RBNZ Fellowship Workshop

The Current Financial Crisis: Historical Perspectives and Implications for New Zealand

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Paper 3: The winds of change for central banks: the impact of economic crises on the central banking world, by John Singleton (VUW)

Discussant comments:

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The Treasury[1]

John's paper is an ambitious and stimulating attempt to distil lessons for the present from the evolution of dozens of central banks over 100 years. It will be just one among many attempts here and abroad over the next few years to discern the lessons of history.

There is a lot here to grapple with. In the limited time available, I will concentrate my remarks in two areas:

- First, some observations on the way John has characterised the historical experience, both at a detailed level and in terms of overarching stories.
- Second, to offer some discussion starters on what 'the next round of central banking reforms" might involve for NZ and for other countries, perhaps emerging from the current severe recession and associated stresses on the financial system, nationally and internationally.

I have some additional more detailed and specific points available in the written version of these remarks.

Specific detailed points:

[1] On secondment from the Reserve Bank of New Zealand. Views expressed here are those of the author only, and should not be imputed or ascribed to either The Treasury or the Reserve Bank of New Zealand. E-mail address: michael.reddell@treasury.govt.nz.

Page 2. John notes "the central banking consensus at the start of the new millennium, which owed so much to the RBNZ, Roger Douglas, and Don Brash". In many respects, what is striking is how few of the specific features of the NZ system have been adopted elsewhere. We had priority in time, in introducing an inflation target, but whether or not we had done it others probably would have done so, for absence of a credible alternative at the time.

Page 3. John notes that the establishment of the RBNZ was delayed because the government was "preoccupied with the depression". That is true, but probably the momentum for a central bank might not have taken hold when it did without the Depression.

Page 6. John cites Schedvin as his authority for his suggestion that Australia was in some sense a central banking pioneer in the 1940s. I'd be more hesitant about taking an official historian's story line at face value, and would want to see more evidence of the influence of the Australian model, and the 1945 legislation, on central banks in other countries. NZ was probably the country Australia was most likely to influence, but our own Reserve Bank legislation was modified in 1950 to give stability of the internal price level a special emphasis. Also note that the Australian model was unlikely to have influenced many, given the curious status of the Commonwealth Bank, as both commercial and central bank, until 1960.

Page 7. It is claimed that the loss of central bank independence in the mid twentieth century was "not so obvious" at the time. This is a curious claim, especially in light of the argument in the following paragraph that "post-war central bankers saw their relationship with government as one of partnership". That strikes me as exactly right, and central bankers in Britain and its Dominions never saw themselves as substantially independent after, say, the mid 1930s (even when, as in the Australian legislation, they had significant statutory independence). The Nugget Coombs approach was widely shared.

Page 8. Leslie Lefeaux had been Deputy Chief Cashier, not Chief Cashier, and was Assistant to the Governors of the Bank of England at the time of his appointment.

Pages 8 and 9. Comments such an "an apparently radical Labour government", and "some of Labour's policies were unorthodox, but life went on", seem to trivialise the extent of the change Labour brought about, and the damage that was done (culminating in the comprehensive exchange controls and protection regimes, which John and his co-authors of the RB history have noted lasted longer than in other countries). This, and the threats to NZ's debt market access, suggest Lefeaux and the Bank were right to be very concerned. Overall, the paper is too grudging about Lefeaux - a man who, so Hawke records, Nash was willing to reappoint, and whose own personal standing is attested by the way in which his last year as Governor was, at his request, treated as unpaid "war service".

Page 10. It is noted that "following the Depression there was a changing of the guard in the central banking world, and a revolution in the...framework within which central banks operated". Notwithstanding the later changes made following the 1935 election, it is perhaps worth noting that the RBNZ legislation established an orthodox conservative central bank model, and was passed very near the trough of the Depression in NZ.

Page 10. It is questionable, at least, in how many countries central banking reform in the late twentieth century was really "part of a wider programme of public sector restructuring". It was so in NZ, but the case gets pretty hard to make in most other OECD countries beyond perhaps the UK. The accountability features of the NZ legislation have not been imitated. Similarly (page 14) did the example of NZ really encourage " a wave of central bank legislation in the 1990s"? Perhaps the case is stronger by default - the notion of agencies specialising in what they are good at (eg central bank focus on inflation, and Treasury on long-term fiscal issues)

Page 14. The claim is made that Canada and Australia "responded to the changes in central banking philosophy by granting de facto autonomy". I think it would be more accurate to say that the two central banks were allowed to reassert the autonomy the legislation had always envisaged, but which had not been asserted/permitted in the 1950s-1980s.

Page 14. It is asserted that "transparency was the hardest part of the CBI project for some central bankers to digest". I think this is misleading in a number of ways. First, his example is a US example, and the statutory independence of the Fed didn't change much for decades. Moreover, I think John looks at the history through a lens of today, rather than understanding the thought processes of the time. The Fed, for example, had published its Humphrey-Hawkins testimonies from the late 1970s (and were seen as something of a model here).

Perhaps more importantly, a reluctance to publish formal interest rate operating targets at times reflected in part a difference in judgement about the role of interest rates. If, say, the link between short-term wholesale interest rates and money demand was quite unstable - as it was clear some key Fed decisionmakers regarded it as being – and yet the relationship between money and either prices or nominal income was more stable, the precise operating target rate might have considerably less information, for all but short-end traders than, say, money supply targets, or even articulations of overall ultimate objectives (eg "low and stable inflation"). Even domestically, in the late 80s and the early 1990s, the RBNZ had a clear commitment to being transparent about things it could be meaningfully transparent about - the ultimate inflation target – but was very hesitant about publically specifying concrete price (interest rate or exchange rate) operating objectives, even though we consistently believed that interest and exchange rate transmission mechanisms were the way monetary policy mainly worked.

Pages 17-18. I'm not sure that the material on post WW1 Austria and Germany is particularly apposite here (interesting as it is). These were, from the West's perspective, defeated enemies, and in Germany's case in particular reparations, and judgements about what could reasonably be extracted, were at the heart of much of the debate.

Page 18. "CBI is the modern equivalent of the Gold Standard". A much stronger - and perhaps troubling – case could be made that it is inflation targeting that is the quasi-equivalent of the Gold Standard. Central banks typically had operational independence in both Gold Standard and inflation targeting worlds.

General comments on Singleton

Singleton rightly notes that central banking institutions, policies, and orthodoxies change, and do so in response to events ("crises"). On its own, this isn't terribly enlightening. The end of history - the Last Judgement - is not yet upon us: historians and wise policy advisers know it, even if successive generations of wide-eyed visionary reformers never quite do. Which agencies of the state look the same today as they were 100, let alone 200, years ago?

Is central banking unusual? I think perhaps it is, at least a little. And perhaps that partly reflects the fact that modern central banking – or even the notion of macroeconomic policy -

is a pretty new phenomenon (I mean in contrast to the Crown, taxes, courts, the military, welfare). But even more so - and this is something I don't think John gives enough attention to - the combination of exclusively fiat money, liberal markets, and full-fledged democracy is new. One can re-cast the story of the last 100 years as one of politicians, officials, and academic economists struggling to come to terms with the newly, and only gradually, emerging reality.

Go back far enough and the central bankers' challenge really wasn't much different to any bankers' liquidity management issues. His liabilities were convertible, and he had to offer a good enough interest rate and maintain enough liquid reserves, to meet any demand to convert (exceptions being made largely for all out war). The judgements involved were largely technical issues: the central bankers didn't always get it right, but there were no very obvious trade-offs, within a world in which domestic convertibility and, hence, fixed parities internationally were so universally seen as the only way money could be. Central bank independence and operational autonomy were not, in such a world, terribly controversial. Unemployment fluctuated, at times markedly, but.....when a factor is in excess supply its price should adjust, and wages more or less did. To a first approximation, it was a labour market issue, not one for central bankers.

By the 1920s and 1930s the picture had changed. Managing convertibility was no longer anything like a purely technical issue (Montagu Norman notes the real political constraints on the BOE's capacity to deflate in the late 1920s, to adjust the British cost structure to the long-term gold parity), and it wasn't because (a) countries weren't willing to live within the disciplines of the Gold Std – French and US to inflate, British to deflate, (b) alternatives were becoming conceivable (adjusting the parity had become conceivable as a tool of policy) and (c) universal suffrage electorates were simply not willing to live within the domestic adjustment constraints of a fixed exchange rate when faced with severe shocks. They weren't then; they haven't been since. The Hong Kong parity has held. The Latvian one will not. Real wage/competitiveness adjustments were/are simply easier through nominal exchange rate adjustments than through nominal wage adjustment. But those were choices, and choices with real redistributive consequences, which central bankers were ill-positioned to make.

The notion of active or stabilising fiscal policy (eg not countering revenue losses in a slowdown) also came into the mix. And hence, as John notes, in most countries central bankers from the mid 1930s through to the 1970s or later came to see themselves, and to be, partners (junior partners in most cases) in the overall business of cyclical economic management. Combined with fairly widespread doubts about the efficacy of monetary policy instruments themselves (especially interest rate adjustments), and heavy use of direct controls (over real and financial sectors), this was both a logical and quite sensible outcome, all the more so in a post-war world in which exchange rates were again (provisionally) fixed. And as Singleton rightly notes, the overall macro outcomes through this period weren't too bad at all for some considerable time – longer than the inflation targeting period to date.

Of course, that regime too fell apart, through the years of high inflation. The fixed exchange rate system broke down. Confidence in the potency and usefulness of fiscal policy waned, as - perhaps as importantly – so did the belief in the usefulness and cost-effectiveness of direct controls (whether in the financial sector or elsewhere). But did it do so because central banks weren't independent? Clearly, largely not. The Fed was independent throughout (at least since the early 1950s) and post oil shock Japan managed to keep inflation well in check with a far from independent central bank. Instead mistakes were made, and memories of the Depression/ fears of unemployment etc were vivid enough that, inflation having risen, it was very difficult for anyone to summon the will to bear the costs (overestimated, but on best professional advice) of getting it decisively lower. It wasn't just venal politicians who made those choices and mistakes – central bankers breathed the same air and for long periods largely shared the same choices (partly, but only partly, because the top central banker was in some sense always a political appointment). But it was eventually done: and the back of inflation was broken in NZ by the time the RB Act was implemented, and lower inflation also pre-dates the legislative changes in the UK and (the more evolutionary ones in) Australia.

Officials and academics spent years searching for a model that would work in a fiat money, floating exchange rate world. The hope vested in monetary targets for a while, and then the inflation targeting model, can be seen as successive ways of telling the monetary policy story in ways that enabling the re-creation of the technocratic myth for a fiat money world. If the public's long-term preferences over things monetary policy can achieve could be articulated in the form of a simple and clear target (for inflation perhaps) then, in a reductionist sense, "all" one needed was a good forecasting model and a reaction function. Politicians might be important, at the margin, in articulating the numbers consistent with price stability, but beyond that a matter for technocrats. And so we have an inflation target as the new gold standard. And take the model to its logical conclusion: a single decision-making technocrat, who can be fired if he stuffs up badly enough. The flavour was memorably captured in a radio interview with Don Brash in 1993 (Reserve Bank Bulletin Vol 56, No 3, 1993) [2].

Nothing is, of course, ever quite that simple. But the elite consensus trotted along tolerably well through the good years of the so-called "Great Moderation", with barely a recession in sight in many countries. But what of the challenges and reconsiderations that might be posed by the current crisis?

Where to from here?

Of course, it is very difficult at this stage to tell how central banking will emerge from the current global crisis. First, we have no distance or perspective, and one of the causes I champion these days in Tsy is not rushing too soon to reform. It took long enough to get into this mess, and we can afford to, and need to, take some time before deciding if, and if so what, structural surgery is needed for national or international institutions. Indeed we are not even through this crisis – personally I suspect NZ has yet to see the worst of the financial stresses that will hit us. Great Depression parallels are cheap and too common: mine is simply to note that if we date this crisis from August 2007, we are now in the 1930s

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Perigo:

Now, why were you anxious about the value of the currency at the time?

Brash:

Mainly because changes in the level of the New Zealand dollar have an effect on the rate of change of prices, in other words, on inflation, in New Zealand. That's true of any small country which is fairly open: the level of the exchange rate, or the change in the exchange rate, tends to affect the inflation rate. And we were concerned that with the exchange rate as it then was, we were running the risk of inflation coming in above 2 percent which is the top of our target.

Perigo:

And then you'd lose your job.

Brash

Exactly right.

equivalent of August 1931. Rather a lot followed that. At present, wholesale retreats into financial and trade protection don't seem likely – but where NZ got to by 1938 was far from apparent in the early 30s either.

And, of course, it is possible that not very much will change at all, and that the next wave of big central banking reforms, whatever it may be, will have to wait some other impetus. And, as with previous waves of reform, different countries are likely to experience pressures, and react to then differently.

However, some issues have already been put into play, from a variety of sources. There is a growing international sense that perhaps central banks need to pay more attention, in setting monetary policy, to emerging asset bubbles (of the sort that seem to come round every decade or two), and perhaps that macro-prudential powers need to be brought to bear as part of better counter-cyclical management.

In one of his first official speeches late last year, our own Prime Minister alluded to this issue at the APEC meetings:

> In particular, central bankers across the world are grappling with the issue of asset price cycles and their consequences for price stability. Housing market booms occurred this decade not only in New Zealand, but throughout this region and the world. The aftermath of these booms is at the heart of current financial market dysfunction.
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> The question is: faced with this situation again would we do something different to address it? To my mind, this question should lead economies to consider whether monetary policy, fiscal policy, and prudential policy should be more counter-cyclical, and lean against credit growth in an upswing.

The broad issue of asset prices, of course, isn't new and Alan gave a good speech on the subject 5 years ago.

And yet surely one of the reasons (not the only one) why no central bank actually **did** anything about the last boom, wasn't that it couldn't do anything - of course we and other could have raised interest rates more aggressively– but the question of mandate. Who were - are - we, as officials to make those sorts of choices? We've found it consistently hard enough to cope with the choices, inevitably distributional in nature, to do with the existing clause 4b of the PTA.

And doesn't the renewed move to give central banks more overall responsibility for financial stability issues, and more powers in this area, run towards the same direction? I'm struck by how few independent central banks in the last 15 years or so have had meaningful principal responsibility for measures involving financial stability, bank regulation etc. In the UK that responsibility was actively removed as part of the package to give the BOE the narrow operational autonomy in monetary policy. In Australia it was removed at much the same time as the Bank was allowed to reassert its independence and focus on a specific inflation target. And in Canada, Japan, the United States, Switzerland and throughout Scandinavia, much or all of financial regulation is beyond the responsibility of the central bank (as it is in the Euro-area). NZ is an interesting exception. Perhaps the trend will now begin to reverse, but if it does can the early stages of threats to operational independence be far behind. The synergies that probably do exist between regulatory, financial stability, and monetary policy raise questions about the coherence of a regime on which the conduct of monetary policy is undertaken by an independent official and regulatory policy involves the Minister more directly (as it does almost everywhere).

The sorts of choice involved inevitably need lots of high level technical input, but it is hard to avoid concluding that they are inherently political.

The same goes for the third leg the PM referred to: fiscal policy.

In the decades after WW2, in most Western countries, monetary and fiscal decisions were considered together and usually made by the same person[3]. For several years in the middle of this decade in NZ expansionary fiscal policy at the peak of the boom was one of the big issues, for both fiscal policy and monetary policy. Expansionary fiscal policy over the 2004 to 2008 period greatly complicated Alan's task as monetary policymaker, and also helped set up the current fiscal mess. I wonder if there is not at least a plausible argument that overall outcomes might have been better if the Minister of Finance had been making both sets of

[3] There were three main exceptions I'm aware of: West Germany (where as Buiter notes, the combination of limited legitimacy of the rest of government, and the horrors of hyperinflation memories created a strong public respect for the Bundesbank), the US (with a very strong tradition of separation of powers, and in particular an executive President who does not command the legislature) and Switzerland.

decisions[4]? How? Well, for a start he would have had to internalise directly the consequences of fiscal choices – either actually raising the OCR, and seeing the exchange rate rise further, or live with - and explain in the House and in public - the Reserve Bank's inflation forecasts that were deviating from his medium-term objective[5]. At present, one of the alleged positive features of the system is that the Minister can use the RB as a scapegoat ("I don't agree with the Governor, but it is nothing to do with me") – rather akin to the way Third World Finance Ministers treat the IMF, not historically a good recipe for enduring reform and strong local ownership. Hard choices need to be owned, and sold – and Ministers tend to have better sales skills than central bankers, and they are the only ones who can legitimise tradeoffs. Perhaps all that additional government expenditure was needed and the exchange rate was just an unfortunate consequence that we had to live with - but, from within the official sector, only a MOF can make that case.

For some of these sorts of reasons, one area where I think John is wrong is in his assertion that "CBI is not as secure" in "Canada and Australia (and perhaps the US) than it is in NZ or the UK. First, evolutions tend to be more robust that revolutions - and to a first approximation ours was a revolution, Australia's an evolution. In fact, the Minister of Finance has far stronger powers, even within the existing legislation, in NZ in particular and the UK than s/he does in any of those other countries. In NZ, the Minister of Finance has extensive exchange rate direction powers, and on my reading of the legislation, could directly assume power to set the OCR himself. Perhaps more tellingly, NZ has had numerous changes of policy target, and two independent inquiries into monetary policy - and only last year the then Minister of Finance and his associate were musing aloud about the section 12 powers. The sectoral distribution issues around large and long exchange rate cycles have been, and remain, much more alive in NZ than they seem to be in other countries.

Moreover, the NZ framework suffers from a legitimacy deficit – unlike most central banks, the Bank 's powers are all vested in the Governor rather than a Board or Ctte, and (unusually) the Minister cannot even appoint his own candidate as Governor. The technocratic myth - Don Brash used to run it – was that the Governor has very little discretion, but we know that to be very far from the truth. It would become even further from the truth if we asked the

[4] Perhaps having had to publish his medium-term inflation objectives each year, rather as his long-term fiscal objectives have to be published.
[5] As he has to explain if Treasury's fiscal forecasts are deviating from the fiscal objectives.

Bank to pursue a less well-quantified objective, and perhaps to do using a mix of instruments, for which the existing accountability framework is not well-suited. I'm not aware of any area of public life in NZ in which so much power is vested in a single individual, without any sort of formal appeal process. It is a model unlikely to be good for the country or the (successive) individuals concerned. This area is a particular vulnerability for the NZ regime, and is just one example of how fragile the entire NZ system could be if, for example, this crisis as it affects NZ were to materially worsen.

Perhaps there may even be some sort of reconsideration of just what decisions we remove from direct ministerial control. The traditional arguments for central bank independence rely on several strands, incl the time inconsistency notion that politicians can't credibly commit because it will be optimal to renege, and a related strand that politicians have short-term interests that lead to policy choices that are damaging in the long run, beyond the life of that particular government. The specific time inconsistency argument has little or no explanatory power: it argues for constitutional entrenchment of price stability and independence, not for politicians setting annual targets (as in the UK). And yet inflation has fallen, stayed low, and is expected to stay low. And as for the more general version of the argument, it applies to most other areas of public life: the temptation to cut taxes, to provide generous welfare benefits, to build vote-winning roads, to scrimp on defence, in ways that aren't consistent with the long-term health and well-being of the country. And on none of them do we remove the key decisions from politicians.

There are some areas where we do keep politicians right out of the mix. In the administration of justice – except the gratuitous prerogative of mercy - we keep politicians right out of the mix, and in jurisdictions like the US the Constitution even prohibit bills of attainder. And similarly in the administration of the tax system – to protect individuals from being singled out by politically motivated administrators. The same goes for health inspectors and building inspectors – we want similar cases treated similarly, without fear or favour. And at another extreme we keep politicians out of the operation of SOEs – because the logic of the model is that we want those entities run as private businesses, except that governments have made the choice not to own them. There are no significant policy or distributional choices being made in the operation of policy. And, of course, there is a myriad of small operational decisions officials make under delegation each day. But does monetary policy really fit that bill?

Perhaps it would have under the original 1980s Treasury conception of an independent accountable central bank. If society's preferences could have been specified simply in – in Public Finance Act jargon - output terms - eg a simple single target for the money base, or bank notes on issues stock, target, perhaps. We would have been back either to a model focused on maintenance of convertibility 19th century model, or simply direct control over issuance. Intense disputes raged around those issues. Treasury worried that without an output measure as a target it would be too hard to ensure that the central bank actually did what it was supposed to. As opposed to a very narrow strict conception of inflation targeting they were probably wrong. But such a model itself simply wasn't tenable anywhere. With a medium-term inflation target and long lags, all perhaps now augmented by concerns about overall macroeconomic and financial stability, perhaps it might have been better expressed as "if you can't write down clearly in advance all the major issues and choices and tradeoffs, perhaps the decisions are better left with Ministers, with input, as the issues arise, from expert advisers". All the more so in a NZ without a strong tradition of separation of powers etc.

In overseas debate on the possible threats arising from the current crisis, one issue that comes to the fore is the nature of the financial risks that central banks have taken on in the last couple of years. Western central banks have typically been very risk averse about credit risk, and took material foreign exchange risk historically mainly as a legacy of the convertibility/fixed exchange rate systems that were the norm through history until the 1970s or 1980s. But this crisis has led many central banks - including ours - to be willing to take a much broader range of credit risks. And in some cases **abroad**, to take decisions that amount to industry policy. Are these choices for independent agencies, or for politicians? Much the same could be said for big discretionary decisions around exchange rate intervention, that put large amounts of public money at stake: they may well be decisions worth taking (as in the NZ case) but who should take them? And again, should one person?

John Singleton notes that "central banks cannot assume that there will always be a political consensus in favour of the principles of the 1990s". Indeed, they can safely assume there will not always be such a consensus. But I think John is inclined to put too much weight on politicians doing things to central banks, and too little on the fact that central bankers, politicians, and academics inhabit much the same air: the same data, the same intellectual climate, the same political environment. If anything, Keynes reminded us that politicians are often themselves slaves of defunct economists. At different times, and in different countries, the leadership will come from different places – sometimes a bold reforming Minister, sometimes overwhelming circumstances, sometimes an academic of genius and influence, sometimes a reformist Treasury, and often enough from central banks themselves - well-positioned, if they choose, to be at forefront of thinking and reflection on the lessons of history, and best way ahead for us all.

As I conclude, I pose a question: Would the world be a worse place, and the long-term quality, and resilience, of decisions be worse, if the next wave of reforms involved abandoning the myth of monetary policy as something merely technocratic, in some sense revisiting the 50s and 60s, and (in countries with political systems like ours) Ministers of Finance, advised by Treasuries and central banks, represented more of a partnership in handling the huge integrated macroeconomic and financial policy challenges our economies face. In such a world, the central bank might have less decision-making authority, but at least as much influence – in private and in public. And Ministers would have to do what only Ministers can do: make and sell the case for hard decisions that balance difficult and conflicting objectives, with real distributional consequences for citizens (for periods long enough to matter), and no obvious or inevitably "right" answers.