Taking monetary policy to the people

By Howard Davies
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The United Kingdom was late to adopt central-bank independence, because then-Prime Minister Margaret Thatcher firmly opposed allowing unelected bankers to control interest rates. She famously asserted that she would never hand that control away, and the Bank of England was not set free until 1997, when Tony Blair's first Labour government was elected.

The Old Lady of Threadneedle Street, as the BoE is known, was 303 years old before she was allowed to make her own decisions – and her own mistakes. While both the US Federal Reserve and the German Bundesbank had long been independent, most other European countries followed suit only in the run-up to establishing a monetary union. For its part, the Bank of France had, since Napoleon, been left "in the hands of the government, but not too obviously so."

For the last 20 years, central-bank independence has marked a kind of "end of history" for monetary policy, after many other regimes were tried and failed. In the years before the 2008 global financial crisis, independent central banks were seen as successful in controlling inflation; and countries with sizable fiscal deficits were especially enthusiastic about central-bank independence because they benefited from lower long-term interest rates. Central banks that also regulate the banking industry were asked tough questions about their insouciance in the face of rapid credit expansion, but they were widely praised for their prompt and decisive response when trouble hit.

But the period of monetary-policy consensus may be coming to an end. In the United States, Republican presidential candidate Donald Trump has challenged Fed governors' independence, and made it clear that he would quickly replace the Fed's leadership were he elected. In Europe, the European Central Bank's quantitative-easing policies have been widely criticized, and ECB President Mario Draghi recently had to defend his approach before a highly critical German Parliament.

British politicians have also begun to protest, even though criticizing the BoE was long considered tantamount to blaspheming in church. British Prime Minister Theresa May, in a recent speech before the Conservative Party Conference, noted that "monetary policy has had some bad side effects. People with assets have got richer. People without them have suffered … a change has got to come. And we are going to deliver it."

William Hague, an influential former Conservative leader, was even more blunt when he recently issued a not-so-veiled threat: if central banks do not "change course soon, they will find their independence increasingly under attack." In that case, he added, "the era of their much-vaunted independence will come, possibly quite dramatically, to its end."

While May has denied any split between her government and BoE Governor Mark Carney, it is clear that monetary policy has become a subject of political debate for the first time in 20 years. In response to these heretical outbursts, Carney has sounded emollient and understanding; and Draghi has laudably engaged with his critics' arguments.

But German Bundesbank Executive Board member Andreas Dombret tried a different tack. At a British Bankers Association Conference in London this month, he said: "It may be time for a gentle reminder that central-bank independence is not debatable," Dombret suggested. "Politicians are well-advised to not exert influence in the wrong places."

One can see Dombret's point. Careless talk about monetary policy can unsettle markets, and politicians need to be careful what they wish for. But they are unlikely to agree that central-bank independence is "not debatable." They will likely ask for more humility from the technocrats, because what politicians give, they may take away. Just because they are debating the social implications of monetary policy does not necessarily mean that they are questioning the legitimacy of those who set the dials.

To be sure, this is delicate territory. There is a powerful argument to be made that central banks, insulated from short-term political pressures, have been careful stewards of price stability, and have served the global economy well. It is not obvious that returning to politically administered interest rates would have any benefits beyond the immediate term.

Still, we must accept that central banks' large-scale quantitative easing takes them into uncharted territory, where the boundary between monetary and fiscal policy is blurred. In the UK, for example, the Treasury decides on the level of economic intervention, while the BoE determines the timing and method of implementation. So, the central bank's independence is not absolute.

Central bankers must demonstrate that they understand the political pressures and unusual circumstances that zero, or even negative, interest rates create. Savers are bitterly complaining that they are being penalized for their prudence; refusing to debate this and other implications of current monetary policies is not an acceptable response.

Independence demands higher degrees of accountability and transparency, whereby policies are explained to the public. To its credit, the BoE has been showing the way forward with a series of open forums around the UK. Taking monetary policy to the people is time-consuming, but it is essential if the necessary political consensus to sustain independence is to be maintained.

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