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Central Banks – independent or almighty?*[1]

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Abstract

Historically Central Bank Independence (CBI) was anything but the norm. CBI seems to contradict core principles of democracy. Most economists were also against CBI. After the Great Inflation of the 1970ies many empirical studies demonstrated that there is a strong negative correlation between the degree of CBI and the rate of inflation. In 1990 most major countries had endowed their central bank with the status of independence. Overburdening with elevated expectations and additional competences are threatenig the reputation of central banks and undermining the case for CBI.

I. The long journey to independence

Today most major central banks are endowed with the status of independence. Historically this was anything but the norm. There are important reasons why central banks were not independent.

Firstly, and above all, the independence of the central bank seems to contradict core principles of democracy. A critic in Germany questioned: "All power within the state comes from the people – except that of the Deutsche Bundesbank?" (Hoffmann 1989 p. 53 – transl. O.I.). Should competence for such an important task as setting interest rates for the whole economy be given to unelected technocrats? (Tucker 2018).

Secondly, for a long time most economists were not in favour of independence for the central bank (for the US see Johnson 1970). It is interesting to note that this position was taken by two camps that otherwise had little in common. On the one hand there were economists like Tobin who argued that the most efficient coordination between monetary and fiscal policy could be achieved by having the central bank act as part of the government. On the other side of the spectrum was the group of liberal – in the European sense – economists like Milton Friedman and Karl Brunner. They argued, in the tradition of Herbert Simons, that (discretionary) monetary policy decisions should not be handed over to central bankers who, in many cases, had demonstrated severe incompetence. Overall, for a

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long-time central bank independence was not treated as a major issue: there was hardly any relevant international discussion.

Against this background, it seems surprising that around 1990 so many countries decided to endow their central banks with the status of independence (Masciandaro 2015). Two reasons for this change of mind can be identified (Issing 2018). The "Great Inflation" in the US in the 1970s triggered, after a significant time lag, a number of studies explaining the institutional background of this development. In the end, innumerable publications have delivered empirical evidence: There is a strong negative correlation between the degree of central bank independence and inflation. As it happened, this consensus emerged at a time when Europeans were preparing the introduction of a common currency and discussing the statute of the future European central bank. Here the example of the Deutsche Bundesbank, as the only truly independent central bank in Europe, played an important if not decisive role. The D-Mark, alongside the Swiss Franc, had been the most stable currency in the world and Germany had also escaped the "Great Inflation" (Issing 2005). It is no wonder that the German government insisted on the status of independence for the future European central bank. All other countries aiming to participate in European Monetary Union had to accept this position – more or less reluctantly – at a time when their own national central banks were not independent.[2]

A German expert of constitutional law delivered the following argument for endowing – in this case the Bundesbank – with the status of independence: "The voluntary waiver of power by the political leadership in favour of monetary policy-makers is limited, authorised by the constitution and revocable at any time by the ordinary legislation" (Stern 1980, translation by O.I.).

In the case that independence is grounded in the constitution, such a change is more difficult to achieve (Tucker 2018). The ECB's independence is even enshrined in an international treaty that can only be changed by a unanimous decision by all member states.

The United Kingdom was a latecomer in this respect, waiting until May 1997 to give its central bank the status of (somewhat limited) independence. Chancellor Gordon Brown's statement encapsulates the change of mind of politicians in many countries:

[2] The deep reservation against central bank independence is cristal clear in the following statement by thenFrench president Francois Mitterand. „La Banque Centrale, la future Banque Centrale…. Elle ne décide pas… Les techniciens de la Banque Centrale sont chargé dàppliquer dans la domaine monetaire les décisions du Conseille Européenne, prises par le douze Chefs d État et de Gouvernement , cest-à-dire par les politiques qui représentent leur peuples….Or j´entends dire partout….que cette Banque Centrale Européenne sera maitresse des décisions! Ce nést pas vrai! La politique monétaire appartient au Conseil Européen et application de la politique monétaire appartient à la Banque Centrale, dans le cadre des décisions du Conseil Européen" (see Issing 2008, p.59). Mitterand made this statement shortly after having signed the Maastricht Treaty in which independence for the future European central bank is enshrined.

"The previous arrangements for monetary policy were too short-termist, encouraging short but unstable booms and higher inflation, followed inevitably by recession. This is why we promised in our election manifesto to…reform the Bank of England to ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political manipulation."

The consensus that had emerged can be summarised as follows:

- Central bank independence in a democracy can be constitutionally legalised

- is a prerequisite for a stable currency

- has to be restricted to a clear and limited mandate.

II. The process of overburdening

In the decade following the "victory" of independence the world enjoyed the period of the Great Moderation. Inflation came down from rather high levels and remained stable.

Growth and employment were at least satisfactory, while variability of output substantially declined. Was this "Goldilocks economy" just the result of luck, due to a decline in exogenous shocks, or did it stem from improved macro policies, especially monetary policy? The jury is still out. In any case, this period considerably enhanced the reputation of central banks and their leaders (Issing 2017a). It was almost unavoidable that, as a consequence, expectations regarding the ability of central banks to control the economy reached an unprecedented and unsustainable peak. This prestige was further heightened during the financial crisis, when central banks were perceived as having saved the world from a repeat of the Great Depression of the 1930s.

The Annual Report of the Bank for International Settlements (BIS 2016, p.22) presents a concise assessment:

"[T]he extraordinary burden placed on central banking since the crisis is generating growing strains. During the Great Moderation, markets and the public at large came to see central banks as all-powerful. Post-crisis, they have come to expect the central bank to manage the economy, restore full employment, ensure strong growth, preserve price stability, and foolproof the financial system. But in fact, this is a tall order on which the central bank alone cannot deliver. The extraordinary measures taken to stimulate the global economy have sometimes tested the boundaries of the institution. As a consequence, risks to its reputation, perceived legitimacy and independence have been rising."

Disappointment with "politics" in general and a loss of trust in politicians have also contributed to heightened public expectations of central banks.

Central banks were not known for warning against such elevated expectations. Indeed, central bankers seemed to rather enjoy this high status. On top of this already fragile position came new obligations. Central banks have been made responsible for macro- and microprudential policies. However, there can be situations in which a conflict may arise with the primary objective of maintaining price stability (and, in case of a dual mandate, high employment).

The main challenge for central banks stems from the responsibility for financial stability. The financial crisis triggered an intense discussion over the extent to which central banks should be made directly responsible for financial stability and how they should deliver on this goal. A consensus has emerged that preserving price stability is not enough. The Great Moderation demonstrated that huge risks to financial stability can develop during times of low inflation. Following Minsky, a stable environment might even foster the build-up of financial fragilities that might end in a collapse of the whole system.

Is there a trade-off between price stability and financial stability? (Issing 2003). This is the key question provoked by the above consensus. While a short-term conflict may arise, there is no reason to sacrifice price stability over the medium- to long-term to preserve financial stability. However, a central bank will lose its reputation if it is perceived to have underestimated or even neglected the threat of financial instability. This is true almost regardless of whether or not the central bank has an official or legal mandate for financial stability.

Would it not be appropriate to explicitly include financial stability in the mandate of the central bank? Before addressing this problem, one should ask what monetary policy can achieve to preserve financial stability. One observation is obvious: the inflation targeting approach is unable to meet this challenge.

According to one approach, macroprudential policy should be the main tool for preserving financial stability, and financial stability should become an "explicit objective of monetary policy to be used when macroprudential policies fail as an instrument of last resort" (Smets 2013, p. 151/152).

However, this approach could blur the ranking of the central bank's objectives. And relying on macroprudential policies in the first place might bring monetary policy into an untenable position. If and when macroprudential policies fail in a boom phase, it might be too late for an appropriate reaction by monetary policy. The challenge might be close to "pricking the bubble", which would cause turmoil in financial markets, cause major economic costs, and have a negative impact on the reputation of the central bank (Issing 2017b).

The ECB's monetary policy strategy presents a much more promising approach. Concerns about financial stability are an endogenous element of the ECB's monetary policy aimed at maintaining price stability.

III. Further self-imposed overburdening

As if overburdening from the sources explained above and the ensuing risk for their reputation were not enough, central banks continue to assume further responsibilities. This will be shown for the Fed and the ECB.

Unavoidably, monetary policy has an impact on the distribution of income and wealth. These implicit consequences are a clear depature from a concept in which a central bank takes decisions targeted at specific sectors or groups in society, e.g. by giving credit at special conditions to students, specific sectors or companies. Such preferential actions are a highly political act that must be reserved to policy-makers who are ultimately responsible to their voters.

In its communication on the new strategy, the Fed announced that it will conduct its monetary policy in a way that will have important distributional effects. In his speech at the annual Jackson Hole symposium in 2020, Chair Jerome Powell emphasised that as America's long pre-pandemic economic expansion – and, one might add, expansionary Fed policy – continued, "the gains began to be shared more widely across society. The Black and Hispanic unemployment rates reached record lows, and the differentials between these rates and the white unemployment rate narrowed to their lowest levels on record."

To assume such a responsibility raises a number of questions. Can the process of the economy running hot always be stopped before inflation gets out of control? How should a conflict with the goal of price stability be resolved? And above all: once the Fed has to tighten monetary policy, those groups mentioned will be the first to lose their jobs. This was an unavoidable effect in the past when monetary policy in the end triggered a recession. However, the explicit acceptance of responsibility for distribution will place an additional pressure on the central bank. In any case, it will be exposed to a political debate that will go beyond what we have experienced up to now – and the central bank's independence will come under strong attack.

In the summer of 2021, the ECB published the result of its strategy review. A major change is the inclusion of challenges stemming from climate change (Issing 2021).

"Within its mandate, the Governing Council is committed to ensuring that the Eurosystem fully takes into account, in line with the European Union's climate goals and objectives, the implications of climate change and the carbon transition for monetary policy and central banking."

Accordingly, the council has published an ambitious action plan to deliver on this commitment. The reference to the mandate is quasi-obligatory and specified by the profound implications of climate change for price stability.

Climate change and corresponding government policies in response to it can have powerful effects on economic development. These consequences are reflected in all kinds of variables – growth, inflation, employment – that will in turn affect forecasts, and in this way influence monetary policy decisions. Identifying the impact of climate change brings a major challenge in terms of adopting existing models and developing new ones. Research in this field and the intention to develop relevant statistical data and indicators to assess factors such as the carbon footprint of financial institutions, alongside the work on modelling, will require huge efforts. Even at a central bank, resources are not unlimited, and existing competences are probably far away from the scientific fields, which are at the core of projecting and addressing climate change, and of assessing complete carbon footprints of individual private or public actors.

Including aspects of climate change in the economic as well as monetary and financial analyses – plus creating an integrated approach – is a complex task, and it remains open to what extent this might affect monetary policy decisions. By contrast, indirect implications of climate change's direct consequences follow from the adaption of the design of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework.

Here is not the place to go into details. The basic underlying idea is to form an in-house judgement on the value of assets that incorporates climate risks and regulatory requirements (disclosure). The "climate-policy-adjusted" price (or risk) will then be the basis for actions by the ECB, from eligibility as collateral to corporate-sector asset purchases.

To call this a tremendous challenge is still a euphemism. Financial markets will price in problems for companies stemming from factors such as the foreseeable end of burning coal – at least in some countries or regions. How should the central bank know better than markets? This is just a very simple example. Assessing climate risks implied in complex production processes in the chemical or other industries (with value chains across the world, including many countries with no or almost no transparency) and finding the correct price for corresponding assets must also take into account potential reactions to government policies. And what about the risk that the central bank might overstate this risk and create a kind of "green bubble"?

On the other hand, there is hardly any likelihood of preventing companies from "cheating" by collecting cheap(er) money through the issue of bonds with the label "green" and redirecting these

funds to the production of “brown” products. The ECB will also have to explain how such a policy will be compatible with the principle of market neutrality, which is set out in the Maastricht Treaty.

Climate change is probably the biggest challenge of our time. Central banks cannot ignore this and must not be seen as being blind to these risks. At the same time, confronting climate change is above all the responsibility of governments that are accountable to their parliaments and ultimately to their voters. Central banks are not made independent so that they can go beyond their mandate or actively correct decisions by parliaments. And with their climate-oriented actions, they should not deliver arguments that stronger measures by governments are unnecessary. If they raise expectations beyond their capabilities in this field, they will undermine their reputation and lose support for their independence, which in the end is indispensable for maintaining price stability.

Besides analytical problems, the ECB justifies its self-declared role in this field with the argument that climate change can have implications for price stability. However, does this imply the ECB, assuming inflation is at target, would argue against significant gradual future increases of carbon taxes that would push trend inflation above 2%? According to the new strategy, the ECB would have to tighten monetary policy in response to such improved climate policies. It is stunning that the ECB did not address this core question, including whether welfare-improving carbon taxes should be excluded from the price index it is targeting. This lack of clarity and transparency does not bode well. It allows for a lot of discretion that risks increasing uncertainty and interference of unelected central bankers in democratic decisions by parliaments.

The biggest threat for the ECB`s independence comes from its self imposed role as the guarantor of the euro area in its composition. Criticism that the ECB has transgressed its mandate began immediately after its capital markets intervention of 2010, in the course of which it purchased government bonds of countries that otherwise would have experienced substantial increases in long-term interest rates. This role was taken to the extreme by the famous „whatever it takes announcement by ECB president Mario Draghi. ECB monetary policy decisions – above all massive purchases of bonds in the QE programme - that particularly benefit countries with a high level of public debt further support this view. The decision to support member countries is, however a clear responsibility of governments of the euro area and not a task of the central bank.

IV. Conclusion

Not least due to their success during the Great Moderation and in helping to prevent a depression after the collapse of financial markets in 2007/8, central banks were already exposed to elevated expectations. What followed was an overburdening with additional competences in micro- and

macroprudential supervision. In the meantime, central banks have assumed additional new responsibilities.

However, central banks are not almighty. Central bankers should instead show a sense of humility. They must clarify and announce what monetary policy can achieve – and even more importantly, what it cannot deliver. Merely de facto accepting excessive expectations or even contributing themselves to this development implies a major threat to their reputation, because disappointment over failures to meet these expectations must follow.

Even when central banks are successful in affecting issues that are not within their core mandate, polities over time will not accept that an independent central bank extends its actions into the domain that must be reserved for politicians who are accountable to parliament and ultimately the voters.

The spread of central bank independence was based on the idea of a clear and limited mandate. To turn the argument around: who could convincingly argue that independence should be given to a central bank that invades deeply into a sphere that must be reserved for the democratic process. "Unelected power" must be limited and continuously justified by appropriate policy.

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