

Issing, Otmar

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Independence of the central bank: Too much power in the hands of unelected technocrats?

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Otmar Issing

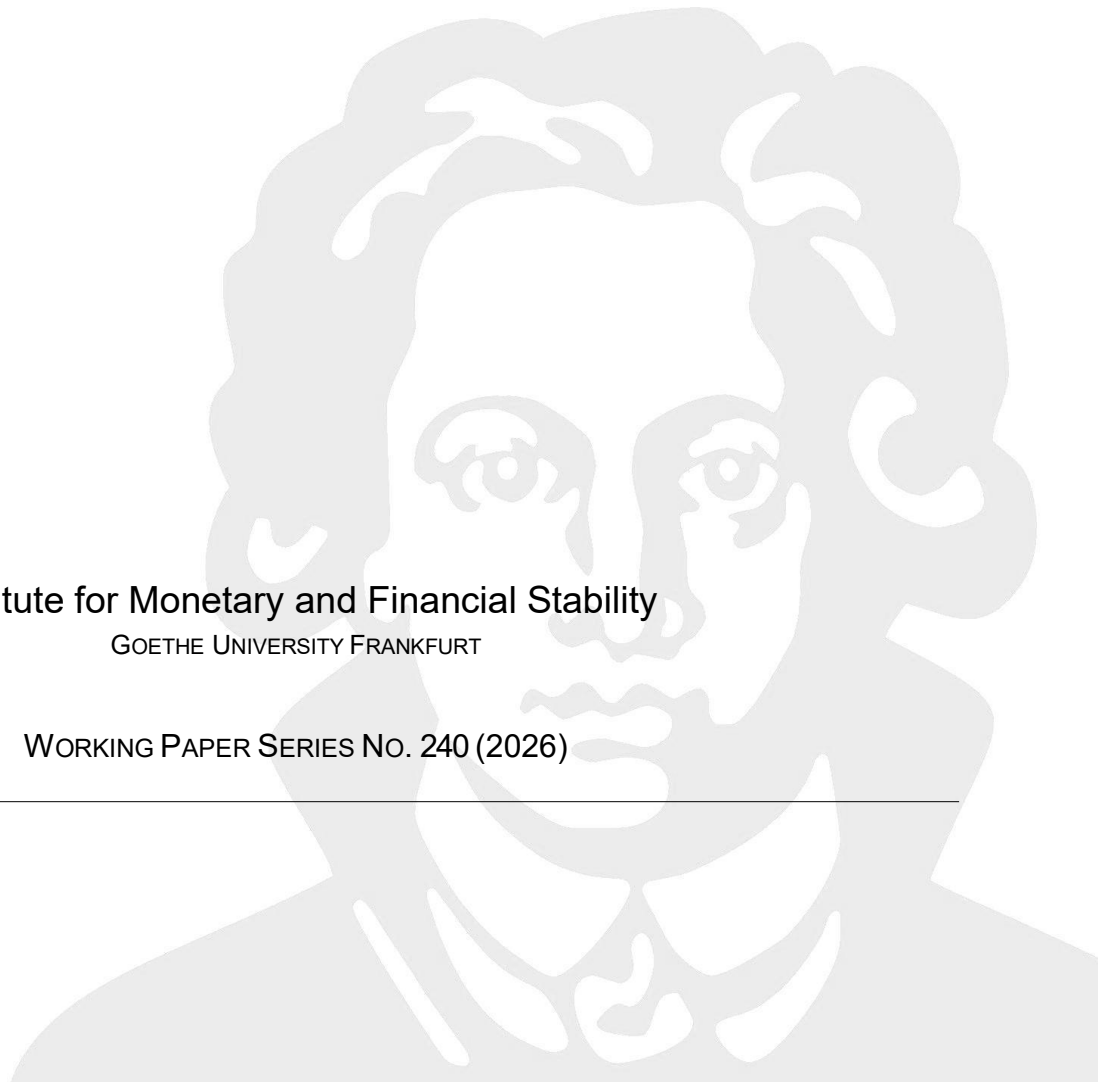
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Institute for Monetary and Financial Stability

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Institute for Monetary and Financial Stability

Goethe University Frankfurt

House of Finance

Theodor-W.-Adorno-Platz 3

D-60629 Frankfurt am Main

www.imfs-frankfurt.de | info@imfs-frankfurt.de

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Otmar Issing

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Under the overwhelming evidence of numerous empirical studies that found a negative correlation between the degree of independence and the level of inflation, many governments granted their national central banks independent status around 1990 (Masciandaro / Romelli). With low inflation rates in the subsequent period—with the notable exception of the sharp price increases after 2020—monetary policy largely confirmed the empirical findings. Consequently, one might expect that independence is now considered an undisputed element of sound central bank governance.

However, this is by no means the case. And there is a crucial reason for this, which finds its simple expression in the following quote: “All state power emanates from the people – except that of the German Bundesbank” (Hoffmann). Shouldn't an independent central bank be seen as a foreign body in a democratic state governed by the rule of law? Placing the central bank on the same level as the independent judiciary contradicts the principle of the separation of powers. Legislative, executive, and judicial branches are the pillars of a state. The central bank's responsibilities fall primarily within the executive branch. A convincing justification is required when the legislature removes such an important instrument as monetary policy from the government's purview and places it in the hands of unelected technocrats. (Insofar as the central bank is assigned tasks in the area of regulation, the legislature is also affected.)

A crucial condition is the self-awareness of politicians, the admission of their inability to guarantee the stability of the currency. This is expressed in the declaration by the then British Chancellor of the Exchequer, Gordon Brown, on May 20, 1997, in which he granted the Bank of England independence: “The previous arrangements for monetary policy were too short-term, encouraging short but unsustainable boom and higher inflation, followed inevitable by recession. This is why we promised in our election manifesto to... reform the Bank of England to ensure that decision-making is more effective, open, accountable and free from short-term political manipulation.” Kydland and Prescott, with their concept of time inconsistency, have provided an important argument for the political behavior described by Brown. By transferring the competence of monetary policy to the independent central bank, the legislature voluntarily relinquishes its own power (Schmidt), protecting itself, out of responsibility to society, from the temptation of making decisions that are popular in the short term but detrimental to monetary stability in the long term (Forsthoff).

It goes without saying that the central bank's independence in its decisions can only be based on a narrow mandate clearly defined by the legislature. Price stability is, in principle and according to the capabilities of monetary policy, the appropriate goal. In reality, however, questions arise such as how to define price stability or a target for a low inflation rate? Should the legislature specify a concrete target or grant the central bank a more or less broad margin of discretion? It is not surprising that this question is not easy to answer. A practice has developed that grants central banks a more or less significant degree of discretion in this matter. Predictably, disagreements repeatedly arise regarding the extent to which the central bank's discretion should or may extend in this issue.

Monetary policy is implemented by individuals. Liberal economists like Friedman were deeply troubled by the discretionary power transferred to appointed, rather than elected individuals in the age of fiat money. Simons succinctly captured the issue in his still influential 1936 article, "Rules versus Authorities." Eucken took a more forceful approach, criticizing "that a monetary constitution which grants policymakers free rein places more trust in them than can generally be expected of them. Ignorance, weakness in the face of special interest groups and public opinion, and flawed theories—all of these greatly influence these policymakers to the detriment of the task entrusted to them." Whatever one may think of this accusation, it points to the inherent dangers faced by independent central bankers. Proposed solutions such as the so-called k-percent Friedman rule ultimately prove unsuitable for eliminating individual freedom through strict adherence to a rule. Scope for discretionary decisions cannot, in principle, be ruled out.

As a consequence, the appointment of central bank executives is of great importance. It is primarily the responsibility of politicians to choose individuals who are up to the task. It should also be borne in mind that the necessary qualities include the determination to pursue the interests of a stability-oriented monetary policy, even in the face of political opposition or pressure from the financial sector. This is anything but an easy task. Rogoff (1985) presents an interesting proposal to appoint "conservative persons" with a high preference for stable money.

It is obvious that leading central bankers can only make truly independent decisions if they are protected from political influence for a comparatively long term of office. Their standing, and consequently the reputation of their respective central bank, depends in the long run on how they are perceived, in word and deed, as guarantors of price stability.

With the goal of price stability, legislators entrust the central bank with a difficult task; by granting independence in monetary policy decisions, they simultaneously transfer considerable power. This combination demands great restraint from central bankers in matters outside their mandate and a certain degree of humility regarding their work. One could even speak of the necessity of an ethical framework of self-restraint (Tucker). These considerations include intensive communication about what monetary policy can and even more important cannot achieve.

Particularly after the financial crisis of 2007/8 and the crucial contribution of monetary policy to preventing a depression on the scale of the 1930s, the reputation of central banks reached a peak. Expectations of monetary policy have often far exceeded its capabilities. It is difficult to say that leading central bankers have actively countered this overestimation. Expressions like "Masters of the Universe " or the title "Maestro" for Alan Greenspan, and the frequent characterization of central banks as the "only game in town " have created an impression that exaggerates their position in society and have thus placed them in a vulnerable position. Disillusionment with their actual capabilities is inevitable. This applies not only to the general public, but primarily to politicians, who will almost inevitably ask whether it is still appropriate to remove such a powerful institution from parliamentary control.

This danger also increases with the expansion of the mandate to include banking supervision, macroprudential policy, and regulation (Issing 2017). The threat to independence becomes all the more serious when central banks themselves contribute to expanding their mandate. If, for example, a central bank attempts to directly influence income distribution through selective lending, it enters a field reserved for politicians, who ultimately have to answer to the electorate. Significant distributional effects can arise if central banks pursue quantitative easing and/or keep interest rates very low for extended periods. Large losses of many central banks, that finally have to be borne by taxpayers, have occurred due to their large scale purchases of long-term bonds at elevated prices, financed with reserves remunerated at the corresponding policy rate. This aspect must not be overlooked when considering these measures.

Climate change causes a tremendous challenge for policymakers. It came therefore not as a surprise that central banks would also face pressure to contribute. However, the options available to central banks are very limited. If they nevertheless raise unrealistic expectations, this will ultimately lead to disappointing results, damaging their reputation in the long run and raising the question of whether central banks are overstepping the bounds of their limited responsibility. Against this backdrop, it is difficult to understand why central banks themselves attempt to develop special expertise in this area.

The greatest threat to independence, however, stems from interaction with fiscal policy. The extensive purchase of government securities over a long period has raised doubts as to whether this can still be considered monetary policy at all, or whether central banks are not also, or even primarily, directing their actions toward serving government fiscal policy. Fiscal dominance characterizes this situation. In the case of the ECB, the massive purchase of government bonds that primarily benefited the highly indebted member states, is special and worrying. Fiscal policymakers will not complain about this "support."

A certain degree of tension should generally exist in the relationship between the central bank and the government. However, all the measures taken by the central bank listed above raise the question of whether central banks, on the basis of their legally guaranteed

independence, are not de facto aligning their monetary policy more or less with the interests of the respective government or, in extreme cases - see the Arthur Burns episode - subjecting it to the will of the government.

Financial dominance exists when the central bank aligns its monetary policy to a large extent with the interests of the financial sector. This risk is, in a sense, a constant companion of monetary policy, but it has dramatically increased due to the balance sheet expansion caused mainly by large scale bond purchases taking out duration risks from markets. The monetary policy measures operate predominantly through the financial sector, be it through lending (credit channel) or via the financial markets. Even without a direct mandate for "financial stability," central banks cannot simply ignore their responsibility for the stability of the financial sector. A clear line cannot be drawn here. Crucially, the mandate of price stability must always take priority; otherwise, independence is jeopardized.

Just as the legislature grants independence to the central bank, it can also revoke it using the same procedure. The degree of legal safeguards can vary considerably. The Fed 's independence is particularly weak from a legal standpoint. It could be revoked, so to speak, "in the blink of an eye " (Rogoff). At the other end of the spectrum is the ECB's statute. The central bank's independence is secured in the most legally conceivable way. A change would only be possible if all member states agreed to it—not impossible, but difficult to imagine.

In the event of a national emergency, such as war, different conditions apply anyway; there's no need to quote Carl Schmitt at length. The political and social foundation of legal independence is its legitimacy (Tucker). The history of the German Bundesbank (and its predecessor, the Bank deutscher Länder) provides a striking example. After an attack on the central bank, then-Chancellor Adenauer lost the public debate. This happened again when, during the passage of the Bundesbank Act (1957), independence was included in the new law against the Chancellor's opposition. And although this law could have been amended at any time with a one-vote majority in parliament, there was never a single significant political initiative directed against independence. Certainly, there were quite a few politicians who viewed independence as a thorn in their side, but an attack on the Bundesbank would have been anything but beneficial to their own careers. In contrast, there is no shortage of such initiatives in the US Congress (Issing 1993).

The legality of independence is one thing; its legitimacy rests on a societal consensus regarding the expediency of this arrangement (Tucker). If this consensus is lost, the legal foundation rests on shaky ground. A clearly defined legal mandate can protect against hastily launched attacks, but it is anything but a guarantee of permanence. If the institutional arrangement of independence persistently encounters widespread rejection, politicians will leave no stone unturned in their efforts to amend the central bank statute accordingly—as is only natural in a democracy. Sceptics like Goodhart predict anyway that by interacting with fiscal policy, with extended responsibilities in banking supervision and financial regulation the idea of the central bank as an independent institution will be put aside. The best

protection against such a development lies in a central bank policy that preserves monetary stability without engaging in quasi fiscal policies, subsidizing the financial sector or extending its mandates in the direction of the domain which must be reserved for politics which have finally to be approved by voters. This is the best and in the end only way to gain and maintain the public's trust.

It would be disastrous if central banks were to jeopardize this foundation by neglecting their primary mandate and encroaching into the realm of politics. By doing so they would undermine incentives of governments and banks to conduct sound politics, risking to contribute to excessive public debt and to elevated risk taking by highly leveraged financial institutions thereby creating a fragile situation in which it will be difficult to conduct a policy for maintaining price stability (Cochrane, Garicano, Masuch).

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