Rethinking central bank independence

By Buttonwood
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Central bankers are under fire. In America, President-elect Donald Trump said that the Federal Reserve chair Janet Yellen should be "ashamed of herself" for keeping rates too low; in Britain, Mark Carney of the Bank of England has been criticised for his views on the economic risks of Brexit; and in Europe, Mario Draghi has faced attacks from critics in Germany (for being too lax) and Greece (for being too tight).

In a new paper Ed Balls, who played an influential role in making the Bank of England independent, has teamed up with James Howat and Anna Stansbury to try to think through the role and wider responsibilities of the central bank. It is very much worth a read and here are my first thoughts (colleagues will doubtless chip in later).

As the paper points out, central bank power has increased in the wake of the 2007-08 crisis, extending well beyond the narrow pre-crisis focus on using interest rate policy to meet inflation targets. But the worry is that

> Absolutist interpretations of complete central bank independence may both undermine the pursuit of new central bank objectives and fray the political support that currently exists for central bank autonomy in their core monetary policy function.

This blogger has had a few pops at central banks himself, largely on the grounds that they ignored the financial risks pre-crisis and that post-crisis, they have failed to meet their inflation targets, while quantitative easing (QE) has had a distorting effect on markets. By passing power to unelected technocrats, politicians may be highlighting their own impotence and adding to voter cynicism. But in defence of central banks, they have used the weapons they had available. The failure has been on the part of elected governments. Some could have used fiscal policy to support expansion (in the US and Germany, in particular) and used tax and benefit policies to offset the redistributive consequences of QE.

A lot of the current criticism of central banks assumes that they had some hidden political agenda (to support the election of Hillary Clinton or to warn voters off Brexit) behind their policy shifts. That is nonsense, in my view. In a low growth, low inflation world, central banks have had little option but to keep policy loose; many of those that tried to tighten policy have been forced to retreat. And central banks tend to reflect the consensus view of economists which was that Brexit would be bad news (those who think the consensus view has been proved wrong might note that the government has yet even to start the exit process). In short, central banks may have made mistakes but they are honest mistakes. In a sense, central banks are being made scapegoats for others' failures.

As the Balls paper points out, in the run-up to the crisis, most economists thought central bank independence was an unabashedly good thing. That stemmed from the experience of the 1960s and 1970s when inflation got out of hand. When politicians played a role in setting interest rates, they were tempted to use policy to manage the electoral cycle; easing ahead of the polls. Conquering inflation required a change in public expectations. Independent central banks could focus on the narrow issue of inflation, without the need to worry about electoral unpopularity. This made their commitment to control inflation credible. And the early evidence suggested that independence did help bring inflation down.

But the crisis showed there was a problem at the heart of policy; a credit bubble built up but, with inflation quiescent, central banks were passive. As the paper notes

> The crisis demonstrated that a focus on price stability alone is too narrow: effective macroeconomic policy cannot ignore the financial sector, and requires coordination between monetary and fiscal policy when at the zero lower bound. New trade-offs have been revealed between stable inflation, full employment and financial stability.
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> What's more, the crisis demonstrated that the modern complex financial system is vulnerable to systemic risks that may be – and were – missed by micro-prudential regulators focused on specific institutions. Such risks might build up over time: for example herding behaviour can lead to pro-cyclical investment strategies.

In the course of the crisis, central banks turned on the liquidity taps as the lender of last resort. But in the light of public anger at the banking sector that caused the crisis, this looked like favourable treatment. As the paper says

> Contrary to Bagehot, they lent at subsidised rates, on the basis of hard-to-value collateral and to a wide range of counterparties. In fact, some central banks even acted as market-makers-of-last-resort.

This raises the tricky issue of whether central banks should be in charge of both monetary policy and of financial supervision. In Britain, the role was split before the crisis but has been (partly) reunited. The paper grapples with this issue. Dividing up responsibility avoids groupthink or regulatory capture (constant dealing with the people they regulate may cause a central bank to become too sympathetic); on the other hand, it can lead to uncoordinated policy.

The authors attempt to square this circle by suggesting that

> The systemic risk oversight body should include the central bank, other regulators and the government. This diverse membership will minimise the dangers of group think and help coordinate responses to systemic risks. The government should chair this body, giving it the power to set the agenda and veto recommendations.

This has the virtue of democratic accountability but at the risk that politicians fail to crack down on financial bubbles for fear of offending, say, homeowners. So there would be a separate macro-prudential policy body that would implement decisions on, say, loan-to-value ratios

> While the government-led systemic risk body should set financial stability priorities and decide on the perimeter of permissible tools, the macro-prudential policy-making body should be operationally independent from government. This division of labour ensures that the goals of financial stability policy are decided by politicians, which will provide overarching political legitimacy for macro-prudential policy while protecting its implementation from short-term political pressures.

Maybe this would work. But that leaves the separate issue of who should look at banks on a day-to-day basis - microprudential policy as it is called. Here the authors say that

> *The micro-prudential regulator should be operationally independent. But given that the case is finely balanced, we are neutral on whether the central bank or a different body should be responsible for bank supervision. The appropriate decision may depend on each country's political and institutional context.*

This starts to look like a complex and confusing system where it may not be clear where accountability lies.

What about monetary policy? The central banks may have staved off a depression but they have not generated pre-crisis growth levels and rates appear stuck at the zero lower bound. Perhaps that was the best they can do; the engines of economic growth are productivity and labour force changes, neither of which central banks can do much to influence. Oddly, it might seem. The Anglo-Saxon critics of central bank policy seem to think that central banks have kept interest rates too low, even though inflation has tended to be below target. The underlying rationale for this critique is that low rates have enabled government to finance big deficits and thus kept the size of the state larger than the critics would like.

There is something to this point. Central bank independence was a policy designed to deal with inflation that was too high, not too low.

The idea was to act as a check on irresponsible governments. But in the current circumstances, central bank policy seems quite convenient; what elected politician would take the unpopular step of raising taxes or cutting spending and appease the vigilantes in the bond markets when a helpful central bank is willing to buy its debts?

That said, fiscal policy has generally been tight in recent years in most countries (governments have been trying to take demand out of their economies) in a way that has counteracted central bank attempts to stimulate. So the authors make their most controversial proposal - when interest rates are close to zero, monetary and fiscal policy should be coordinated.

A coordination mechanism should be established that respects the following three principles. It should be triggered by the central bank, it should protect democratic control over fiscal policy and it should be limited to the zero lower bound. An open letter system, in which the central bank outlines its views about the appropriate stance of fiscal policy at times when interest rates are below a pre-defined level close to the zero lower bound, would meet these principles.

On its own merits, this sounds entirely sensible. But if you think central banks are in the political firing line now, what would happen if they started commenting on fiscal policy, particularly close to an election? Imagine if Ms Yellen were to advise the Republicans against tax cuts for the rich?

Anyone with an interest in monetary policy should read this excellent paper. But many will find reasons to disagree with it.