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Central Bank Independence in Times of Tranquility and Stress

Central banks are major players in setting national and international economic order and policies. This is true both in times of financial tranquility and in times of stress. However, the particular role central banks are allowed and expected to play can change drastically over time. A spectacular example in case is provided by the shifting responsibilities assumed by, and given to, central banks over the recent past. The financial and economic crises of the last ten years have dramatically changed views and beliefs concerning appropriate and admissible central bank policies.

The Role and History of Central Bank Independence

Over the 1990s and early 2000s, central bank independence has become widely accepted as a crucial instrument of creating and safeguarding central bank credibility and monetary policy effectiveness. Central bank mandates enacted during this period almost universally reflected this view, granting central banks independence – to varying degrees – from their respective political authorities. There exist solid theoretical arguments and a convincing body of empirical evidence demonstrating a clear correlation between the independence of a central bank and its performance in terms of monetary stability. At the same time, there is no evidence that, in terms of long-run averages, this is achieved at the cost of below-average economic growth or increased instability of real economic variables.

Independence from government and pressure groups keeps central banks out of day-to-day politics and allows them to take a long run perspective on their policies and goals. It has always been well understood, however, that central bank independence can never be absolute, but makes sense only under a mandate set out clearly by law or constitution and within a reliable framework of accountability and responsibility towards society and its political agents.

There are differing views about the precise form central bank independence should take and how far it should go.[1] An important distinction can be made between „instrument independence" and „goal independence". Instrument independence refers to the central bank's ability to set instruments autonomously and without any interference by government to achieve a goal. If this goal is set by the government and not by the central bank, say in the form of an annual inflation target, the central bank has no goal independence according to this distinction. Debelle and Fischer (1994) and subsequently others[2] have argued that central banks should have instrument independence but not

[1] *Central bank independence has many different dimensions; on details see, e.g., Cukierman (1992).*

[2] *See, e.g., de Haan et al. (1999), Mishkin and Schmidt-Hebbel (2001) or Blinder et al. (2001).*

goal independence. The argument is that goal independence of a central bank contradicts democratic principles so that the goal has to be set by government. The central bank, however, should have instrument independence, insulating it from short-run political manipulation.

Other authors, among them this writer, have argued that this view is questionable and that goal independence, if properly understood and implemented, represents the superior solution (Baltensperger, Fischer and Jordan, 2007). There can be no question, of course, of central banks being totally free to do whatever they want. However, if granted under a clear legal or constitutional mandate, notably one for monetary and price stability, and within a reliable framework of accountability, goal independence in no way contradicts democratic legitimation of central bank policy. Goal independence then merely means that the central bank has more scope for short-run flexibility in fulfilling its mandate, compared to a framework where government determines central bank policy goals on a short term basis, e.g. by setting annual inflation targets. This is valuable, especially for central banks with a high level of accumulated credibility and reputation, and can contribute to improving central bank policy performance in response to shocks.

Beyond this, and more importantly, a firm legal or constitutional commitment to a monetary stability goal for central bank policy, supplemented with goal independence, reduces the danger of abuse of the government's monopoly power for creating (central bank) money. Society's stability objective is better protected by such an arrangement than by one allowing the government to determine central bank policy goals. After all, major threats to monetary stability emanate much more often from government, and from public pressure groups influencing government, than from the central bank itself.[3] Central bank goal independence can be a valuable guard against political temptations to trade off short run gains of one sort or another against long run risks to monetary stability.

There are three major sources of such temptation. They are related to government's fiscal motivations, to its short-run stabilization and growth motives, and to the danger of overburdening central banks' financial stability function. They will be taken up in turn below.

Political Threats and Uncertain Status of Central Bank Independence

However, a word of caution concerning the power and status of central bank independence – and of central bank mandates and legal or constitutional norms in general – is in order first. This status by necessity is always uncertain and frail. It would be an error to assume that it is given once and for all. Central bank independence, and laws and norms in general, can be granted by so-

[3] *On this danger, see e.g. Friedman (1960), Hayek (1978), Friedman and Schwartz (1987) or Bernholz (2003).*

ciety and its political agents, but they can also be questioned and, if so desired, adjusted or withdrawn. They can be reinterpreted, evaded or even, in certain cases, simply ignored. This is an experience we witness in many instances today. Central banks around the world, with fairly widespread public approval, have extended their range of actions in „innovative" and hitherto unimaginable ways. *Unconventional monetary policy measures* have become common, including *quantitative easing* and *credit easing* in various forms, meaning direct interventions of the central bank in segments of the credit and capital markets where, with good reason, they have traditionally refrained from being active. Central bank independence from government and politics has been questioned and effectively weakened in many cases, most notably and recently in Japan.

Central bank independence and central bank mandates are important and valuable, in spite of all this. They represent obstacles which must first be overcome if a violation or change is considered. These obstacles are the higher, the more forceful and politically binding the underlying laws and norms are. To what extent this is the case depends crucially on how well these norms are supported by political actors and the general public. Confirmation by a public vote is probably the strongest form of legitimation we can think of. In the final analysis, the battleground for all this is the competition of intellectual concepts in the marketplace for ideas.

Fiscal Motives and Central Bank Policy

Independence of monetary policy from fiscal decisions of governments is a central element of successful monetary constitutions. This has been increasingly recognized over recent decades. I am strongly convinced that this remains true for the future and should be preserved at all cost. A dependence of monetary policy on the decisions of fiscal authorities is, historically speaking, the biggest danger to monetary and financial stability.[4] In today's context of debt crises and frail banking systems in many countries and regions, this is a potentially explosive risk.

Of course, in a consolidated view of the public sector, monetary and fiscal decisions are linked to each other through the sector's budget constraint. Central bank profit (seigniorage) is part of public sector revenue. In this sense, monetary and fiscal actions are necessarily linked and must be coordinated in one way or another. But precisely for this reason it is of paramount importance to choose the appropriate pattern of coordination. The monetary authority must have priority in setting its instruments in pursuit of its mandate (which must ask for monetary stability and not, not even indirectly, for fiscal objectives), and the fiscal authorities must adjust and passively accept whatever fiscal revenue results from this central bank action. This is the only type of coordination consistent with enduring monetary stability and success. In the case of the euro area, where the fiscality of not just one federal government is involved, but that of 17 independent and sovereign members, this is all the more obvious.

In response to recent financial and economic turbulence and crisis, central banks all over the world have moved towards a dangerous course mixing up monetary and fiscal motives for public policy actions. The Federal Reserve

[4] *See, e.g., Bernholz (2003).*

and the Bank of England have been engaged in massive purchases of government debt through their programs of *quantitative easing* for some time. Japan has just recently announced even more aggressive steps in this direction. The European Central Bank, while more reluctant than others vis-a-vis a policy of quantitative easing, has started its own controversial program of acquiring sovereign debt of financially troubled member countries, beginning with large purchases of Greek government debt in May 2010 and extended since in various ways. While all this is defended by central banks as monetary policy measures, it clearly has the effect of financially supporting the governments whose debt is acquired by keeping their refinancing conditions more comfortable than they would otherwise be.

Is it acceptable for central banks to buy government debt? Let me briefly examine this much discussed question and the line separating admissible from non-admissible actions. In this, we must clearly differentiate according to motivation:[5]

- *Government debt purchases as an instrument of „normal" monetary policy.* Many central banks have a tradition of buying outstanding debt of their governments on the secondary market as a matter of routine, typically short-term debt. This is the textbook example of an open market operation. There is nothing wrong with this, as long as the central bank is guided by monetary policy motivations, i.e. it is setting the conditions for these purchases (price, quantities) in accordance with its monetary policy objectives and mandate.
- *Government debt purchases as an instrument of „unconventional" monetary policy.* Some central banks, notably the US Federal Reserve and the Bank of England, have engaged in large purchases of government debt, of different maturities, in order to directly influence the conditions in the corresponding market segments. The shift to this policy of quantitative easing is due to the fact that central banks' traditional policy rates, like the Federal Funds Rate in the US for example, were close to zero already and thus not useable as an active instrument anymore. Again, in principle, there is nothing wrong with such measures, as long as the central bank's underlying motivation is one of monetary policy. However, these policies and the huge increase in liquidity generated by them are risky. The time will come when this liquidity will have to be withdrawn from the market again. Only the future will tell whether central banks will be politically able and willing to rein in this liquidity in due time, once economic conditions normalize and the demand for liquidity returns to traditional levels.
- *Government debt purchases with a (possibly hidden) fiscal motivation.* In practical terms, it is difficult to keep monetary and fiscal motives apart, once the central bank starts intervening directly in the markets for long-term government bonds and consciously works at keeping long-term rates low. Central banks such as the Federal Reserve or the Bank of England officially justify their policies of quantitative easing in monetary policy terms. Intellectually, this is defensible. Nevertheless, suspicion that fiscal motives may also play a role cannot be very far. Fiscal motives can enter in two ways. First, keeping rates low means a direct relief for

[5] *On this, see also Baltensperger (2012).*

current government finances. Second, factoring in future inflation may lower the real burden of existing government debt, as long as inflation premiums in nominal rates adjust only with lags. Not infrequently, more (future) inflation is actively advocated for precisely this reason. In Europe, the ECB defends its sovereign debt purchases with the need to stabilize money markets and ensuring the transmission of monetary policy in the troubled periphery countries, and thus in the euro area overall. Again, this is an intellectually supportable argument. However, since the effects of these purchases are so obviously and directly fiscal, and since fiscal woes are at the very heart of today's euro area problems, it is difficult to accept it at face value. In practice, separating admissible from non-admissible actions is difficult and the line between them all but clear-cut. Even if the present motivation is clean, at least on the part of central banks, the heavy burden of public debt and the bad state of public finances in many countries and regions, combined with weak banking systems and a possible need to recapitalize banks will make it very difficult to normalize monetary policy in due time and withdraw the drug of near-costless money our economies have become so accustomed to. Reducing the size of central banks' balance sheets will put pressure on asset prices and create losses for many market participants. An increase in interest rates will render sustainability of fiscal programs in many countries more doubtful than ever and limit severly available options for current and future expenditure and tax policies. Central banks may suffer losses on their accumulated portfolios of government debt. Commercial banks will bear losses on their holdings of public and private debt, making them vulnerable to shocks of all kinds and an indirect threat to government finances. For all these reasons, political pressure to postpone policy corrections „in order to buy time to adjust" is bound to be strong. Central bank independence is a major instrument of defence against such pressure.

It will be more important than ever and needs to be strengthened wherever possible. Regretfully, the same forces which create this pressure are likely to also weaken the independence of central banks.

Short-Run Stabilization and Growth Motivations

A second danger to central bank independence can result from societies' desire to support cyclical stabilization and growth of the real economy. As a result of the „Keynesian revolution" of the 1940s and 1950s – but partly even before – the idea received increasing strength that monetary policy should be considered as an instrument of cyclical stabilization and growth. Central bank mandates of earlier times, such as the Federal Reserve's *Full Employment and Balanced Growth Act* of 1978, reflected this view. In the 1960s and 1970s, the idea of a tradeoff between inflation and real economic conditions which could, and should, be exploited by central bank policy became firmly entrenched, both among main-stream academic economists and in policy circles. It became commonplace to accept „a little" inflation as the price for improving employment and growth. Given the low-inflation experience of the 1940s and 1950s, keeping inflation within manageable bounds was thought to be easy.

This view was thoroughly discredited by the history of subsequent events. It became increasingly clear that it was much more difficult to control the dynamics of inflation than was initially believed. Inflation expectations arose and became more and more firmly entrenched. The monetary impulses (and inflation accelerations) required to keep unemployment low became larger

and larger. The credibility of monetary policy suffered accordingly. The result was the „Great Inflation" of the 1970s and 1980s which, initiated by the USA, eventually spread all over the world. Severe costs in terms of monetary restriction and resulting stabilization crises had to be suffered to re-establish conditions of monetary stability over the 1980s and 1990s.

A central part in this return to monetary stability and „normality" was played by the „Monetarist counter-revolution" of the 1970s and 1980s, which emphasized the role and endogenous nature of inflation expectations and initiated a return to more classical positions on monetary policy, both in academic economics and in central bank thinking. As a result, price stability / low inflation returned as the overriding objective of monetary policy, with the stabilization objective as an additional, subsidiary goal to be aimed at, granted that the core objective of stable money was ensured. This shift back to a monetary stability objective is also reflected by a variety of central bank mandates issued in more recent times, e.g. in the UK, for the euro area, in Japan or in Switzerland.

At the same time, this change in perspective led to a much more structured approach to monetary policy-making, compared to earlier times, an approach based on a coherent analytical framework and established economic theory. Two separate, but equally important roles of such a structured approach can be distinguished: its internal role for the analysis and decision-making process of monetary policy on the one hand, and its external role as a device for communication with market participants and the general public on the other hand. A first such approach, employed by some central banks in the 1970s and 1980s already – notably the Deutsche Bundesbank and the Schweizerische Nationalbank, but for a limited period also the Federal Reserve – was the framework of Monetary Targeting with its emphasis on (usually annual) money growth targets. In the course of the 1990s, this approach was supplanted on a wide scale by the strategy of Inflation Targeting with its emphasis on (again, usually annual) inflation targets for central bank policy. A third approach, which received considerable academic attention but was never put into practice in actual policymaking, is represented by the framework of Nominal Income Targeting with its emphasis on short-run (say annual) targets for nominal GDP. A common and central feature of all these approaches, as they were usually used and discussed in the literature, is that the core objective of monetary policy is price stability (low inflation) and that the central bank's money growth target, inflation target or GDP target (whichever it may be) must aim at this ultimate objective, i.e. must be set such that long run price stability and low inflation expectations remain firmly anchored.

Today, such a strategy may formally still be in place at most central banks, but actual policy decisions bear little relation to it. Actual policy instead is determined to an overwhelming extent by a *crisis mode* of one sort or another. The insights these strategies are based upon, gained at great pain and cost during the 1970s and 1980s, are in danger of being lost again. In this regard, the current situation reminds me strongly of the prevailing mood of the 1950s and 1960s. Two decades of low inflation have once again created a wide-spread belief that inflation is not a problem anymore, not even potentially, that inflation dynamics can be easily controlled if inflation should return nevertheless, and that „some inflation" may even be desirable as a means to stimulate the economy and overcome recession and lack of growth. The fact that, due to accumulated deficits and excessive levels of debt, fiscal policy in most countries is hardly availabe anymore as a workable and effective instrument of macroeconomic policy contributes to the sense that central banks are the only institutions which can save the world from endless recession and decay. That this means asking much more of central banks than they can reasonably be expected to deliver is largely suppressed.

In this context, Nominal Income Targeting has experienced a somewhat strange revival. Under Nominal Income Targeting, a target rate of growth for nominal GDP would be fixed which is consistent with long-run price stability (low inflation). If, say, „accepted inflation" is 2% and potential long-run real growth is estimated to be 3%, the target rate of growth for nominal GDP would be 5%. As long as actual nominal GDP grows at a rate of less than 5%, monetary policy would remain expansionary, i.e. it would aim at raising the nominal rate of growth (bringing it up to its desired level), regardless of whether inflation exceeds its long-run acceptable value of 2% or not. In the current context of recession and economic slack, this would force monetary policy to remain expansionary, of course. This is precisely the reason the switch to the Nominal GDP strategy is recommended by its proponents: as an instrument to make higher inflation acceptable (and consistent with the new strategy).

But the new strategy, if it were to be implemented as a successful long-run framework, would also require monetary policy to switch to a restrictive mode (i.e. aim at lowering nominal GDP growth) as soon as the target rate of growth is exceeded, regardless of whether this is the result of high inflation or real growth. If, say, real growth were to stay at a (still „unsatisfactory") level of 2%, but inflation rose to 3.5% or 4%, monetary policy would have to shift to restriction. For the new policy to gain credibility it would have to strictly obey these rules.

But would this really be credible in today's world and under today's conditions? Hardly so. It is obvious that sceptics (probably rightfully) would expect the current proponents of the new strategy to quickly argue that 2% real growth is still too low, that 3.5% or 4% inflation is not really a problem and should not allow us to prematurely stifle economic recovery. A new strategy needs time to gain credibility and cannot be expected to work upon mere announcement. Sceptics would see, or at least suspect, that today's proponents of such a policy shift are mainly concerned with real economic conditions, especially unemployment, and that they are trying to correct real economic problems through monetary policy means not really suitable for achieving this end. Sceptics would (probably rightfully) expect that the proponents would quickly be willing to adopt yet another new strategy, if their suggested policy change does not work as desired. If credibility were so easy to gain, what is attempted through a change to Nominal GDP Targeting according to this proposal could just as easily be achieved through a temporary increase in inflation targets within a framework of Inflation Targeting. It is not clear why a fundamental policy and strategy change would be helpful in this. On the contrary, it would raise uncertainty and weaken central bank credibility and reputation, if adopted for the reasons suggested here.

This proposal represents a remarkable example showing how stabilization and growth motivations can generate intellectual pressure and political influence on central banks and their monetary policies. Such pressure can get very strong and it would be naive to believe that an existing central bank mandate, even if well designed, can fully protect against it. Central banks operate not in a vacuum, but within a social and political system and are unavoidably prone, to some extent, to respond to such pressure. Nevertheless, the design of central bank mandates and the degree to which central bank independence is institutionally secured and supported by society are of great importance in this regard.

Central Banks and Financial Stability

Maybe the most important threat to central bank independence today stems from the central bank's financial stability function and the way in which this function has been extended, and is still being extended, in the wake of recent and current financial and economic crises. The role of central banks in financial supervision and bank regulation has been expanded in many countries and systems. The idea of giving central banks a very broadly defined mandate for financial stability, next and parallel to its monetary policy mandate, finds wide acceptance. In my view, this is a „toxic gift“ offered to central banks, and I would much prefer if it could be declined.

There can be no doubt that central banks have certain responsibilities for financial sector stability. This is a major reason why historically they were created. But traditionally, and for good reasons, this role has been limited to ensuring an adequate system-wide provision of liquidity and guaranteeing the safety and efficiency of the payment system. These tasks are inseparably linked to the regulation of money and the central bank's monetary policy. In consequence, they must necessarily be assigned to the central bank. The main function of the central bank which follows from this is the function of a Lender of Last Resort, i.e. of an agent who stands ready to provide emergency funding to banks in times of crisis and scarce liquidity, ensuring an adequate supply of money and means of payments for the system as a whole. According to traditional doctrine, lending of last resort help must be restricted to banks which are (temporarily) illiquid and therefore in need of funds, but may not be extended to fundamentally insolvent banks.[6]

Fiscal measures are not and should not be tasks of the central bank. Saving insolvent banks and other institutions with public money or guarantees are fiscal measures. The responsibility for them must rest with government, or with a separate regulatory authority mandated by government for this task. The same applies to preventive measures and regulations aimed at reducing the likelihood of events which might make necessary emergency help of this kind. Emergency help to governments, e.g. to euro area member state governments by the ECB, is even much more obviously fiscal in nature and was never part of traditional doctrine of lending of Last Resort. This doctrine was always meant to apply to banks only – as a response to a problem of asymmetric information specific to private capital markets and banks – but never to governments and states. Today's frequently heard call on the euro area to allow such help „in order to make the ECB a true central bank" is an absurdity, in my view.

Admittedly, the distinction between illiquidity and insolvency can be difficult in practice and there exist links between the two. Illiquidity can force emergency sales of assets and may lead to losses and insolvency. Conversely, insolvency can cause a loss of confidence on the part of customers and markets and lead to problems of refinancing and illiquidity. Nevertheless, at a fundamental level, the distinction is of central importance. Lending of Last Resort is justified as a reaction to the existence of money and capital market imperfections. Its purpose can never be to keep alive institutions with no credible long-run survival capacity.

For this reason, measures and decisions involving the liquidation, restructuring or recapitalization of insolvent or nearly insolvent banks must be clearly separated from Lending of Last Resort actions. Preventive measures and regulations serving the avoidance of insolvency problems must be seen along the same lines. In my view, it would be best to assign responsibility for these tasks to a separate supervisory and regulatory agency, distant enough from both government and the industry and endowed with sufficient authority to allow it to set up a successful and effective supervisory regime independent of day-to-day politics and its pressures.

However, since the decisions of this agency may have direct and important fiscal implications – most obviously if the recapitalization of a bank is at issue – such an agency can never have the degree of independence granted to central banks today. The financial author-

[6] *The classical reference is Bagehot (1873).*

ity by necessity is closer to government and politics than the central bank should be. For this reason it is best not to link both institutions under the same roof, even if the proximity of tasks makes coordination between them obviously important.

In principle, a double mandate for the central bank for both tasks is possible, of course. Indeed, the overwhelming part that central banks have played in recent crisis management throughout the world, and the fact that they often appeared to remain as the only institutions still able to act, have induced many countries and regions to go precisely that route, notably the USA, the United Kingdom or the euro area. In my view, this is a dangerous course. The potential fiscal implications of financial authority decisions are likely to bring the central bank much closer to government and politics than is desirable. The independence of central banks could be easily damaged as a consequence. Efforts to separate the two functions through internal institutional devices („Chinese walls“) can never be fully effective, as long as the final responsibility for actions in both functions rests with the same central bank governing board. Only full institutional separation could correct that. The potential for conflicts of interest between the two functions is obvious, notably if monetary policy decisions (e.g. central bank asset sales, interest rate increases) create losses in bank portfolios and risks for bank's equity positions and solvency. It is not difficult to imagine that this could create great pressures for central banks to deviate from what would be an appropriate policy under its monetary policy mandate alone.

Perspectives and Outlook

What is likely to happen? Political pressures on central banks are and will remain strong. It would be naive to expect that this will have no effect on their actions. Monetary policy is likely to stay under this influence for some time and remain weak. In Europe, the additional argument that the ECB and its monetary policy are the only effective instruments still available to save the euro, and that they must be used to this end at all cost, reinforces this tendency. Not a pretty outlook for monetary stability.

Should we expect a future of monetary decay and chaos beause of all this? I do not believe so. In spite of my scepticism concerning current central bank policies, I do not believe that excessive pessimism is in place. Fundamentally, knowledge of the fact that sound money is of central importance for a successful eonomic and social system, and that sound money requires sound monetary policy, is still firmly anchored. Hopefully, this insight will gain strength again in the future. It is likely, though, that this will be the case only after the risks and the costs of the current policies have become more visible and painful.

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