Klaas Knot: Central bank independence and unconventional monetary policy – challenges for the European Central Bank

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the Bank of Mexico international conference "Central bank independence – Progress and challenges", Mexico City, 15 October 2013.

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Ladies and gentlemen,

It's a great pleasure for me to have been invited to speak at this conference of the Banco de México. Especially so as this event marks the 20th anniversary of its autonomy. And I gladly congratulate the Banco de México on this important milestone.

The topic of this Conference – central bank independence: progress and challenges – is very well chosen, I would say.

For from the dawn of the financial crisis, back in the summer of 2007, the role of central banks and particularly the relationship with governments has been controversial.

In light of the theme of this session, my remarks will focus on one of the most independent central banks of the world, the ECB. I do so as the ECB's unconventional actions have also sparked intense debate about its independence.

The main question I try to address is how the ECB should respond to today's complex and challenging environment in which its independence could be at risk.

I would like to start off my remarks by reminding people the long-standing wisdom that it is imperative to protect central bank independence.

Already in the early 19th century, the economic theorist David Ricardo explained why it wasn't a good idea to entrust governments with the power to issue paper money. For governments, he argued, would almost certainly abuse this power. For instance, if circumstances compelled them to create money, such as at times of war.

Instead, Ricardo reasoned, central banks must be governed by individuals who should be "*entirely independent*" of the government, and who "*should never, on any pretence, lend money to the Government, nor be in the slightest degree under its control or influence*".

Clearly, Ricardo's original ideas are still valid today, for most of the world's major central banks enjoy a substantial degree of independence. In fact, it is generally undisputed that central bank independence is the way to protect governments against the temptation to misuse monetary policy for short-term goals – for example, by creating sudden inflation to ease budget pressures. By granting monetary policy to the discretion of an independent central bank, the focus can be on long-run stability.

Research has also shown that independence enables central banks to run more credible monetary policy, making it "easier" to achieve their goals.

A final merit of central bank independence, especially relevant in the current juncture, is the scope it creates for unorthodox measures during crisis periods.

In fact, the greater a central bank's independence and credibility in normal times, the greater its flexibility and credibility to engage in unconventional monetary policy during critical times. Thus, during crises, an independent central bank has much more flexibility to take actions that might otherwise fuel inflationary fears.

This brings me to the essence of this session. Much of the current controversy surrounding central bank independence is related with central banks' ability to engage in unconventional monetary policy.

As many have argued, their large-scale purchases of financial assets and other unorthodox measures have taken central banks into “unchartered waters” and explicitly challenged the notion of central bank independence.

The unprecedented expansion of central banks’ balance sheets since the start of the crisis is certainly revealing. It shows that central banks’ balance sheets are becoming more and more exposed to economic risk and political pressure. Eventually, this may result in a substantial amount of negative capital in a central bank’s balance sheet. This is undesirable, because it could undermine a central bank’s credibility and independence. On the one hand, a government guarantee to cover potential losses would protect a central bank’s financial position. But, if the government has to invoke this guarantee, the fiscal dimension of monetary policy becomes very visible, and the previously solid line between fiscal and monetary policy will be blurred.

An additional concern for central banks is that unconventional monetary policy increasingly comes with some sense of “public unease” about the role central banks play.

While the majority of the public doesn’t understand the way central banks operate, many consider central banks at the same time as the only player with room for maneuver. The fact that criticism of central banks is creeping more and more into the mainstream debate – whether or not this is justified – implies that the public is looking increasingly critically at central banks.

While this may not put central banks’ independence or room for maneuver immediately at risk, it does signify that central banks may need to step up their efforts on transparency and accountability. This is a topic I will return to later.

Now I would like to turn to how central banks should operate in this more complex and challenging environment with a particular focus on the ECB.

In my view, there are six points of special interest for the ECB, which I will deal with in the remainder of my remarks.

To start with, it is imperative that the ECB sticks to its mandate to maintain price stability over the medium term. This, despite the many calls to widen its mandate to explicitly include financial stability considerations and/or domestic employment goals.

In theory, delegation of a task to an independent authority is more acceptable

– when the delegated task is clearly specified and has no overlap with other policy tasks;

– when there are relatively few distributional implications;

– and when a clear-cut measure of accountability can be achieved.

These conditions are largely satisfied when monetary policy is primarily geared at achieving price stability. Especially if we compare this with monetary policy disciplined by a dual mandate, which is – in Volcker’s words (2012) – “*operationally confusing and ultimately illusionary*”.

Second, the ECB should continue to explain the rationale behind its unconventional monetary policy measures to the public. While most major central banks have employed unconventional monetary policy in response to the crisis, the exact measures and foundations have differed significantly across central banks.

The ECB’s approach differs from that of the other major central banks in that its unconventional monetary policy measures aim to support the effective transmission of monetary policy to the economy, instead of delivering a direct stimulus.

In this sense, ECB’s unconventional monetary policy measures are a complement to, rather than a substitute for, standard monetary policy. They aim to restore a more normally functioning transmission mechanism and contribute to an environment where standard measures can operate effectively. Underlying this approach is the euro area's financial structure: in the euro area, banks are the main agents for channeling funds from savers to borrowers, while in many other countries market-based financing predominates. The largely bank-based structure of financing in the euro area is reflected in the ECB's monetary policy and in the design of its unconventional monetary policy.

It could hence be argued that ECB's unconventional monetary policy measures are "purely" monetary policy. And, I would add, should also remain there.

Third, the ECB should take the specific modalities of the unconventional monetary policy-measures into account. For these modalities might influence the extent to which central bank independence is at risk.

After all, large-scale outright asset purchases will result in a different risk profile for the central bank's balance sheet than unconventional monetary policy directed at providing liquidity support to the banking system in collateralized operations. In my view, one particularly nice feature of the bulk of ECB's unconventional monetary policy measures concerns its "natural" or "embedded" exit.

This makes the ECB less sensitive to political pressure than in a situation in which it would have to make an explicit choice for unwinding.

For instance, one of the key elements of the ECB's response to the intensification of the sovereign debt crisis was the design of the Longer-Term Refinancing Operations or LTROs.

These LTROs ensured that banks had sufficient liquidity over the medium term, while at the same time embedding phasing-out as a design feature. Or in other words, the exit was taken into account up-front.

Fourth, the ECB should be clear about the limits of monetary policy and manage expectations of what it can achieve.

This is important because central banks are – undeservedly – considered to be the only player with room for maneuver and therefore subject to unreasonable expectations of what monetary policy might achieve. These expectations should be downplayed to avoid disappointment with the public and the political pressure that might follow.

In particular, the ECB should stress that the problems in the euro area are not problems that monetary policy can completely solve, as they are rooted in weaknesses in banks' balance sheets, weak government finances and supply side rigidities in many economies. All the ECB could do is provide "breathing space" for banks and governments to act, and it has done so.

Fifth point, at the same time, the ECB should try to sustain or provide the right incentives to governments and banks. As regards governments, sound public finances are an important underpinning of central bank independence. Conducting an independent monetary policy is made significantly more difficult in the event of large budget deficits. A similar story could be told for labour and especially product market reforms.

That is why I very much argued for and welcomed the explicit conditionality in the form of an ESM programme in the Outright Monetary Transactions scheme. This ensures that governments make the necessary efforts to restore the sustainability of public finances, reform of the supply side of their economies and in doing so contribute indirectly to central bank independence.

For banks, such conditionality hasn't been used so far. However, given that it is very important to provide the right incentives, it might be worthwhile to explore whether some kind of conditionality might be introduced for banks in the as yet unforeseen case of new liquidity stress in the euro area. For instance, it might be investigated whether the provision of additional liquidity could be made conditional on strict asset quality reviews or efforts to build up adequate capital.

This would contribute directly to restoring the health of the financial system and the transmission mechanism. As a consequence, this would lessen the need to sustain unconventional monetary policy over a longer period, and hence also contribute indirectly to reducing the pressure on central bank independence.

Finally, such an approach would help to address the unpleasant side-effects of earlier unconventional monetary policy measures. [I'm referring for instance to how banks have used LTROs to buy higher-yielding sovereign bonds, and thus contributed to the diabolic loop between governments and banks instead of having provided an impulse to lend to the real economy.]

Finally, as we all know, central bank independence is sustainable only if it is accompanied by strong accountability and a high level of transparency.

As the ECB's role in policy making has increased significantly during the crisis, it needs to find ways to further enhance transparency and accountability. The public needs to be explained in the clearest possible terms why the ECB has opted, or not opted, to take certain measures.

A richer way of communicating our deliberations would definitely contribute to this. More openness would also give the public a more balanced impression of the discussions conducted in the Governing Council. This, in turn, would support the predictability and credibility of our monetary policy.

At the same time, we should avoid that more openness about the deliberations in the Governing Council leads to enormous pressure on the Governors of national central banks and puts the independence of individual Governing Council members at risk. Members are acting in the interest of the euro area as a whole, but often have to explain these decisions to a predominantly national audience.

A richer way of communicating our deliberations will sharpen the European mandate. Increased transparency should not jeopardize this important building block of our institution. I therefore believe we should stick to the principle of collective rather than individual accountability.

Let me conclude: "*Independence can't just be a slogan*".

The preservation of central bank independence in a democratic society ultimately depends on asking reasonable deliverables from the central bank. At the same time, as society changes, the interpretation of "reasonable deliverables" might change over time, and hence the preference for central bank independence.

This has implications for both central banks and governments. Central banks should not take their independence for granted, but protect it continuously.

Governments, on the other hand, should not put all their hopes on central banks.

Instead, they should explain the fundamental reasons behind their choice to delegate powers to an independent central bank, and at the same time do their own job.