsible fiscal or exchange rate policies were promoted.<sup>4</sup>

The foregoing considerations obviously raise the related question, namely whether the US Fed and other central banks reacted quickly enough, and not just well enough, when they finally began to see the crisis spread beyond American borders. It is too early to answer the second part of this question, as the present panoply of actions to relieve stress in the credit markets have yet to take full effect. It is clear that the monetary authorities in the US, the euro area, the UK, and elsewhere, are now almost literally throwing everything they have at the problem. Nevertheless, one can question at least a couple of threads in the recent conduct of monetary policy. First, as regards the stance of monetary policy, it is now plain to almost everyone that The Fed, and other central banks, were enablers of the financial bubble that burst beginning in 2007. A fear of deflation, ostensibly defeated in the early 2000s if it ever threatened world economies in the first place, should have prompted central banks to tighten policy in a less measured fashion. Second, when the weaknesses in the financial system began to surface in 2007, the US Fed decided to act in a piecemeal fashion, perhaps worrying that any other approach might prompt panic. The policy, which does elicit some sympathy, seemingly backfired because expectations of future failures were already in place, as the BIS also noted at the time. The eventual tide overwhelmed policy makers when they took a stand against bailing out Lehman Brothers, again in an apparent and sensible fear of the moral hazard problem that can grip a financial sector that seeks relief from governments for bad decisions. Once again, however, events turned against the authorities and the last shred of confidence that existed in credit markets vanished. It did not help that the response of the US Treasury and The Fed was hurried and ill conceived, until both the Bush administration and the

Congress were forced to heed the realities of the situation and pass relief measures for the financial sector. That these measures included spending promises unrelated to the current financial crisis only served to further undermine the credibility and the ability of politicians not only to deal with the problem but to recognize its severity. Perhaps most importantly, since previous attempts at containing the crisis were not entirely successful, one can imagine financial markets assigning a rising probability that there is at least one more major financial or economic shock to come. Consequently, until expectations that the worst is over for the world's economic system have passed, it is unlikely that monetary policy will return to anything that can be characterized as "normal."

## Governments must also step in and act in concert with the central banks.

Second, one must also consider the role that financial supervisors and regulators played in the lead-up to what became a financial crisis on a global scale. Recriminations have already begun with former US Fed Chair Alan Greenspan meekly testifying before Congress in October 2008 to the effect that he could not understand how the "financial tsunami" of the century could have come about under his watch. His testimony also reminds us of the extreme reluctance of central bankers to admit their mistakes. Indeed, when Milton Friedman wrote of his dislike for the concept of central bank independence, it was precisely because he felt that such an autonomous institution would be prone not to acknowledge its failings precisely at a time when introspection was most needed. I do not unreservedly share his conclusions because there is much to recommend in the principle of allowing the central bank the discretion of running day-to-day monetary policy, so long as governments set the overall objectives that such policies ought to achieve. However, there are many who harbour the illusion that the central bank and their political masters are equals. Nothing is further from the truth. Democratic accountability obligates the central bank to follow the mission that is set out by the government, acting as the representative of the wider public. It is precisely the clear and transparent division of responsibilities between the government and the central bank that not only highlights where the ultimate responsibility for monetary policy lies, but central bank autonomy also prevents the central bank from being unfairly scapegoated when things go wrong. A corollary is that it is precisely at a time of crisis that the mettle of a central bank, and its leadership, tends to be tested. At this stage, however, the successful management of a crisis is no longer the responsibility of the central bank alone. Governments must also step in and act in concert with the central banks. This principle also applies to likely reforms aimed at ensuring that the central bank and financial sector supervisors coordinate their duties in a fashion that is less likely to lead to the

kinds of abuses that have apparently taken place. Whether this means the trend to separate central banking from supervision will be reversed remains to be seen but there is little doubt that the roles of both institutions will be subject to some reforms.

When the financial system needs liquidity, central banks can inject it quickly, and they can widen the types of financial instruments that can be used as collateral when financial institutions take up the offered liquidity. And sustained reductions in the policy rate, which for us means the Bank of Canada's overnight rate target, also send powerful signals on the Bank's monetary policy stance.

Fiscal policy has been in the background for the past decade, since Canada began to enjoy surpluses. This has led to a form of complacency, along the lines of suggesting that fiscal policy does not matter or, more importantly, that it need not complement monetary policy. Both interpretations are incorrect. True, fiscal measures can take time to legislate, and their effects might be unexpected – the summer stimulus package in the US is long forgotten even if there are plans afoot to try again.

As noted previously, a central bank is a creature of the state, and only when the government and the Bank operate together is their work effective. Indeed, for over a decade, inflation has been low and stable precisely because governments supported the goal, the public came to see the promise of stable prices as credible, likely to persist for the foreseeable future, and in harmony with fiscal policy more generally.

At present, however, there is a clear danger stemming from the lacklustre response to the global financial shock from the Canadian government. Initially, the political reaction was tantamount to indifference. After all, the financial crisis was thought to be someone else's problem. Europeans governments have since found, to their regret, that this is simply not the case. In Canada, the presumption has been that the heavy lifting can be done mainly by the Bank of Canada alone, or in cooperation with other central banks. Unlike the United States, where measures to reverse the loss of confidence are reaching extraordinary levels, with equity stakes in banks, more fiscal stimulus in the offing, and attempts to inject liquidity at a prodigious rate, we in Canada are at least in the position where we need not consider all of these measures, at least not so far.

The Bank of Canada has performed as expected through liquidity injections, shifts in its portfolio of assets, and reductions in the policy rate. The recent rapid depreciation of the Canadian dollar also implies a looser monetary policy and, should the need arise, further reductions in the overnight rate remain an option. Until then, it is time to act to wring out of the system the toxic loss of confidence that plagues financial markets worldwide.

Fiscal authorities can act quickly if their aim is to build a sense of normality in financial markets. The C.D. Howe Institute's Monetary Policy Council, in October 2008, departed somewhat from its usual pronouncements, based on what its members think the future holds for the Canadian economy, by

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unanimously recommending that the government guarantee interbank lending, which it has now done, albeit somewhat belatedly. This move will level the playing field with financial institutions in the rest of the industrial world and send perhaps a more important signal, namely that only when the government and the central bank act together can the present difficulties be successfully tackled.

If additional measures are necessary to correct any imbalances in the financial system then both the government and the Bank of Canada need to be seen to act in harmony. Other countries have recognized that fiscal and monetary policies need to complement each other. Whether this objective is met successfully remains to be seen but it is an ideal worth striving for. If the credit crisis contributes to a decline in business expectations that exceeds any reductions in demand due to an imminent recession, a return to stagflation, conveniently forgotten in recent weeks as thoughts turn to recession and deflation, would not be out of the question. Accordingly, Canada's fiscal authorities should at a minimum have a plan for a scenario that includes the possibility of a more protracted and deeper recession than is currently anticipated. Policy makers, of course, need to be aware that reckless borrowing, or ill-advised fiscal measures such as the reductions in the GST or unwise increases in expenditures, will eventually be punished heavily by financial markets.

At an international level, Canada must defend its floating exchange rate regime and the monetary policy strategy of targeting inflation. Policy makers worldwide must guard against overreaching when it comes to coordinating on creating a new international financial system. Cooperation, while certainly desirable in the international sphere, need not lead to explicit policy coordination. The latter has a tendency to fail, at least judged by the historical experience. The position elaborated, by among others, the British Prime Minister, Gordon Brown, to the effect that the world needs a "second Bretton Woods," makes it appear that international coordination of financial

policies is rather more straightforward than it actually is. It took several years for central banks to work out some common banking standards, known as Basel I and, more recently, Basel II. The resulting rules, not currently ratified around the world, are complex, to say the least. Given the complexity of the issues, and the desire of politicians to be seen as solving problems quickly but cooperatively while protecting against encroachment on areas where a loss of sovereignty is at stake, these objectives are clearly in contradiction. It is hoped that governments will not take the easy route of restricting the movement of capital, or consider limiting exchange rate movements. Let us not forget that Bretton Woods failed while the present monetary policy regime, which has grown in popularity in recent years (Siklos, 2008a; 2008b), has already outlasted its predecessor.

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## Endnotes

- <sup>1</sup> Ben Bernanke, before he became Chair of the FOMC, delivered the following comments at a celebration of Milton Friedman's 90<sup>th</sup> birthday. "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again." (Bernanke, 2002)
- <sup>2</sup> Not everyone agrees with this proposition. Some have claimed that, at least until the summer of 2008, interest rates, after proper allowance is made for expectations of future inflation, were too high. See, for example, Wolf (2008, 2008a). Real interest rates were, in fact, too high in the lead up to the Great Depression. See Siklos (2008).
- <sup>3</sup> An alternative view has it that the Great Depression began in the real economy, as a reduction in aggregate demand that then found its way into the financial system which, when compounded with mistakes in the conduct of monetary policy, produced the greatest economic slump of the 20th century. Advocates of this view, however, have never been able to convincingly explain how this sudden drop in demand emerged in the first place. In what follows this line of reasoning is not followed. For more details about the various views on the origins of the Great Depression, see Temin (1989, 1994).
- <sup>4</sup> One lesson learned from past policy mistakes is that governments and central banks need to act jointly. As shall be argued below, while there is hope this will continue to be the case, there are some dark clouds on the horizon.



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Le CIGI a été fondé en 2002 par Jim Balsillie, co-chef de la direction de RIM (Research In Motion). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario. Le CIGI exprime sa reconnaissance envers le gouvernement du Canada pour sa contribution à son Fonds de dotation.





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