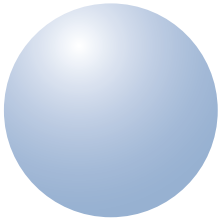


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Monetary system stability as a precondition for local and international order

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

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 ĵ QG IHZ RI WKH DQDORJLHV W\SLFDOO\ GUDZQ E\ FRPPHQWV like the old Cold War because, while everywhere, evenly matched and ideological, that was

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.

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GUDIWLQJ DQG QHJRWLDWLQJ WKH :72 WUHDW\ PXVW HcHFWLY

Monetary system stability as a precondition for local and international order

welfare costs of friendshoring, we would do well to hold onto the fact that it could help the liberal

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 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

SYRLGLQJ VHOI LQÄLFWHG PLVWDNHV

And then comes the third of the Three Musts, which is that to hold on to our way of life the rich be said about this but I want to focus on one elemental thing. A necessary precondition for any 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 09, many rich democracies have experienced dangerous toxicity in domestic politics, and yet the 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

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

Monetary system stability as a precondition for local and international order

A striking example comes from not long after the Bretton Woods regime unravelled in the HDUO\ V ZKHQ SUHWW\ P XFK DOO RI WKH PDMRU FXUUHQFL WR WKLQN RI WKLV DV WKH HQG RI D JOREDO V\ VWHP RI ¿[HG H P XFK PRUH 7KH GROODU LWVHOI ÀRDWHG DJDLQVW JROG HQ monetary order based on a commodity standard; the only arrangement known since commercial VRFLHW\ HPHUJHG LQ WKH VHYHQWHHQWK DQG HLJKWHHQWK F 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 R cHU HQKDQFHG VHFxULW\ DVVLVWDQFH LI WKH\ SURPLVHG WR when today you read about maybe Saudi exports or Iranian exports to China being denominated LQ 5HQPLQEL WKLV LV QRW PHUHO\ RI LQWHUHVW WR HQUJ 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 DQG ODWHU UHdGHUV ZKR VH PDLQ LQWHUHVW LV PRQHWDU\ Dc WKDW WKH VWDNHV LQ PRQHWDU\ DcDLUV DUH KLJKHU WKDQ W 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 PLVVLRQ SULFH VWDELOLW\ DQG ¿QDQFLDO V\ VWHP VWDELOL \HDUV WKDW KLJK LQÀDWLRQ LV GHHSO\ XQSRXODU ZLWK Dc HTXDOO\ FOHDU WKDW WKH :HVW FDQQRW DcRUG DQRWKHU ED 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 PHDQWLPH 6HSDUDWHO\ PDQ\ ¿JXUHV DUJXHG WKDW WKH JLD higher monetary policy rates and the suspension of QE purchases in order to avoid excess GHPDQG FUHDWLQJ XQGHUO\LQJ LQÀDWLRQDU\ SUHVXUHV LC DOUHDG\ GULYHQ XS KHDGOLQH LQÀDWLRQ UDWHV 6LPLODUO\ 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 the target, which is to say consistent with the anchor holding. Arguably, then, risks were taken capture because they force policymakers to think about the balance of risks given the whole range of feasible scenarios.

*LYHQ WKH LQWHUQDWLRQDO VLJQLƒFDQFH RI WKH GROODU)HGHU DO 5HVHUYH†V IDLOXUH WR DOWHU FRXUVH DIWHU WKH % 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, 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, 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 (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.

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what is going on in the economy; a remarkably interesting but hard job, and one that central
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Reckless regime reforms

Given the stakes, it is uncomfortably relevant that some central bank monetary regimes were
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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,
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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
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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
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PLJKW KDYH EURXJKW EDFN PPHRULHV RI WKH V DQG V

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,
DQG RUGLQDULO\ ZRXOG KDYH ZDUUDQWHG DQ LQÅDWLRQ ULV

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 & HQWUDO %DQN (&% PDLNQLJ FOH DU WKDW LWV ¿UVW SULRU absolutely vital task where the ECB cannot decently (and arguably cannot lawfully) exercise discretion in how to support EU policies (Tucker, 2023a).

+HUH LQ %ULWDLQ ¶V µPRQHWDU\ DFWLYLVP¶ ZDV UHPR FKDQJH RI ¿QDQFH PLQLVWHU PDLNQLJ RQH ZRQGHU ZKHWKH change. But it would be still better to return to a more vanilla remit. A useful exercise for the DXWKRULWLHV ZRXOG EH WR ORRN DW WKH YHUVLRQ DQG V 0RUH FDQ EH VDLG 2QH WKLQJ WKDW FRXOG EH FODUL¿HG H 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

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

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 HFRQRPLF HdFLHQF\ DQG VRFLDO FRKHVLRQ ± DOWKRXJK JRR 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 WKDW JULSSHG PDQ\ :HVWHUQ FDSLWDOV DIWHU WKH HQG RI

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ENDNOTES

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

ø 6HH 7XFNHU FK DQG IRU D WHFKQLFDO YHUVLRQ RI WKI

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

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SDJHV LQ WR RYHU SDJHV LQ ,Q ZRUG FRXQW WHUP

(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 LQWHQW DQG HcHFW

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