

The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

Memo to the Commission on Central Bank Policies

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1. There is now a broad consensus that excessive liquidity supported by major Central Banks around the world contributed to the global financial crisis.
2. The policy error was a result of a systematic flaw in currently fashionable Central Bank doctrines, which encourages a focus on inflation in the prices of goods and services and pays little attention to asset price bubbles and other factors that might contribute to financial market fragility, with severe consequences for the rest of the economy.
3. Ironically, there is little empirical evidence to support adverse real effects from low to moderate inflation; but there is strong evidence—reinforced by the current episode—of adverse real effects from failures in financial markets.
4. There is considerable theory and evidence behind the notion that monetary policy operates at least partially through credit channels, and that accordingly regulations that affect the ability and willingness of financial institutions to lend can have first order macro-economic effects.
5. All policies are made in the context of uncertainty, and while it is true that one cannot be *sure* that one is facing a bubble, there was mounting evidence of the *likelihood* of such a bubble. It was correctly pointed out that the bursting of a bubble could have severe economic consequences.
6. In responding to uncertainties, Central Banks need to be mindful of asymmetries and irreversibilities: it may be easier to dampen an economy that is overheated, than to reignite an economy that has been forced into a recession; and a firm that is bankrupted as a result of too high interest rates will not be unbankrupted when interest rates are lowered.
7. Part of the current problem was that excess burden on maintaining the economy at full employment was put on monetary policy. Had the United States, for instance, passed a tax cut that was designed to stimulate the economy more, there would have been less need for loose monetary policy. One cannot view monetary and fiscal policy in isolation.
8. Monetary policymakers should also be more mindful of the channels through which monetary policy operates, and in particular, whether its stimulative effects are a result of an expansion of consumption (which may not be sustainable) or investment. Policy makers in the United States should have been sensitive to the fact that the effects of monetary policy were being felt mainly through increased household indebtedness and a housing bubble, rather than through increases in real productive investment. Previous episodes of instability have been related to housing bubbles and consumption booms.

9. The conduct of monetary policy is an important responsibility of government, and should therefore be subjected to normal standards of public governance, including transparency and accountability.
10. Monetary policy can have large distributive consequences; especially in times of crisis, there can be significant consequences for the distribution of risk bearing. Even when it is viewed that there should be some degree of independence, Central Bank boards should be *representative* and have some form of political accountability. There is often a risk of capture, e.g. by those from the financial sector.
11. Poorly designed bank regulations can be pro-cyclical, exacerbating downturns, and act as automatic destabilizers. It is important, for instance, to make sure that capital adequacy requirements (or provisioning requirements) are cyclically adjusted.