What Should Central Banks Do?

We have enumerated a number of additional pressures that central banks will face in the post-crisis economic environment. These will make it difficult for them to implement their policies using a traditional framework in which price stability is the overarching goal. Unavoidably, they will become entangled in debates over public debt and its management and come under pressure to do something to help maintain competitiveness in the production of tradables.

While the two sets of issues arise most immediately in different sets of economies—high public and private debts are mainly a problem for the advanced economies, while exchange rate overvaluation is largely a worry for emerging markets (although Japan and Switzerland are currently experiencing difficulties)—they are related. While emerging markets may increasingly look to financial regulatory measures to keep international capital "out" during periods of surging capital inflows, advanced economies have incentives to keep capital "in" and create a domestic captive audience to facilitate financing for the high existing levels of public debt.

Concerned about overheating, inflationary pressures, and competitiveness issues, emerging market economies may, in some cases, welcome changes in the regulatory landscape that keep financial flows bottled up in advanced economies rather than let them spill across borders. This creates the possibility that advanced and emerging market economies may at some point meet on the common ground of increased regulation and/or restrictions on international financial flows and, more broadly, on returning to a more tightly regulated domestic financial environment.

This much is positive analysis. We turn now to the normative question of how central banks might handle these difficult burdens placed on them.

A first point is that central banks are more likely to safeguard their independence and credibility by acknowledging the tensions between inflation targeting and competing objectives than by denying such linkages and proceeding with business as usual. Central bank independence ultimately rests on political consensus—on the convergence of views among leading political interests that society's broader economic goals are best served by this independence. A central bank perceived as insensitive to problems of debt sustainability and exchange rate overvaluation is likely to be dragged into bruising political battles and will not be able to maintain its independence for long. This does not mean that central banks must become debt-managers' and development ministers' poodles, but neither can they aspire to the purity of driven snow.

Exceptional circumstances might require exceptional responses. In those circumstances, it is crucial that the central bank clearly communicate what it is doing and why, and how its actions are consistent with its broader policy framework. When taking unconventional steps to support the market in sovereign bonds, central banks need to make clear the rationale for their action. If the justification is disorderly conditions in the market due to temporary liquidity problems or panic, its purchases are likely to be temporary and should be explained as such. If the action is designed to help give the government extended breathing space so it can put in place a package of adjustment measures to revive the economy and grow out from under the debt burden, purchases may have to continue for a lengthier period, and again this should be explained.

An example of what not to do can be seen in the case of the European Central Bank, which resumed purchasing peripheral euro-area bonds without adequately explaining why it was following this course of action. Not surprisingly, its initial action did not restore confidence.

On the exchange rate overvaluation front, central banks will have to devise a communication strategy that acknowledges the importance of the level and volatility of the exchange rate, without