



The point is underlined by the harsh fact that our core institutions have not

been working well. Monetary-financial policy falls into that ignoble category. In the past 15 years, we have caused the biggest global financial crisis since the 1930s, then opted for a mix of macroeconomic stimulus that fuelled another bout of speculative excess, and recently have struggled to maintain low and stable inflation. What *we* should learn from that takes up the bulk of my remarks.

Prescription, which I am counselling against, is profoundly different from another kind of endeavour. That involves trying to explain what seems to have worked for us, what definitely has not worked, and which successful measures seem to depend on local conditions and, by contrast, which might possibly be transferable to other circumstances. That is what, incompletely and rather crudely, I want to attempt concerning 2022 and 2023's monetary-financial problems. In a nutshell, the problem is that we still have not found institutions that are reliably committed to pre-emptive actions to maintain monetary-system stability.

II. Moral hazard runs through delegated regimes for monetary system stability

The two core functions of central banking are easily stated: price stability and banking stability. Because nearly all the money held and used by nearly all of us is the deposit money issued by commercial banks, the two are umbilically linked.² Both functions are increasingly delegated by legislators to independent central banks because each depends upon pre-emptive actions in the face of, respectively, inflationary shocks and banking system vulnerabilities. Over the past decade, however, few such independent power holders have acted pre-emptively.

That is a problem of moral hazard, as it involves deviating from mandates. We need, somehow, to make it harder for policymakers to depart from stability-oriented policies.

III. Price stability

The harder case is price stability, for the simple reason that, writing in mid-2023, we do not yet know, for sure, whether monetary policymakers have let inflation out of the bag. Plainly, the energy cost shocks rooted in Russia's war on Ukraine (and the oil-producing states' geopolitical choice not to offset them) raised the price level, and hence for a while headline inflation. It would have been unnecessary and crazy to seek to offset those shocks entirely. Some accommodation made sense. But, at the time of writing, it remains unclear whether inflation will come back to target or settle some way above it, requiring a policy-engineered slowdown.

Just in case that is the outcome, it is not too early to ask why we find ourselves in this predicament. Some possible proximate causes are already clear enough: relying too heavily on monetary policy to revive underlying growth after the Great Financial Crisis of 2007–09; continuing to add to the monetary stimulus even when, during the COVID-19 pandemic, there was extraordinary fiscal support that could

have been funded in the capital markets; not heeding contractions in labour supply after the pandemic, which left some economies with excess demand even though they were not growing rapidly; and nearly a decade of forward guidance leaving policymakers on autopilot rather than responsive to shocks.

Behind those various technicalities, deeper forces might have played a part, including a wish to promote ‘inclusive growth’ (as the Federal Reserve framed it in what looked like an appeal to progressive politicians); a desire to steer credit to useful places and away from unworthy ones; and an apparent assumption among the political classes that inflation was an earlier generation’s problem, making possible a shift to ‘monetary activism’ (as a British government stipulated in the Bank of England’s 2013 Remit).³ Putting that together, it was as if central bankers could focus on more pressing problems because medium-term inflation explanations were surely anchored to target. But that was always risky because the true anchor was always central bankers’ *own* willingness to act pre-emptively, even when that would be unpopular.

1. Remedies

While there is no obvious remedy, several measures could be taken to reduce the chances of revisiting the problem anytime soon. One is to strengthen automatic fiscal stabilisers, overcoming politicians’ self-interest in sitting on their fiscal hands when monetary policy is constrained (most obviously by the ‘zero’ lower bound on nominal interest rates).

A second measure, getting closer to the bone, is to make it clearer that central banks should stick to actions that directly serve their core stability mission. The point is hardly to marginalise other public policy objectives. It is, rather, to retighten the harness binding central bank leaders’ desire for professional esteem and public prestige – on which the utility of independence depends – to their success in delivering the mission that warranted their extraordinary powers in the first place. Milton Friedman was half onto something, but not what he thought, when in the early-1960s he claimed in a letter to Stanley Fischer: ‘the two most important variables in [central bankers’] loss function are avoiding accountability on the one hand and achieving prestige on the other’.⁴ What he missed is that, in some circumstances, exposing oneself to accountability can help sharpen incentives, and so offers a route to prestige.

Third, therefore, a lexicographic objective, under which business cycle stabilisation is subordinated to price stability, remains best as it removes ambiguity about the need, at all times, to maintain *securely* anchored medium-term expectations.

IV. Banking system stability

Similar sentiments can be brought to the banking stability mission, where moral hazard problems were at the root of 2023’s banking failures – the collapse of Silicon Valley Bank and other large United States regional banks, and the unravelling of Credit Suisse. In the US, the authorities ignored international norms when they formally decided to

cease planning for the failure of large regional banks, and did so even though they must have known they did not have a good plan.⁵ In Switzerland, meanwhile, the authorities not only set aside a resolution plan discussed for years with international peers, but they also did not refinance an ostensibly well-capitalised bank, which might have avoided a fire sale of the core business. If there were insufficient unencumbered assets any of them would accept as collateral, the central banks were in a bind (as lending unsecured is for elected fiscal officials).

1. *Complete liquidity insurance for 'safe assets'*

Among remedies, the biggest is to accept that, for a solvent bank, the central bank will act to enable *all* short-term liabilities to be paid out. That implies those with access to central bank liquidity insurance should be required to cover 100% of their short-term liabilities with assets eligible at their central bank, and should pre-position those assets with the central bank (acting, effectively, as a sub-custodian) so that they cannot be used for other purposes.⁶ Access to such insurance cannot credibly be limited to de jure banks unless the state uses a hard-to-amend law to prevent any other kind of intermediary from conducting a systemically dangerous maturity transformation. Except where that condition is met, the insurance should be available to any issuer of 'safe assets', defined as those instruments that users (investors, traders, intermediaries) feel no need to analyse. Like money, they are, as economists put it, information insensitive. And like money, they enjoy network economies, and so are liquid – until some revelation shatters an illusion, there is a run for the exits, and supposedly safe assets become, in a flash, illiquid, or worse.⁷

Under that regime, the amount of capital an issuer of money-like safe assets had to carry against its core banking business would be determined by the excess collateral (known as 'haircuts') required by the central bank. Since central banks suffer political costs when they suffer losses from financial system support operations, they have incentives to be cautious in setting and monitoring haircuts. In other words, in the Western political culture, mitigating moral hazard in the application of banking policy is more incentive compatible for a central bank as lender of last resort (LOLR) than it is for a standard prudential supervisor.

2. *The LOLR and resolution policy for fundamentally bust firms*

Normatively, however, in constitutional democracies such liquidity insurance must be subject to the proviso that the unelected central bankers should not lend to anyone that is fundamentally insolvent. That is a matter of *our* values –specifically, those associated with the separation of powers between executive government and an elected legislature. Lending to fundamentally bust firms distributes resources from longer-term creditors to short-term creditors. In consequence, solvency bailouts and lending to firms that, even after receiving liquidity assistance, will not be able to discharge all their obligations must be reserved to elected politicians, because only they can decently discriminate between different creditors.⁸ When a prospective borrower *is* fundamentally broken but the state wishes to avoid a taxpayer bailout, the distressed intermediary must go into

a bankruptcy or special resolution process that is designed to avoid systemic chaos. This is already agreed policy in all major banking centres, but needs to be applied, as it was not in the US, to all significant banks.

Separately, central banks need to make it clear that they stand ready to lend to a resolved bank in case it (initially) suffers liquidity strains. Some have still not done so, leaving the financial system weaker than it needs to be. Being clear about lending into effective resolutions would give the central banks leverage, via their collateral valuations and haircuts, over the size of recapitalisation a resolution must deliver. Even though it might not be widely grasped, central bankers are vital to making resolution policy credible.

V. Summing up

There might seem to be an awkward tension in this comment. On the one hand, I urge rich states to refrain from preaching and proselytising to poorer and weaker states, who need to find their own way. On the other hand, I seem to advocate certain policies for monetary system stability. Where do I stand?

The former consideration dominates. While IMF programme conditions obviously bite, and are framed for specific circumstances, I think states should take the IMF's routine general recommendations as interesting ideas rather than authoritative (in the sense of having content-independent authority). That is partly because real crises focus the mind, as illustrated by a sad example in the banking field. For half a decade or so from the late-1990s, the IMF started proselytising moving banking supervision away from central banks, favouring integrated all-purpose financial regulators instead. This was after the United Kingdom took that course in 1997. At the time, I thought it was a bad idea for Britain as London's culture would not incentivise information sharing between the regulator and the LOLR. Sadly, that is how it turned out, and we reaped the consequences in 2007. The IMF, dare I say, was barely equipped to judge whether it was a good idea in the UK, let alone whether it was a sensible policy to float for the rest of the world.

A happier but still instructive example is inflation targeting. It started in New Zealand. A few years later it was adopted by Sweden, and then Britain. At the time, there was almost no academic literature on the subject, and international organisations were not proselytising it. That is not a bad model: scan the world for good ideas, and ask whether any might work at home.

So, the reform ideas I float here are just that: my take on some serious local difficulties in the rich world, which might or might not be of use to those bearing responsibility elsewhere. This leaves an awkward but important question hanging in the air: what notice developing countries should take of the plethora of standards and codes pushed their way by the IMF and other international bodies and groups. Members of the G20, including some large

EM economies, overtly sign up to them and are in the room when they are being drawn up. This is as close to consent as it gets in international affairs.

Which other states are in a broadly equivalent position depends on the subject matter and, therefore, which international body draws up a standard. Except where a state has been properly involved (entailing something like consent), I suggest they ask themselves whether it would be useful for them, all things considered, to tie themselves to the mast of a particular standard.

The calculus would be different if IMF programme conditions were overtly (and credibly) linked to compliance with codes and standards. But they are not. And if they were, agreeing the standards and codes might well end up involving more demanding processes: what some would misleadingly term global democracy. Given geopolitics, that is not on offer.⁹

Years ago, perhaps a decade before I left office in late-2013, I was visited by a very senior Indian official who asked whether they should bow to international pressure to liberalise capital flows. My suggestion was that they listen very carefully to the substantive arguments of everyone who tried to persuade them one way or another, but without paying much notice of where the advice came from, as few concerned would be around to take responsibility if the choice backfired. Indian officials had to make up their own minds. I did not know at the time that, in a tiny way, I was echoing Peel.

Notes

¹ Hurd and Young (2010).

² Tucker (2018).

³ Smialek (2021); HM Treasury (2013).

⁴ Fischer (1990).

⁵ Systematic Risk Council (2019).

⁶ King (2016); Tucker (2019).

⁷ Holmstrom (2015).

⁸ Tucker (2020).

⁹ Tucker (2022).

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