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Research Report

Can a less boring ECB remain accountable?

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CAN A LESS BORING ECB REMAIN ACCOUNTABLE?

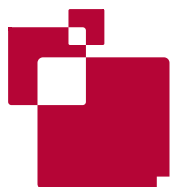
JEAN PISANI-FERRY AND JAKOB VON WEIZSÄCKER

Highlights

- Until recently, there was widespread agreement that central banks should focus on one objective: price stability. On this basis, an intellectual apparatus was developed that put the emphasis on transparency and predictability. As the governor of the Bank of England once said, central banks were proud to be boring.
- In the crisis, central banks haven't been boring. In the wake of the crisis a new consensus is emerging, calling on central banks to take more responsibility for financial stability. They will have to participate in macro-prudential supervision. But there is no fool-proof way to identify bubbles before they burst, so this new responsibility is likely to require increased discretionary decision making.
- In addition, institutions in charge of financial stability will also require new instruments, including financial regulation. As a result, it seems almost unavoidable that some forms of responsibility will have to be shared between the ECB and other policy institutions. But increased discretionary decision making, coupled with shared responsibility for policy instruments, poses serious accountability and reputational risks for the ECB, which deserve to be addressed proactively.

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CAN A LESS BORING ECB REMAIN ACCOUNTABLE?

JEAN PISANI-FERRY AND JAKOB VON WEIZSÄCKER, SEPTEMBER 2009

ACCOUNTABILITY AND TRANSPARENCY in central banking were defined and promoted as objectives at a time when central banks around the world thought their mission was to be predictable, guarded and conservative – “boring”, as Mervyn King, the governor of the Bank of England, aptly said in 2000¹. Indeed, in recent decades the trend has been for central banks to become more independent in order to credibly focus monetary policies on price stability. This clear focus and independent mandate have gone hand in hand with greater transparency and accountability of central bank action.

Yet, since the crisis started in 2007 and especially as it has evolved into a global shock of historic proportions, central banking has become anything but boring. Central banks have *de facto* taken on a much enhanced role and have successfully contributed to limiting the consequences of the financial crisis. The ECB in particular emerges from the last two years as a greatly-strengthened institution that has been able to react to unexpected events forcefully and creatively.

But these developments also have longer term implications for the role of central banks. In particular, recent experience suggests that they should worry about financial stability before bubbles build up, and not only – as Greenspan had it – once they burst. This would break with the trend of the last few decades, which has been towards central banks having a single policy objective, namely price stability, and a precise, even numerical definition of that objective.

To attempt to stop bubbles before they have a chance to become systematically threatening will

be a considerable challenge. Almost by definition, there is no fool-proof way to identify bubbles before they burst. Distinguishing them empirically from genuine productivity boosts (which should be accommodated by monetary policy) will require delicate judgement calls. This is why central banks before this crisis were reluctant to take on responsibility for the price of assets in the same way as for the price of goods and services.

Furthermore, beyond their specific remit, central banks are bound to be given an enhanced and qualitatively new role in the monitoring and prevention of financial risks. In the US, the Obama plan envisages giving the Fed responsibility for the supervision of all large financial institutions, and creating a Financial Services Oversight Council in which the Fed will participate and on which it will be able to rely. In Europe, the European Council agreed in June to implement the proposals contained in the De Larosière report and to create a European Systemic Risk Board² chaired by the president of the ECB as a macro-prudential early warning mechanism.

This new mission is bound to bring central banks onto a much more political terrain than they have been confined to so far. For these ‘warnings’ may intrinsically cover a much wider range of policy domains than traditional monetary policy, not only those of regulatory and supervisory agencies but in some cases domains where the usual players are governments and parliaments.

The likely broadening of the central bank’s mandate to include, directly or indirectly, macro-financial stability immediately raises delicate issues about the desirable division of labour.

1. “Our ambition at the Bank of England is to be boring”, King (2000) said, “our belief is that boring is best [for the management of the economy]”.

2. Report of the High Level Group on Financial Supervision in the EU, Jacques de Larosière et al (2009).

‘Central banking has become anything but boring since the crisis started in 2007 and as it has evolved into a global shock of historic proportions.’

Which of these powerful instruments should be placed under the direct control of democratically-elected and immediately-accountable governments, which should be under the control of specialised agencies with sometimes considerable autonomy in decision making, and which should be under the control of independent central banks? And how should these different actors exchange information and coordinate?

To explore the possible implications of this macro-prudential agenda on central banking, in particular on transparency and accountability, the remainder of this note proceeds as follows. The next section outlines how central banking evolved before the crisis. The third section explores the new agenda in more detail. The fourth and final section formulates a set of questions that might be of particular interest for the dialogue between the European Parliament and the President of the European Central Bank.

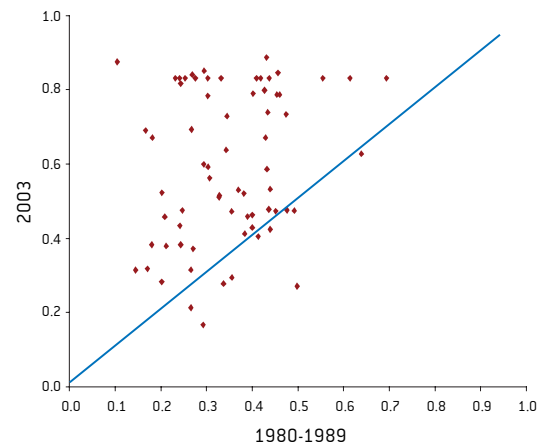
This note does not address any of the exit strategy issues and is entirely devoted to the longer-term post-crisis agenda.

CENTRAL BANKING IN RECENT DECADES³

Perhaps the most marked trend in central banking in recent decades has been the rapid increase in central bank independence, as shown by Figure 1.

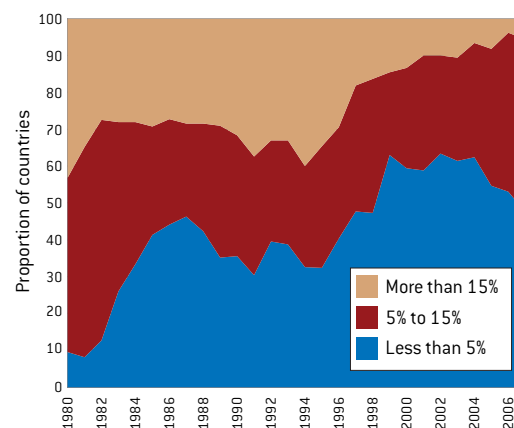
In parallel, the trend has been to make price stability the priority for monetary policy, steering away from the traditional trade-off between inflation and output stabilisation (with the notable exceptions of the US and, formally at least, Japan). It is worth noting that greater central bank independence and the strengthened focus on price stability have yielded impressive results. Globally, inflation rates have come down significantly in recent decades. Inflation higher than 15 percent per year has now become a rarity even in the developing world (Figure 2).

Figure 1: Central bank independence in the 1980s and the 2000s



Note: central bank independence index based on four components, relating to, respectively, appointment procedures for the head of the central bank, the resolution of conflict between the central bank and the executive branch of government, the use of an explicit policy target, and rules limiting lending to government. Source: Crow and Meade (2008), based on Cukierman, Webb, and Neyapti (1992).

Figure 2: World distribution of inflation rates, 1980-2007



Source: IMF, World Economic Outlook database.

Differences in outcomes do persist, not only because of differences in the general institutional set up. It matters not only what central banks aim to do but *how* they go about doing it. Since the early 1990s, central banks have increasingly relied on a specific implicit rule based on medium-run inflation forecasts – inflation targeting. This started in 1990 in New Zealand, soon followed by Canada, the United Kingdom, Sweden, Australia and others. The ECB itself has been increasingly

3. This section partially draws on Bénassy-Quéré, Coeuré, Jacquet and Pisani-Ferry (2010).

'The crisis is leading to a fundamental re-examination of the central banks' mandate and strategy. This is not merely a marginal shift. It is likely to have serious institutional and policy consequences that will require intense political reflection.'

influenced by this approach, although it always fell short of adopting it.

Inflation targeting is a sophisticated strategy. Contrary to what is commonly believed, it does not target the current rate of inflation, but the central bank's own inflation forecast. This forecast is conditional on all available information, including the current (and possibly future) monetary stance. The transparency of the rule is ensured through publishing both inflation forecasts (frequently accompanied by their standard deviation) and the models and assumptions used to prepare them.

This strategy has two significant advantages. First, it ensures a high degree of transparency and predictability of monetary policy because the central bank has one primary objective and communicates in real time on how likely it is to reach its objective within a given time frame. Second, it combines the advantages of a rules-based policy with reliance on a wider set of information that is traditionally associated with the discretionary approach⁴.

This recent trend has indeed further enhanced transparency and accountability in central banking. Eijffinger and Geraats (2006) quantified these effects, defining transparency as "the extent to which central banks disclose information that is related to the policymaking process". They even distinguish between several types of transparency as seen in Table 1.

By the late 2000s central banking around the world was therefore converging on a model characterised by high degrees of independence, specialisation (on the price stability objective), and transparency. These three characteristics were mutually consistent as well as consistent with accountability.

However, this has fundamentally changed with the crisis in which asset price bubbles have played a key role. The crisis is leading to a fundamental re-examination of the central banks' mandate and strategy. As will be discussed in the next section, this is not merely a marginal shift. It is likely to have serious institutional and policy consequences that will require intense political reflection over the coming months and beyond. And it is likely to affect in a rather fundamental way the approach to transparency and accountability.

A NEW POLICY FRAMEWORK

The current global financial crisis was triggered not least by asset price bubbles that developed during years of price stability. As a result, the notion that financial stability needs to feature much more prominently among the objectives of central banks, and that a framework for macroprudential supervision should be developed, has rapidly gained prominence and can today be considered mainstream⁵. However, this has important doctrinal, institutional and procedural implications, which matter for accountability and

Table 1: Central bank transparency index, 2002

	Australia	Canada	Euro area	Japan	N. Zealand	Sweden	Switz	UK	USA
Political	3	3	3	1.5	3	3	2.5	3	1
Economic	2	2.5	2.5	1.5	3	2	1.5	3	2.5
Procedural	1	1	1	2	3	3	1	3	2
Policy	1.5	2	2	1.5	3	3	2	1.5	3
Operational	1.5	2	2	1.5	2	3	0.5	2.5	1.5
TOTAL	9	10.5	10.5	8	14	14	7.5	13	10

4. For a recent survey of inflation targeting see Svensson (2008).

5. See eg De Larosière (2009) and IMF (2009).

which are far from fully understood at this stage.

Perhaps a good starting point is the 'Tinbergen rule', which states that an institution needs as many policy instruments as there are policy objectives⁶. The past trend towards specialisation was very much an application of this rule: in a nutshell, the central bank was given one objective, price stability, and was in control of one instrument, the short-term interest rate⁷.

If an institution has more than one objective and only one instrument, or more generally more objectives than instruments, it must engage in trade-offs across objectives – which is precisely what the monetary policy framework, developed over the last few decades, tried to avoid. Trade-offs complicate accountability and transparency as the institution needs to rank equally desirable objectives and make real-time choices between them⁸.

This is especially important for a pan-European institution like the ECB. In the past, countries such as Spain and Ireland experienced serious real estate bubbles. It would have been very hard to explain to the other euro-area countries that a country without any suspected bubble should suffer increased interest rates and subsequently higher rates of unemployment as a result of fighting a suspected bubble elsewhere despite the absence of an immediate inflation risk.

The solution to this dilemma is to have as many instruments as there are objectives – which in principle ensures that these objectives can be reached. But this does not eliminate all questions. Notably, one question that remains is whether each instrument should be assigned to a particular objective pursued independently by a particular institution, or whether instruments and objectives should be managed in conjunction.

Whatever the response, ensuring the accountability and transparency of a multi-task institution is bound to be more complex than for a single-task institution.

The accountability challenge becomes even more complex when coordination between different institutions controlling different instruments is involved. In fact, one of the arguments frequently made against coordination among institutions is that it blurs responsibility and complicates accountability.

In concrete terms, if the central bank is to be directly or indirectly given responsibility for financial stability, the interest rate instrument will no longer be enough and needs to be complemented by other means. These should primarily belong to the financial regulation toolkit, as is the case for countercyclical capital requirements to “dampen rather than amplify the financial and economic cycle” (as indicated in the April 2009 G20 declaration)⁹. But other instruments can be considered, such as supervisory guidance, legislative measures or possibly even tax measures that influence effective real interest rates, such as the deductibility regime of mortgage payments.

This perspective helps shed light on the current debates. The system currently envisaged in the EU (Box 1, overleaf) would give to the European Systemic Risk Board the task to “monitor and assess potential threats to financial stability and, where necessary, issue risk warnings and recommendations for action and monitor their implementation” (European Council conclusions, 18-19 June 2009). This suggests the ECB at the same time will potentially have to pay more attention to financial stability in the setting of interest rates *and* contribute to ensuring that other means are used to contribute to the same end.

'If an institution has more objectives than instruments, it must engage in trade-offs across objectives – which is precisely what the monetary policy framework, developed over the last few decades, tried to avoid. Trade-offs complicate accountability and transparency.'

6. After Jan Tinbergen, Dutch economist who was awarded the Nobel prize in 1969.

7. This is clearly a simplification, but one that comes close to the representation of the role of central banks in the modern macroeconomic literature.

8. See De Grauwe and Gros (2009) for a detailed discussion of the trade-off involved for central banks with only the interest rate instrument to deal with price and financial sector stability.

9. There is still discussion in the supervisory community and among experts on what is the best instrument to reach this goal. No consensus has yet been reached. An alternative is the 'dynamic provisioning' in the reserve requirements for banks, as is already current practice in Spain.

BOX 1: MACROPRUDENTIAL RECOMMENDATIONS OF THE DE LAROSIÈRE REPORT

In October 2008, the European Commission President requested a group of high-level experts to prepare a report on the future of financial regulation and supervision against the background of the economic crisis. This report, published in February 2009, contained a host of recommendations regarding the micro-prudential regulation of financial institutions and products at the European level. However, it recognised that these steps will need to be complemented by better macro-prudential supervision, taking into account that apparently independent micro-risks can be highly correlated because of system-wide and macro-economic linkages. As a result, excellent micro-prudential regulation may fail to detect the build-up of major economic risks.

To address this problem, the De Larosière report recommended the creation of a European Systemic Risk Council (ESRC), to be chaired by the President of the ECB and organised under the auspices and with the logistical support of the ECB. ESRC members should be the member of the General Council of the ECB, the chairpersons of the *Committee of European Banking Supervisors*, the *Committee of European Insurance and Occupational Pensions Supervisors*, the Committee of European Securities Regulators, and a representative of the European Commission. Whenever justified by the issues at stake, the Governors of the relevant national central banks could choose to be represented by the head of the relevant insurance or securities supervisory authorities. The ESRC should pool and analyse all information relevant for macro-prudential supervision and assure a proper flow of information between it and the micro-prudential supervisors.

If and when the ESRC issues a macro-prudential warning, there should be mandatory follow-up and actions by the relevant authorities in the EU. If the warnings are of a serious nature, then the chairman of the Economic and Financial Committee (EFC) is to be informed, so that the EFC, together with the European Commission, can implement a strategy to address these risks. Should the risks be of a global nature, then appropriate international bodies (International Monetary Fund, Financial Stability Forum, Bank for International Settlements) are to be informed to define appropriate actions at EU and global level. Enforcement at the European level is proposed to be organised via the EFC in case a national supervisor's response to a risk warning is deemed inadequate.

This proposed creation of a European macro-prudential supervisory body has received widespread support and was endorsed by the European Council in June 2009 (which decided the creation of a *Board* rather than a *Council*, hence ERSB).

However, while the desirability of an early warning system is almost universally agreed, there are legitimate questions about how effective it will be in practice. First, historical experience shows that bubbles generally have a plausible narrative of a positive productivity shock that is accepted by a significant proportion of the economic actors and experts. Second, it is unclear if, in times of crisis, the coordination and free information flow between national authorities and the European macro-prudential supervisory body would continue to function adequately despite possibly divergent incentives. In view of these difficulties in times of stress, it may well be that functional macro-prudential supervision at the European level will ultimately require truly European micro-prudential counterparts. However, such a step has proven difficult politically because national governments jealously guard their national micro-supervisory role, which is why even the De Larosière report trod carefully in this respect.

'Can the ECB be held accountable for the achievement of financial stability although it is not fully in charge of the corresponding instruments, and the responsibility for implementation is left to the regulatory and supervisory agencies?'

QUESTIONS FOR THE FUTURE

The preceding analysis raises a number of questions, which can be summarised as follow:

- a) Should the definition of the ECB's objectives be amended to give more weight to financial stability? If not (assuming the treaty language can accommodate the increased weight likely to be given to it in practice), where and how should the objective be defined in a way that facilitates the monitoring of the central bank's performance? Should financial stability be considered part of the 'general economic policies' that the ECB should support? Or should financial stability be considered a condition of lasting price stability?
- b) If the central bank is to give more weight to financial stability, what are the implications for the assignment of monetary policy to the primary goal of price stability? Does it mean that the central bank should be able to trade-off short-term price stability for longer-term financial stability, in other words to set the interest rate at a level that is higher than what is required to achieve price stability over the usual forecast horizon? Or should the central bank err on the side of caution? How should such decisions be communicated and how should central bank accountability be ensured?
- c) When pursuing financial stability, how can the ECB as an interest-rate setting institution take into account the variety of situations within the euro area? Do serious threats to financial stability in some countries or markets justify reacting more aggressively, implicitly giving them more importance than justified by their quantitative weight?
- d) How much discretion should there be in the management of countercyclical regulatory instruments? Should action be based on rules, or should there be room for discretion, at least during a learning phase?
- e) How does the ECB intend to manage the risk of increased competencies coupled with the increasingly political character of its decisions ultimately undermining support for its independence?
- f) Can the ECB be held accountable for the achievement of financial stability although it is not fully in charge of the corresponding instruments, and the responsibility for implementation is left to the regulatory and supervisory agencies?

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