Boris Vujčić: The role of central banks and how to insure their independence

Speech by Mr Boris Vujčić, Governor of the Croatian National Bank, at the Symposium on "Central Banking in Central and Eastern Europe: Policy Making, Investment and Low Yields", organized by the Czech National Bank and OMFIF (Official Monetary and Financial Institutions Forum), Prague, 10 June 2016.

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Dear colleagues,

Dear Mirek, Dear David,

Thank you for the invitation. I stand here in front of you with a bit of mixed feelings. I am always happy to be with you, always happy to be in the wonderful Prague, at the CNB, but at the same time it is not easy to bid farewell to a fellow Governor and a friend.

The idea for me to say a few words on this occasion about central bank independence was not mine, but I endorsed it immediately. No central banker would refuse to talk about the central bank independence. This topic was not chosen by coincidence. The role of central banks has greatly changed from before the Great Financial Crisis, and central bank independence is today being challenged from many directions. As David already mentioned today, central banks seem to have been the only game in town for quite some time now. Why is that so? There is an old joke about a guy who comes to visit a friend in the evening and sees him kneeling on the grass in his yard and searching for something. He asks him what happened. A friend replies: "I lost my keys." He asks him: "Did you lose them here?" "No," the friend replies – "on the opposite side of the yard." "So, why are you searching for them here?" Because this is where the light is." This may be the best answers to the question why there has been so much focus on monetary policy over the last seven years.

What did central bankers banks get into a situation where they have to worry again about the independence of monetary policies? There are at least three reasons. First, prior to the crisis, there was a large build-up of private debt, and during the crisis also of public debt. Second, the existing monetary policy instruments are now put in use for a much broader scope than before, with marked redistributive consequences. Third, central banks were given new mandates, primarily in the area of financial stability, making them policy makers of last resort. As a consequence, central banking has entered a new, challenging and, I dare say, even perilous period.

Let me briefly elaborate on each of these points.

The role of central banks today has greatly changed from before the Great Financial Crisis. The sources of challenges faced by central banks can be provisionally divided into those idiosyncratic to monetary policy (e.g., it is harder to conduct monetary policy with low interest rates), those that are "secular", due to an altered economic reality (e.g., a high leverage in a short to medium term, or unfavourable demographic trends in a longer term) and to their interactions.

Central banks today operate in an environment of extremely low interest rates and high indebtedness of both the private sector and sovereigns, which narrows their maneuvering space. Yet they are expected to shoulder ever-increasing policy burdens, which is referred to as "mandate creep" (Gürkaynak & Davig, 2015).

First, over the last couple of decades central banks have stewarded the world economy through a period of rapid private debt build-up, which in many emerging markets continued during the crisis, followed by a rise in public debt during the crisis.

Indebtedness is at historically high levels. Such an environment of high public and private indebtedness has a two-way relation with monetary policy: *ex ante*, monetary policy, generally, might have been too lax before the crisis and contributed to excessive leveraging, while it is nowadays, *ex post,* considered as a key for debt sustainability. Nonetheless, central banks will not run out of ammo as long as they command the printing press. But, more importantly, regardless of the amount of ammo used, central banks may still fall short of reaching their objectives (Shin, 2016).

Second, the existing instruments are put in use for a much broader scope than before, with marked redistributive consequences. Previously, prior to the Great Financial Crisis, redistributive consequences had been annulled over the cycle i.e. affected only the intertemporal choices of a representative agent. In contrast, in today's protracted era of low interest rates, monetary policy has strong and direct distributional consequences. No wonder then that there is so much discussion on monetary policy and inequality these days (Bernanke, 2015; Bullard, 2014; Coibion, Gorodnichenko, Kueng, & Silvia, 2012; Mersch, 2014; Yellen, 2014).

Furthermore, the ideas which have been recently pushed forward, such as the "QE for the people", centre around growing inequalities and the (perceived) failure of the QE to jumpstart the economy. Such initiatives promote ideas such as "helicopter money", but also "infrastructure investment" and alike. ***One of the characteristics of these initiatives is their quasi-fiscal nature,*** as such policies would have direct redistributive consequences. ***This is unlike low or negative interest rates, or indeed the QE itself, which do not have first order redistribution effects.*** Which, of course, is not to say that they do not have any redistributive consequences. "As long as assets are unevenly spread across the population, shifts in their prices will have redistributive effects..." (Broadbent, 2014***). However, it is a very different world in which non-elected technocrats would have a mandate to do an outright redistribution implied by such initiatives.*** It seems that it has become a communicational challenge to convey that central banks simply do not have a mandate to do so.

Third, central banks have been given a new mandate, primarily in the area of financial stability. This mandate is far broader than the "lender of last resort". Some of the new/old macroprudential instruments indirectly affect depositors and debtors (e. g. higher capital or liquidity requirements), while others have a more direct effect by affecting the credit alocation (for instance, loan-to-value or debtservicing ratios). Moreover, the degree to which the goal of financial stability is fulfilled is very hard to objectively measure and quantify. The distributional impact of financial stability policy is often more central to its effectiveness than is the case with monetary policy. Macroprudential tools have distributional effects that are central to their success. In recent times, after the global financial crisis (GFC), and after the realization that prudential policies were often not where they should have been before the crisis, we have seen a reversal of the trend of extracting supervision outside of central banks, and the trend of returning it back to central banks. That was a useful lesson. In the case of the Czech National Bank, as with most Central and East European central banks, supervision has always been within the central bank. Moreover, in 2006, the CNB started to supervise the whole financial system, including insurance companies, pension funds and investment funds (after a merger with the Security Exchange Commission and a supervision office of the Ministry of Finance). It was under Governor Tůma's mandate and Mr. Singer was Vice-Governor at that time. And it seems that nobody should have any complaints with regard to this, as today the Czech financial system is both efficient and stable.

Central bank independence, of course, has been a controversial concept for much longer than the current discussion. It requires the delegation of powerful authority to a group of unelected officials, in order to prevent the redistributive consequences of inflation. More techically, an independent central bank is a device to overcome the problem of time consistency: the concern that policymakers will in future renege on a policy promise made today. These consequences, especially in the case of hyperinflation, can be devastating for the economy, and can also have a deep political impact, as we have witnessed in the past. Now, with the financial crisis, an earlier rationale for central bank independence has also re-emerged: the need to prevent or limit panics.

Consequently, there is an unavoidable conflict between the goals of democratic legitimacy and policy effectiveness (Cecchetti & Schoenholtz, 2015). In other words, the "anomaly" of powerful authority being in the hands of unelected officials naturally raises questions of legitimacy and fears of the concentration of power in the hands of a select few. All of these can trigger a popular discontent as has recently been experienced.

Issues on democratic legitimacy arise primarily within the redistributive realm of monetary policy, i.e. when monetary policy does somebody else's job. Ironically, had there not been for the expansion in both the mandates (formal as well as informal) and expectations of central bank policies, the issues of independence and democratic legitimacy would not have surfaced with such intensity.

Further challenges arise from the lack of ability to quantify numerically the resilience of the financial system in the same way as inflation is quantified as a monetary policy goal. This is especially true if judging the state of financial stability requires knowledge of privileged information about individual institutions that a financial supervisor cannot disclose. As a result, outside observers will find it difficult to assess objectively the progress toward financial stability. Most of the observers find the monetary policy goal – price stability – easier to interpret, no matter how complex measuring price stability and understanding the impact of interest rate changes may be. To make an independent central bank work, political leaders must delegate the necessary powers and establish an oversight regime that ensures accountability without undermining the institution's policy effectiveness (Cecchetti & Schoenholtz, 2015).

Central to the issue of price stability as a monetary policy goal is the real impact of low inflation on the economy, which, it seems to me, we still do not know much about. There is little or no evidence that low inflation, or small deflation, hurts growth. Nor do we know much about the ability of monetary policy to affect the inflation rate in a globalized world in which, on the one hand, we have a global pool of liquidity, and, on the other, competitive pressures arising from all corners of the world, based on significantly improved global allocations of capital and labour and differential productivity growth rates.

New economic circumstances and new instruments and mandates create new challenges with implications for central banks' independence, particularly within multinational currency zones/monetary communities. But distribution conflicts spill over to monetary policy even within a single country. For example, due to strong pre-crisis borrowing (some) households got heavily leveraged prior to the crisis. The subsequent fall in real estate prices led to a part of households getting "under water". Given that financial assets are far more concentrated than loans, the two groups of households would prefer different, if not completely opposite monetary policy stances.

When it comes to financial stability issues, a recent set of government interventions in Central and East Europe in issues bearing repercussions on financial stability marks another challenge. The Hungarian conversion of CHF loans, followed by the Croatian one, the Romanian introduction of "limited liability" (non-recourse) mortgage loans with a retroactive effect or a recent discussion in Poland on bank taxes and the conversion of CHF loans. Such a political economy might challenge the conduct of monetary policy and supervision, where the main objective is the stability of the banking system and, indeed, a prevention of public funds being spent on insured savings.

Is it possible that central banks will try to "optimize" independence by making new circumstances endogenous? For example, they might start treating inflation target more flexibly, while simultaneously trying to achieve other, not legally mandated goals, such as debt reduction. The reduction of an aggregate debt overhang could be fast, although painful in the short-term, through some form of debt restructuring. Alternatively, the slow method entails that the borrowers' income growth exceeds the rate of interest, while the debt stock is kept fixed. This is colloquially termed "growing out of debt".

This "new reality of lost central bank independence" has already been voiced by many economists. They claim that if central banks do not adapt to new realities, the political paradigm about the acceptable model of central bank autonomy may change. Blancheton (2016) qualifies this as "tacit low-degree independence", claiming that central banks have "endogenized the necessity of participating in the liquidation of public debt", and points to the history of central banking, "which shows that the balance of power with governments is, under such circumstances, inevitably unfavourable". In the same manner, Wren-Lewis (2016a, 2016b) attributes the loss of independence to central banks themselves, as they did not see a massive increase in financial sector leverage – "That should have rung alarm bells, but instead it produced at most muted notes of concern about attitudes to risk" – then they stood by during the premature fiscal consolidation and obsessive austerity and, finally, adjusted demand to the incorrectly perceived low level of supply.

The competing view is that central banks have done a good job with monetary policy, in extremely challenging circumstances, and have even managed to strengthen independence*.* One venue for that is within institutional arrangements that share the responsibilities for supervision and macroprudential policies, be it national or international bodies of cooperation that have strengthened and standardized prudential regulation, thus making national capture, either political or coming from industry, less likely.

In order not to jeopardize their independence, for example by being complicit when accepting to do somebody else's job, central banks have to be cautious in expanding their mandates and mindful of redistributive effects inherent to non-orthodox monetary policies, negative interest rates, macroprudential policy, and so on. The moment central banks consciously embark on that road, or "turn a blind eye" to redistributive effects in the name of higher goals, they risk losing their independence.

Additionally, transparency, as a traditional response to strengthen central bank independence, might not be sufficient*.* The blow to independence only partially comes from ignorance, it is to a higher degree caused by strong economic interests. Nonetheless, central banks need to further the understanding of the new economic realities and circumstances. Intellectual capacities and knowledge are often the best defense mechanism of central banks.

In the end, let me now say a few words about the CNB.

The Czech National Bank, headed by Miroslav, has also tested the limits of independence against non-orthodox views*,* and sometimes against the mood of the Czech general public, which is traditionally very conservative in monetary matters. When the Czech National Bank decided to establish the current exchange rate commitment, it was exposed to quite a serious criticism at home. Fears immediately arose that everything would become more expensive and that the fragile recovery of the Czech economy would be undermined. Some "expert" commentators, for example, claimed that foreign holidays of the Czech people would become 15% more expensive after a 5% currency depreciation, as they would need to pay 5% more to the travel agent, 5% more for swimming dresses and sun-tanning creams, as well as 5% more for calamari and ice-cream at the beach. But as Mirek himself put it, that was a time when the Czech National Bank could actually make full use of its independence, which allowed it to do things that might be unpopular in the short term, but prove to be beneficial in the medium term.

The CNB approached all its battles, either in the area of monetary policy, or regarding institutional issues, even when it looked as David vs Goliath – or Sparta Praha against Real Madrid – fearlesly, well prepared, armed with thorough research, underpinned by theory, with the assertivenes possessed only by those who strongly believe that the right is on their side.

So, this is not a farewell, but a new beginning. We are not losing one of our own, a fellow Governor and a friend who has been in the trenches with us. We are gaining a powerful ally in you, Mirek, whatever your next position is.

Thank you and see you soon.

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