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Unconventional Monetary Policy and Central Bank Independence

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As we look back at the great financial crisis, it seems to me we can see a **sort of paradox about the independence of central banks**: On the one hand, central bank independence coupled with a high degree of credibility have allowed central banks to act in the **bold**, **unconventional** and **aggressive** manner that has been so important in avoiding economic calamity. **On the other hand**, the consequences of the **unconventional policies** they embarked upon to save the world economy **arguably represent a potential threat** to the very independence of central banking that has served us so well for the past two decades.

We can, of course, think of a number of potential threats to central bank independence arising from unconventional monetary policy. These range from the classic blurring between fiscal and monetary policy at the zero bound, to potential political attacks on central banks in association with large balance sheet losses on their asset purchases.

In my brief comments today, however, the issue I want to raise is that **insufficient progress on designing and implementing a robust and credible macroprudential policy framework could bring about much broader future challenges** to central bank independence.

To explore this issue, we need to consider the biggest policy lesson from the Great Financial Crisis. The crisis revealed a huge gap in our policy framework – we paid insufficient attention to the implications of the credit cycle, and the resulting fragility of the financial system as a whole.

Post-crisis, a broad consensus has emerged that we need to fill that gap with Macroprudential policy. Everything I have seen since the crisis has gradually brought me to the point where **I am convinced that such a macroprudential policy toolkit needs to reside in central banks**.

The clue is in the name. Macroprudential policymakers need to be monitoring the macroeconomic environment, and the links between the macroeconomy and the financial system.

Those links are so close to monetary policy that it **seems inevitable to me that macroprudential policy must be located in the central bank**. How else can you make sure that macroprudential tools do not cross wires with what monetary policy is trying to achieve?

The challenge of setting up an effective macroprudential policy framework is an urgent one, because a prolonged period of extensive unconventional monetary policy is **likely to lead to precisely the kinds of distortions and ultimate vulnerabilities in financial markets that macroprudential policy is designed to address**. After all, unconventional monetary policy is designed to create incentives for investors to take on ever greater duration or credit risks. To the extent that these policies are effective, they will lead to deviations in some asset prices from fundamentals, and greater exposure to those asset prices among investors who have taken on more risk.

Therefore now is precisely the time when we need to design and implement a credible and tough Macroprudential policy framework. In a sense, you can think of macroprudential policy as effectively protecting economies from the unintended consequences of central banks' own unconventional policy actions.

Today's challenge is that we have **not yet converged** around a robust macroprudential policy framework. Tools and institutional frameworks are, of course, analysed and debated vigorously, as amply demonstrated here today. For the most part, however they are not yet firmly in place. Moreover, and crucially, in most cases, policymakers certainly do not yet have the political backing and formal competence to make the tough decisions that Macroprudential policy will require.

On one level, this should not come as a surprise. After all, we went through a similar process in the debates around monetary policy in the 1970s and 80s. Was inflation stabilisation the right goal for monetary policy? And should it really be given to unelected central bankers? At the time, these were very big and heavily contested questions, both analytically and politically. Fortunately, the case for operationally independent CBs, with a primary focus on price stability, eventually won the day.

I fear it will be even harder for macroprudential policy. It is inherently more political than monetary policy, with powerful lobbies affected by it. The tools associated with it – for example leaning against credit booms in particular sectors such as housing, or forcing financial institutions to hold more capital throughout the cycle - will have obvious, and significant, distributional effects.

This means **we will need to persevere to build structures and institutions that give macroprudential policymakers the independence they will need**. Based on what I experienced on the job in Switzerland, and what I see as an observer in other countries, it seems to me this is a battle that has yet to be won.

Ultimately, what I am concerned about is a kind of race against time. The risk is that u**nconventional** monetary policy cannot be removed in time, **extensive distortions** build up in financial markets and a **robust macroprudential framework** with clear powers and responsibilities is **not yet firmly in place.**

In this constellation, it is not difficult to imagine a **worst case scenario where central banks are given the responsibility for half-baked, incomplete macroprudential policy tools** which they will not be able to carry out effectively and with determination. As a result, when deployed, they will at best only partly achieve their objective or, at worst, fail altogether, with the consequence of another unchecked boom bust credit cycle occurring.

In such a scenario, one would have to anticipate a subsequent tremendous blame game. **Central banks would then be seen to have failed twice** – in helping fuel distortions and in being unable to do anything about them. This would undoubtedly be a fertile environment for politicians and the public to ask why anyone should trust central banks to set macroeconomic policy in the first place. Or to misquote Oscar Wilde: "*To allow one financial crisis to occur may be regarded as a misfortune. To allow two to happen looks like carelessness."*

In such a worst case scenario, the very real gains from the debates of the 70s and 80s – giving central bank the independence they need to deliver price stability – would be under its greatest threat since that battle was won. **We would not just have lost the battle for macroprudential policy, but we would risk losing independence to carry out monetary policy, too**.

I am, of course, an optimist at heart and believe such an outcome can be avoided. Not getting involved in macroprudential policy for fear of getting contaminated does not strike me as a viable option for central banks. As I said at the outset, it seems to me the crisis has shown clearly that Macroprudential policy must become part of the remit of central banks. Therefore, we need to make, and win, the case for credible and tough macroprudential frameworks, implemented by policymakers who have the independence required to make difficult and at times unpopular decisions. And we need to do so quickly, given the risks to financial and economic stability which are inherent in the current Unconventional Monetary Policies.

Let me close with a final point that you will not be surprised to hear from me. And here I want to echo something Jaime said at the Group of 30 yesterday in Washington. **Nothing matters more than initial conditions**. I could not agree more and therefore I believe that above all else, it is crucial that we ensure that banks operate with much larger capital buffers in the future. Much higher loss absorbency capacity is, by far, the most effective macroprudential tool.

Sadly, I have become convinced that we fell short in Basel III. Insufficient capital shock absorbers are the first-order macroprudential problem. The more complex a macroprudential machine we try to build, the more likely it will end up not working as intended and the more likely central banks will be blamed and potentially threatened in their independence for unsuccessfully trying to deploy them. A properly capitalized banking system, throughout the credit cycle, will make all the complicated second-order macroprudential questions much easier to address.