Conference Paper 3 - May 2024

# Monetary system stability as a precondition for local and international order

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This is an updated version of the IIMR's Public Lecture delivered in London on 16 October 2023.

# Monetary system stability as a precondition for local and international order

*Paul Tucker*

## INTRODUCTION

Novels can tell us a lot about the world, and about a time. At the beginning of the Nobel Prize winner José Saramago's *The Year of the Death of Ricardo Reis* – the avatar of Pessoa, the poet not the LSE economist for whom Portugal can also hope great things – the eponymous hero is disembarking in Lisbon after a long journey. Away for 16 years, he lacks local currency but that doesn't matter at all for the porter who helps with the luggage. Not only a particular world but also a greater truth is captured in how this is described: "I have only English money, Oh, that's fine, and he saw ten shillings placed into his right hand, *coins that shone more brightly than the sun itself*" (my emphasis).

It is the 1930s. Reis has returned home on, inevitably, an English liner, and sterling is still – just about – the international reserve currency. For a poor man to hold some sterling: that's a thing, a piece of fortune. But, in those interwar years, clouds of discord loom, with warships anchored unusually in Lisbon's harbour. Gold, as the novel's next chapter quietly notes in passing, would have been even better.

A novel set at any time over the past half-century would have similar travellers carrying not sterling but US dollars, which became the unrivalled world reserve currency after World War II and, as such, both symbol of and buttress for Washington DC's global leadership. Money, infrastructural networks and geopolitics have been linked since time immemorial, but especially so in the commercial society that emerged from the eighteenth century, and in which we still live. So, it matters greatly that, for the first time in a long time, there is a competition for supremacy, including in monetary affairs. It is, of course, between Beijing and Washington (and its European and East Asian allies).

This lecture attempts to sketch the interlinkages between the worlds of hard power, geo-economics, and the monetary system. Monetary stability will emerge as one facet of the broader stability on which any kind of domestic and international order depends. My remarks will start at a very high level, descending gradually to some granular observations on the challenges that have recently afflicted domestic monetary policy. If there is a message, it is that the mental and policy silos that were a natural product of the Pax Americana will serve us poorly in the new era. Overcoming this is, for the moment, at best work in progress. Doing so somehow needs to be combined with maintaining central bank independence, which has already been under strain.

### GEOPOLITICS AND BASIC ORDER

In my book *Global Discord* (Tucker, 2022), I argue that the contest between the People's Republic and the West will persist for many decades. It will be – and is already – in everything as well as everywhere. Neither side is currently or foreseeably capable of knocking out the other, and their rivalry is deeply ideological. That combination of characteristics is so unusual that I find few of the analogies typically drawn by commentators useful. The current contest is not like the old Cold War because, while everywhere, evenly matched and ideological, that was manifestly not in everything. Soon after World War II, Stalin walked his Soviet bloc out of the highways of international commerce, leaving the field open to the US. Washington and the key European states were able to craft the new system of international regimes and organisations – the General Agreement on Tariffs and Trade and later the World Trade Organization (WTO), the International Monetary Fund (IMF), the World Bank, and much more – in their own image, which meant according to their – our – deep values.

But nor is the current contest like the struggle between Britain and the Second German Reich at the turn of the twentieth century because, while certainly about power, that was not especially ideological. Today's most certainly is. Anyone who doubts that should take a look at Document Number Nine, which was leaked or released from the Party's Central Committee in 2013, not long after Leader Xi took power.[1] It proclaims the seven No's, which carefully instruct Chinese people not to flirt with anything like Western-style democracy. Two ban questioning the essence of China's post-1949 system. More significantly, the other five draw a line through some of the central tenets of our liberal system of government: free elections and a separation of powers, a free press, civil rights such as free speech, free markets, and basic human rights proclaimed as universal values.

More instructive for us, I suggest, than either the Cold War or Britain's struggle with the Second Reich is the long eighteenth-century contest – from roughly 1689 to 1815 – between London and Paris. That too was everywhere, in everything, deeply ideological – with Britain resisting successive variants of French universalism – and evenly matched. If it is any guide, the current contest could last more than a century, with hostility and conflict interspersed with periods of relative calm and rapprochement.

That picture is apposite right now. If and when China's economy stumbles, as well it might given its internal debt imbalances, no doubt City and Wall Street commentators will say something along the lines of: well that's that, China's challenge is going the same way as Japan's back in the 1980s, back to normal. But that would be a profound misjudgment. China in the early decades of the twenty-first century is nothing like Japan towards the end of the twentieth. Japan was a commercial rival but an ally in everything that matters most. It sheltered, as we in Europe do today, under the US security umbrella. It had become a democracy without losing its sense of its own history and Confucian heritage. By contrast, China provides its own security, and tends to see its history in opposition to that of the West. Moreover, its economy is so vast that it could probably continue to increase its hard power – the proportion of its national income devoted to the military – even if its economy moves sideways for an extended period.

When, almost a decade ago (Tucker, 2016), I started working on what became *Global Discord*, I saw four plausible scenarios, which the book labels Lingering Status Quo, Superpower Struggle, New Cold War, and New World Order. Only the first and last could be stable resting places, but a new world order is unrealistic until other nascent powers – India, and perhaps Indonesia – are in a position to demand seats at a new top table. Back then, we remained in a Lingering Status Quo but were drifting towards the superpower struggle I have described. Less than a decade later, for the most part we subsist between Superpower Struggle and a New Cold War in which blocs retreat from commerce in the interests of security. This will, I repeat, see peaceful phases – indeed, we might be in one at present given various de-escalation measures – but tense moments lie ahead, most obviously in the South China Sea, but also beyond the region Beijing claims as its own. We already have at least one proxy war, since Putin could hardly sustain his war of aggression against Ukraine without Beijing's tacit support and material help, but direct conflict cannot be ruled out. This is quite a prospect, presenting enormous challenges for economic policymakers as well as, more obviously, for their peers on the security side.

### A case study of careless hubris: The trade regime

Our predicament is underlined by an episode from the high tide of Washingtonian hegemony. It concerns the state-owned enterprises subsidies case that went through the WTO's trade dispute system around a decade ago. It is an amazing story.

The People's Republic of China was using its state-owned enterprises (SOEs) to subsidise other businesses' exports, and after a while Washington stated that Beijing could not do that because subsidies are against international law. They were, DC said, a violation of the WTO treaty obligations, so either Beijing had to stop or the US would be entitled to put in place what are known in the jargon as countervailing measures, which just means they could impose import tariffs that offset China's subsidies. Beijing responded to the effect that Washington was correct that they were subsidies but, crucially, they were not illegal subsidies under the treaty. Hence there was a dispute, which went through the WTO's formal Dispute System, eventually reaching the Appellate Board, which is the trade regime's apex and so rather like, say, the Supreme Court in the US, or the German Constitutional Court.

Well, the Appellate Board concluded in favour of China. And it did so on the intriguing ground, which although not the most important part of the story is nevertheless rather amazing, that SOEs are not 'public bodies' within the meaning of the treaty. Given that in China's Party state, the Party is in charge, this is an unconscionable decision. One where, rather as occasionally happens with the US Supreme Court, the Appellate Board was simply out of its depth.[2]

But the inadequacies of the trade-court justices are hardly the big issue here. The US response was effectively to withdraw support from the Dispute System, which led to its withholding approval for new justices – a policy that began, I want to underline, under President Obama not President Trump.

Since time immemorial, such awkward circumstances have been handled via diplomacy and bargaining. In other words, despite Beijing having on this occasion won the case, great powers would typically want to search for a tolerable modus vivendi. That would entail negotiation and bargaining between Washington and Beijing; and once they had made some meaningful progress, with China giving up some of its forward-looking gains and the US reducing its losses, they would bring in the other great trade powers, perhaps the EU and Japan. In that slightly wider group they would come up with language that could become part of international law. Problem solved? Well, no, because that kind of old-fashioned commercial diplomacy has no chance in the WTO regime since the treaty contains a provision that gives every member – and remember the WTO has lots and lots of members – a veto over proposed amendments. In other words, for practical purposes the treaty is unamendable.

Two things follow from that story. The first, which is remarkable enough, is that the officials drafting and negotiating the WTO treaty must effectively have thought they were producing the perfect treaty, because they inserted clauses making it next to certain that they could never be changed. Rather, it was set to be interpreted, and so developed, by the Appellate Board. Whoever thought those interpretations could never be contentious – contentious to the point of poisoning international relations – had not thought carefully. This concerns competence, but turns out to be the smaller of the two points.

The second and more profound point, possibly explaining the first, is that there was, in effect, an implicit assumption that the Appellate Board would be operating in a benign world where no future Power would kick against the liberal values supposedly inscribed into the trade system – inscribed there in the minds of its Western architects and stewards. This, I suggest, reveals that there really was an end-of-history moment in Washington and other Western capitals, meaning that the WTO treaty negotiators did not try to cater for the possibility that future rising powers might hold to quite different visions of international commerce.

Although other stories point in the same direction, including the ill-judged IMF imperium in East Asia after the late-1990s financial crises there, this is the best example that the liberal capitals lost sight of prudent statecraft after the end of the Cold War. Today, it leaves some international organisations veering towards being moribund.

## The Three Musts

Against that rather bleak background, I want to suggest some high-level principles to guide the governments, legislators and technocrats of advanced-economy liberal democracies. Where the very basics of our political way of life might be at stake, we can say policy should, where relevant, aim to minimise the maximum plausible costs from the geopolitical contest. What that means in practice can, I suggest, be grouped under three headings, which in a rhetorical style familiar from Beijing we might call The Three Musts. They are to avoid dangerous overdependence; to make and keep friends and allies around the world; and to avoid costly self-inflicted mistakes.

### *Avoid dangerous overdependence in a scary world*

Avoiding dangerous overdependence is the business of derisking, which I was helping to advocate before, with ‘friendshoring’, it became a slogan. It can, of course, overshoot, and so risks propelling us into a protectionist spiral that ends with a cold war-like scenario of disconnected economic blocs. Prudence cuts both ways. But when economists understandably fret about the welfare costs of friendshoring, we would do well to hold onto the fact that it could help the liberal parts of the world navigate – even survive – superpower conflict.

I suspect few multinational corporations have got their heads around this. A few months ago the *Financial Times* reported the big boss of a giant European manufacturing multinational saying that withdrawing from China is unthinkable. But if withdrawing from China is truly unthinkable, that implies that withdrawing from the United States and Europe is thinkable, or alternatively that the firm had not thought about the choices it might face or find imposed upon it. That is sobering.

*Making and keeping friends around the whole world*

The second of the Three Musts is to make friends and keep them; and, where judged appropriate, cement and develop formal alliances. In its spell as hegemon, Washington has varied in how well it does this, and even in how hard it tried (which might amount to much the same thing). At times, US administrations have seemed to lose interest in some parts of the world, including Central Asia, parts of the Middle East, their own backyard in Latin America, and even their partners in Europe. But the awkward truth is that a hegemon must retain a close interest in every part of the world – if only for the realpolitik reason that it cannot discount the possibility of a rising power challenging its supremacy. Recall, here, the significance of Document 9.

*Avoiding self-inflicted mistakes*

And then comes the third of the Three Musts, which is that to hold on to our way of life the rich liberal democracies cannot afford to make unforced mistakes at home or abroad. A lot could be said about this but I want to focus on one elemental thing. A necessary precondition for any political society being capable of flourishing is that there is some kind of basic order at home, and externally. Among many other obvious but vital things, not least effective but legitimate policing under the rule of law, this requires stability in the monetary system.

The twentieth century was littered with examples of political instability following monetary instability – most dramatically and tragically in the interwar years. Both massive banking crises and runaway inflation fracture confidence in the state. Since the global financial crisis of 2007–09, many rich democracies have experienced dangerous toxicity in domestic politics, and yet the pain inflicted would not have been very hard to avoid if policymakers had only remembered what bankers never will: that banks are inherently fragile. Central banks are meant to institutionalise the memories of what can go wrong.

**A bureaucratic implication of the Three Musts: The end of policy silos**

To take the Three Musts seriously, we must heed a broader point. Since the ebb and flow of the geopolitical contest will be everywhere and in everything, and since the basic order of the world can no longer be taken for granted, it will render redundant the policy silos that recent generations comfortably inhabited. To give just one example, for many decades it was perfectly possible to be a monetary policymaker without knowing much at all about trade policy (as opposed to trade economics). No longer. In fact, I suggest that from today effective economic policymakers in any of the major capitals will need to be alert to when and where the interests of the security people – the war and peace people – are affected or relevant.

The point can be illustrated with an example from the global financial crisis. During one of its worst phases, somebody walked into my then room and said that the Federal Reserve had refused India a swap line. It does not matter what a swap line is in any detail; it is just a line of credit from one central bank to another, collateralised by the currency of the borrower. India wanted one of these lines in order to help it navigate the global collapse that US (and European) improvidence had unleashed on the wider world. So, this person comes in and says the Federal Reserve have refused India a swap line, and I respond with something like, "Don't they realise India is going to be a power!"

My point was that the matter was above the pay grade of unelected central bankers. That did not mean that the Fed should have decided to lend, or that the president should have ordered them to do so. It means, rather, that the highest levels of the executive needed to be made aware of the sensitivities in case they wished to help Delhi in other ways in the interests of cordial relations. As it turned out, China's border skirmish with India during 2020 was a much bigger problem for Delhi, leading to the revival of the Quad (India together with the US, Australia and Japan).

## MONETARY REGIMES AND BASIC ORDER

In that story of monetary diplomacy, we begin to see the connections between being the security hegemon and being the issuer of the dominant international reserve currency. They flow in both directions. Just as sterling's role in world finance underpinned the Pax Britannica (and vice versa), so the dollar and the Pax Americana. An extraordinary proportion of world trade is invoiced in dollars (even when neither importer nor exporter is US-based). And foreign sovereigns and companies from all over the world borrow in dollar capital markets, as they once did in pounds.

For an audience of people who work in finance or economics, it is obvious that the state that issues the world's premier world reserve currency is able to borrow more cheaply in international markets because those markets will be more liquid. This goes not only for government borrowers but also multinational companies and international banks. The latter have a special advantage because when it most matters, the reserve currency-issuing central bank is the ultimate lender of last resort to the international economy. (Talk of the IMF having that role is wide of the mark, analytically and politically.)

Other things being equal, those effects – especially for the cost of government borrowing – make it easier than otherwise to have a large (and even rising) share of GDP go into hard-power stuff. But the connection runs the other way too. Historians have documented in fascinating ways the extent to which the use of a reserve currency is often tied to security relations. Rising powers press the merits of their currency, and incumbents try to underpin use of theirs.

A striking example comes from not long after the Bretton Woods regime unravelled in the early 1970s, when pretty much all of the major currencies floated against the dollar. People tend to think of this as the end of a global system of fixed exchange rates, as of course it was. But it was much more. The dollar itself floated against gold, ending roughly two and a half centuries of a monetary order based on a commodity standard; the only arrangement known since commercial society emerged in the seventeenth and eighteenth centuries. The era of fiat money had arrived, and no one – including the central bankers – knew what would happen. Washington was really worried that this uncertainty could threaten the dollar's status as an international currency. Cutting through the details and nuances, a US government team travelled to Saudi Arabia to offer enhanced security assistance if they promised to carry on invoicing oil exports in dollars. So, when today you read about maybe Saudi exports or Iranian exports to China being denominated in Renminbi, this is not merely of interest to energy-market aficionados but, rather, is a geo-economic move in a geopolitical game with the very highest imaginable stakes.

The ways that reserve currency supremacy both supports and is supported by military dominance brings us to a prosaic constraint on domestic policy. No state's currency is likely to survive as a widely used international reserve currency unless it maintains domestic price stability, and so avoids secular nominal depreciation in its exchange rate. In other words, the scope of our third Must entails avoiding big mistakes in domestic monetary policy. For listeners and later readers whose main interest is monetary affairs, the burden of this lecture is, therefore, that the stakes in monetary affairs are higher than they have been for half a century, and probably since World War II.

## Sticking to the knitting: Monetary-system stability

For central banks, the practical import of that is that they should concentrate on their core mission: price stability and financial-system stability. It has been abundantly clear in recent years that high inflation is deeply unpopular with almost everyone, and it should have been equally clear that the West cannot afford another banking crisis. And yet only a few years ago the top central bankers seemed variously to be prioritising inclusive growth, climate change, or broader aspects of social justice. It matters, therefore, whether policy mistakes have been made in their core mission over those years. Arguably, they have.

We start with mistakes in maintaining price stability. Some people, including me as it happens, suggested that the government bond purchases in spring 2020 should have been conducted as market maker of last operations rather than quantitative easing (QE), meaning that they would have been unwound when markets stabilised, and the money injection sterilised in the meantime. Separately, many figures argued that the giant US fiscal stimulus in 2021 warranted higher monetary policy rates and the suspension of QE purchases in order to avoid excess demand creating underlying inflationary pressures in circumstances where cost shocks had already driven up headline inflation rates. Similarly, in the UK some voices suggested that policy needed to be tightened after so many people – especially early retirees who could sustain their spending habits – dropped out of the workforce, reducing the economy's productive capacity.

Each of those shocks – a monetary shock, an aggregate demand shock, and a supply shock – had a bearing on how much of the energy-price cost shock could prudently be accommodated by monetary policymakers consistent with expectations of future of inflation remaining in line with the target, which is to say consistent with the anchor holding. Arguably, then, risks were taken with inflation, and those risks crystallised. Even if they were not bound to do so, surely during that period the risks to the inflation outlook were asymmetrically on the upside; circumstances that inflation fan charts of the kind employed by the Bank of England were well designed to capture because they force policymakers to think about the balance of risks given the whole range of feasible scenarios.

Given the international significance of the dollar, the most notable of those episodes was the Federal Reserve's failure to alter course after the Biden fiscal stimulus. Sometimes old orthodoxies have something to be said for them. In this case, the political economy orthodoxy was that the institution of independent central banking enables separation between distributional choices and macroeconomic stabilisation. Elected politicians in a representative assembly choose how to redistribute resources, and unelected central bankers, using powers delegated to them by the elected legislature, merely decide how to ensure that the pace of growth is sustainable and consistent with price stability.

That rather straightforward set-up has a bearing on the quite spiky debates, here in the UK, on whether firms have been guilty of price gouging, or militant workers guilty of inflationary wage demands, or both, or neither. There is one simple way of thinking about this, which starts from what should be expected in conditions of excess demand when monetary policy is not directed to bringing the path of nominal demand and aggregate supply back into line. Broadly, under those conditions, one would expect firms to increase their prices, and workers to want to catch up as their real wages are eroded. With a single labour market, the public sector faces those wage demands but is likely to resist because it cannot pass higher costs into higher prices, so public sector unions are likely to contemplate strike action, and the state is likely to contemplate cuts in the quantity of services provided and in its workforce. As summarised, there is no price gouging or militancy here. Of course, in a richer story there could be elements of both, but the big point is that on the surface things will look like militancy or gouging when, in fact, the driver is unchecked excess nominal demand.

To the extent that that simple story has merit, we can also say that the implied policy mistakes do not, contrary to not a little commentary, lie in flawed models (whether New Keynesian or other varieties). The blame placed on models is not wild but risks being a distraction. For what it is worth, in my time in the policy world the top people did not believe in the models in any absolute kind of way, which after all would amount to believing that we have reached the frontier of economic science, with nothing more to be learned. As soon as one puts it like that, the absurdity of completely trusting the models becomes obvious. There is always an element of judgment, bearing on what the models do not cover, and on estimates of key variables such as the natural rates of interest or employment, and indeed whether those concepts hold up. As economic science pushes out the frontier, the realm of monetary judgment shifts too, but it is not remotely eliminated. And that is true even before contemplating the realistic possibility that useful knowledge is lost or willingly discarded.

So, those with responsibility for making decisions affecting millions of people surely know – or should know – that their tools and their staff are flawed, leaving them having to *think* about what is going on in the economy; a remarkably interesting but hard job, and one that central banks have typically tried to convey in their inflation reports and speeches.

**Reckless regime reforms**

Given the stakes, it is uncomfortably relevant that some central bank monetary regimes were tweaked in recent years. In the US case, the changes seem quite peculiar with the benefit of hindsight, and some would say without any hindsight. This was highlighted during 2023 in a paper and presentations by Don Kohn, a former vice chair of the Federal Reserve and, earlier, a long-serving Director of Monetary Affairs (Eggertsson & Kohn, 2023). I draw from that here.

As you know, Congress gives the Fed a dual mandate covering, crudely, price stability and full employment. In 2019, the Fed changed the way this is presented in their own documents, listing employment first. Given the amount of agonising that goes into such things, that was something.

More interesting, perhaps, is that in its 2020 elaboration of the framework, the Fed said that the maximum level of employment is a broad-based and inclusive goal, which is not directly measurable and, actually, not directly controllable. Indeed, as Don points out, the Federal Reserve does not have any instruments that can address hopes for inclusive growth, hugely important though inclusive growth is in terms of the wider public policy goals an elected government might pursue with its hugely richer set of instruments. So, what the Fed was up to in making these statements is somewhat mysterious. Unless, that is, they were planning to keep the foot on the accelerator in the hope that a period of strong nominal demand growth would draw people back into the work force and drive up real wages without igniting inflationary pressures; a policy that might have brought back memories of the 1960s and 1970s.

Consistent with that – although few seemed to notice at the time – the Fed said, in terms, that when they looked at measures of the employment objective, they would be looking at shortfalls against full employment but not the other way around. This asymmetry was a quite a big thing, and ordinarily would have warranted an inflation risk premium (and its attendant real costs) being priced into nominal bond yields. That that did not happen might owe something to QE, which of course switches off the most precious market device for disciplining monetary policy.

Turning to the United Kingdom, to the extent that there are parallels, the regime shifts came about very differently, driven more by executive-branch remodelling. As you know, the Bank of England's monetary policy mission comes from a parliamentary statute. It is to maintain price stability and, subject to that, to support the government's economic policy, including its objectives for growth and employment. In other words, in a lexicographic set-up, the law provides that the Bank should not cut across government policy except where necessary to maintain the nominal anchor.

The same statute tells the Treasury to flesh out the objective by setting the monetary policy committee an annual Remit defining price stability, and so on. The first Remit came from Gordon Brown (with Ed Balls at his side) back in 1997. It set an inflation target of 2 per cent, and stated that the committee should seek to avoid excessive volatility in the face of cost shocks. Thereafter, the Remit barely changed for many years, including during the early years of the Tory–Liberal coalition government. Sometime during the global financial crisis, provision was made for QE, but in ways that did not add to the agreement between the Bank and Treasury, published when QE began in early 2009, that the Bank would seek Treasury approval for each round: a permission that could hardly be withheld without some more dramatic measures.

Then in 2013 the core of the Remit was recast. A paragraph was added encouraging the Bank to adopt forward guidance, which rather irritated one of my colleagues at the time because one would think that forward guidance was clearly within a central bank's discretion. Where exhortation shades into policy steer is murky territory.

But the really big thing was that, on the secondary objective, the text of the Remit shifted from a rather bland statement of government economic policy to a rather more flavourful bullet point statement. The first of those bullets stated that the government's economic strategy included "monetary activism and credit easing, stimulating demand, maintaining price stability and supporting the flow of credit in the economy" (HM Treasury, 2013). So, monetary activism now came before maintaining price stability. The new remit was effectively telling the Bank of England to embrace a new mindset.

Subject to the statutory priority given to price stability in the Bank's lexicographic objective – a not insignificant constraint that might have been tested in the courts had this been the US – a democratically elected government was obviously within its rights to set its own economic priorities. Looking back, however, it is striking that there was next to no public debate about this rather profound innovation – in the media or elsewhere. There was nothing along the lines of, 'Hold on, Bank of England independence was about getting away from a politically inflected monetary policy of the kind the country experienced during the early-1970s' Barber Boom and Competition and Credit Control.'[3]

Instead, the 2010 government's will for monetary activism went along with what the political pundits came to call fiscal austerity. The Remit amendments underpinned the equilibrium of a Stackelberg (sequential move) game in which, if the fiscal authority did not stimulate the economy to help it recover from the effects of the global financial crisis and the euro area crisis, the monetary authority simply had to do more, and more, and more.

A question for economic historians, then, is whether that activism, via forward guidance and QE, went on for too long pretty much everwhere in the rich West, leaving it badly exposed in the event of adverse cost shocks. The Fed's move to asymmetry basically embraced that prospect, and was exposed when the gods punished their complacency, endangering public support for democratic governance. In the UK, by contrast, it is the silence among investors and commentators that is striking.

## Back to price stability

It will not be surprising, therefore, that I want to suggest it would be useful to get back to basics. In the US that would involve re-embracing a framework that is symmetric between wanting to avoid overheating and underheating, and which is absolutely dedicated to ensuring the nominal anchor is secure. In continental Europe, given all the speculation, it would mean the European Central Bank (ECB) making clear that its first priority is price stability not climate change, an absolutely vital task where the ECB cannot decently (and arguably cannot lawfully) exercise discretion in how to support EU policies (Tucker, 2023a).

Here in Britain, 2013's 'monetary activism' was removed in 2017, which coincided with a change of finance minister, making one wonder whether the Bank or mandarins sought the change. But it would be still better to return to a more vanilla remit. A useful exercise for the authorities would be to look at the 2012 version and see whether they really need to add anything.[4]

More can be said. One thing that could be clarified everywhere is that, although both involve purchasing bonds, there is a fundamental distinction between QE and acting as a market maker of last resort. The former is aimed at stimulating aggregate demand, while the latter is aimed at stabilising temporarily illiquid and malfunctioning capital markets. In fact, bonds might be purchased for other purposes too. Each purpose needs its own governance and constraints, which would improve both the substance of policy and its communication (Cecchetti & Tucker, 2021).

Here in the UK, it would also be good if the Bank moved back to labelling its quarterly report the *Inflation Report*. That sounds cosmetic, but the *Monetary Policy Report* effectively invites policymakers to ask themselves how the Bank's instruments can be used to pursue public policy goals that, in a democracy, belong with the elected part of government. I would also like to see the Bank move away from publishing its policy decisions, the minutes, and forecasts all at the same time. Again, that sounds prosaic but I wonder whether the block release has shifted internal deliberations towards a leader-led model, and to inputs to policy (such as the forecast) being conflated with the communication of policy. The jumbo release of information might have seemed natural during the prolonged (in my view, overly long) period of strong Forward Guidance, but it is somewhat at odds with the norm of one person–one vote that animated the Monetary Policy Committee during its first two decades, and had been an important precondition for independence being politically palatable.

All that might be reinforced if, again pretty much everywhere, jurisdictions moved towards the kind of appointment process used in the UK for the senior judiciary. I say that because I have come to think that politicians have decoded the independence game. The trick to bringing monetary policy to heel is not simply to repeal it, or to appoint central bankers who obviously prioritise the wishes of the president, prime minister, and so on. It is, rather, to extend the mandate (in letter or interpretation), and to appoint people who seem to be the real thing. Anyway, all this has coincided with a bout of high inflation that many think could have been smaller and shorter.

## Banking stability and the insurer of last resort

Enough of monetary policy. I want to say something about banking, since the stability of the banking system is integral to the stability of the monetary system as a whole for the basic reason that most of the money we each use comprises the monetary liabilities of private banks.

During 2023, there were banking failures on both sides of the Atlantic. A bunch a large regional banks failed in the United States, and in Switzerland a globally systemic group, Credit Suisse, unravelled and was rescued with government help. In both cases, one can say in broad terms that the authorities had decent plans but did not apply them. In the United States, following lobbying the Fed and Federal Deposit Insurance Corporation (FDIC) exempted large regional banks from resolution planning, even though they had been warned that some of those banks had large runnable uninsured-deposit books, were unlikely to be resolvable (without state-sponsored subsidies) via transfer to another bank, and that any such episode risked contagion to other regionals (Systemic Risk Council, 2019). This was a straightforward instance of moral hazard within the authorities, and requires reforms that would incentivise unelected financial stability policymakers to stick to their policies.

That case is important but straightforward to understand. The demise of Credit Suisse is a much bigger deal, not only because of its size and complexity, but because in my view it raises new issues that are not reflected in the current international regime, and were barely thought about after 2009.

First, it seems possible that a basically solvent bank unravelled because its reputation became so tainted by a series of scandals that customers fled, taking their money with them. In its origins, this was more akin to the franchise-destroying run on the accountants Arthur Andersen after the Enron scandal than a standard bank run triggered by doubts about solvency. In the circumstances, thinking about resolution – notably, by bailing-in bonds – in terms of restoring solvency slightly misses the point. What was needed was something more akin to open-bank conservatorship.

Second, the Credit Suisse affair seems to reveal that some private banks might not routinely carry assets that are eligible at the discount window of pretty much any central bank (Tucker, 2023b). If so, the lender of last resort cannot help bridge to a solution, whether that be resolution or open-bank conservatorship. It is a desperate situation, which ought to alarm top policymakers in Washington, London, Paris and Frankfurt.

If anything like that stacks up, it reinforces the case Mervyn King and I have been making for some years for central banks to require all banks – including all banking-like entities within a banking group – to pre-position with them sufficient eligible collateral to cover 100 per cent of runnable liabilities and commitments (King, 2016, pp. 269–81; Tucker, 2019a). That would obviously be useful in a crisis. It would not prevent runs but it would ensure that fundamentally solvent banks were not forced into socially damaging asset fire sales.

More than that, though, the process of applying the policy would reveal, well before any crisis, when a bank did not have sufficient eligible collateral, which might be the case for banks with asset books comprising exotic loans which it would be hard for central bankers to sell, redeem or collect. Such loans might, for example, be secured against large yachts moored in remote places, and owned via entities in offshore centres, the point being that the central bank would have no idea of how to collect the underlying collateral if ever it needed to do so. So, in the spirit of mechanism-design economics, the process of seeing what collateral a bank could put up would reveal whether it could be helped by the lender of last resort. Where not, a bank could not be permitted to fund itself with runnable liabilities but, instead, would need to fund with long-term bonds and equity, or change its asset book. In other words, its business model would have to change.

That, by the way, is a description in just a few words of a fundamental reform of banking policy that would make banking much safer, and so more socially acceptable because less prone to rescue by taxpayers. It would not stop banks making money, although no doubt they would say that it did until they passed the costs on to their customers. As with the reforms described earlier to help get back to preserving price stability, this is important not just because it would promote economic efficiency and social cohesion – although goodness, we need both. It is important because monetary system stability is not something we should continue to gamble with when we, the world of free liberal democracies, likely face the greatest challenge to our way of life for a very, very long time.

## SUMMING UP: MONETARY STABILITY IN THE SERVICE OF LIBERAL DEMOCRACY IN STRESSED TIMES

It is true what those ancient Greeks said about hubris and nemesis. The end-of-history moment that gripped many Western capitals after the end of the Cold War makes the point. We find ourselves in circumstances where, to repeat my Three Musts, we must undo some of the unnecessary vulnerabilities we accumulated while imagining history had been designed for us, and only us. We must, second, not forget we need friends all around the world, which means accepting they have their own views of the good and the right, drawn from their own histories. And, perhaps above all, we must strive to avoid avoidable but very costly mistakes.

The third prescription requires elected legislators to grasp that the new geopolitics bear on domestic policy as well as foreign policy. I have provided illustrations of that from my old stomping ground. Monetary-system stability is not only a precondition for the good life, as former Bank of England governor Eddie George used to say. It is also a precondition for our political system to survive the challenges coming our way. The global financial crisis, the rise in underlying inflation, and 2023's banking collapses could have been avoided. Monetary officials and their overseers need to return to the basics. It might strip them of celebrity, it might be boring, but it will deliver for them an honourable place in the history of the free world.

In the past, I have argued that since monetary policy can be used as an instrument of taxation, it should never be in the hands of the elected executive. Given our deep constitutional values, including notably the separation of powers, the monetary levers should be delegated to arms-length officials who are carefully constrained by their principals in the legislature (Tucker, 2019b, ch. 10). I have tried to argue that today's fractious geopolitics remind us of something equally vital: that monetary system stability is a matter of national security. Saramago conveyed that in just a few lines. Thank you.

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**ENDNOTES**

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[1] https://en.wikipedia.org/wiki/Document_Number_Nine (accessed 30 April 2024).

[2] See Tucker (2022, ch. 17); and for a technical version of the story, Mavroidis and Sapir (2021).

[3] Seasoned attendees of the delivery of this lecture told me afterwards that they had not known about this reform.

[4] The same goes, by the way, for the UK's Financial Policy Committee. Its remit grew from roughly 4.5 pages in 2013 to over 7.5 pages in 2021. In word-count terms, this was a three-quarters increase (Aikman, 2021.) It then shrank back to around 5.5 pages in 2022, but retained a new emphasis on routinely getting on with supporting government policy so long as doing so does not damage stability. Again, this elicited next to no commentary. It was later described to me by an insider as profound in intent and effect.

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This paper has not been previously published.

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