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SPP Roundtable Bulletin

TRUST AND CENTRAL BANKS[1]

The question of trust

The need for trust amongst participants in financial affairs is self-evident. Without it, bank runs and financial chaos are inevitable. Confidence in the professionalism and capabilities of central banks is essential for successful policy delivery.

Trust has several dimensions. It is useful to distinguish between trust in people and institutions. In both cases, it is based on experience, reason and emotion, but how it is earned is different. Trust is difficult to gain, but easy to lose.

Trust in central banks over time

Central banks have always needed trust, although its nature has changed significantly over the years. During the gold standard era, central banks needed to be trusted to abide by the rules of the game: to observe parity, to maintain convertibility and to serve as lender of last resort in the event of bank runs.

With final abandonment of the gold standard in 1971/3, central banks needed to be trusted to maintain the value of fiduciary money by preventing inflation. To do this, they had to have the requisite powers and the capacity to use them, which led to formalised monetary policy frameworks and autonomy in the conduct of monetary policy. Central banks used their powers responsibly and earned the trust of the public even though changes in economic landscape beyond their control such as the opening of China and India also helped them achieve success. Confidence in central banks was augmented by their resolute action in dealing with the global financial crisis.

Now the trust that central banks have enjoyed is in peril. Populist charges against experts and the institutions they inhabit have altered the political landscape. Dissatisfaction with government more generally has spilt over to central banks. During the “great moderation”, ahead of the crisis, central banks received credit for things that were not necessarily under their complete control; now they are being blamed for things that they alone cannot be expected to determine.

Quantitative easing (QE) is a good illustration. Central banks helped to stave off depression by buying assets in unprecedented quantities. But in doing so, they became in effect fiscal agents, purchasing large proportions of newly issued government debt in a number of key jurisdictions. QE has reached its limits and may have permitted the expansion of debt to levels that are not sustainable if interest rates are raised quickly towards pre-crisis levels. Central

[1] Record of themes discussed at a meeting of the Forum on 20 July 2017

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Disclaimer: The views expressed are unattributed and may not be taken to represent the views of any individual member of the Forum banks' ability to resume conventional monetary policy in a manner that does not compromise financial stability is still an open question.

In the area of financial stability, central banks are being asked to do more too. Yet this area cannot be divorced from the political dimension and requires collaboration with others if it is to meet success. The difficulties inherent in formalizing responsibilities and roles raise questions about the appropriate degree of autonomy. Metrics to achieve financial stability (along the lines of inflation targets for monetary policy) are elusive.

Wider and more diffuse mandates are not the only factors that could erode the trust that central banks have enjoyed. The notion that central banks, despite their unprecedented action to prevent financial meltdown, have not done enough to restore ethical behaviour by bankers, may have contributed to the erosion of trust in central banks. Indeed, the application of ever stricter compliance codes convinces some observers that those subject to the codes are untrustworthy. Also, digitalization can contribute to the loss of trust by permitting difficult-to-understand technologies, such as cryptocurrencies, to flourish, opening the way to cybercrime in its various dimensions and removing personal contact from everyday financial operations.

To summarise, past successes are at odds with current challenges. Success in eliminating inflation and picking up the pieces after the financial crisis gave central banks a strong reputation. However, they have no track record in preventing crisis, and their wider mandates have increased calls for greater controls and accountability. The man in the street may see this 'attack on independence' as a sign of lack of trust by their own elected representatives in a technocratic institution.

The case of the EME's

We should not look at the question of trust through the prism of the large mature economies alone. In the emerging markets and some smaller jurisdictions, trust in central banks has been a vital factor in policy success, and much thinking in relation to integrity and probity of delivery of policy has emanated from these central banks. For example, they earned significant trust in many cases where they were successful in bringing down inflation. The EME's, and particularly in Asia after the Asian crisis, initiated the deployment of instruments to underpin financial stability. It was telling that no EME suffered the distress of the industrial countries at the time of the GFC.

Of course, they have their own difficulties. In relation to monetary policy for example, trust can be eroded as prices in city centres rise and people question the claim that central banks have actually delivered price stability. Furthermore, QE in the mature economies has resulted in massive inflows of capital into some EME's, requiring strong macroprudential measures. Korea has experienced extreme credit growth and the central bank reacted strongly. Malaysia has experienced a recession and growth has been slower. The policy response has been one of gradualism, which has produced good results.

Retaining trust: what are the solutions?

How can central banks best guard against the loss of credibility that is essential for effective policy delivery?

First, it is essential to determine what central banks can and should do, versus what they should not and cannot be reasonably expected to do. The more mandates, the greater potential for failure of delivery in any one of them and hence the erosion of trust overall would impact their effectiveness with the others.

Second, it is important to specify the objectives in each policy areas clearly as possible to provide guidance as to its functionality and what to put in place to achieve it. The central bank also needs to have the powers and capacity to achieve their objectives.

Thirdly, in each policy area - not just monetary policy - there needs to be an acceptance by stakeholders of the 'legitimacy' of the decision-making processes so that sometimes unpopular policy choices can nonetheless be delivered effectively. Other financial authorities may also need to play a role.

Fourth, when there is more than a single mandate – as will often be the case in future – effective conflict resolution arrangements will be required, whether through hierarchy or process, that is regarded as legitimate by all participants in relation to all the policy areas for which they have mandates.

Finally, a comprehensive communication strategy should be developed. This needs to be cohesive and credible to convince the many stakeholders that the central bank knows what it is doing; to provide adequate accountability; and to assist in delivering policy through 'soft' instruments [ie statements of intent] where risks of using hard instruments cannot be well known in advance.

Above all, the central banks need to make clear what they can and cannot achieve: in particular, the limits of their and the fiscal authority's responsibility. It is important to look at the nexus between trust and communications. As central banks are on the front line, they are often an object of blame. They need to make it clear that they alone cannot deliver in all policy areas. They also need to be clear on unintended as well as intended effects. For example, in relation to QE, unintended consequences such as distortions of asset prices, and implications for banking models need to be clearly communicated against the success of staving off depression.

Some specifics: monetary policy vs financial stability

Central banks expect to retain trust that they understand and can control inflation in 'orthodox' times. But this has been severely tested by the zero bound and QE in the aftermath of the GFC, which gets them so much closer to the fiscal dimension.

While the main stakeholders have been happy with the credit expansion to date, central banks are now in a precarious position. They need to be visibly less obsessed about price stability and more focussed on financial stability. Financial stability, based on a realistic assessment by all stakeholders of a sustainable growth rate, should be the long-term objective.

It is crucial that central banks succeed in their contribution to financial stability. Central banks need to understand, and be seen to acknowledge, that financial stability is a shared responsibility.

In the GFC, central banks picked up the pieces. Now, mitigating the build-up of pressures is part of their explicit mandate. It is appropriate that mandates should be broad, but there needs to be greater understanding, both in official sector and by the public, of what this involves in practice.

Finally, there needs to be a rebalancing in communications so the central banks spend more time communicating on financial stability and the long-term orientation that is needed.

Conclusion

In today's populist environment, central banks face a challenge in retaining the trust and confidence that they enjoyed during the great moderation and dealing successfully with the crisis of 2007-2009. Closer collaboration with other authorities is now key, to meet objectives that are not subject to objective measurement. These circumstances make clarity about what they can and cannot do and about how they go about their business all the more important. The challenges in addressing the issues that can erode trust are very significant. But more overt efforts to be clear on the issues they face and to seek improvements can only help.