Unelected power?

3,5 Min.

Central banks
Independence
Monetary policy

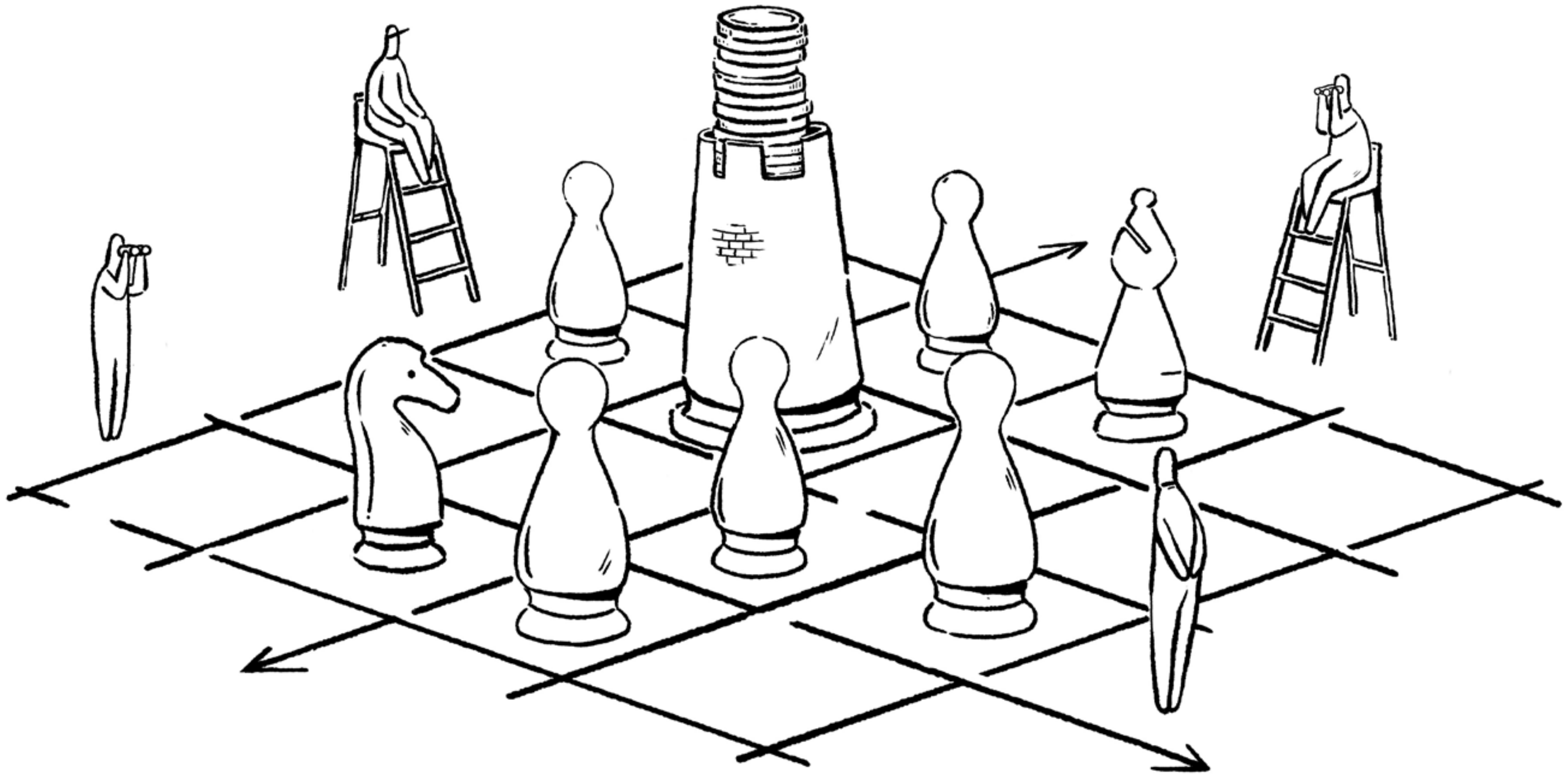
In the debate about interest rates, central banks are the key protagonists. Their decisions have far-reaching consequences, but unlike democratically elected governments, their power is not vested in them by way of election. Is this a problem? Sir Paul Tucker, former Deputy Governor of the Bank of England, and Professor Otmar Issing, former chief economist and former member of the Executive Board of the ECB, discuss the topic in an exchange of emails.

MODERATORS Felix Schütze und Dirk Stauer —— **ILLUSTRATION** Merlin Flügel

Felix Schütze wrote on 7 February 2019 at 1.47pm
Are central banks too independent?

Otmar Issing wrote on 11 February 2019 at 8.23pm
For a long time, the independence of central banks was not an issue internationally. Germany and the Bundesbank were the exception. In 1948, i.e. before the creation of the Federal Republic of Germany, the Allies – or to be more precise the US – imposed independence upon the newly established Bank deutscher Länder. In 1957 its successor, the Deutsche Bundesbank, became West Germany`s central bank. And against the will of Chancellor Konrad Adenauer, independence was also enshrined in the Bundesbank Act.
The global picture started to change in the wake of the Great Inflation of the 1970s. An initial study by Bade/Parkin, which revealed a negative correlation between the degree of central bank independence and the rate of inflation, was more or less ignored. Over time, however, a growing number of empirical studies supported this finding. By around 1990, this had become the mainstream view.

Independence was bestowed upon one central bank after another and it took only a few years before most major central banks had been given a statute in which independence and the goal of price stability were key elements. The Maastricht Treaty of 1992/93 was a prime example, while the Bank of England was a relative latecomer in 1997.
The following period of low inflation and robust growth confirmed the empirical findings. Central bank independence was a key precondition for the implementation of the right monetary policy.



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Felix Schütze wrote on 12 February 2019 at 10.26am

Sir Paul Tucker, do you share the same view on the independence of central banks? In your book Unelected Power you come to another conclusion. Could you please briefly explain your view?

Paul Tucker wrote on 14 February 2019 at 12.13pm

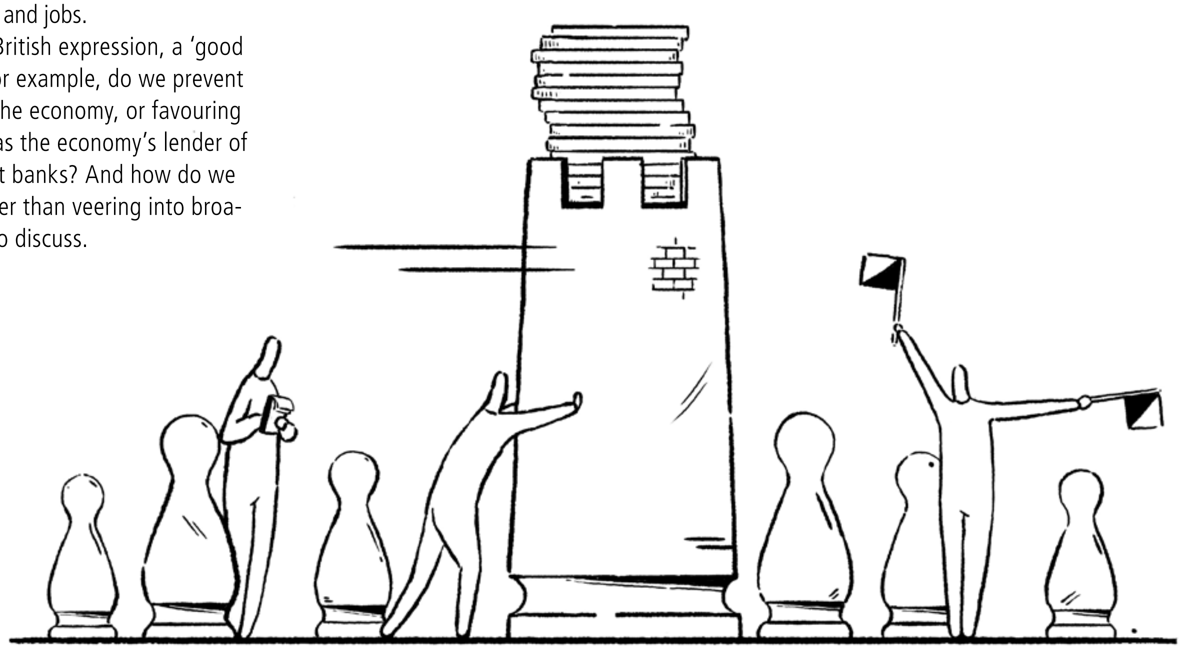
Everything Otmar says is true. Also, to be clear, I do think independent central banks are a good thing, when properly designed and constrained. Certainly they can help to improve aggregate welfare. Little good comes from pervasive uncertainty about the future value of money, given its role as a unit of account, medium of exchange and store of value. Low and stable inflation doesn't by any means guarantee the good things in life for citizens, but it is probably a precondition for achieving them.

What's more, I think a constitutionalist case can be made for central bank independence given the deep values, in liberal representative democracies, regarding the separation of powers. The monetary instrument is always latently a fiscal power: the power to redistribute resources among different groups by generating an unexpected burst of inflation that reduces the real value of debt, including government debt, denominated in money, as nearly all debt contracts are. In consequence, as I argue in Unelected Power, the very last people who should have day-to-day control over monetary policy are the elected executive, since it gives them the ability to tax without having to get formal approval from the elected assembly. We can think of the gold standard as an earlier period's institution for solving this problem, but it is a solution that is unlikely to be tolerable for full-franchise democracies given the volatility it entails in economic activity and jobs.

So independent central banks are, to use the British expression, a 'good thing'. But we can't just leave it there. How, for example, do we prevent them from steering the allocation of credit in the economy, or favouring some parts of the population over others, or, as the economy's lender of last resort, subsidising fundamentally insolvent banks? And how do we ensure that they keep to monetary affairs rather than veering into broader areas of public policy? There is much left to discuss.

Dirk Stauer wrote on 15 February 2019 at 8.03am

Professor Issing, do you think that central banks have paid enough attention to the impact of their policies on issues like the distribution of income and wealth? Or have they, on the contrary, been following a clandestine agenda to stabilise the political order, for example in Europe?



Otmar Issing wrote on 16 February 2019 at 4.13pm

There is hardly any monetary policy decision that is without distributional consequences. Many are negligible, some are substantial. The dividing line is between those distributional aspects which are an unintended side effect of monetary policy to achieve the goal of the central bank, and those which are explicitly directed towards distribution of income and wealth. In this context, one must not forget that maintaining price stability is in the interests of the weaker members of society who are hardest hit by inflation. This distributional aspect is an additional argument for price stability or for stipulating low and stable inflation as the primary goal for a central bank. If a central bank uses instruments such as special credit conditions for specific groups, certain banks, companies or households, the distributional effect is planned by the central bank. Decisions of this kind must remain in the domain of politics and thus ultimately under the control of the electorate. Such actions are not compatible with the status of independence. If a central bank ignores this principle, it undermines support for independence and will trigger opposition against it.

Dirk Stauer wrote on 18 February 2019 at 7.53am

Do you agree Paul Tucker? Have central banks fulfilled their role when price stability is achieved – and has this aim really been the guiding principle for monetary policy in recent years?

Paul Tucker wrote on 19 February 2019 at 8.23am

I'm with Otmar on most of this. As I explain in Unelected Power, in a constitutional democracy where a representative assembly is elected to make distributional decisions, an independent agency might take policy actions that have distributional effects but should not make big distributional choices. Where an independent central bank is constrained by its legal mandate to pursue a particular course that has distributional effects (for example, when it turns to QE because it is at the zero lower bound for interest rates), this can be distinguished from the moral precept that a person should have regard to the foreseeable (unintended) effects of their actions. I do, however, think that central banks should be active in highlighting distributional effects, because the elected fiscal authorities would then have the opportunity to offset them.

I want to add two other qualifications to what Otmar has said: First, even for the pursuit of price stability, I believe a monetary authority's objective should be set (or endorsed) by elected politicians, after a public process, rather than by the central bankers alone. That is, in part, because the choice between, say, an inflation target of 2 per cent or one of 3 per cent entails deciding the rate of the 'inflation tax' on non-interest bearing money. Furthermore, democratic societies should want to separate, as far as possible, accountability for the design of a delegated policy regime (with elected politicians) and accountability for its day-to-day stewardship (with central bankers). Given the euro area's incomplete political constitution, this is not possible for the European Central Bank, which is both more and less than a normal central bank.
Second, Otmar raises a very important point about operations that could steer the supply of credit. I would not go so far as to say that central banks should never conduct such operations, but there should be high hurdles. I elaborate on this in Unelected Power, but they should include regular monetary policy instruments being exhausted, and elected government determining the allocative parameters, with the central bank basically being left to decide how much and when. That need not undermine independence but, again, it is not feasible for the ECB.
I wonder, however, whether we should turn to the role of central banks in banking system stability?

Otmar Issing wrote on 19 February 2019 at 4.32pm

Anyone writing about central bank independence nowadays should have read and digested Paul Tucker's outstanding book Unelected Power. He defines the principles for delegation of power in a democracy in an all-encompassing way.
With the greatest respect for the arguments he puts forward in his book, I have two qualifications. Firstly, I doubt that it would be appropriate for elected politicians to define the target rate of inflation for price stability. The rationale for any particular number might change over time and politicians could be tempted to change the number and to interfere with the independence of the central bank. In the case of the ECB – Paul might agree - this approach would not be viable.
A central bank does not live in some kind of nirvana. This means that it should, and I think it would, adapt its monetary policy to fundamental changes in societal preferences. The right to change the status of the central bank must always remain with the legislature.
Secondly, I am not convinced that there are circumstances in which there would be a need for preferential credit supply by the central bank to specific groups. I think the government has a host of instruments at its disposal to channel credit to special purposes.

Finally, a word on the ECB. The biggest threat to its independence comes from transgressing its mandate and playing the role of the exclusive saviour. Responsibility for guaranteeing the cohesion of the European Monetary Union must remain in the domain of politics, i.e. in the hands of the governments of member states.

Paul Tucker wrote on 21 February 2019 at 4.47pm

Otmar raises three big points of course.
On the first, if the objective is not set by politicians, it is set by unelected technocrats, which is also problematic. Of course I agree that it would not be good if politicians could chop and change the objective. One option is for it to be set in secondary legislation, so that executive-branch politicians could not change it on a whim.
On the second, I broadly agree with Otmar, but there is an important nuance here. Central banks implicitly make credit decisions when they decide which instruments to include as eligible collateral in their operations and facilities, and which to exclude. The same goes for how they value the collateral they take, and how much excess collateral they want when lending against different instruments (known as haircuts). Some central banks have increased the transparency of their collateral policy, and that's a very good thing.
On the third and biggest point, I completely agree that the 'only game in town' problem is very important, and that central banks should not encourage it. I also believe that the ECB should have consulted euro area governments before rescuing the euro area project. But, on the other hand, it is a real problem that the foundations of the euro area are not robust and that there was insufficient recognition of the weak incentives members have to comply with fiscal rules (to which, perversely, they have strong short-term incentives to agree). Things would have been much worse if the euro area had completely imploded, and I do not know of anyone who has worked out how to manage an orderly, non-contagious exit of a member of the monetary union, or who knows how to contain the geopolitical implications of the euro area splitting apart. So, all told, this is a very uncomfortable position for the ECB's top brass, who also face a euro banking market with 19 different private-monetary systems. As the lender of last resort, that's yet another problem.

Dirk Stauer wrote on 22 February 2019 at 10.40am

What is the ECB's approach to this heterogeneous banking landscape, Professor Issing? Does the central bank try to take specific national features into account? And if so, how? And is this task complicated by its relatively new responsibilities in banking supervision?

PROFESSOR OTMAR ISSING

Born in 1936, chief economist and a member of the Executive Board of the European Central Bank from 1998 to 2006. During this time, he developed the monetary policy strategy of the ECB and was one of the architects of the introduction of the euro. He has been President of the Center for Financial Studies at the University of Frankfurt am Main since 2006. From 2008 to 2012 he headed the Advisory Council on a New Financial Order appointed by German chancellor Angela Merkel. He was also a member of the High Level Group of the European Commission chaired by Jacques de Larosière and a member of the Eminent Persons Group of the G20. Professor Issing spoke at the sixth risk management conference in November 2011.

Otmar Issing wrote on 25 February 2019 at 9.17pm

The question as to whether one size can fit all has always been and remains one of the fundamental concerns around the ECB´s monetary policy. In a monetary union there can be only a single monetary policy and the ECB´s mandate of maintaining price stability pertains to the entire euro area. From the beginning, the euro area has been, and continues to be, a heterogeneous group of countries which far from fulfil the criteria for an optimal currency area. As a consequence, the impact of the single monetary policy can differ substantially across member states.

This applies not only to the real economy of these countries but also to the banking sector. In the first years of its existence, the ECB provided liquidity to the banking system primarily via its main refinancing operations. This pattern changed fundamentally after the financial market crisis of 2007/08. The longer-term refinancing operations (LTROs), the targeted longer-term refinancing operations (TLTROs) and the enormous volume of the purchase programme for public-sector debt had a very different impact on banks in different member countries. It is hard to believe that this is merely an unintended side effect of those operations.

The ECB is now also the single supervisory authority. It remains an open question whether this is the optimal arrangement for the eurozone. In the report of the De Larosiere Committee, we argued against transferring this responsibility to the ECB. We referred to potential conflicts with monetary policy and risks for the independence of the central bank. Our proposal for an independent banking supervisory authority would have required a change to the Treaty on European Union. For the foreseeable future, this seems extremely unlikely. However, the arguments mentioned remain valid.

Paul Tucker wrote on 1 March 2019 at 0.40am

The uncomfortable truth of the European monetary union is that its membership extends beyond anything that could be described as an optimal currency area. As part of a political project to build Europe, that could of course make sense. But lacking the fiscal institutions of a normal currency area and with an incomplete banking union, the effect is to leave the ECB as a quasi-fiscal institution. Those who object to this must somehow face up to its inevitability until the economic union is given deeper roots.

Where Otmar and I part company, however, is over the role of central banks in the stability of the banking system. I would make the following points, all set out more carefully in Unelected Power. First, since our societies have chosen a monetary system in which most of the money we use comprises the deposit liabilities of commercial banks and since they are intrinsically tied to the supply of credit to the economy, there can be no monetary-system stability without banking-system stability. Second, as the issuer of the economy's final settlement asset, central banks are inevitably the lender of last resort (LOLR) to the banking system. Third, LOLR policy and operations are impossible to frame and execute effectively without deep and up-to-date knowledge of the condition of individual firms, and of the system as a whole. More than that, the central bank cares about getting its money back, and needs to avoid lending to fundamentally broken firms. In a nutshell, as Paul Volcker said thirty years ago, "neither monetary policy nor the financial system will be well served if a central bank loses interest in, or influence over, the financial system." Central banks are inevitably involved in overseeing the soundness of banking. No one should doubt that, as a matter of fact, the Bundesbank is, and has long been, intimately involved in supervising banks and in determining prudential standards. So, inevitably, will be the ECB.

The big question, then, is whether that should be recognised in the formal legislative framework. Some in Germany think not because it would (a) expose central banks to accountability for banking failures, and (b) blur functions. The first is a strange argument. Given our democratic and rule-of-law values, power should be formalised and accountable, not operating in the shadows. The second argument is typically coupled with a belief that information flows between a separate regulator and central bank can deliver what is needed. That is, I fear, closer to faith than reason, as my country discovered to its considerable (and inevitable) cost in 2007/08. Bureaucrats too often hoard information and are hesitant to cooperate across organisational boundaries when that could dilute their (relative) power or standing.

So, there might seem to be two possible models: a choice between, on the one hand, separation of monetary policy and supervision but with impaired cooperation and, on the other hand, combination but a blurring of functions. I believe that the blurring problem can be overcome through an institutional design that gives central bankers the right incentives. This would include giving a central bank supervisor a clear objective that can be monitored and prudential decisions and monetary policy decisions being taken by separate bodies within the central bank (which the ECB's Single Supervisory Mechanism gets close to delivering).

I quite understand that in Germany's particular case, it would be awkward to put banking supervision formally under the Bundesbank, as the Basic Law does not readily permit domestic regulatory agencies to be formally insulated from politics. But that is a local issue, which does not apply elsewhere, and should not drive European policy or jurisprudence. ‹

SIR PAUL TUCKER

Born in 1958, Deputy Governor of the Bank of England from 2009 to 2013. From 1980, he held a variety of senior posts at the Bank of England. Sir Paul was also a member of the steering committee of the G20 Financial Stability Board and a member of the Board of Directors of the Bank for International Settlements. He now lives in the US and holds the position of President of the Systemic Risk Council. He is also a Fellow of the Harvard Kennedy School of Government. In 2014, he was awarded a knighthood for his services to central banking.

Postscript

UNELECTED POWER, Sir Paul Tucker, Princeton University Press, 2018: This book prompted a debate about the independence and democratic legitimisation of central banks.

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