The Global Battle Over Central Bank Independence

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This talk

- Financial crisis aftershocks have partially broken down the consensus on the wisdom of central bank independence.
- To the extent that central bank independence is weakened globally, macroeconomic stabilization policy will not be executed as well in the future as it has been since the mid-1980s.
  - This suggests more macroeconomic volatility ahead.
- "Fiscalization" of monetary policy will tend to complicate the policymaking process substantially.
  - Live example: The ECB's OMT program.

Consensus Weakening

What is the consensus on central bank independence?

- Effective macroeconomic stabilization policy has to be implemented in a timely manner in reaction to macroeconomic shocks. Example: Taylor-type policy rules.
- Fiscal policy adjustments through tax, spending, and borrowing policy tend to be slow and must be carefully negotiated.
- Monetary policy can be implemented in a timely and technocratic manner.
- *Hence the conventional wisdom*:
  - Focus fiscal policy decisions on the medium and longer run.
  - Delegate monetary policy to an independent authority.

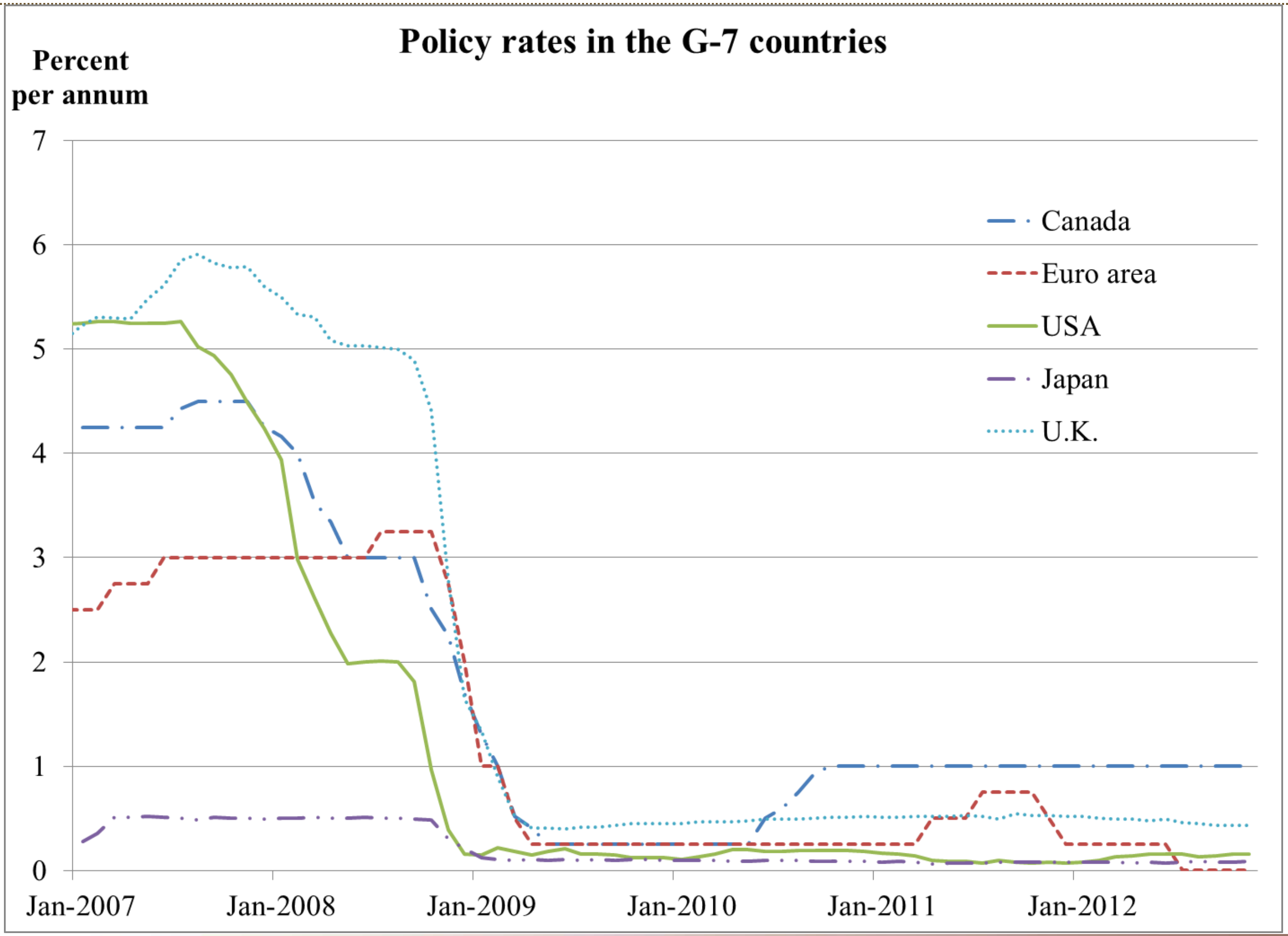
Why is this the consensus?

- The goal is to have an effective macroeconomic stabilization policy.
- If monetary policy is not delegated to an independent authority, then it too becomes part of the slow and complicated negotiations associated with fiscal policy.
- The society would be left without a way to make timely policy adjustments in reaction to macroeconomic shocks.
  - The result would be more macroeconomic volatility.
- The consensus therefore suggests that macroeconomic outcomes will be better with an independent central bank.

Why is the consensus breaking down?

- The central banks in the G-7 encountered the zero lower bound on nominal interest rates.
- This led many to talk about the need for fiscal authorities to step up and conduct macroeconomic stabilization policy.
- However, the usual political hurdles asserted themselves and led to a hodgepodge of fiscal policy responses not particularly well-timed with macroeconomic events.

Policy rates



Source: Haver Analytics. Last observation: November 2012.

Aside: The zero lower bound and fiscal programs

- The binding ZLB does not necessarily imply a need for fiscally-oriented macroeconomic stabilization policy.
- Central banks have conducted stabilization policy effectively even while at the zero bound.
  - Two key tools: QE programs and forward guidance.
  - Evidence: Inflation has generally stayed near target instead of falling dramatically.
- The NK literature suggests that an effective monetary policy makes fiscal stabilization policy irrelevant, and that forward guidance keeps monetary policy effective even at the ZLB.*

* *See:* J. Bullard, 2012, "Death of a Theory," *FRB of St. Louis Review*, March/April, 94(2), pp. 83-102.

Fiscal Responses

The central bank and fiscal policy

- Nevertheless, many see fiscal stabilization policy as desirable in the current context.
- One idea: Suggest that the central bank take actions that are cumbersome to accomplish through a democratically-elected body.
- This may be seen as one way to get the relatively speedy monetary policy decision-making into a fiscal policy context.

Slower, Negotiated Decision-Making

- This is a "creeping politicization" of monetary policy.
- Some central bank independence is lost since the monetary authority is taking actions at the behest of other policy actors.
- Monetary policy decisions then become wrapped up with fiscal policy decisions, slowing down the process through negotiation and making it considerably more complicated.

A proper approach

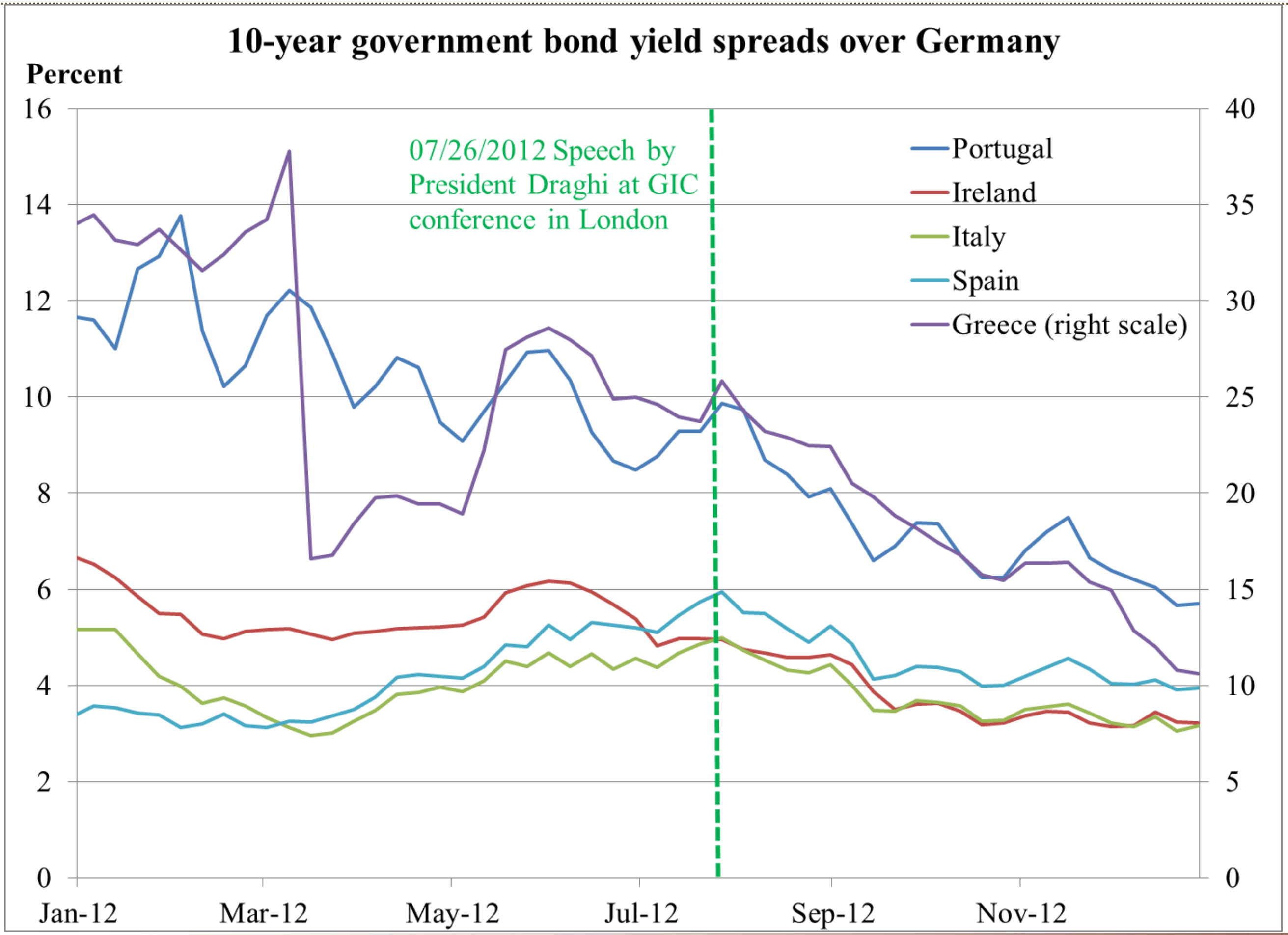
- Why ask a central bank to design programs outside of its area of expertise?
- Democratically-elected institutions could certainly create a fiscal stabilization authority, perhaps modeled on the FOMC, that could make technocratic fiscal decisions in speedy reaction to macroeconomic events.
- Such an authority could be allowed to act within assigned limits and under a clearly-specified mandate with periodic reporting.
- I have never heard of such a proposal, but Congress clearly does create specific institutions for specific purposes.

Outright Monetary Transactions

The recent ECB program

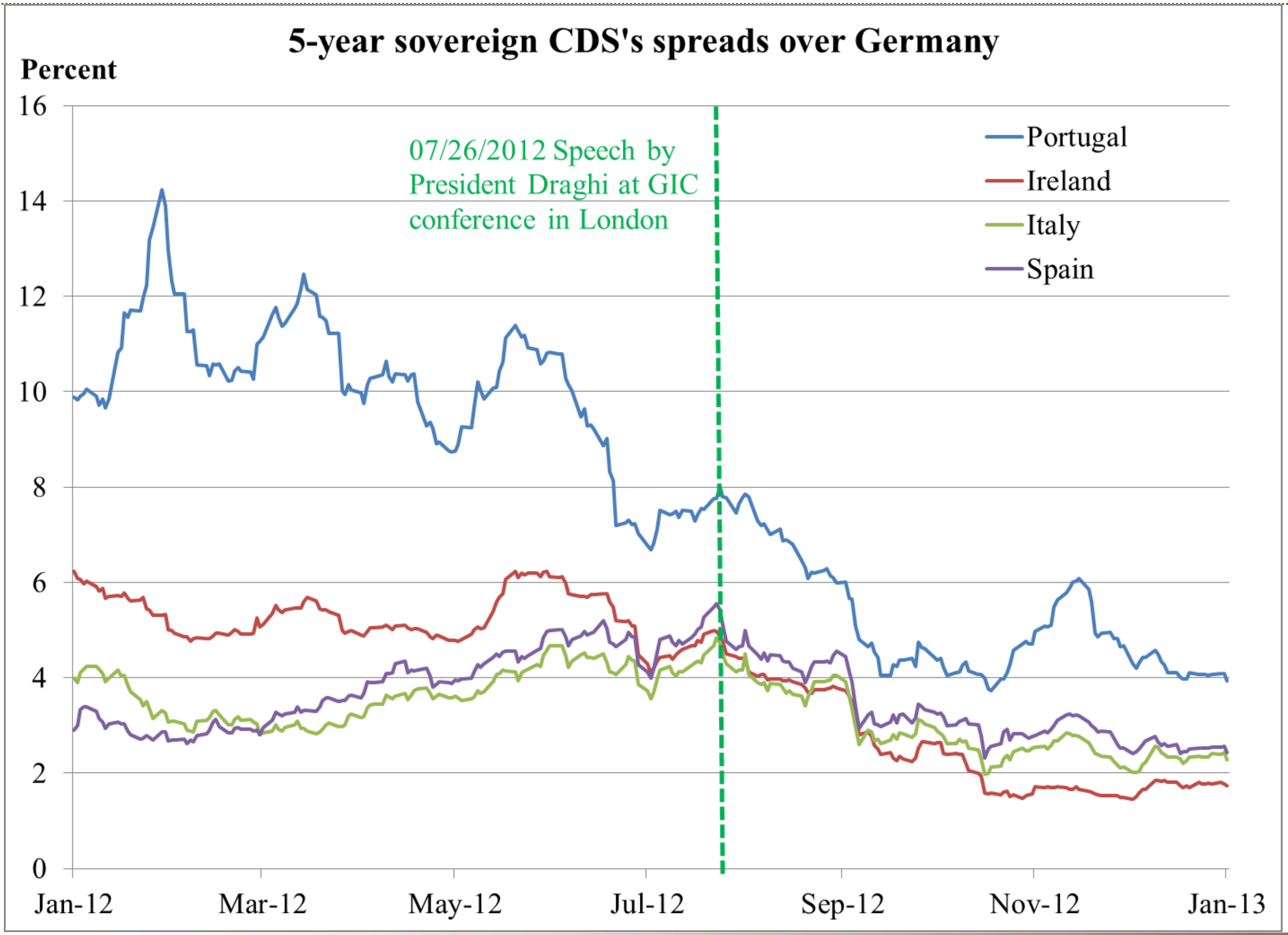
- The European Central Bank recently announced an "outright monetary transactions" (OMT) program.
- This program has been widely interpreted as a promise to buy the sovereign debt of individual nations.
- A key element of the program is that purchases, should they occur, are conditional on the nation meeting certain fiscal targets.
- Purchases would be sterilized, so that the program is not the same as U.S.- and U.K.-style quantitative easing.
- The program has been regarded as "successful" so far.

Euro area 10-year bond spreads



Source: Financial Times and author's calculations. Last observation: week of December 28, 2012.

Euro area 5-year sovereign CDS's spreads



Source: Bloomberg and author's calculations. Last observation: January 2, 2013.

Fiscalization of monetary policy

- This is "fiscalization" of monetary policy: Asking the central bank to take actions far outside the remit of monetary policy.
  - The analog in the U.S. would be a promise to purchase, or even monetize, state debt in exchange for the state maintaining a fiscal program considered prudent by the central bank.
- Assistance like this from a central authority to a region is best brokered through the political process in democratically-elected bodies.
- In Europe, the ECB is in essence substituting for a weak pan-European central government.

Ordinary monetary policy

- Ordinary monetary policy provides or removes monetary accommodation in response to macroeconomic developments.
- There has been a large macroeconomic development in Europe: Eurozone recession.
- Yet, little direct action has been taken by the ECB in response to the recession.
  - The policy rate has not been significantly adjusted.
  - The ECB has not employed QE or used forward guidance.

A muted response

- One could argue that the monetary policy response to the European recession has been muted compared to more ordinary circumstances.

- Why? By nearly all accounts, the monetary policy process has been bogged down by political wrangling over the OMT and other programs.

Ordinary monetary policy derailed

- *End result*:
  - By conducting a fiscal action, the central bank has been pulled away from its ordinary macroeconomic stabilization policy.
  - Standard monetary policy has become wrapped up in the fiscal policy package and subject to the negotiations that surround that package.
  - This defeats one of the original purposes of central bank independence: Having a monetary authority that can react to macroeconomic shocks quickly and effectively.

Conclusions

Summary

- Financial crisis aftershocks have introduced a "creeping politicization" of central banking globally.
- The macroeconomic performance of nations with politicized central banks has historically been quite poor.
- One live example of the current trend is the ECB's OMT program.
- One interpretation of the OMT is that it is a fiscal-type operation, and that ordinary monetary policy has become part of the negotiation over the fiscal package.
- This has altered the response of the ECB to the European recession.

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