Central bank independence – a path less clear

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It is always a pleasure to return to Mexico City; especially so on this important occasion. Anniversaries are always a good time to reflect on the past in an effort to learn and to plan for the future. And, since this is an anniversary of autonomy, my task is to look at the history and the future of central bank independence. Before I start, let me be clear: I believe that central bank independence has served us well in the past, and will continue to serve us well in the future.

Of central bankers and mountaineers

As I come from a Swiss-based institution, an alpine analogy seems apt. Central bankers today are a bit like winter mountaineers who, after a lengthy walk through benign and predictable terrain, get hit by an avalanche. The survivors are now regrouping, trying to figure out how to proceed safely.

I grant that, being prudent, most central bankers would never go hiking on an avalanche-prone snowfield, but I'm sure you see the point. The question today is whether the techniques and institutional arrangements that kept us on the right path during the pre-crisis decades are still good enough. Or do we need to make adjustments for the rougher terrain ahead?

During the closing decades of the last century, a consensus emerged on how central banks should be designed. The key insight was that a central bank best serves society's interests when it exercises independent authority over decisions designed to achieve clearly specified objectives focused on maintaining the value of money. To buttress its independence, so the consensus went, the central bank should have full control over its resources and financial strength. Accountability would be ensured through transparency. That is, there was a consensus that the mountaineers themselves were best equipped to find the right way. The result, after some trial and error, was a smooth and steady path – the Great Moderation.

But this consensus has fallen victim to the recent financial and economic avalanches. Broader, deeper and more open-ended responsibilities for financial stability have dragged central banks into politically charged territory. To carry out

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these new responsibilities requires them to balance between several different objectives. This raises the risk of conflicts, adding to the ruggedness of the terrain. The aims of financial stability policy elude easy definition and measurement, transparency faces limits, and accountability remains elusive. At the same time, monetary policy in major advanced economies has recently involved large-scale purchases of financial assets, taking several central banks into previously unexplored territory.

A brief recap of the pre-crisis standard model

To appreciate the challenges ahead, it is worth taking a closer look at the consensus model that most of us take for granted. This was the result of two intellectual streams coming together. The first was a much improved understanding of how the macroeconomy and the financial system function and interact, while the second flowed from fresh insights into how decision-making for public policy should be organised.

Macroeconomic foundations

In the consensus model, it was nearly axiomatic that prudential, fiscal and monetary policies could be separated. Instruments could then be cleanly mapped to specific policy objectives, with minimal overlap.

- Prudential policy would use capital and liquidity regulation to reduce the likelihood that individual institutions would fail; to limit contagion from such failures; to ensure continued market functioning; and to counter the moral hazard arising from retail deposit insurance and implicit government guarantees. And, because its ultimate purpose was to address an externality, prudential policy was thought to be more or less unchanging through time.
- Fiscal policy, by setting taxes and expenditures, would focus on promoting growth and employment. It would address social preferences about the way that income is distributed across households and among its ultimate uses, consumption, investment and government expenditure. And, through straightforward countercyclical taxes and spending, fiscal policy could automatically stabilise the macroeconomy. Importantly, fiscal policy could focus on long-term objectives.
- By contrast, monetary policy would serve as the short-term, flexible tool for maintaining price stability and stabilising aggregate demand. All this would be achieved by the central bank's judicious use of its balance sheet, or even just announcements, to adjust a short-term interest rate (or the exchange rate).

The differences in time horizon – prudential policy, timeless; fiscal policy, low-frequency and long-term; and monetary policy, high-frequency and short-term – reduced the need for any one authority to worry much about the objectives of the other two. And, importantly, we had empirical models that let us predict the response of target variables to changes in instruments. For example, we had rules of thumb that would tell us what a 25 basis point change in the policy rate would do to output and inflation one or two years ahead.

Organisation and governance

These clearly separated responsibilities translated into equally clear governance arrangements. Well defined tasks (such as monetary policy and, to a lesser extent, the enforcement of prudential regulation) were delegated to independent agencies. This delegation recognised that attempts to centralise *all* public policy decision-making can have undesirable consequences. In some areas, decisions would be driven by politicians pursuing their own short-term re-election interests, or the interests of particular groups they represent.

Delegation of state powers raises important constitutional questions. To put it starkly, central bank independence is fundamentally at odds with representative democracy. As a result, steps were taken to make the delegation more palatable. Such measures included:

- specifying the objective clearly;
- avoiding overlaps between policy tasks assigned to different authorities so as to reduce the need for trade-offs that would require negotiation; and
- holding authorities accountable, primarily through transparency.

By consensus, monetary and prudential policies satisfied the conditions for delegation. Fiscal policy did not. Objectives for monetary and prudential policy were more easily defined, it was thought, so that instruments could be assigned in a way that would obviate the need for active coordination or negotiation. And, since fiscal policy makes distributional choices that are both greater and more visible, it is best left to the politicians.

Starting in the 1980s, the idea of central bank independence spread. The success of independent central banks such as the Bundesbank in containing inflation in the 1970s encouraged the delegation of monetary policy to independent central banks. Evidence that greater independence was correlated with lower inflation further accelerated the trend.

Post-crisis challenges to the standard model

The crisis has thrown the deficiencies of the standard model into bold relief. We have become acutely aware of a whole raft of overlaps and conflicts. Among other things, we now see that:

- monetary policy influences fiscal policy through the central bank’s balance sheet;
- fiscal policy influences monetary and regulatory policies through its financing choices;
- monetary policy influences regulatory policy through its influence on balance sheets;
- regulatory policy influences fiscal policy through its treatment of sovereign debt; and

- regulatory policy influences monetary policy by changing borrowing costs.

And, in the aftermath of the crisis, we see that these policies are even more intertwined, since the restoration of financial stability can be expensive and central banks are often called upon to bear some of the cost.

After receding for a few decades, the issue of interconnections and trade-offs between the various policies has returned in full force. As a result, we are being forced to reconsider the standard model.

Theoretical foundations reconsidered

Starting with the theoretical foundations, we need to better understand the linkages between the financial system and the real economy if we are to build a framework that will deliver macroeconomic stability. It would be wrong to claim these linkages have been ignored. In fact, I would argue that the entire literature on the monetary policy transmission mechanism is about this relationship. After all, the point of monetary policy is to influence prices and output by adjusting financial conditions.

But focusing solely on the relationship between policy rates and financing conditions for households and corporates proved to be an oversimplification. If we are to build a more resilient system, we need to understand why debt is so prevalent a form of finance; and how to integrate debt and default, booms and busts into macro models. And then we need to calibrate these models so that policymakers can use them.

Governance foundations reconsidered

Turning to governance, we confront challenges in at least four areas. These arise from the newly prominent role that financial stability must play in macroeconomic stabilisation:

First, policy objectives today are less clear than they were a decade ago. There is no simple operational definition of financial stability, and there are no numerical measures. If the task is hard to describe, constructing the financial stability analogue to inflation targeting is even more difficult. And without clearly defined targets, it is extremely difficult to specify the objectives for an independent authority and to make it properly accountable.

Second is the challenge of transparency. A high level of openness about decisions and their rationale is harder to achieve when constructing financial stability policy. Without clear metrics, it is difficult to justify financial stability actions that are seen to hinder the financing of profitable projects. Yet a high level of transparency is needed if accountability is to match the level of authority typically delegated in the standard model. And, in the prudential realm, transparency can be counterproductive when paying heed to institutional fragility.

Third is the risk of greater political sensitivity to central bank decisions. Financial stability policy will often target individual firms, products or sectors. This makes much more obvious exactly whose interests are affected. And the greater overlap between instruments and objectives entails a greater risk of policy conflicts. This is particularly true when the focus is on preventing the worst macroeconomic outcomes. When the best response to such conflicts cannot be known in advance, the only option may be discretionary decisions with potentially large consequences for welfare. And, in most countries, such decisions are normally reserved for elected representatives.

Finally, arm’s length coordination may no longer be feasible. In many countries, financial regulation is divided among several agencies, some under direct political control. Coordination increasingly involves multi-agency councils. Most of these are chaired by ministry officials rather than by central bankers. Working collaboratively to analyse threats to economic and financial stability may provide more insights than working separately. And, in principle, one might foster this collaboration by assigning all the relevant responsibilities to the central bank. But this may be asking too much of the central bank, putting its independence at risk and compromising its ability to achieve any of its objectives.

What lies ahead?

In the same way that mountaineers will proceed differently after surviving an avalanche, it is hard to see how the standard model could return as the foundation for policy frameworks. Does this mean that we must forgo the advantages of independent central banking? It would be easy to be despondent, but I am not, for several reasons.

First, the great virtue of de-politicisation through delegation holds even more forcefully today. Financial stability policy is exposed to more lobbying and political pressure than is monetary policy: stopping people from doing things they believe to be profitable and productive is never going to be popular. But the ability and the credibility to do just that is crucial if financial stabilisation efforts are to succeed.

Second, I am confident that when designing robust institutional frameworks we can manage the challenges that I have described. Remember that we have been here before. In the late 1970s, many of the ingredients of what I have called the standard model were still missing. We had little knowledge of how to connect the things under our direct control, interest rates and central bank liabilities, to the things we ultimately cared about, inflation and growth. We had little experience of explaining what we were doing or why, so that transparency and accountability were lacking. Even the need for independence was not widely appreciated.

Perhaps today’s starting point for integrating financial stability into policy frameworks is more difficult than the one we faced nearly half a century ago, but we can take heart from the fact that we did make progress then. And I believe that policymakers are also better now at learning from each other. There are now a number of experiments under way on institutional design for financial stability policy frameworks. These include different configurations, some entirely inside central banks and other involving finance ministry officials. In the same way that we came to central bank independence a quarter century ago, by testing various governance structures for financial stability policy, we will be guided toward best practice which can then be widely adopted.

Given organisations such as the BIS, with its Central Bank Governance Group and other fora – in which both Agustín Carstens and his predecessor Guillermo Ortiz have played very important roles – the emerging lessons will be quickly made accessible to others. That is, through cooperation, I am optimistic that we will learn more quickly this time.

Coming back to our mountaineers, a new awareness of avalanche dangers has clearly complicated the task of finding the way. But that awareness also offers a great opportunity: to discover a much safer path for the journey ahead.

Ladies and gentlemen, I wish the Bank of Mexico all the very best over the next 20 years.