The Monetary Realist

Reconsider Central Banking, Not Monetary Policy

BY ADAM S. POSEN

Given the real economic cost of housing market collapses in the United States and European Union, all kinds of people want to be reassured that policymakers will prick bubbles in future before they get too big. As a result, the monetary policy consensus of the last twenty years centered on anchoring inflation expectations with short-run business cycle management has come under fire. In this environment, some central bankers, particularly in the United States, who previously stood their ground opposing targeting asset prices with monetary policy, have begun to give way. This is an understandable impulse, but not really a constructive one.

Several central banks, including the Fed, indeed let us all down over the last five to ten years. Their neglect of duty, however, was not in their monetary policymaking focused on inflation stabilization. Central banks let us down in their laissez-faire attitude to bank supervision and financial regulation. Forcing central bankers to use monetary policy to prick bubbles would therefore lead to a double failure: it would fail to preempt future asset price booms, and it would let central banks off the hook potentially to do more harm in the financial sector again. We should reconsider central banking, not monetary policy.

Just because you have a problem does not mean the tools at hand will fix the problem. If I have a hammer, I can hammer in the morning, in the evening, the whole day long usefully repairing my roof, hanging pictures, and rejoining cabinet frames. If I have a bathtub leak, and I only have a hammer, I probably cannot do much to stop that leak, however. In fact, if I take my hammer to the bathtub pipes, I will probably end up with a much bigger problem. What I need is a wrench. I should be held responsible for fixing the leak, and thus for having a wrench and being ready to use it. But I surely should not be forced to bang away at those pipes with a hammer, no matter how much my bathwater drips into the apartment below.

Yet, by revealed preference, regulations and supervision do constrain financial company behavior, or else they would not spend millions of dollars lobbying elected officials to change or to prevent those regulations.

It is nothing but wishful thinking that monetary policy is the right tool with which to pop bubbles. If you go through the postwar history of central banking, you can argue there was possibly one instance where a central bank successfully popped a bubble through monetary means, and that was the Melbourne property boom in Australia about five years ago—and that success

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was fleeting. By April 2008, the International Monetary Fund characterized the Australian property market as the fourth most overvalued in the world. You cannot find another successful case, and importantly that holds when there was no shortage of central banks which tried to preempt bubbles with interest rates. The Bank of Japan did tighten rates to try to end the bubble economy at the end of the 1980s, with no success. The Japanese bubble only actually burst without reinflation when collateral requirements on real estate borrowing were tightened.

In other words, dealing with financial problems requires financial instruments. Regulation and supervision are far more directly effective than monetary policy in that regard. Some pundits will claim that regulations are doomed to fail, because innovative financial companies in a global economy will inevitably get around them. Yet, by revealed preference, regulations and supervision do constrain their behavior, or else they would not spend millions of dollars lobbying elected officials to change or to prevent those regulations. It is not credible that the world financial system would ever be run largely out of just the Cayman Islands and the Isle of Man, either.

We will never have 100 percent effective regulation, or rather cannot impose that without killing the economy, but we can have enough financial regulation and supervision in a vibrant economy if we keep at it. It is like me cleaning my apartment. Yes, even if I clean my apartment, there may still be some dust left, and I will only have to do it again a week later, but it will be a lot better than the mess if I do not try to clean at all. And ultimately, that was how our problem arose in the last few years: the central banks and other supervisors just let the financial mess pile up.

Forcing central bankers to use monetary policy to prick bubbles would therefore lead to a double failure: it would fail to preempt future asset price booms, and it would let central banks off the hook potentially to do more harm in the financial sector again.

To prevent bubbles and limit their harms, what we really need to do is strictly watch the watchmen of our financial system. As the history of this period is being written, it is already becoming clear that there were many decisions made—not just by the Fed, but especially there—to stand down voluntarily from supervision, to barely enforce regulations that were on the books, to prevent supervisory practice from keeping up-to-date with what was going on. The late Federal Reserve governor Ned Gramlich documented in great detail how the Fed let down its regulatory role on mortgages. There is clear documentation that the Fed also previously blocked efforts to regulate over-the-counter derivatives, and in fact encouraged banks to enter into unsupervised off-balance sheet activities.

The Fed was able to make this mistake because it had too much discretion in the regulatory and supervisory arena. It had the wrench, but chose not to use it. So we should be reconsidering central banking, not monetary policy, and in particular moving to a much more rule-based system for the central banks in financial policymaking. Getting financial regulation to work means imposing greater constraints and accountability on the supervisors and regulators themselves, as well as on banks and traders. It was central banks' abuse of financial discretion, not their activist monetary policy, that let us down. ◆