Central banks and the revenge of politics

By Otmar Issing
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The reputation of central banks has always had its ups and downs. For years, central banks' prestige has been almost unprecedentedly high. But a correction now seems inevitable, with central-bank independence becoming a key casualty.

Central banks' reputation reached a peak before and at the turn of the century, thanks to the so-called Great Moderation. Low and stable inflation, sustained growth, and high employment led many to view central banks as a kind of master of the universe, able – and expected – to manage the economy for the benefit of all. The depiction of US Federal Reserve Chair Alan Greenspan as "Maestro" exemplified this perception.

The 2008 global financial crisis initially bolstered central banks' reputation further. With resolute action, monetary authorities made a major contribution to preventing a repeat of the Great Depression. They were, yet again, lauded as saviors of the world economy.

But central banks' successes fueled excessively high expectations, which encouraged most policymakers to leave their monetary counterparts largely responsible for macroeconomic management. Such "expectational" and, in turn, "operational" overburdening has exposed monetary policy's true limitations.

In other words, central banks' good reputation now seems to be backfiring. And "personality overburdening" – when trust in the success of monetary policy is concentrated on the person at the helm of the institution – means that individual leaders' reputations are likely to suffer as well.

Yet central banks cannot simply abandon their new operational burdens, particularly with regard to financial stability, which, as the 2008 crisis starkly demonstrated, cannot be maintained by price stability alone. On the contrary, a period of low and stable interest rates may even foster financial fragility, leading to a "Minsky moment," when asset values suddenly collapse, bringing down the whole system. The limits of inflation targeting are now clear, and the strategy should be discarded.

Central banks now have to reconcile the need to maintain price stability with the responsibility – regardless of whether it is legally mandated – to reduce financial vulnerability. This will not be easy, not least because of another new operational burden that has been placed on many central banks: macro-prudential and micro-prudential supervision.

Micro-prudential supervision, in particular, implies the risk of political pressure, interference with central banks' independence, and policy conflicts, all of which could influence the behavior of financial intermediaries, by encouraging them to assume greater risk. They know that their supervisor has powerful tools at its disposal – for example, it can lower borrowing costs, thereby protecting banks (at least for a while) – and a strong interest in protecting its reputation. But, given the overburdening of central banks, reputational defense may be beyond their capacity.

While this is a global phenomenon, the European Central Bank is exceptionally weighed down. As the central bank of the 19 member states of the European Monetary Union (EMU), the ECB also faces "extra-institutional overburdening." This became apparent in May 2010, when the ECB assumed the responsibility of purchasing the government bonds of countries that otherwise

would have experienced substantial increases in long-term interest rates.

That intervention was a lose-lose proposition for the ECB. It was essentially driven by politics: the ECB was picking up the slack for policymakers who were unwilling to fulfill their obligations. But if the ECB had refused to intervene, financial markets could have faced substantial turmoil, for which, rightly or wrongly, it would have been blamed.

From that moment on, however, the ECB took on the political role of guaranteeing not only the survival of the euro, but also the continued inclusion of every EMU member country. In 2012, ECB President Mario Draghi cemented this responsibility, pledging to do "whatever it takes" to preserve the euro. "And believe me," he asserted, "it will be enough."

This stance led many to accuse the ECB of exceeding its mandate and violating European treaties. But the European Court of Justice and the German Constitutional Court have, all in all, rejected that view. Nonetheless, further litigation regarding the ECB's unconventional monetary-policy measures is underway.

Against this background, it is perhaps unsurprising that central-bank independence – *de jure* or *de facto* – is once again up for debate. The purpose of central-bank independence has always been to enable monetary policy to focus on maintaining price stability, without being subject to political pressure. While this approach has always been controversial, given that it implies handing substantial control over the economy to unelected technocrats, past inflationary episodes have fostered broad acceptance of central-bank independence.

When central-bank mandates exceed price stability, however, their independence may seem increasingly out of place in a democratic society. This is particularly true for the ECB: the stronger the perceived link between the extension of the ECB's mandate and politics becomes, the more criticism its independent status will confront.

The failure of elected politicians to act appropriately – particularly in some eurozone countries – has turned central banks into the "only game in town." And this is turning out to be less a boon to their prestige than a threat to their independence. The ECB, especially, is set to face growing pushback against its independent status, regardless of whether it manages to "save" the EMU. After all, it would have to be quite powerful to succeed – too powerful for any democracy to abide.

Otmar Issing, former Chief Economist and Member of the Board of the European Central Bank, is President of the Center for Financial Studies at Goethe University, Frankfurt, and the author of The Birth of the Euro.