CHAPTER 5

Rethinking Central Banking

There is an emerging consensus that the framework underpinning modern central banking must be rethought. A monetary policy framework focusing on price stability and output growth will also affect financial stability through its impact on asset valuations, commodity prices, credit, leverage, capital flows, and exchange rates. One country's monetary policy can spill over to other countries, especially when central banks follow inconsistent frameworks, with cross-border capital flows serving as the transmission channel. All this suggests that the conventional framework for central banking is inadequate. It is too narrow to meet domestic and global needs.

There may be broad consensus on this point, but there is still little agreement about the particulars of the new framework. It is those particulars that we seek to elaborate in this chapter.

Monetary Policy and Financial Stability

1. Financial stability should be an explicit mandate of central banks. Other micro- and macroprudential policies should be deployed first, wherever possible, in the pursuit of financial stability, but monetary policy should be regarded as a legitimate part of the macroprudential supervisors' toolkit.

2. When rapid credit growth or other indicators of financial excess accompany asset price increases, the authorities should employ stress tests to measure the effects of changes in credit conditions on asset prices, economic activity, and financial stability. Instead of seeking to identify bubbles, the authorities should simply ask whether current financing conditions are raising the likelihood of sharp reversals in asset prices that are disruptive to economic activity.

3. Where the answer to the aforementioned question is yes, central bankers should then lean against the wind using a combination of the tools at their disposal, turning first to nonmonetary micro- and macroprudential tools, but also to monetary policy tools when necessary. If this results in periods when, in the interests of financial stability, the central bank sets policies that could result in deviations from its inflation target, then so be it.

4. Responsibility for the maintenance of financial stability can be assigned either to the central bank or to a self-standing financial supervisory authority. But in both setups, close coordination between