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Central Banking in a Complex Environment

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Central Banking in a complex Environment

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I Introduction

The environment in which central banking is carried on in a modern, developed economy is complex. Not only are there involved financial and technical relations among the financial units of the economy but also the policy objectives which a central bank serves have many not necessarily compatible directions. In addition the way in which households and business firms react could changes in the values of financial variables releveant to central bank operations. The complexity of the environment within whcih central bank decisions ~~and operations~~ are made and operations executed can be examined under four headings:

1 The goals objectives and areas of responsibilities of central banks

2. The structures and practices of financial markets

3. The instruments of central bank policy

4The division of labor, arrangements for cooperation among the various units which determine and execute economic and financial policy.

As the financail and economic structure and institutions evolve there is another dimension to the complexity of the environment within which a central bank as well as the other government policy organizations function. The assignments and operations of the policy agencies must always be responsive to changes in the environment. We will attempt to make each of the dimensions to the complexity of policy operations more precise. We will also attempt to determine whether the very complexity of the environment indicate which of the alternatives, aims, functions, and operations of the central bank it is best to emphasize, that is, ~~as~~ does the complexity of the environment yield ~~it has~~ some guide lines as to how central banking should be used.

There is still another element which adds to the complexity of the problem of policy operations through the financial system. The standards by which the performance of an economy as well as the performance of the financial markets are judged change as time passes and as knowledge od the system increases. Our current sensitivity to deviations from full employment, price level changes, and balance of payment difficulties combine with various attempts to control the terms and directions of the flow of financail resources add up to a much more strict standard by which ~~Americans~~ performance is judged as well as an increase in the domain which the central banks and other policy agencies are expected to affect. It must be recognized that a set of policy institutions, objectives, and operations which may be sufficient to achieve an acceptablle economic and financial performance within a given set of institutions and when judged by one set of standards may be insufficient after institutions and standards change. The evolution of either institutions or the strictness of standards may make particular policy prescription obsolete and a particular set of rules of behavior for the central bank out of date. The analysis of central banking must take both types of posibble evoltutionary developments into account. Hence the analysis of central banking must always consider how ~~the preferred operations or~~ the prescribed operations of a central bank are related to ~~a~~ particular attribute ~~atrophies~~ of the economy and the policy prescriptions are conditioned by ~~upon~~ a particualr weighting ~~waiting~~ of goals and ~~the~~ interpretations of the significance of particular attributes of the economy.

The institutional framework within which the appropriate behavior responsibilities of the central bank will be discussed is that of the U.S. The central bank under discussion will be the Federal Reserve System. Our objectives are to describe the complex environment within which the Federal Reserve System must operate, isolate those aspects of the economic and financial world for which the federal reserve system has special authority and responsibility, and determine the extent to which these special factors limit the ability of the federal reserve system to attain other objectives. The end result of the investigation will be the derivation of an appropriate division of labor and responsibility among the federl reserve system, the fiscal authorities, and the policy makers who affect structural variables.

In what follows the view is developed of the central banks functions can be considered under three headings:

1 The lender of last resort

2. The operator of monetary policy

3. The determinant of financial practices

A central bank is the organization which has the primary responsibility to preventing unstable monetary and financial conditions and developing. It is the only organization in an economy which has the weapons which can be used to prevent financial crises from developing and to offset any destabilizing events that occur in the financial markets: ie a central bank must be a lender of last resort. However the lender of last resort functions of the central bank must not be restricted to any narrowly defined set of monetary or banking institutions but rather the central bank has to be a lender of last resort to the financial markets as they exist. We must not confuse the lender of last resort functions of the central bank and those operations which a central bank must undertake in order to equalize destabilizing factors which arise from the technical characterisitics of the banking system. A lender of last resort function is an economic rather than a technical banking function of the central bank.

A central bank can affect the quantity of money and in a fractional reserve banking system this means it can affect the amount of financing which is available. Hence the bank can affect the monetary environment in which the economic decisions of the private sectors and the other public policy agencies are made. The central bank is responsible for maintaining a monetary environment which is appropriate to the achievement of economic objectives given the operations of the economic policy agencies. The maintenance of an appropriate monetary environment has required that the central banks operations should largely be based on short run economic stability objectives. It will be argued that as financial markets and the fiscal system ~~by~~ are now operating, this short run stabilizing objective is not of primary significance. It is best for the central banks market operations longer run considerations.

The third function of the central bank is really an outgrowth of its lender of last resort responsibilities. The central bank has the power to protect or to penalize particular financial practices and institutions. These powers enable a central bank to affect the terms on which particular activities are financed, that is to affect relative prices. Such qualitative powers which are an outgrowth of its responsibility for financial stability can be used to affect the overall behavior of the economy as well as the allocation of resources. It is interesting to note that many of the special agencies set up by governments to generate financial practices for particular objectives of the government such as housing ~~or~~ farm credit as well business carry on Central Banking functions. ~~and~~ A properly organized and administrative central bank would by its guaranteeing and endorsing have made ~~some~~ of these special agencies quite unnecessary.

The lender of last resort functions of the central bank must be so organized that they can respond to changes in financial markets. In particular this function has preventative as well as rescue aspects. The maintenance of an appropriate monetary environment cannot be defined independently of the structural and financial attributes of an economy and of the ruling priorities among economic objectives. In addition ~~to~~ central banks actions which protect and prevent financial practices also affect the conditions for a stable monetary environment. The third function-- to affect financial market practices and ~~??????~~ usages depends, upon ~~which~~ the finance ~~s~~ that are available to different sectors, this has often been vested in special purpose authorities which usually are guided by precise legislative rules. It would be better if such functions were centralized and if the legislative prescriptions took the form of specifying guide lines and objectives rather than are specifying ~~which changes the economy, while~~ the precise terms upon which financing is to be made available to certain sectors. On all three accounts the lender of last resort , the maintenance of appropriate monetary conditions, and the regulator of financial practices the central bank should be granted discretionary powers rather than be ordered to conform to a rulewhether the rule be legislative or due to the decision of the central banks administrators. Is that the present treatment of depreciation allowances distorts the investments chosen and put in place by the private sector. It is a serious distortion of the pay-offs of investments in favor of those investments with a relatively short life or those investments with relatively favorable depreciation allowances