Conference in memory of Tommaso Padoa-Schioppa

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I am honored to be asked to participate in this conference. Tommaso was a role model for me as a central banker. He was a public servant who served his country and the global financial system in many different capacities. To each he brought a deep intellect, broad interests, wide knowledge, curiosity, and recognition that policy takes effect through the real world of payments systems, imperfectly formed expectations, and constraints on policymakers. But at the same time, he insisted that policy must take account of how decisions are shaped by economic principles and how those decisions have to be made in the context of a longer-term perspective. It's a world in which there's no substitute for policy maker judgment. Tommaso had no peer in exercising that judgment.

Nowhere is the need for judgment so evident as in the challenges that have faced central banks in the ongoing economic and financial crisis. We have seen unprecedented shocks to the economic and financial systems. No rule book guides the responses and there is little relevant experience to bring to bear. In these circumstances, distinctions that seem so clear in models and sometimes on op. ed. pages of newspapers become very blurred—e.g. the distinctions between liquidity and solvency and between fiscal and monetary policy. Inspired by Tommaso, I will draw on 3 plus years of experience central banks have had dealing with this crisis to outline some general principles and challenges in designing unconventional policies in these extraordinary times.

Principles

The first principle is that such policies are best if designed and explained as natural extensions of more normal policy tools—rather than as something completely different, exotic, and revolutionary, exploiting heretofore undisclosed and untested authorities and channels. Central banks are not grabbing new powers, but instead have been forced by circumstances to exercise old powers in new ways.

With respect to *liquidity operations*, perhaps most basic and time-tested function of a central bank is to supply liquidity to banks and other intermediaries when funding sources begin to dry up. Supplying liquidity under such circumstances is designed to forestall or limit fire sales, to keep credit flowing to households and businesses, and generally to avoid or limit the adverse feedback loop of constraints on lending and spending. Lending in size to a potentially wider-than-usual range of counterparties against a wider-than-usual range of collateral is completely in keeping with the principles of traditional central banking exercised in an era in which many credit flows bypass banks. Consistent

with Bagehot, it is critical that central bank rates and collateral requirements be both a little tighter than market rates and valuations in normal times, but not chase the market spiral of higher rates and reduced collateral values in the panic. If the parameters are set to the conservative side of normal, unusual borrowing will wind down when market functioning is restored.

Many central banks have also been required to seek additional *monetary policy* accommodation when short-term policy rates are already at the the zero lower bound. In these circumstances, acting on intermediate and longer-term interest rates by shaping market expectations about future policy or by buying longer-term assets is a natural extension of lowering short-term interest rates in more normal times, which works mainly through its effects on longer-term rates and asset prices.

A second closely related principle is that actions must be related to and be explained as furthering the achievement of the long standing objectives of central banks to promote financial and price stability in the context of sustainable growth and employment. Central banks are not trying to do something new and different; instead, their actions are aimed at legislated or treaty goals in an environment in which traditional tools have not proven effective enough. To the extent they become involved in, say, credit allocation or extra support of government bond markets, that should be explained as necessary and temporary, not a permanent addition to the central bank tool kit.

The third principle is that unconventional policy actions heighten the importance of transparency, clarity, and accountability for the central bank. Much of the opposition to unconventional policies comes from a lack of understanding and from suspicions that central banks have taken on new powers unchecked, that the actions won't be effective and could be counterproductive, that they serve narrow private interests rather than the public interest, and that oversight and accountability are lacking. This sort of reaction is not surprising given lack of experience with such policies and circumstances. But these reactions also point to a premium on clear explication of the actions—their rationale and expected effects and their costs and benefits. Those explications must include a discussion of uncertainty and risks associated with the actions; central banks and the economists who comment on their policies must admit what we don't know.

Clear explanations can be challenging when the policymakers themselves disagree on effects and channels, but that is a healthy and inherent aspect of operating in these circumstances. And there can be a tradeoff between transparency and effectiveness, but central banks need to err on the side of transparency wherever possible to diffuse suspicion and opposition. Clarity, transparency and accountability are necessary to preserve the political backing for independent central banks.

Challenges

Policies based on those principles still face substantial challenges. One such challenge is the calibration of policy. For *liquidity operations* the central bank should lean on the side of doing more rather than less; Bagehot said to "lend freely" in a panic. Operationalizing this command may not be straight forward, however. Central banks try to direct their efforts toward solvent institutions, but "solvency" can be difficult to discern in a crisis when the distinction between insolvency and illiquidity may not be distinct. The lack of liquidity can result in insolvency as funding becomes more expensive or

assets need to be sold at fire sale prices, which argues in favor of a generous supply of liquidity to intermediaries in a panic situation. Central banks need to be conscious of the moral hazard produced by their lending, but not paralyzed by such concerns. The financial system and the economy shouldn't be sacrificed to avoid moral hazard. The moral hazard effects of generous central bank liquidity provision can be addressed with the instruments of regulation and supervision.

The calibration of *monetary policy* at the zero lower bound through asset purchases and balance sheet expansion is especially difficult. Most central banks have little or no experience with policy of this sort and are learning about its effects as it is implemented. As a consequence it cannot at this point be made rule based. Among other difficulties, its effectiveness depends importantly on the behavior of banks and on circumstances in particular markets—such as the housing market in the United States—at a time when financial institutions and markets are in uncharted waters.

The quantity of reserves and monetary base created by unconventional policy presents special challenges for calibration and explanation. Reserves are a product of the asset purchases, but the question is what is driving the effect of the policy actions on the economy—is it the asset or liability sides of the central bank's balance sheet? A popular and strongly held view in some quarters is that it is the liability side—and that "printing money" (central bank liabilities) is inherently inflationary. But, in my view, once interest rates are at zero, added reserves themselves don't have much effect—they certainly do not automatically feed into money supply and inflation. These relationships are marked by pronounced nonlinearities and there is no necessary feed through from the size of a central bank balance sheet to prices—at least while output gap is very large. Instead the effects of central bank portfolio policies arise primarily from the purchase side through their implications for the prices of bonds and other assets.

A difficult calibration issue arises from the possible spillovers onto other countries. Should policies in each country be recalibrated to take account of their effects on other countries—even beyond the feedback of those effects on the home country? There was much comment from other governments and central banks along these lines after the Federal Reserve undertook its second round of large-scale asset purchases.

Monetary policies do have effects on trading and capital flows with other countries—that's one of the several channels through which monetary policy achieves its goals. A number of commentators seem to believe that unconventional policies have greater spillovers—though why this should be so is not clear. There's a theoretical possibility that global economic performance can be enhanced when one country sacrifices for the sake of another—runs suboptimal monetary policy from its narrow perspective. But its quite unclear how those gains are to be redistributed back to the sacrificing country. Should the economy suffering from high and persistent unemployment and experiencing low inflation sacrifice domestic welfare to help foreign countries restrain inflation? I find this a dubious proposition, especially when the foreign countries who suffer from the inflationary impulse of easier policy do so in large part because they are protecting export led growth by holding down exchange rate appreciation. Whatever the theoretical possibilities, in real life can we really improve on the model of each country pursuing price stability at home in a flexible exchange rate environment.

A second class of challenges arises from the potential fiscal policy implications of central bank actions in a crisis. As general principle, central banks should not be involved in fiscal policy. Only the elected representatives should be deciding how to use taxpayer funds. But the distinction between

fiscal and monetary policy is harder to make in a crisis. Some blurring of the boundaries may be a necessary byproduct of legitimate central bank actions that follow the general principles outlined above. Those actions can necessarily entail taking added risks onto the central bank balance sheet. For example, as I noted, collateral valuations behind liquidity facilities should be based on conservative principles in a non-crisis environment. But failures can occur in the middle of crisis and valuations be slow to return to normal. Recall also the difficulty of distinguishing liquidity and solvency among borrowing institutions. In some liquidity facilities it established during the crisis, the Federal Reserve took the credit tail risk because we judged that was required to restore market functioning. Monetary policies at the zero lower bound also tend to involve some added fiscal risk. The Federal Reserve for example has taken considerable duration risk onto its balance sheet; the Swiss National Bank has assumed foreign exchange risk.

Although central banks may need to assume added fiscal risk in stabilizing the financial system and economy in a crisis, that assumption should be guided by a number of general principles. First, it should be overt, not covert; everyone should understand the risks. Second, it should be minimal consistent with achieving goals for financial and macroeconomic stability—including price stability. Third, it should be seen as temporary, and planned for unwinding as soon as consistent with economic objectives.

All these principles apply to government bond purchases as well as other forms of monetary and liquidity policies. These purchases --"monetizing debt" –are sometimes portrayed as inherently inflationary and mixing monetary and fiscal policy. Also, to the extent these purchases blunt market signals to political authorities, they can be problematic with respect to incentives to restore healthy long-run fiscal trajectories. Still, in a bad situation such purchases may be necessary to achieve goals. Bond purchases cannot be a substitute for the difficult decisions needed to place budgets on a long-term sustainable basis. But they do not have to result in inflation or feed fiscal profligacy provided the central bank undertakes such purchases in the context of achieving its long-run price stability objective and everyone understands that they will be reversed one day.