Reconsidering Central Bank Independence

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Our Story

The book re-iterates the case for Central Bank Independence (CBI) with respect to monetary policy decisions against the background of post “Global Financial Crisis" (GFC) policy decisions.

We place CBI at the center of this story for two reasons:

1. CBI was central to the benign outcomes of monetary policy in the late 20th century, including the rise of inflation targeting
2. Independence of monetary policy decisions has been eroded in many jurisdictions, sometimes crudely (e.g. Turkey) but, more often, through the expansion of the central bank’s (CB) agenda which has overburdened monetary policy

The harm we fear lie on two levels:

1. Worse monetary policy outcomes
2. Harm to the real economy

The background

CBs are just more than three centuries old, though the modern roles and responsibilities of central banks only emerged fully in the Post-War period.

These responsibilities are still expanding.

The earliest CBs were established to manage government debt - a financial policy role - or to develop the commercial banking sector.

By the 19th century some CBs acquired a monopoly over the issuance of legal tender. This tremendous power created the scope for:

1. The CB's lender of last resort role in the banking sector (e.g. Bagehot's rule)
2. Potential for
   I. balance sheet operations and
   II. interest rate policy, though the latter only emerged much later.

The Book

Reconsidering Central Bank Independence

PART I THE THEORETICAL FOUNDATIONS

1 History of Central Banking

2 Focus on Inflation: The Rationale for CBI since Ancient Days

3 The Political Economy of CBI

PART II BALANCE SHEET OPERATIONS IN DIFFERENT TIMES AND CBI

PART III THE POLITICAL ECONOMY OF CBI IN THE REAL ECONOMY

Part I: The Theoretical Foundations

Inflation is a permanent phenomenon, even in Germany, a 2020 Euro has a fifth of the value of a 1960 D-Mark equivalent.

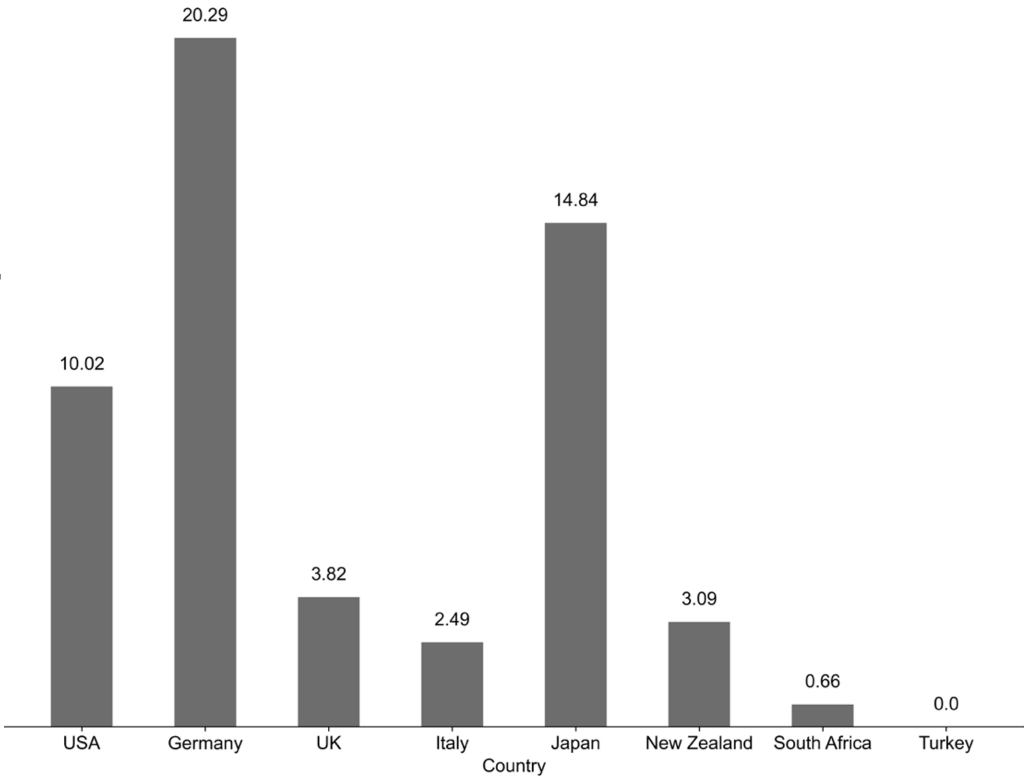

Figure 1.1: The purchasing power at the end of 2020 of 100 units of local currency units in 1960

Source: Data from OECD statistics

Inflation: a short history (I)

Already in the antique era, inflation hit economies:

- Greece
- Rome (Cesar, baracks emperors)
- Later Spain in the aftermath of the Latin American gold rush
- Aftermath of WWI and WWII respectively

Causes are mainly political: All hyperinflations in history (up to today: Zimbabwe, Venezuela, Turkey) are caused by governments' inability to finance their budgets. Details differ enormously across countries.

That does not imply that governmental debt always creates hyperinflation.

Inflation: a short history (II)

Consequences are dire:

- Trust in society diminishes
- Misallocation, including
  - A lack of investment and
  - ’Concrete gold’, i.e. real estate purchases
- Redistribution from lenders to borrowers
- Social peace is at stake
- Personal stress for individuals

The answer (I): rules vs. discretion

As consequence, government can restrict themselves in order to avoid hyperinflation ➔ Estonian fiscal rule! Such a rule is indirect.

A direct rule is a monetary rule; regardless of the school, most economists favor rules over discretion in monetary policy:

- Chicago: Herbert Simons, Milton Friedman
- Austria: Friedrich A. von Hayek
- Freiburg: Walter Eucken
- Virginia: James Buchanan, Geoff Brennan
- East coast: Kydland, Prescott, Barro, Gorden

The answer (II): central bank independence (CBI)

The widespread literature on rules vs. discretion has led to a global consensus. Money matters and central banks should be independent from daily politics:

- Independence for a policy maker requires clear definition of the policy objective, which is is approved by the political authorities.
- Typically, the commitment to monetary stability has to be included in the legislative framework, as is the central bank’s freedom of action to pursue it.
- CB must have the freedom to choose the instruments and the magnitude of their adjustments to pursue the assigned policy objectives
  ➔ instrument independence
- The manner of the Governor’s appointment, the security of her tenure and requirements for potential candidates is another relevant dimension in practice.

The answer (III): central bank independence (CBI)

- Government must commit not to pressure the CB to accommodate fiscal policy by CB balance sheet policies. Avoid monetization of public debt by the CB.
  ➔ Strict separation from fiscal policy including a ban of loans to the government
- No direct influence of parliaments or ministries
- But: accountability and transparency
- Tinbergen rule: each policy objective is assigned to one instrument (and agency)

How to measure CBI: statute reading, turnover rate of CB CEOs

Empirical evidence favorable: high correlation between CBI and price stability

Part II: Balance Sheet Operations and CBI

Monetary policy seemed very successful in the 1990s and early 2000s. Keywords:

- *Great moderation*
- New economy

However, in combination with a very generous housing policy in the US and housing booms elsewhere, e.g. Ireland, Spain or even Estonia, the loose monetary policy contributed to an asset inflation, but no conventional inflation.

The *Global Financial Crises* (GFC) or Great Recession was built up.

Crises, balance sheet operations and CBI: The Great Moderationn

We look at five countries and their balance sheet policies before and after the crises:

- Eurozone: ECB (and Bundesbank before)
- US: Fed
- UK: Bank of England
- Japan: Bank of Japan
- South Africa: SARB

They all expanded their balance sheet with much different consequences.

Crises, balance sheet operations and CBI: The Great Recession

The financial sector obviously sensed this and sold securizations of the loans.
Consequences:

- Savers lost a fortune
- House prices dropped
- Loans were not repaid
- Banks collapsed
- Countries went almost bankrupt
- The Eurocrisis followed suit.

We analyze these developments and discuss its consequences for CBI.

Part III: Political Economy of CBI

- This independence is not only defined relative to political pressure, but also against undue market influence.
- The CBs balance sheet remains part of the consolidated public sector balance sheet, which was why Friedman (1961) did not regard CBI as a plausible solution to the difficulties of monetary policy.
- And this is why the financial stability objective of the CB cannot be pursued with the same independent agenda
- At the same time, the limited independence of the CB has been politically controversial, some saw it decline
- Others found them too independent: does CBI imply a “democratic deficit”?

The Olsonian perspective

- The reality of large balance sheet operations in response to the GFC created scope for an expansion of the policy agenda of central banks.
- New ends next to financial stability: sustained economic growth, the fiscal problems on the Euro-periphery, jobs, investment etc.
- The transition to the “green economy” was added to this list within a few years
- During the pandemic balance sheet operations are extensively used to support accommodating fiscal policy
- Interest rates hit the ZLB
- These measures were encouraged by the mistaken arguments of the Modern Money Theory scholars who argued that there is no practical public sector constraint, when supported by balance sheet operations.
  ➔ neither modern, nor about money, nor theory!

Risks associated with the new monetary activism

- Inflationary risks
- Repressed structural change and the Zombie economy
- Is the state a good entrepreneur?
- Old-age protection in a low interest environment
- Political unwillingness to reform under a “Whatever it takes” rule

Governments should not misuse the central bank, but allow for structural change and address the fundamental supply-side problems emerging over time, including digitalization, climate change, challenges due to emerging economies and globalization, demographic change

The alleged democratic deficit

- In 2019 (then) President Trump asked on Twitter: “who is our bigger enemy, [Fed Chair] Jay Powell or [China’s President] Chairman Xi”
- Medium term commitments are not necessarily undemocratic, especially not in a republic with a constitution.
- There is an important distinction between two levels of political action:
  - the constitutional level (where formal rules are constructed politically) and
  - the level of in-period politics (where ends are pursued, given the institutional framework)
- But politics at the constitutional level requires clear accountability, and that implies considerable transparency ➔ “Willem in Euroland”

Political Economy of CBI: what next?

- In 2021, inflation hit the industrialized world
- Some central banker claimed it had nothing to do with balance sheet operations
- Notwithstanding, central banks reacted by reducing monetary growth and increased interest rates
- The old monetarist consensus regained support

➔ **CBI still intact?**

There is mild support for optimism!

Thank you very much