Monetary politics

Central bank independence is both a recent and a far from universal orthodoxy, notes William White. But the financial crisis has left the world with less of it and the likely further erosion could have significant long-term consequences

Central Bank Independence Commentary

Since the beginning of the global economic and financial crisis in 2007, expansionary policies by central banks have been 'the only game in town'. Fiscal and regulatory policies have generally been pulling in the opposite direction. This sense that central banks are no longer capable of choosing their own monetary policies 'independently' has raised concerns in some quarters. These concerns have been exacerbated by the recognition that central banks are being drawn ever further into the pursuit of financial stability, diluting their earlier focus on price stability. Longer-term investors are wise to be concerned – but they must keep the issue in perspective.

Central bank 'independence' is, in fact, a very recent phenomenon. The term was first used in post-war Germany and some other central European countries. After the hyperinflation following the first world war, and the very serious inflationary experience after the Second World War, it seemed important to establish an institutional bulwark against this ever happening again.

However, elsewhere in the advanced market economies (AMEs), the post-war period was characterised more by the domination of central banks by their respective Treasuries. This was certainly the case in the US and the UK, a punishment for what many felt was the contribution of central bank errors to the Great Depression. As memories of the Great Depression faded, and as the analytical model increasing shifted towards a belief in a self-adjusting economy and efficient financial markets, central banks began again to assert some autonomy. It took the inflationary experience of the 1970s to foster the cult of 'independence' in the central banks of the major AMEs. Given a mandate of price stability, these institutions would ensure that the costs of high inflation, not least the painful need to reduce it eventually, was never again repeated.

Nor has the appetite for central bank 'independence' been global in scope. While many emerging market economies (EMEs) have 'inflation-targeting' regimes and are 'independent' in principle, in practice many of them still work very closely with their respective Treasuries. Indeed, in many countries, not least China, the core decisions about monetary and financial matters are still taken by the government.

One important reason for this, as international capital flows have increased substantially, is that a country can have an 'independent' or autonomous monetary policy only if it is willing to let its exchange rate float quite freely, and many governments are unwilling to let this happen. Many have export-orientated growth strategies and worry about a loss of competitiveness. Others are worried about momentum trading, and large and disruptive exchange rate movements.

William White

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Faced with monetary expansion in the major AMEs, many EMEs have leant against currency appreciation by foreign exchange rate intervention and easier monetary policies than they would have otherwise followed. This is hardly 'independence'.

Instability

The term 'independence' itself bears closer scrutiny. Central banks, like all government institutions in democracies, need to be governed by three things – their mandate, their assigned powers, and their need to be accountable for meeting their mandate. The mandate of central banks has, in recent years, been focused more on price stability, but the mandate of many of them is formally much broader than that. In addition, there are a wide variety of procedures for governments setting the mandate – the ECB is unique in doing this itself – and a wide variety of procedures to hold central banks accountable to governments for what they do.

Again, this is hardly 'independence'. In fact, there now seems general agreement that what people really mean by 'independence' is the capacity of central banks to use the policy instruments under their control without any political influences. This might seem limited but it remains of great value.

Perhaps the greatest contribution that can be made by central banks is to have a longer-term policy perspective than many governments, politicians and even electorates. Thus, they must avoid following polices that have short-term benefits that are more than offset by longer-term costs. In the lead-up to the global crisis that began in 2007, the longer-term cost to be avoided was generally that of the instability of the price level. Both significant inflation and deflation were thought costly, although Europeans tended to be more worried about the former and North Americans more about the latter.

Since the crisis broke, there has been a greater willingness to admit that expansionary monetary policies can also have other longer-term costs. Price stability is not a panacea. By encouraging monetary and credit expansion, easy monetary policies can encourage the accumulation of debt to levels that prove unsustainable. Ironically, as this perception has been sinking in, central banks everywhere have been following similar policies to those that led to the crisis in the first place. Today the combined level of debt owed by the government, corporate and household sectors in the G20 is now 20 percentage points of GDP higher than it was in 2007. Similarly, although some deleveraging has taken place, leverage in the financial sector remains very high by historical standards.

What are the threats to what remains of central bank independence? Looking first at the recent past, central banks have, in the process of crisis management, engaged in operations that could threaten their capital adequacy. In particular, the purchase of assets or the acceptance of collateral whose value could fall over time might force central banks to recognise losses.

Strictly speaking, a central bank could continue to carry out its normal functions without capital, since it is the ultimate provider of the domestic means of payment. Nevertheless, in the event of serious losses, central banks could suffer a serious reputational blow that could have much broader implications for public confidence. Were recapitalisation by the government to be necessary, it is also hard to imagine that certain conditions would not be imposed on how central banks behaved in the future.

Further, many of the actions carried out by central banks in the recent past have also had distributional implications. For example, some issuers of liabilities have benefited from central bank purchases while others have not. Some firms have been deemed solvent, others not. Perhaps most important, the broad stance of monetary policy has also had important implications for income distribution. Not least, debtors have benefitted at the expense of creditors, an issue that is receiving increasing public attention. Since distributional issues are quintessentially political, all of this implies that central banks and governments have already begun to work more closely together. Some central bank 'independence' has already been lost and history suggests that, once lost, it will be hard to get it back again.

Inflationary

Looking forward to a time when the current crisis has been resolved, it now seems generally accepted that some policy response will be required to restrain the growth of imbalances that could potentially lead to future crises. Both monetary policy and regulatory measures (so called macroprudential policies) would seem to have a role to play. However, monetary policy tools and macroprudential tools each affect both aggregate demand and systemic stability. They do not then satisfy the assumptions required to allow the allocation of one instrument (in pursuit of price stability) to the central bank and the other instruments (in pursuit of systemic financial stability) to some other agency. Regardless of agreements on 'who does what', there will also have to be ongoing communication to agree on what needs to be done, how it should be done, when it should be done, and so on. In this way, the 'independence' of central banks will be still further constrained.

The preceding paragraph looked forward to a time when the current crisis has been resolved. However, it has not been resolved. This constitutes the greatest threat to central bank 'independence'. If easy monetary conditions lead to still more debt accumulation, then an unsustainable and deflationary dynamic process is set in motion. The headwinds of debt lead to slower growth, but slower growth leads to more debt accumulation and still more headwinds. As well, associated misallocations of both real and financial resources also contribute to reducing the level and perhaps even the growth rate of potential output. Clear signs of this process are already very evident – not least, very slow growth and growing concerns about deflation.

On the one hand, the unsustainability of this monetary process could be admitted and governments could take alternative steps to restore sustainable growth. These would include both supply-side and demand-side measures to raise growth, but also explicit measures to restructure and write off unsustainable debts. Evidently, recognising losses would hurt creditors, but perhaps less than not recognising them.

On the other hand, and more likely, governments will turn to some combination of financial repression and inflation to reduce the real burden of debt service. This could well work smoothly, again to the significant cost of creditors, as it did in many countries after the second world war. However, the process need not be smooth. Governments with both big deficits (say, due to slow growth) and big debts need to borrow but could find lenders increasingly unwilling to lend. In these circumstances, direct financing of the government by the central bank would be inevitable and potentially highly inflationary. Economic history provides examples of such processes, including cases where deflation was quickly transformed into inflation. In such circumstances central bank 'independence', however defined, is simply swept aside.

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