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Reflections on the Past and Future of Central Bank Independence

Seminar on The Relevance of Central Bank Independence: Challenges and Outlook/Banco de México

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Good morning. It is my pleasure to participate in this conference on the occasion of the 25th anniversary of the autonomy of the Banco de México. I take the opportunity to congratulate you on this landmark. Events such as this contribute to highlighting the relevance of the independence of monetary authorities, and my words today will be along these lines.

In my address I shall first briefly refer to the independence of the Banco de España, both as a national central bank in itself but also as a member of the European System of Central Banks. Then, I would like to share with you some more general thoughts about current challenges to central banking from the perspective of their independence.

The independence of the Banco de España

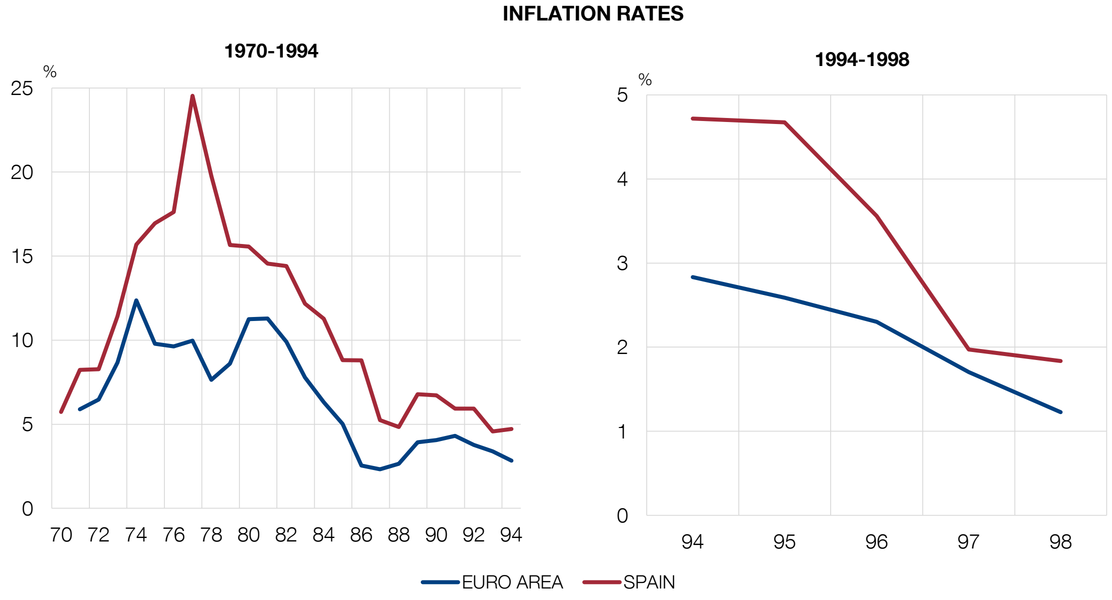
The Banco de España was granted institutional independence in July 1994. So this year, as is also the case for the Banco de México, marks the 25th anniversary of our Law of Autonomy. The independence of the Banco de España came about as part of the European economic integration process. Following the requirements laid down in the Maastricht Treaty, central banks in the European Union were meant to pursue the primary objective of price stability and be vested with a large degree of independence, both political and operational. Participation in the monetary union also entailed a change in the relationship between Treasury and central bank so as to incorporate the prohibition of monetary financing of government deficits.

Central bank independence was granted with a large degree of legal protection and, as a matter of fact, no country in the European Union can change it at its own discretion. Of course, the independence of the central bank does not mean arbitrariness, as it is well counterbalanced by high transparency and accountability requirements and practices.

Granting independence to the Banco de España some years before the introduction of the euro as a common currency reflected Spain's strong ambition to become a founding member of the European Economic and Monetary Union. It was also the result of a firm political conviction as to the benefits of price stability and the advisability of delegating the pursuit of this goal to an independent central bank. Price stability requires a medium-term orientation and the independence of the monetary authority creates credibility by helping to keep inflation expectations anchored while avoiding time inconsistency problems.[1] These reasons were particularly compelling for the Spanish economy in light of the previous experience of relatively high inflation.

[1] The main argument to preserve central bank independence is that it avoids the so-called *time inconsistency problem*. When the monetary authority is not independent, it may consider other, shorter-term legitimate objectives, and may use monetary policy to repeatedly boost aggregate demand above what would be consistent with its inflation objective. As a result, an *inflationary bias* may be generated. This inflationary bias is ultimately anticipated and incorporated into agents' expectations, and, therefore, into price-setting and wage bargaining. The upshot is higher inflation without hardly improving the level of output and employment in the economy. This means monetary policy loses its effectiveness and the commitments to price stability cease to be credible.

Figure 1



The independence of the Banco de España, along with the new monetary policy framework based on direct inflation targets, was decisive in bringing inflation down and in fulfilling the Maastricht requirements in a short period of time.[2] In this regard, the Spanish experience in relation to EMU accession meant a qualitative leap forward in terms of credibility, communication and transparency, which facilitated the anchoring of inflation expectations to a new regime of price stability, providing a focal point for collective wage bargaining, the setting of regulated prices, etc.

The task of taming inflation did not fall entirely on the shoulders of the Banco de España, as Spain showed a strong and credible political will to lower inflation that helped bring about the anchoring role of the whole European institutional setting.

With the launch of the euro, two decades ago, the Banco de España started to participate in the formulation and implementation of the euro area common monetary policy. Governors from the national central banks in the euro area are members of the Governing Council of the European Central Bank, a collegial decision-making body. Governors do not represent national interests and they vote in their own capacity considering the interest of the euro area as a whole.

National central banks in the euro area can also carry out other functions as long as they do not interfere with their responsibilities in the common monetary policy. For instance, the Banco de España is the national competent authority for banking supervision. However, all these additional functions do not necessarily enjoy the same level of independence[3] as the monetary policy tasks conferred by the Treaty. With the creation of the Single Supervisory

[2] National inflation rates had not be more than 1.5 percentage points higher than the average of the three lowest inflation rates in the European Union. In 1993 inflation in Spain maintained levels close to 5%. Achieving the Maastricht inflation criterion required major efforts in a very short period of time. Inflation dropped to levels below 2% in 1997, allowing our country to join the euro area in 1999.
[3] See remarks by Yves Mersch, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, Roundtable Discussion on Central Bank Independence (Frankfurt am Main, 12 November 2019). – https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp191112_1~f304b47e14.en.html

Mechanism (SSM) in 2014, the Banco de España's supervisory role was integrated into a new institutional framework with the European Central Bank at its core. I will come back to this function later on.

Some lessons on central bank independence

Let me share with you some reflections about central bank independence nowadays. This will be in the form of five lessons which, in my view, should be kept in mind when thinking about central bank independence, particularly at the current juncture of seemingly tamed inflation but with difficulties in achieving price stability objectives in some advanced economies.

1. Institutional settings matter

First, I would state that independence, to be effective, must rest on a robust legal and institutional framework. Independence must be formally recognised in all of its relevant dimensions: namely, at the institutional, functional, personal and financial levels. This is the case in the euro area, where the Maastricht Treaty[4] provided the appropriate framework; but unfortunately it is not the case in other regions, thus making the task of central banks much more complicated.

2. The need to deliver

Second, the main reason for central bank independence is a utilitarian one: independence is an instrument to enhance effectiveness in order to achieve agreed objectives in the general interest, such as price or financial stability. The social value of central bank independence is thus inextricably linked to the effectiveness of its policies. The corollary is clear: central banks should employ the full set of instruments available to them to fulfill their mandates.

Central banks are entrusted with the fulfilment of a precise set of objectives and, to do this, they are given the powerful tool of independent statutes. But trust must be earned daily and backed by hard evidence (on our effectiveness), and not based on faith or belief.

3. The extension of independence to other economic policy functions

Third, we should bear in mind that the time-inconsistency argument for an independent monetary authority is also relevant – and thus, may also be applied – to the need for an independent financial supervisor, as short-term incentives to relax supervisory policies may have important consequences over financial stability in the long run. In turn, this may also influence monetary policy-making. And this argument applies both for micro-prudential and macro-prudential supervision.

[4] See article 130 (ex-article 108 TEC) of the Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (2016/C 202/01):
When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.
https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:C:2016:202:FULL&from=EN

Regarding micro-prudential supervision, the importance of independence in this field, besides its relevance in monetary policy, is actually a worldwide recognised standard enshrined in the Basel "Core Principles for Effective Banking Supervision"[5]. The Basel Core Principles are part of the "Key Standards for Sound Financial Systems"[6] determined by the Financial Stability Board (FSB) that deserve priority implementation depending on country-specific circumstances. Moreover, implementation of these principles is generally assessed through the IMF/World Bank Financial Sector Assessment Programs (FSAP[7]).

In the Euro area setting, the creation of the SSM in 2014 added this dimension of independence.[8] However, building a system of banking supervision in the euro area in parallel with the monetary union posed challenges from the perspective of central bank independence. In particular, it could raise concerns of potential conflicts between the prudential supervision of European banks and the primary goal of price stability. This was foreseen in the institutional design of European supervision, assigning to the Supervisory Board – a new body within the European Central Bank – the planning and execution of the supervisory tasks. In consequence, separation between monetary policy and supervision was a key pillar for the conferral of supervisory tasks on the European Central Bank.

Regarding macro-prudential supervision, the European institutional setting promotes its independence as the European Systemic Risk Board recommends central banks have a prominent role in national macro-prudential authorities.[9] [10] In the Spanish set-up, the Banco de España is entrusted with deciding independently when macro-prudential tools regarding

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[5] See Core Principles for Effective Banking Supervision – Basel Committee on Banking Supervision (September 2012) https://www.bis.org/publ/bcbs230.pdf

[6] For more information about the Key Standards for Sound Financial Systems, see the FSB website: https://www.fsb.org/work-of-the-fsb/about-the-compendium-of-standards/key_standards/

[7] For more information about FSAPs, see the World Bank website: https://www.worldbank.org/en/programs/financial-sector-assessment-program

[8] See article 19 of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions:

1. *When carrying out the tasks conferred on it by this Regulation, the ECB and the national competent authorities acting within the SSM shall act independently. The members of the Supervisory Board and the steering committee shall act independently and objectively in the interest of the Union as a whole and shall neither seek nor take instructions from the institutions or bodies of the Union, from any government of a Member State or from any other public or private body.*
2. *The institutions, bodies, offices and agencies of the Union and the governments of the Member States and any other bodies shall respect that independence.*

https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R1024&from=en

[9] See Recitals 7 and 12 and sub-recommendation B3 of "Recommendation of the ERB of 22 December 2011 on the macro-prudential mandate of national authorities" (ESRB/2011/3): https://www.esrb.europa.eu/pub/pdf/recommendations/ESRB_2011_3.en.pdf

[10] See Recital 24 of Regulation No 1092/2010 of the European Parliament and of the Council on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board:
The ECB and the national central banks should have a leading role in macro-prudential oversight because of their expertise and their existing responsibilities in the area of financial stability. National supervisors should be involved in providing their specific expertise. The participation of micro-prudential supervisors in the work of the ESRB is essential to ensure that the assessment of macro-prudential risk is based on complete and accurate information about developments in the financial system. Accordingly, the chairpersons of the ESAs should be members with voting rights. One representative of the competent national supervisory authorities of each Member State should attend meetings of the General Board, without voting rights. In a spirit of openness, 15 independent persons should provide the ESRB with external expertise through the Advisory Scientific Committee.
https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:C:2016:202:FULL&from=EN

the banking sector should be activated or deactivated. Accordingly, other sectoral financial regulators are given responsibilities for activating their own tools.

In particular, the Banco de España is now empowered to require that banking institutions establish countercyclical capital buffers by credit segment, limits on concentration in relation to economic activity sectors, and limits and conditions when underwriting new loans (in terms of loan-to-value, loan-to-income and debt service-to-income ratios, and also the maturity, the currency in which the operation is denominated and whether the interest rate is fixed or variable, among others). These new instruments complement those previously available to the Banco de España and included in the European legislation:[11] the countercyclical capital buffer, the systemic risk buffer and the buffer for systemic banks, among others.

In addition, this year saw the creation of the Macroprudential Authority Financial Stability Council, whose main goal is to contribute to the promotion of coordination and the exchange of information on financial stability issues among the Banco de España, the Ministry of Economy and Enterprise, the Spanish National Securities Market Commission and the Directorate-General of Insurance and Pension Funds). All in all, this new institutional setting is a significant step forward in reinforcing financial stability in Spain.

4. Other policies should also promote economic and financial stability

The notion that other economic policies should complement monetary policy and also contribute to economic stability has always been embedded in the design of the European Economic and Monetary Union. As such, from the start, the Maastricht convergence criteria went beyond inflation to also include targets in terms of fiscal discipline.[12]

The Spanish experience in the effort to comply with these criteria illustrates and reinforces the critical importance of other policies, such as fiscal consolidation or liberalisation reforms. This is an important lesson not to be forgotten: central bank credibility is an essential element for the effectiveness of monetary policy, but monetary policy is more efficient when

[11] The CRD IV/CRR regulatory package makes available a set of macroprudential instruments that national competent authorities can resort to with a view to preventing the emergence of cyclical systemic risks or mitigating structural systemic risks, such as: a) the capital conservation buffer; b) the countercyclical capital buffer; c) the buffer for other systemically important institutions; d) the systemic risk buffer. Regulating capital buffers aimed to (i) ensure a level playing field between EU Member States, as an essential pre-requisite for the functioning of the internal market, (ii) prevent regulatory arbitrage, (iii) ensure maximum harmonisation, and (iv) enhance transparency and predictability in the macroprudential field. See articles 130, 131,133, 134,135-140 of CRD IV.
https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN
https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN

[12] See Hernández de Cos: *El reto de la unión fiscal europea* (2014):
In response to the euro area sovereign debt crisis, there has been a deep reform of fiscal governance in the European Union. This reform includes a strengthening of the corrective arm of the Stability and Growth Pact, with the setting of a ceiling on public spending and the introduction of greater coordination in countries' budgetary processes. In the corrective arm, greater significance is accorded to the debt criterion and the sanctions system has been reinforced. Members are obliged to reform national fiscal frameworks and set up independent fiscal authorities, which must conduct public assessments regarding the implementation of national budgetary rules. Overall, the reform echoes the latest economic literature, which stresses that it is the design and not only the mere existence of fiscal rules that has a bearing on their effectiveness. However, the new framework of governance is now more complex and the room for discretionality in its application remains ample. Its effectiveness will thus depend on such application being strict.
Full article available in Spanish: https://www.funcas.es/Publicaciones/Sumario.aspx?IdRef=1-01141

For more information on the reform of the economic governance in the Economic and Monetary Union see Caballero, García Perea, Gordo (2011) available in Spanish:
https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/11/Ene/Fich/art5.pdf

coupled with and complemented by an appropriate balance in overall economic policy-making.

Actually, beyond accession criteria, this notion was also enshrined on an ongoing basis through the Stability and Growth Pact and, later on, with the Macroeconomic Imbalance Procedure. This latter check on structural and broad macroeconomic policies was the response to the hard-learnt lesson (especially in countries like Spain) that a lack of competitiveness and excessive credit cycles could seriously hamper the optimal conduct of monetary and financial policies and usher in financial fragmentation.

Also, strictly in the realm of monetary policy, fulfilling our price stability mandate has become more challenging in recent times. Natural interest rates in the main advanced economies have been gradually falling over the last three decades and they currently stand at historically very low and possibly negative levels. There are also good reasons to think that natural rates may be stuck at very low levels for long periods. This, in conjunction with a lower bound for policy rates, seriously curtails the space for conventional monetary policy. Unconventional measures, such as asset purchases, negative interest rates and forward guidance, have helped us to *partially* overcome the lower bound constraint, thus becoming a necessary tool in our monetary policy framework. Notwithstanding, unconventional measures have their own limitations.

In this context, inflation will ultimately be the outcome of the interaction between a number of factors. In order not to overburden monetary policy, it is essential to achieve a balanced policy mix. Such mix should include long-term growth-enhancing fiscal policies and sufficient structural reforms that increase productivity.

Preserving central bank independence thus requires acknowledging this interaction among policies and, hence, it is the duty of central bankers to call for an appropriate mix of economic policies that help us achieve our price stability goal while minimising potential side effects.

The specificity of the euro area, with a common monetary policy and 19 different fiscal and economic policies, considerably increases the complexity of finding the right alignment of economic policies. The aggregation of national fiscal policies does not necessarily translate into an adequate fiscal stance for the euro area as a whole. In short, the current euro area institutional architecture does not allow for a systematic implementation of an active fiscal policy based on targeted, timely and temporary measures. Thus, the absence of a common fiscal capacity in the euro area makes it difficult to achieve an appropriate policy mix. Building this fiscal capacity, with adequate size and design, should be a priority on the agenda.

The Eurosystem should continue to push for more growth-enhancing reforms at the national and European levels and for the completion of a more robust euro area institutional setting. This includes completing the Banking Union, the Capital Markets Union and creating a stabilising central fiscal capacity that will help the euro zone economy reduce its vulnerabilities and better weather potential future episodes of stress.

This brings me to highlight one further dimension of the value of central bank independence. Independence contributes to the role that monetary authorities tend to play with respect to other policies. Their technical recommendations, free of short-term political pressures or vested interests, may provide valuable guidance for other economic policies. Although this function is not always formally incorporated into the legal framework, in the case of the Banco de España this role is recognised in our Law of Autonomy. Indeed, this legislation establishes a function to “advise the government”, which supports our role in evaluating other public policies. This is also the case of the European Central Bank, on which the Treaty confers an advisory function with regard to proposals for European Union and Member States’ legislation within its fields of competence.

5. The key importance of transparency and accountability

The fifth and final reflection concerns highlighting the importance of pursuing the highest standards of accountability and transparency vis-à-vis both society and the political representatives. Indeed, accountability and transparency support both the effectiveness and also the legitimacy of central bank independence. We need to keep in mind that monetary policy is now more complex and society is constantly raising the bar for these standards.

The adoption of unconventional tools marked a shift away from the “one goal, one instrument” policy setting in which accountability was easier. More instruments at play might have also raised concerns about the possibility that central banks have stepped beyond their mandates, thus potentially endangering the public perception about the value of their independence. Yet allow me to emphasise that, in parallel, central banks have strengthened transparency by providing the general public with extensive information about the rationale behind these monetary policy measures within our existing mandates.

In particular, in the case of the Governing Council of the ECB, the accounts of our monetary policy meetings are published and the President and Vice-president hold a joint press conference with a Q&A session after each decision. In addition, members of the Governing Council routinely engage in public events and deliver speeches to explain our decisions and the rationale behind them. And, of course, the President of the ECB regularly participates in sessions with members of the European Parliament as do governors of national central banks in their corresponding parliaments.

I deem it essential to persevere in this direction to reinforce the democratic accountability of the central bank.

In communication with the public, central banks should carefully balance the need for clarity and the intrinsic complexity of monetary policy decisions. To strike the right balance it is worth noting that transparency does not mean providing certainties on intrinsically complex issues but clarity on the inevitable uncertainties and trade-offs that affect monetary policy-making. An added difficulty in the euro area is having to communicate to citizens from 19 different countries in which public opinion sometimes focuses more on national affairs than on European issues.

On top of high transparency standards, we should explore additional tools that could contribute to reinforcing the legitimacy of an independent public institution. In fact, I find that public policy evaluation could be a key and powerful tool in this regard. A periodic evaluation of the central bank’s performance and impact in the pursuit of its objectives could be a very potent mechanism as regards accountability to citizens.

Despite all these challenges, let me conclude my intervention by saying that I remain optimistic about the ability, determination and capacity of independent central banks to keep on providing valuable services to the societies we serve.

Thank you very much.