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Comments on Harold James: Central Banks: Between Internationalisation and Domestic Political Control

It gives me great pleasure to discuss this interesting paper by Professor Harold James. In my comments, I would like to focus on four key points that I took away from Professor James' paper:

1. Autonomous or independent central banks are more likely to exist in federal systems of government.
2. Central banks' status and independence are subject to cycles related to financial and economic crises.
3. There is a tension between international co-operation among central banks and domestic political control that becomes more pronounced in the aftermath of a crisis.
4. As we currently find ourselves in the aftermath of a deep financial crisis, the situation will be more challenging for central banks than it has been in the recent past. They face more critical domestic scrutiny, and there is a larger risk that central bank independence will be undermined and central bank cooperation questioned.

All of the above points are convincingly argued and well illustrated by the case study of European monetary integration, which is interesting in its own right. However, I think that the above statements, although correct in themselves, only sketch a particular picture, making the conclusions perhaps too pessimistic, at least regarding the monetary policy part of central banking. Let me expand on this.

In the last two decades or so, there have been powerful drivers behind the dominant monetary policy framework, which is composed of price stability as the main goal, independence for central banks to apply monetary policy instruments in order to reach that goal, and flexible exchange rates.

First, the former experience of high inflation and the realisation, underpinned by experience and theory, that there is no long-run inverse relationship between inflation and unemployment gave strong support for the intellectual case that price stability should be the main goal of monetary policy. Additionally, the expansion and development of capital markets strengthened the constituency for price stability.

Second, real and financial globalisation made fixed exchange rate regimes with free capital movements increasingly difficult to operate. An alternative nominal anchor was therefore called for in many countries that had previously used a fixed exchange rate for that purpose.[1]

Third, there were improvements in the "science" and "technology" of monetary policy formulation and implementation. In addition, the repeated nature of monetary policy decisions gives scope for learning through trial and error to a much greater degree than is possible in the case of financial stability. After all, we take decisions on interest rates all the time, whereas we fortunately deal with financial crises only once in a while. All of this gives monetary policy the aura of a science to be entrusted to technocrats.

These factors are unrelated to the form of the state, and to a significant degree they are still with us. Furthermore, although I may be wrong, and I might be too strongly influenced by what I experience in my own country, I do not sense any great drive for the abolition of price stability as a goal or for the transfer of monetary policy decision-making to politicians. Yes, we central bankers are all facing more critical scrutiny, and that is not all bad. There are also more critical comments from politicians, but it seems to me that, in general, they have no strong desire to get involved in the decision-making process. After all, that would make them responsible, which is not always convenient. Better to leave it to the central bankers and be free to criticise.

It is another matter that due to the crisis we have moved into territory that is necessarily more politicised, as Professor James describes quite well. In addition, the governance arrangements for systemic or marcroprudential policies are in the process of being worked out. Should central banks be allocated key tasks, as now seems likely, then we need to acknowledge that not all of the arguments for central bank independence that apply to monetary policy will necessarily carry over. Financial stability is more multifaceted than monetary policy, and it involves more trade-offs. Additionally, financial stability is necessarily a cooperative activity, involving other institutions, ministries and the government.

Should central banks be allocated additional tasks in the financial stability field, we might need to make a distinction between the independence and autonomy of the institution, on the one hand, and the various functions, on the other. Central bank independence is not a religion. It has to be argued in each case. The governance arrangements for the financial stability functions will be different from those applying to the monetary policy function, as financial stability requires more cooperation with other institutions and may involve more

[1] In my former incarnation as Chief Economist of the Central Bank of Iceland from 1994-2004, I was deeply involved with this process in my own country when it moved away from exchange rate targeting to inflation targeting in the late 1990s and the early 2000s. See, for instance, Gudmundsson *et al* (2001). But it later became clearer that financial globalisation makes even the conduct of inflation targeting and floating exchange rates complicated in very small, open, and financially integrated economies. See Gudmundsson (2008).

political oversight. The key issue is to preserve the independence of the monetary policy function.

The crisis has put policy coordination more firmly on the agenda, not least in small, open economies where policy conflicts can be very damaging. It is not clear what this will mean in terms of central bank autonomy and stature. I tend to think the case can be made that central bank independence in terms of setting monetary policy can coexist with better policy coordination, but this should be explored further. Here again, the distinction between the independence of the institution and of the functions might be of key importance.

Finally, as I am supposed to give the perspective of the policy maker, let me say the following: yes, there are cycles in history, but the role of groups and even individuals still matters. It is far from a foregone conclusion that we are seeing the end of independent central banks. Central bankers can influence these developments, and so they should. As we enter uncharted waters, and as other functions are introduced, possibly with different governance arrangements, it is up to us to try to preserve the independence of the monetary policy function that has served society so well in the past.

References:

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