27 March 2019

SPP Roundtable Bulletin

THE OVER MIGHTY CENTRAL BANK?[1]

Central banks have always been subject to various degrees of lobbying, political pressure and efforts at capture. Interest in central bank operations is welcome and desirable. It itself constitutes one of the many checks and balances on an institution which, to use Paul Tucker's phrase, circumscribe the powers of the "over mighty central bank".

Recently central banks in a number of countries have been subject to an uncommon degree of overt or subtle political pressure. This matters since their autonomy has earned political legitimacy in the light of experience over many decades as the complexity of delivering financial policy has become more challenging, and as the importance of effective policy delivery to underpinning healthy economic and social development become manifest. Accordingly this bulletin seeks to set the context for such pressures, outlines the reasons leading to them, and points to several of the areas that need to be addressed if central banks are to be able to continue to do their jobs effectively and with appropriate degrees of autonomy.

Context

One of the most egregious examples of a challenge to autonomy was the attempt by the Venezuelan president to move 20 tons of central bank gold out of the country on a Russian transport plane after it was unable to transfer gold out of its central bank custody account at the Bank of England. Less barefaced, but just as telling, was pressure on the Reserve Bank of India, which led to the resignation of the Governor in December 2018. This followed prolonged and increasing policy disagreements with government nominees on the Board, including on debt restructuring measures, banks' capital requirements, interest rate policy and the transfer of RBI earnings to the government. In Turkey, President Erdogan has been vocal in his opposition to higher interest rates. In January 2019, he obtained from Parliament emergency powers to take all necessary measures in case of any "negative development" that could spread across the financial system.

Political challenge in one form or another has also occurred in countries with long traditions of checks and balances and respect for central bank autonomy, including the US and the UK. In the US, President Trump has broken with political tradition lasting decades and publicly opined on the Federal Reserve's interest rate policy. In addition, he has questioned the suitability of the Fed's Chairman, reportedly sought legal advice on whether he could sack him and has nominated candidates for the Board of the Federal Reserve who share his views about monetary policy. In the UK the Bank of England has been accused of "joining project fear" following publication of 'fat tail' negative economic forecasts in no-deal Brexit scenarios. Examples from Italy and other countries could also be cited.

[1] This paper sets out themes discussed at a meeting of the Forum 27 March 2019. The meeting was moderated by Gavin Bingham and Andrew Large. Current members of the Forum are Vitor Constancio, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, Andrew Sheng, Masaaki Shirakawa, Paul Tucker and Zeti Aziz. Former members include Lamido Sanusi and Sir David Walker. The meeting was held under "Chatham House Rules". The themes discussed are informed by inputs from Forum participants but do not purport to represent the views of any individual member of the Forum. Forum members participate in meetings in their personal capacity, and their participation does not imply the agreement of any public or private institution with which they are or have been associated.

While these recent episodes are worthy of note and share common features, the inroads into central banking independence are not universal. Both Brazil and Mexico, despite having populist presidents (one on the right and one on the left), have continued to accord their central banks autonomy. Indeed, in Brazil the Bolsonaro government has announced its attention of giving the central bank de jure autonomy. One reason is the high regard in which these central banks are held in their respective countries. In both cases the central banks successfully tamed inflation that was far higher and more unrelenting than in the industrial countries. Another reason is that these two countries escaped the direct effects of the great financial crisis of 2007 to 2009 (GFC) thanks in part to more stringent regulation put in place following their own earlier financial and sovereign debt crises. Similarly, the Bank of Japan, which was subject to substantial popular and political pressure following the bursting of the property bubble and subsequent financial crisis, is now seen to be doing its part to address the country's problems. Central banks and other public authorities are accorded respect when they have a demonstrated track record of achieving their mandated objectives effectively, efficiently and impartially. But circumstances matter. Even central banks that are successful in discharging their mandates can become subject to pressure.

Reasons for recent inroads into central bank autonomy

The increased challenges to central bank independence have occurred because of the confluence of a number of factors, many of which have given them increased influence over the lives of ordinary citizens. This has become pronounced at a time of greater divisiveness within society and disaffection with established institutions caused, in part, by income and wealth inequalities. This manifests itself in populism and, in some jurisdictions, support for strongman leadership and autocratic tendencies in government. Popular disaffection with the political establishment is clearly in evidence in France with the 'gilets jaunes', in the UK with Brexit and in the US with political polarisation. In Hungary, Poland and Romania, after the pressure for reform waned following accession to the EU, the autonomy of impartial, apolitical technocratic institutions such as the courts has been challenged. The underlying reasons are beyond the scope of this note. Suffice it to say that central banks are not immune. Despite being largely technocratic institutions, they are seen to be run by members of the elite and are held by some to be culpable in part for the issues which have given rise to populism itself.

This wider mandate, in particular in the financial stability domain, is another factor that gives rise to challenges to central bank autonomy and raises questions about the degree of autonomy which is appropriate. Any expansion of mandate leads to questions about the nature and extent of the control that should be exercised to counter the threats posed by the augmentation of power and authority. However, in the case of financial stability, other factors are also at work. Financial stability is a policy area that requires collaboration among a number of authorities and decisions on the trade-offs between the appropriate degree of stability ['how safe should the system be?'] and other broad social economic and political objectives ['how much economic growth?' or 'what distribution of income is warranted?'].

This casts the question of central bank autonomy in a new light. Potential conflicts between financial stability objectives stipulated for the central bank, and other broad social and political objectives can lead to challenges about the extent that the central bank can act without regard to these other, broader social and political concerns. Macroprudential policy decisions may have distributional effects which may lead to political reaction. And in the area of recovery and resolution conflicts can arise both as between 'going concern' supervisory authorities and resolution ['gone concern'] authorities on the one hand, and as between central banks as stabilisers of the financial system and governments who may have to provide finance on the other. Beyond this, widened mandates to include microprudential supervision and conduct can lead to political reaction.

The **passage of time since the last financial crisis has bred complacency**, and the will of politicians to insist on the delivery of financial stability has diminished. The need for measures to foster financial resilience and for strong institutions with clear mandates to deliver it is now felt to be less pressing. Indeed, one focus of the international regulatory community is to reduce market fragmentation, which some hope will lead to consistency by dismantling the more onerous national regulations seeking to secure financial stability. So today there are fewer advocates of giving regulators and central banks the autonomy they need to foster financial stability than there were immediately after the GFC. Claims that autonomy and independence are needed to ensure delivery of policy may fall on deaf ears.

Quantitative easing (QE) and its close cousins have not only led to distortions of asset prices, which are seen to benefit the rich, but also blurred the distinction between monetary policy, fiscal policy and government debt management policy. This stirs popular resentment, and the need for consistency in operations in these areas raises questions about the need for the central bank to be autonomous in its operations, even if there is agreement on the objectives and the conceptual distinction, for example between the actions of the central bank and the debt manager.

A final factor is a potential **need to rethink the basis for central bank funding.** If, for example, cyberfinance were to lead to a radical decline in the use of banknotes and of the central bank's accounts for the settlement of wholesale transactions, not only would this have an impact on the nature of monetary policy, but new ways of funding the central bank's activities would need to be put in place. This of course requires political support and could raise the question of the demand for control by the state which would provide the resources needed for the central bank to operates.

Does this populist challenge matter? How does it manifest itself? And what does this do to the ability of the central banks to perform their mandates? Short of taking these mandates away, the populist challenge will need to be met.

Much discussion surrounds the question of the right degree of autonomy. Achieving – or retaining - it is important and differs according to the various policy mandates. Meeting the challenge requires central banks to deliver - and be seen to deliver - their mandates effectively.

1. Factors shaping the degree of autonomy needed

Before it is possible to determine whether the challenges to central bank independence are likely to be demanding, it is necessary to consider what degree of autonomy is needed for effective policy delivery. Independence is not of value in its own right. It is only useful if it contributes to effective policy delivery. The question of the appropriate degree of autonomy is part of the larger question of what governance arrangements are needed to secure effective policy delivery.

A balance clearly needs to be struck between giving central banks sufficient autonomy to perform their mandated public policy tasks and ensuring that appropriate checks and balances are in place to deter the abuse of power. In this context, it is useful to distinguish between the different policy mandates that central banks have, as they should shape the nature of the autonomy given to the central bank. Monetary policy, macroprudential policy and supervision all require different degrees of autonomy.

In the case of **monetary policy**, autonomy is desirable because of time consistency considerations. It can be accorded to central banks since they typically have a full array of instruments under their control that they can use alone to achieve monetary policy goals. The goals themselves can be set out in legislation or agreed with the government.

The amount of autonomy needed for the effective delivery of price stability by central banks has varied over time. Prior to the breakdown of the Bretton Woods system and the ultimate abandonment of the gold standard in the early 1970s, the vast majority of central banks did not need autonomy to deliver price stability. All they needed to do was to maintain parity to the dollar and as long as the Federal Reserve had sufficient autonomy to deliver price stability and succeeded in delivering it.

Rampant inflation ensued once this system broke down. Central banks in countries with flexible exchange rates then needed to have sufficient autonomy to deliver price stability. Clearly articulated targets or objectives for inflation made it possible to hold central banks to account for their monetary policies, which central banks conducted so that inflation ceased to be a social, political and economic bane in what some have called the “golden age” of central banking.

his came to an end with the great financial crisis that began in 2007. Since then monetary policy has become far more politically contentious. Quantitative easing, introduced to stave off depression, has had distributional effects and has generated asset price distortions. The fact that QE was the instrument of choice for central banks and has proven hard to exit, has made central banks and their policies a focus of controversy.

Central banks are not in a position to address questions about the distribution of income and wealth or to deal with the discontent of those who have not experienced an increase in real incomes for decades while witnessing the very rich becoming richer and richer. Nonetheless central banks are sometimes seen by the public, unfairly perhaps, to be culprits as their QE operations raised the value of the assets of the rich above what they would otherwise have been. Autonomy is now under attack from populists, some of whom extol the virtues of Modern Monetary Theory (MMT) which suborns the central bank monetary policy to the government.

By contrast, central bank actions do affect **financial stability**. Today about half of the central banks around the world have financial stability mandates which specifically provide for secondary objectives of supporting the government’s wider economic policies but without legal or practical definitions. Importantly, central banks do not have the capacity to deliver financial stability on their own. Collaboration with others, including the government, is needed to prevent, manage and resolve financial crises. Moreover, achieving financial stability may involve short-term or even long-term trade-offs with other broad policy objectives. This can be a source of significant ambiguity and tension.

The nature of any autonomy needed by central banks for effective policy delivery is necessarily different from what it was in the halcyon days of monetary policy when focus was on restoring price stability. It is now recognized that price stability, on its own, is not sufficient to prevent the emergence of severe financial imbalances. Today central banks face the simultaneous challenge of continuing to foster financial stability on the one hand and performing what is now a trickier mandate in relation to monetary policy. Indeed in fighting deflation through QE, they have made financing of governments easier and perhaps inadvertently sown the seeds of MMT. This in itself may create the impression that their autonomy has been reduced and, as debt levels rise, could lead to further dangers of financial instability.

Finally, microprudential supervision and conduct regulation are increasingly mandated to central banks, where the desirable degree and nature of autonomy are still different. In this case, the need is for arrangements that prevent industry capture and avert pressure from government to achieve social or other goals through directed lending.

2. Other vital factors shaping effective policy delivery

In addition to needing the 'right' degree of autonomy for particular policy mandates, we need to look at other vital components of policy delivery.

Objectives and decision making

The array of functions and mandates performed by the central bank is broad and, the arrangements to achieve the appropriate degree of autonomy may need to differ across policy areas. Several factors are fundamental. Firstly clear objectives are needed in relation to each policy area. The objectives should apply to all those authorities which have roles to play in the policy area in questions. Second there needs to be an effective process for decision making with powers or influence to make sure that policy decisions are actually carried out. This also requires a mechanism to ensure that conflicts of policy mandate are well managed and that the communication strategy with respect to process and policy decisions is both well founded and achieves consistency across policy areas: including where communication is used as a soft instrument of policy itself.

The practice of using committees for decision making has become widespread. Sometimes these committees have external members, who can impart expertise and an independent perspective to complement the 'insider' expertise of full-time central bankers. The presence of external members both brings new perspectives and militates against groupthink. The UK has external members on its policy committees who perform these roles. In the United States the presidents of the regional Federal Reserve Banks who attend the FOMC meetings serve these functions.

Decision-making in the financial stability domain often takes place in financial stability committees. Apart from situations where the entire financial stability mandate rests with the central bank, various Authorities are often represented on such committees. The weight of the central bank varies. So does the mandate of the committee and its ability to make and enforce decisions. The mandates given to such committees are normally balanced between the need to respect the governance processes of the member Authorities – including those of the central bank – and the need to avoid inaction bias and supervisory forbearance in the face of frictions with other governmental priorities.

Decision making in the microprudential supervisory and conduct areas takes place within the context of administrative law. As such it must provide for due process and respect for broad principles of proportionality and recourse by those affected. Thus the central bank is likely to be autonomous in this area only within the bounds set by the framework for administrative actions within the jurisdictions.

The appropriate design of decision-making arrangements and, with those, the appropriate degree of autonomy of the central bank, is therefore context and policy mandate dependent. Having separate committees for separate decisions (e.g. monetary policy, financial stability policy and supervision) permits greater expertise to be brought to bear in each particular area. Having a single committee for all policy decisions makes it easier to achieve consistency in policy action.

People

Having the right people in the right place at the right time is arguably the most important factor for effective policy delivery. Rogoff's "conservative central banker" who has a different time horizon and different preferences from those of the political class is more likely to work towards meeting central bank objectives than a political crony or a nepotistic appointment. Qualification requirements, appointment procedures, length of tenure, security of tenure, staggering of appointments, safeguards from meddling, gardening leave and other methods to alleviate contemporaneous and inter-temporal conflicts of interest can all help to ensure that the people charged with decision-making powers in the different functional areas are professional, impartial and motivated to work towards meeting the central bank's policy objectives. The proper design of such arrangements will help provide the appropriate degree of autonomy.

Financing

CB's must have adequate financial integrity to perform their duties. Even though they can operate, and have operated, with negative equity, there is a risk that this could undermine their policy delivery capacity.

Central bank balance sheets are not well understood. Even highly trained economists recruited to central banks from leading universities do not understand central bank accounts before their induction training. Central banks can and do make losses in the course of carrying out their policies. As long as the central bank does not engage in quasi-fiscal activities that should rightly be channelled through the government accounts, the losses are generally neither a sign of incompetence or bad policy decisions: indeed they may be both necessary and intended. Moreover they do not constrain the central bank in the conduct of policy as long as the institution generates sufficient cash flow to cover its expenses and can decide independently on the financial operations reflected in its accounts.

Although the amount of autonomy needed in the different domains varies, the central bank is a single institution and it operates more effectively when it has a common culture . Its financial accounts reflect its various policy actions operational decisions. Both money market and lender of last resort operations are reflected in the financial accounts even when they are off balance sheet, such as some conducted during the GFC. Regulatory or administrative decisions that affect the behaviour of economic actors but do not impinge directly on the central bank balance sheet require resources in the form of salaries for staff time or generate income in the form of supervisory fees.

Clearly, for effective policy delivery central banks need sufficient discretion over financial and operational decisions reflected in their accounts. In turn this may require automaticity of process for recapitalisation. Recapitalisation can take the form of retention of future profits or the outright provision of additional capital by the owner (the State). Whatever the process, it should be designed so that the central bank retains sufficient discretion over financial operations reflected in its accounts to achieve its policy objectives.

3. *Governance: Transparency, accountability and communication*

Central banking is esoteric. This is one reason why its accounts are not easy to understand. It is also a reason why efforts to be open and transparent may not suffice. It is not enough just to provide information. Disclosing information without appropriate explanation may place the central bank in the limelight and make it subject to unwarranted political pressure. What is needed is to communicate effectively. As the understanding and interests of different audiences varies, this requires communications policies tailored to different needs.

By and large central banks are good at explaining what they do, the reasons for their actions and how they do it. They are less successful in communicating the rationale of their policies. For example why should the inflation target be 2%? Why is a given level of stability or degree of safety appropriate? This is particularly important in the area of financial stability as there are no numerical targets and trade-offs with other polices for which the central bank is not responsible may well be opaque. It is important the politicians and others concerned with central bank policy understand both what the central bank can and cannot do and why it is doing what it does.

Conclusion

Technocratic institutions, whether they be courts, international institutions or central banks, do not find it easy to operate in a political and social environment tinged with populism. For central banks, the challenges are particularly great. This is because they have been given a larger range of responsibilities, whose effective performance requires different types of autonomy. The key to approaching the implications of this for effective policy delivery lies in a better understanding both of the rationale for autonomy, and the areas which require attention if the legitimacy of that autonomy is to be preserved.