



IS THE CASE FOR CENTRAL BANK INDEPENDENCE DEAD?

**ED BALLS
AND
ANNA STANSBURY**

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ALESINA & SUMMERS: THE 1990S CASE FOR INDEPENDENCE

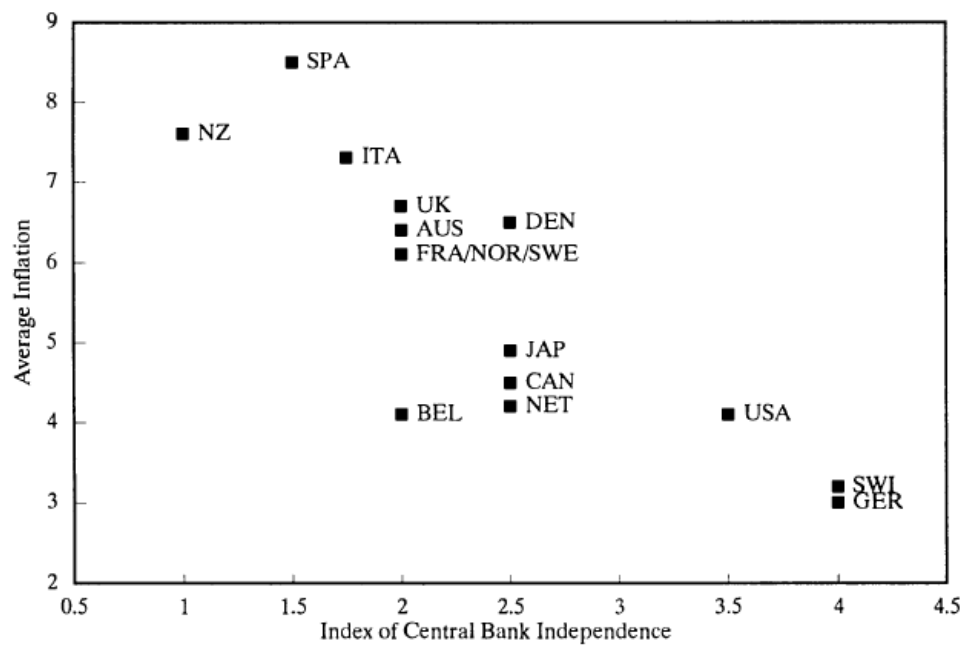
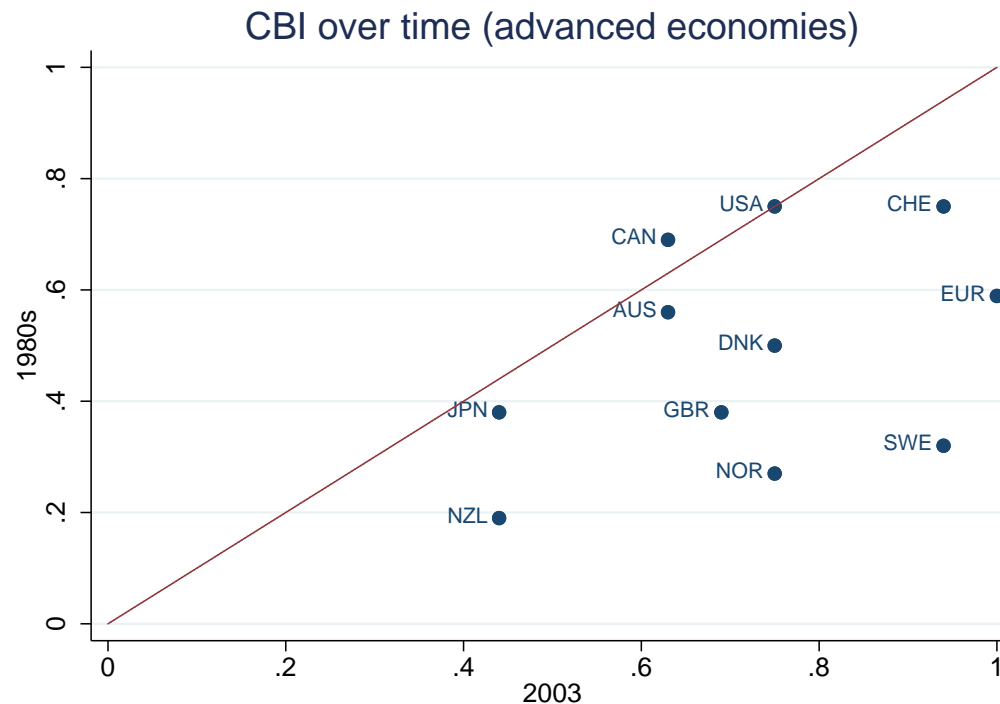


FIG. 1a. Average Inflation

Source: Alesina and Summers (1993)

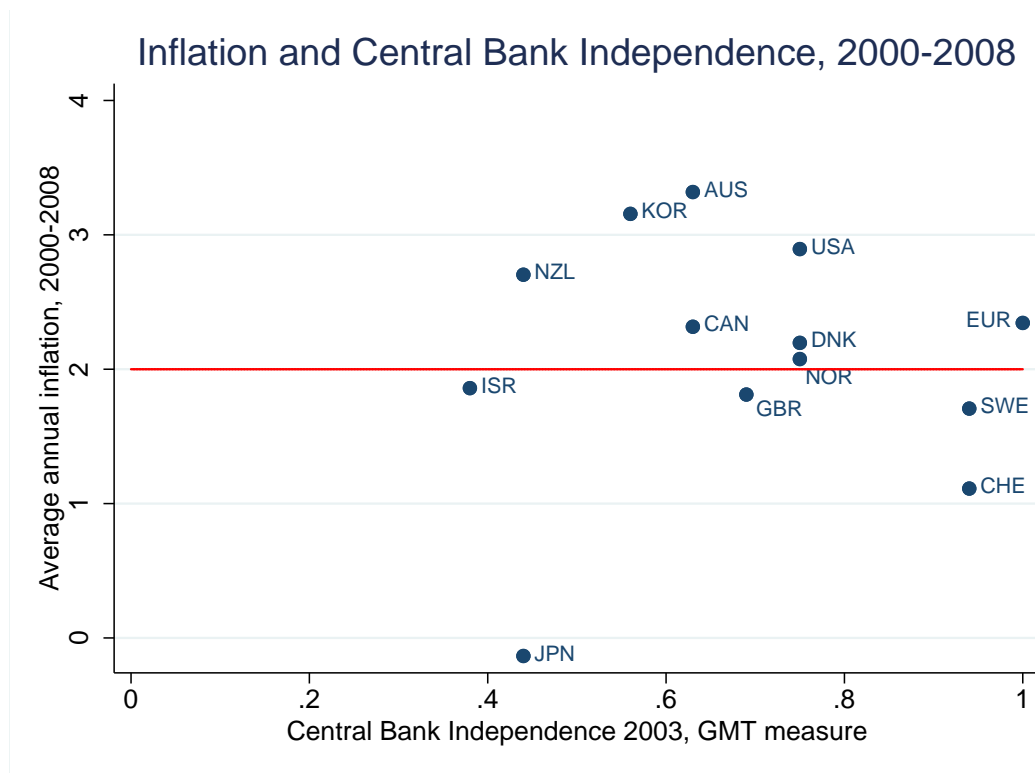
SINCE THE 1980S, MOST COUNTRIES INCREASED CENTRAL BANK INDEPENDENCE



Source: Balls, Howat and Stansbury (2018).

CBI data from Grilli, Masciandaro and Tabellini (1991) and Arnone, Laurens, Segalotto and Sommer (2007)
Euro area data point for 1980s is weighted average of the 1980s CBI of the 2003 Euro member states

BUT THE INFLATION-INDEPENDENCE CORRELATION DISAPPEARED PRE-CRISIS



Source: Balls, Howat and Stansbury (2018).

CBI data from Arnone, Laurens, Segalotto and Sommer (2007); inflation data from World Bank WDI

WHAT HAS CHANGED SINCE THE FINANCIAL CRISIS?

Pre-crisis:

- Consensus that central bank independence a good thing
- Build-up of financial sector risks
- Low and stable inflation

Post-crisis:

- Consensus around central bank independence under pressure
- New macroprudential responsibilities, tools and structures
- Too-low inflation and zero lower bound

PUBLIC AND POLITICAL CRITICISM

115TH CONGRESS
1ST SESSION

H. R. 24

[Report No. 115-318]

To require a full audit of the Board of Governors of the Federal Reserve System and the Federal reserve banks by the Comptroller General the United States, and for other purposes.

'Get back to normal policy', Schäuble urges ECB



News

Central bankers have collectively lost the plot. They must raise interest rates or face their doom

WILLIAM HAGUE

18 OCTOBER 2016 • 6:15AM



Central bank independence is losing its lustre

Monetary policy involves trade-offs that are fundamentally political in nature

WOLFGANG MÜNCHAU [+ Add to myFT](#)



ACADEMIC CRITICISM: I/ POSEN CRITIQUE

“The impact of central bank independence on economic outcomes is highly overrated...”

...It's not to say central bank independence wasn't important... but it took place against this background of a common effort across all central bankers to bring down inflation...

*...Central bank independence was as much a **reflection of the effort** and the credibility gained as a cause.”*

Adam Posen (2017). Speech at Bank of England “20 years on” conference.

ACADEMIC CRITICISM:

2/ ALESINA CRITIQUE

“One argument put forward by Fischer and DeBelle (1994) is that the policy goal, say the target level of inflation, should be chosen by elected politicians, while the Central Bank should have the independence of choosing the policy instruments more appropriate to achieve that goal...

...This is a rather "minimalist" view of the meaning of Central Bank independence”

Alberto Alesina and Andrea Stella (2011). “The Politics of Monetary Policy”.
Handbook of Monetary Economics

ACADEMIC CRITICISM:

3/ BUITER CRITIQUE

“Central banks in most of the advanced economies have become too powerful...

...In particular, they have accrued a host of deeply political responsibilities and powers. They have neither the legitimacy nor the capability or skills to discharge all these responsibilities effectively.

*I propose a **return to narrow central banking.**”*

Willem Buiter (2014). “Central Banks: Powerful, Political, and Unaccountable?”
Journal of the British Academy

ACADEMIC CRITICISM:

4/ SUMMERS CRITIQUE

“When the primary policy challenge for central banks was establishing credibility that the printing press was under control, it was appropriate for them to jealously guard their independence.

*When the challenge is to accelerate, rather than brake, economies, **more cooperation with domestic fiscal authorities and foreign counterparts is necessary**”*

Lawrence Summers (2016). “The Age of Secular Stagnation”, *Foreign Affairs*

OUR RESEARCH HIGHLIGHTS TWO IMPORTANT DIMENSIONS TO CBI

Operational independence:

the ability of the central bank to select and use monetary tools with autonomy

Political independence:

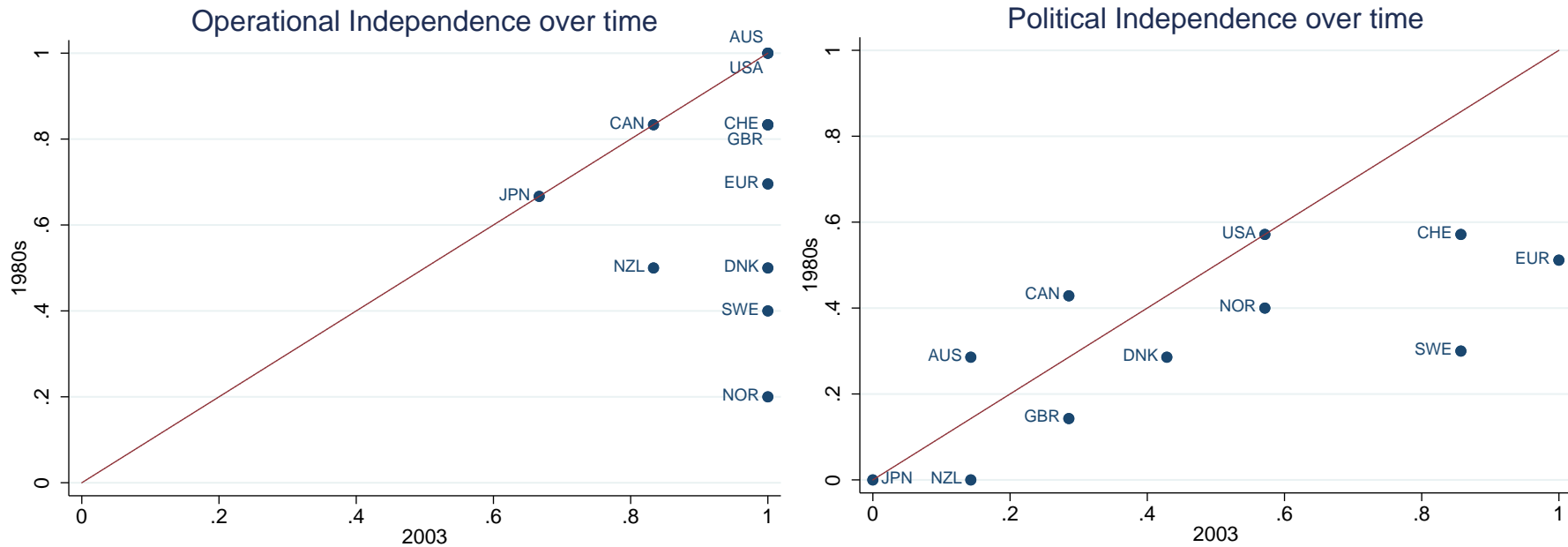
the absence of possibility for political influence over the central bank

e.g.

Bank of England is operationally independent but not politically independent – government sets inflation target

ECB and Fed are both operationally and politically independent

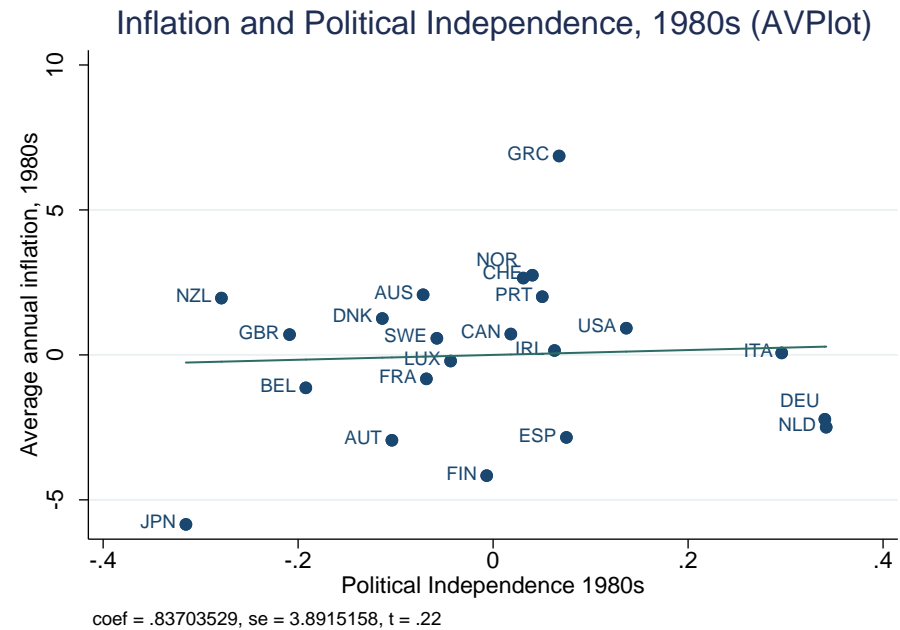
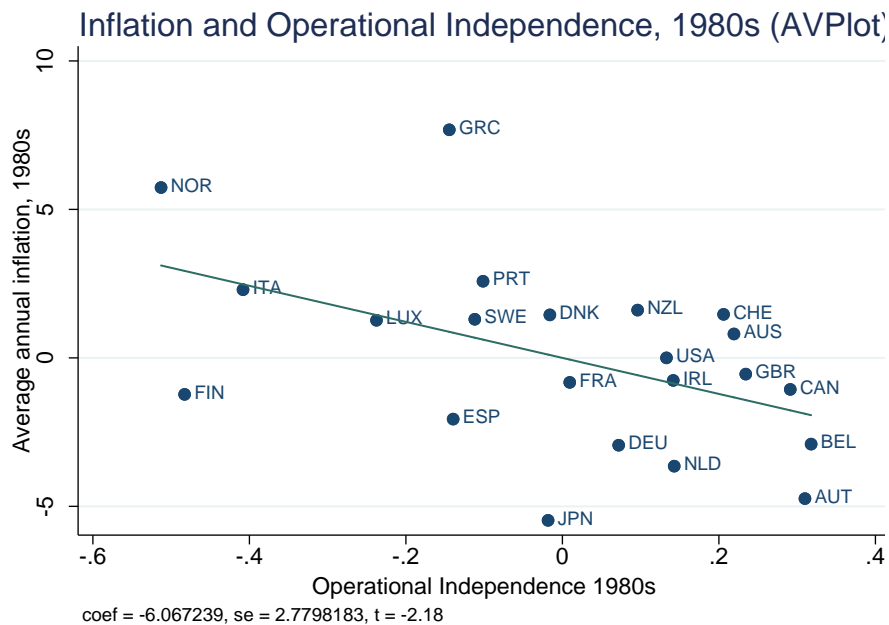
ADVANCED ECONOMIES INCREASED OPERATIONAL CBI (BUT NOT POLITICAL)



Source: Balls, Howat and Stansbury (2018).

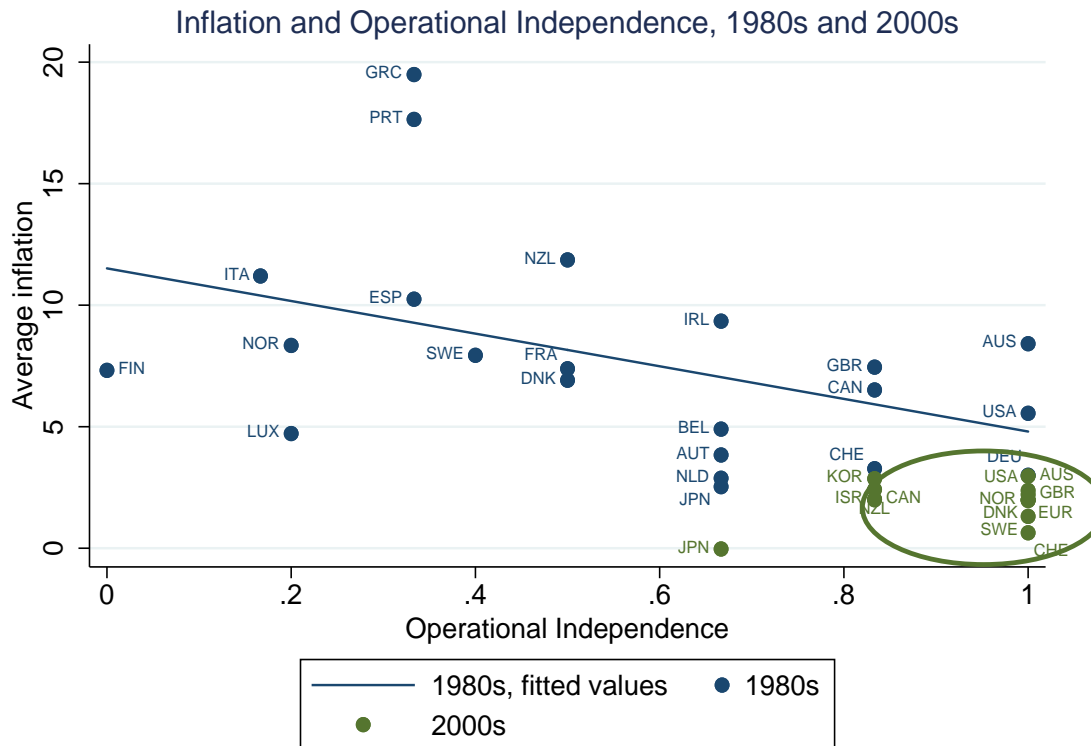
CBI data from Grilli, Masciandaro and Tabellini (1991) and Arnone, Laurens, Segalotto and Sommer (2007)
Euro area data point for 1980s is weighted average of the 1980s CBI of the 2003 Euro member states

ONLY OPERATIONAL CBI MATTERED FOR ADVANCED ECONOMIES IN 1970S/80S...



... contrary to the Alesina critique

...AND BY 2000S THEY ALL HAD HIGH OPERATIONAL CBI AND LOW INFLATION



... suggesting that – notwithstanding the Posen critique – the 1980s/1990s case for operational independence remains

BUT CRISIS HAS GIVEN CENTRAL BANKS ADDITIONAL POWERS AND CHALLENGES

- Macro-prudential policy

*Can central banks manage these extra powers and responsibilities?
Or is this an area central banks should withdraw from? (Buiter)*

- Monetary-fiscal coordination

Does central bank independence make this impossible? (Summers)

CRITERIA FOR REFORM: WHEN DOES INDEPENDENCE MAKE SENSE?

When should a policy function be located in an independent institution?

- Political incentive to “cheat”
- Clearly-defined goal and effective accountability mechanism
- No first-order distributional impact
- No significant fiscal impact

When should that institution be the central bank?

- No conflict with monetary policy
- Relevant expertise in the central bank

MONETARY POLICY

When should a policy function be located in an independent institution?

- ✓ ■ Political incentive to “cheat”
- ✓ ■ Clearly-defined goal and effective accountability mechanism
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SYSTEMIC RISK OVERSIGHT AND MACRO-PRUDENTIAL POLICY

When should a policy function be located in an independent institution?

- ✓ ■ Political incentive to “cheat”
- ~ ■ Clearly-defined goal and effective accountability mechanism
- ✗ ■ No first-order distributional impact
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IS BUITER RIGHT THAT CENTRAL BANKS SHOULD GET OUT OF MACROPRUDENTIAL POLICY?

- Macro-prudential policy and systemic risk management is clearly a risk for both the credibility of central bank independence and democratic accountability
 - Hard to define a clear goal
 - First order distributional impact
 - Risk of significant fiscal impact
 - Potential conflict with monetary policy
- But in our paper we argue that operational independence can help provide a solution

OUR SOLUTION FOR MACRO-PRUDENTIAL POLICY

Separate **systemic risk oversight** and **macro-prudential policy**.

A **systemic risk oversight** body should:

- Be responsible for monitoring systemic risks and setting policy priorities
- Include members from the central bank, regulators and the government
- Be chaired by a government representative

A **macro-prudential** body should:

- Be operationally independent from government
- Bring together central bank and financial regulators
- Be led by the central bank

Argues for a hybrid model between current Fed and Bank of England

MONETARY-FISCAL POLICY COORDINATION

When should a policy function be located in an independent institution?

- ✓ ■ Political incentive to “cheat”
- ✓ ■ Clearly-defined goal and effective accountability mechanism
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- ✗ ■ No significant fiscal impact

When should that institution be the central bank?

- ✓ ■ No conflict with monetary policy
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IS SUMMERS RIGHT THAT MONETARY-FISCAL COORDINATION AND CBI CONFLICT?

- Lack of monetary-fiscal coordination was clearly a big problem post-crisis
 - *“Fiscal policymakers, far from helping the economy, appeared to be actively working to hinder it... Monetary policy ... cannot carry the entire burden”*
Ben Bernanke (2015)
 - *“A stronger collective policy approach is urgently needed, focusing on a greater use of fiscal and pro-growth structural policies, to strengthen growth and reduce financial risks”* Catherine Mann, OECD Chief Economist (2016)
 - *“It is essential that fiscal policy supports the nascent recovery. Planned near-term fiscal tightening will be a drag on growth”*
IMF (2013) United Kingdom Article IV Consultation
- In our paper we explore whether operational independence can help find a solution

ONE POSSIBLE SOLUTION FOR MONETARY-FISCAL COORDINATION

One possible solution could be a **fiscal open letter system**

Once the interest rate goes below a pre-defined threshold close to the ZLB, the central bank writes a quarterly open letter to the government, with its view on the ***appropriate stance of fiscal policy to help meet the inflation target*** (and support growth)

This would meet three conditions:

- Decision to send letter triggered by the central bank
- Ability to send letter confined to the zero lower bound
- Government retains control over stance and content of fiscal policy

But – still a risk that central bank may be drawn into politics?

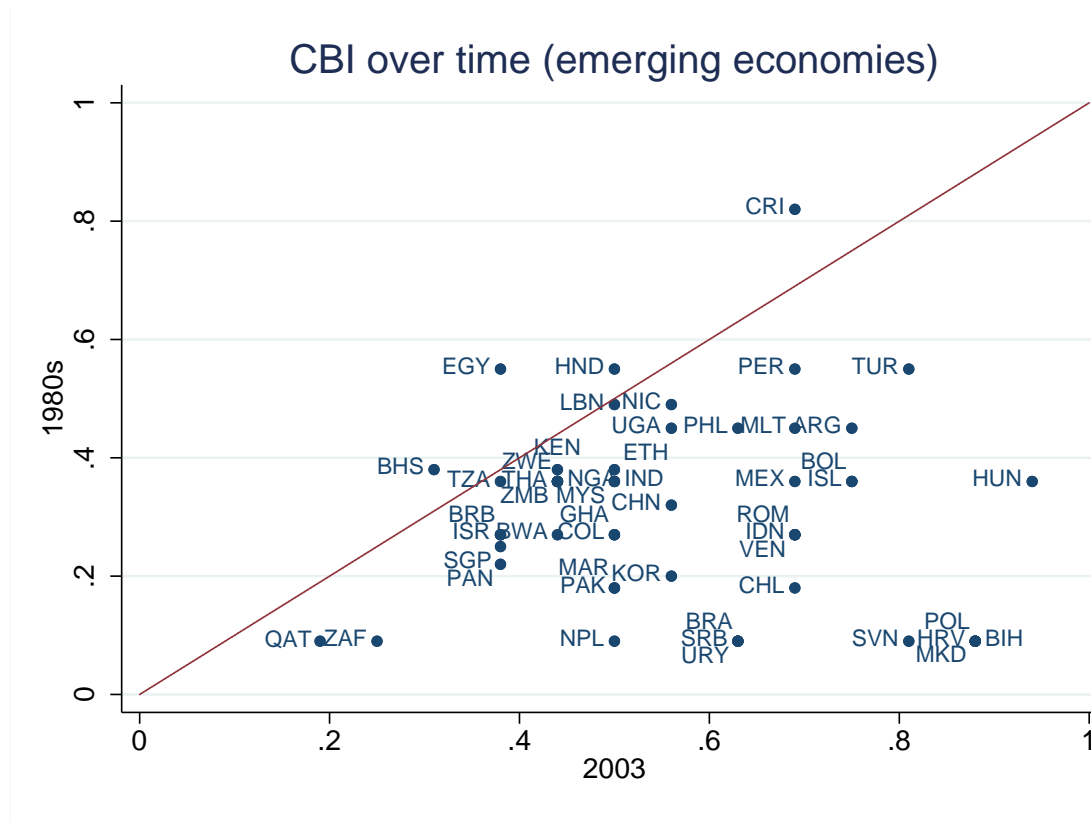
CONCLUDING REMARKS

- The case for operational independence is not dead (if it was ever alive – Adam?)
- But since the financial crisis independent central banks have become more unpopular as their powers and responsibilities have increased.
- Our paper argues that the solution must strike the right balance between operational independence and effective political oversight.
- No country has it right yet on macroprudential policy: the U.S. and U.K. can learn from each other



APPENDIX SLIDES

CENTRAL BANK INDEPENDENCE OVER TIME IN EMERGING ECONOMIES



POLITICAL AND OPERATIONAL INDEPENDENCE OVER TIME IN EMERGING ECONOMIES

