   

The Domain of Central Bank Independence

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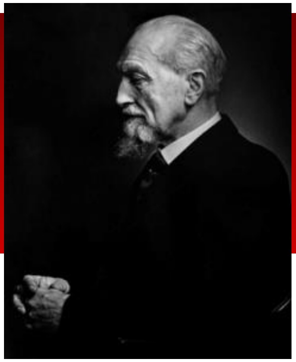
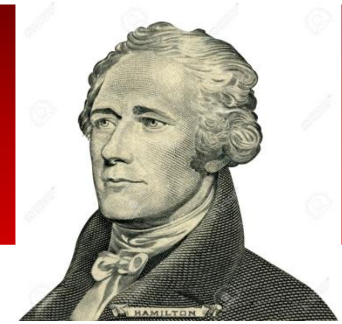
Montague Norman's vision: apolitical central banking



- "Montague Norman used to dream that the BIS would one day foster a core of central bankers ***entirely autonomous of governments***."
  - Source: Steven Solomon, *The Confidence Game*, 1995
- Why? Because politicians cannot be trusted to produce "sound money."
  - This idea long predates monetary policy.
- Independence implies *monopoly power*. But over what domain?

The five classic functions of a central bank



1. Guardian/operator of the payments system
   - Fiscal agent of the government
2. Supervisor/regulator of banks/FIs
3. Guardian of financial stability
4. Lender of last resort
5. Monetary policy ← **the new one**

1. Payments system

- CB need not run it, but can/should supervise it.
  - Financial "plumbing" must be more reliable than cable TV.
- Monopoly here? Not lately. Modern CBs have *competition* in providing various means of payment.
  - Loss of seigniorage could be a threat to CB independence.

2. Supervisor and/or regulator

- This is (at least) a 3x3x3 classification:
  1. Supervisor, regulator, or both?
  2. Just banks, all FIs, or something in between (e.g., SIFIs)?
  3. Microprudential, macroprudential, or both?
- The CB can have competitors in most cells.
- Hence lots of room for cross-country differences
  - ECB was written out of sup/reg *by design*, then put in *by necessity*.
  - The Fed has always been in, but with multiple competitors.

3. Financial stability

- Dates back centuries (has changed form)
  - The "Lords of Finance" made a hash of it
- Who else can do this job?
- Well,… in a crisis, the Treasury or Finance Ministry will be needed (maybe also the legislature/parliament).
- So no monopoly.

4. Lender of last resort

- Only an institution that can “print money” can be the LOLR.
  - So it’s a natural monopoly.
- Must be handled with care (moral hazard, inflation)
- A rarely mentioned paradox: LOLR loans are apt to be highly political events. Yet the function is assigned to non-political technocrats.

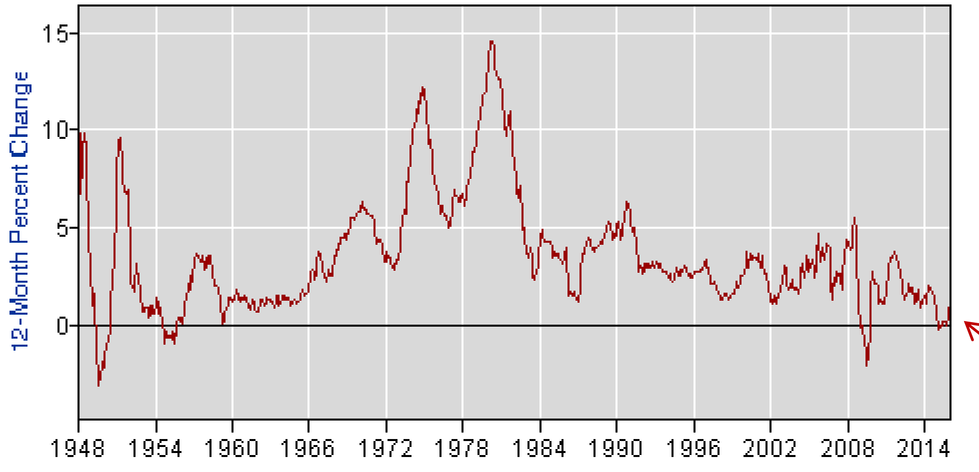
5. Monetary policy

- Pre-crisis, CBs were moving toward a consensus: Control an *overnight interest rate* to achieve an *inflation* target.
- Now monetary policy is much broader:
  - More instruments (e.g., QE, forward guidance,…)
  - More goals (e.g., financial stability; why not employment?)
- Remember the main argument for CBI: Politicians with *short* time horizons will inflate *too much*.
- But there are two "buts":

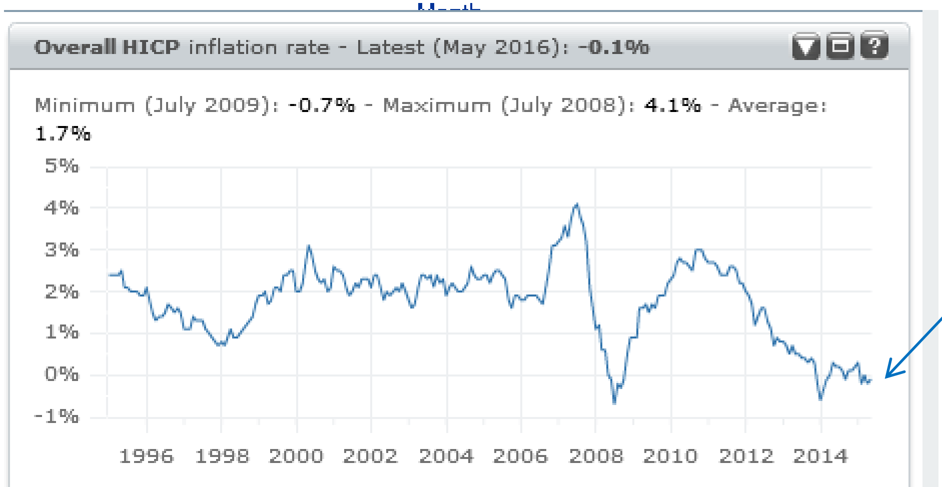
But what if inflation is too *low*?

Success in pushing inflation *up* looks minimal so far.

US-CPI



EA-HICP



We are here.

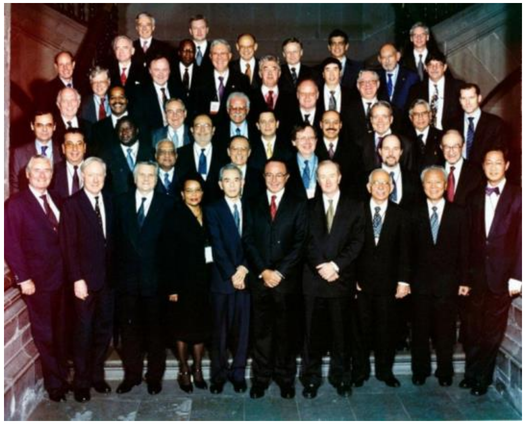
But what if modern central banks “listen” to the markets too closely?

- Two meanings of the verb “to listen.”
- Danger: Central banks can inherit the markets’ super-short time horizons (which make *political* time horizons look *long*).

Can a central bank be too independent?

- Certainly yes.
  - We don't really want CBs to be "entirely autonomous of governments." (Sorry, Monty!)
- In 1999, many observers thought the ECB's design might give it too much independence.
  - ECB "law" is a *treaty*, and ECB has no real *government* "above" it. (Compare the Fed.)
  - You don't hear those worries much today!
- In the US today, there is a backlash against the Fed for its unchecked and unbalanced power.

This disjuncture of views is surprising--and pretty interesting.



Let's hope the central bankers have it right!