Challenges to Central Banking from Globalized Financial Systems

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Discussant's comments by Michael Reddell
Reserve Bank of New Zealand [1]
On

The Central Bank's Role In Debt And Reserves Management

by Hugo Frey Jensen,
Danmarks Nationalbank

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Thank you for the opportunity to comment today on Mr Jensen's paper, which has given us an interesting description of the Danish system. As I knew very little about Danish arrangements until I read the paper, I will focus my remarks this afternoon on a slightly more general framework for thinking about what role a central bank should have in reserves and debt management (two quite different functions, both conceptually and practically).

Before setting out, we should remember that given the wide variety of system operated around the world, it is wise to be cautious about reaching strong conclusions. Although my own preferences will become clear as my comments proceed, when similar countries adopt such different systems one should be wary of thinking that the choice matters too much.

My own framework for thinking about this starts with the question of why, at the deepest level, we have central banks at all. My reading of history, and my understanding of macroeconomics and financial crisis literature, suggests that financial stability is in fact the primary reason we choose to have fiat money, issued and managed by an agency of the state. The market could provide money, but as societies we have concluded that such systems would be excessively prone to damaging runs, and that the sorts of externalities that would arise point to a need for a lender of last

[1] Opinions expressed here are those of the author and do not purport to be those of the Reserve Bank of New Zealand.

resort; some agent willing to make the supply of liquidity/cash elastic in the face of marked changes in demand. A state-issued fiat money system is well-attuned to that need, but without a commodity anchor the price level could be, in principle, indeterminate. It is this that creates the need for something called "monetary policy" - managing/maintaining the value of the state-issued money. And of course, day-to-day, it is monetary policy that attracts most attention to central banks. Increasingly too, the ability to adjust a nominal exchange rate, to help facilitate real national macroeconomic adjustment to shocks, has become a pressing part of the equation. But attractive as that flexibility is, the sheer volatility of floating exchange rates raises other financial stability types of issues.

In recent decades, we have become increasingly conscious again that that the value of money is not something best managed, day to day, by politicians. For whatever reason, political control of the short-term management of monetary policy seems (not always, but on average) to produce worse inflation results (which society then regrets and has to correct for over the medium-term) than a system in which the discretionary decisions are left to independent (but accountable) officials.

This sort of arms-length type of relationship is not uncommon in public life. For example, in democratic societies we draw boundaries between the roles and powers of the executive, the legislature, and the judiciary. That no doubt produces "inefficiencies" at times, but the "inefficiencies" are the price worth paying for the greater good of an open, democratic, and accountable government and society.

So when thinking about the tasks, tools, and responsibilities that a central bank should take on, we should not be looking simply at which set of arrangements offer the greatest short-term efficiencies. We should focus instead on those that best support the long run goals - financial stability, and the effective operational independence of the central bank in the conduct of monetary policy.

And it is here that I pause to wonder whether the Danish example has very much to teach us - indeed, even (provocatively to wonder whether Denmark needs an independent central bank at all[2]. At a wider political level, the Danish government and society has chosen not to operate a national monetary policy, but to, in effect, be part of the deutschemark (and subsequently euro) bloc. With a commitment to free capital flows, we all recognise that a decision to peg the exchange rate, simply means

[2] Were it not for the expressed desire to take Denmark into EMU.

that interest rates must be adjusted in line with changes in Frankfurt. Indeed, as I think Mr Jensen mentioned, the speaker from the ECB knows more about what will shape Danish monetary policy than Danish central bankers do. There is no real scope for a fundamental monetary policy tension between the Danish central bank and the government, as the overriding imperative, governing interest rate decisions, and use of reserves, is simply to maintain the peg. Indeed, whereas in most countries part of the scope for tension between governments and central banks arises over the short-term counter-cyclical nature of interest rate adjustments (how far, how fast, what risks etc) Mr Jensen, notes that in Denmark, the instrument of cyclical stabilisation policy is fiscal policy - which is, and always will be, in the hands of the elected government.

Thus, it is not clear that in Denmark it matters at all how the various functions and tools of debt and reserves management are distributed between the government (Ministry of Finance) and the central bank. These are issues that come to the fore in the increasing number of countries where there is a genuinely national monetary policy – either a floating exchange rate, or (in a smaller number of countries) a fixed exchange rate with (at least somewhat) effective capital controls.

What of debt management? Can I first make clear that in New Zealand's case the central bank is involved in administering domestic public debt operations, but has little close involvement in formulating debt management policy. I would be wary of taking that formal involvement any further, for two reasons.

First, it seems preferable for the central bank to be able, as far as possible, to treat the government as simply another (albeit large) borrower. Its spending and borrowing decisions will have macroeconomic impacts (but so, say, will the household sector's collective decisions, or the health of the banking system and the implied ability or willingness to lend). However, provided - and this is a key proviso - governments can secure central bank financing only at the discretion of the central bank, and on terms acceptable to the central bank, government debt should not normally be something the central bank should want to focus on uniquely. Recall too that the real long-run threats of conflict arise not so much from specific borrowing strategies, as from the total size of the public debt - and no matter how closely a central bank is involved in debt-raising and management strategies, the size of the fiscal debt/deficits is, inevitably and inherently, a political choice.

Secondly, while there are some potential signalling issues and risk associated with public debt management, I think they are often overstated (this applies for example to arguments about the issuance or inflation-indexed bonds, or to debates about whether or not, during a disinflation, governments should issue more short or long-term debt). As a first approximation, again what really matters is the overall borrowing requirement, and whether or not it is at levels consistent with allowing a durable commitment to a central bank's price stability goal. They may perhaps be some financial stability issues - especially when issuing foreign currency (denominated or linked) debt in the form of negotiable securities, but a sense of perspective is important here as well. For countries where there is a deep credibility problem, it is often practically impossible to issue, for reasonable terms, anything other than foreign currency debt. Delivering low inflation will provide an increased range of debt management options, but debt management choices (other than outright central bank finance) are unlikely to materially determine whether or not a good track record is established on inflation.

And my third reason for unease is that I am wary of taking on any tasks or structures that may make a central bank more amenable to behind the scenes influence from ministers or other officials. Keeping this sort of arms-length relationship is a key reason why it is normal for a central bank to have a degree of budgetary independence. We should seek good relationships between ministries of finance and central banks, but we should not be so involved in central government issues that we begin to see the world through political eyes (or we defeat the purpose of operational autonomy). And nor should we grab enthusiastically at new tasks or responsibilities which can be used as leverage - however subtly or indirectly – over the conduct of monetary policy. A task that one has (and wants to have), but which is bestowed at someone else's discretion, gives the bestower the potential for leverage or influence. A heavy inside involvement in shaping public debt management policy, creates some (perhaps small, but unnecessary) scope for that sort of influence.

None of which should be taken to mean that I see no role for the central bank in this area. It may well be that the administrative conduct of some functions fits sensibly with other central bank operations. More importantly, it is desirable that the central bank should have the right to be kept informed, to be consulted, and to advise and comment - in public if necessary. Central banks will be likely to have some expertise in related areas, and in many countries available expertise is thinly spread. But I believe the central bank is more likely to keep its own long-term

responsibilities in focus, if it is a relationship that remains at arms-length: informed and interested, rather than being a key day-to-day inside player.

There are few (or no) financial stability advantages to the central bank being heavily responsible for debt policy, and some monetary policy risks. My approach to reserves management is a little different – although again it is as well to remind ourselves of the range of approaches adopted even within the group of OECD countries. At one extreme, for example, in Japan the foreign reserves are owned by the Ministry of Finance and intervention, while conducted by the Bank of Japan, is at the behest of the Ministry of Finance. By contrast, in Australia, reserves are owned by the Reserve Bank of Australia, are financed by the RBA's own domestic liabilities, intervention is conducted entirely at the discretion (and risk) of the central bank, and the central bank holds sufficient capital to minimise reputational risks associated with fluctuations in the market value of the reserves. New Zealand provides something of an intermediate case.

Our modern financial systems are prone to at least a couple of types of crisis:

- a run to cash (or to safe/secure) domestic assets, from other local currency liabilities.
- a run from the domestic national currency, to the currency of another country.

We take for granted that the response to the former sort of crisis is a core aspect of central banking - whether that need is met by "automated" systems for providing liquidity, something rather more discretionary, or (commonly) some combination of the two. It is less than entirely clear to me, why we would not assign responsibility for a run from the currency primarily to the central bank.

At the Reserve Bank of New Zealand we have done quite a bit of thinking about intervention policy in recent years. Amid all the ongoing debate, one thing that was very clear to me was that foreign exchange intervention was more likely to be effective (and/or profitable) when the discretionary responsibility, including the judgement as to when and how intervention will complement or substitute for a monetary policy response, is in the hands of accountable central bankers. Other systems can work, but they seem to set up the risk of unhelpful dynamics, and tensions between the central bank and government of the day, in a way that is unlikely to be most conducive to the management of periods of

pressure. Both financial stability, and the operational independence of monetary policy seem likely to be best-served if reserves management and intervention policy are vested in the central bank.

Can I comment finally on the information-gathering advantages of central banks assuming responsibility for public debt policy and operations. Mr Jensen noted that this was one reason why the Danes adopted the structure they did. I recognise the advantages of practical exposure to markets, but again I think the Danish situation is unusual. In Denmark, there is no floating exchange rate, no independent national monetary policy (and no Danish vote in the ECB), and the central bank is not responsible for bank supervision and that may make it more difficult to encourage financial market participants to provide ready access to information etc. By contrast, in a system with an independent national monetary policy, market participants are usually quite ready to keep in touch with the central bank, and keen to learn how its own thinking is evolving. Moreover, for a central bank which is also a supervisor or regulator, there are additional avenues for building a knowledge base and regular contacts with markets.

Perhaps finally, as I have argued at times in my own institution, we should recognise that valuable as practical market experience and exposure is, other government agencies face similar challenges without becoming direct market operators themselves. Our civil aviation regulatory bodies do not typically run airlines (to get practical insights on the business), our ministries of agriculture do not typically operate meat-packing plants, and so on.

Thank you