

Jiří Rusnok: The changing world of central banking

Keynote speech by Mr Jiří Rusnok, Governor of the Czech National Bank, at the conference of the Czech Economic Society, Prague, 17 May 2021.

* * *

Ladies and gentlemen, members of the Czech Economic Society, esteemed guests from the Czech Republic and around the world:

Let me start by thanking the organisers for inviting me to this conference. It is an honour and a pleasure to be here today to communicate some thoughts about central banks. I will split my address into two thematic parts. In the first, I will talk about central bank independence, about the central banking paradigm from the historical perspective, and about some of the challenges that central banks face today. In the second, I will try to shed some light on the humdrum reality of our monetary policy decision-making during the Covid crisis. I say that with tongue in cheek, because, as you know, real-life decision-making is fortunately never humdrum.

Let's turn the clock back a few decades and briefly remind ourselves how central banks gained their independence and what consequences it had. This will help us understand the framework in which central banks have long been operating and the it is now facing.

How did central banks gain their independence?

Central bank independence stands on theoretical and empirical foundations. The main argument for central bank independence is inflationary bias, the existence of which was confirmed by the high rates of inflation seen in most advanced economies in the 1970s and 1980s. Inflationary bias is the outcome of discretionary monetary policy that leads to a higher than optimal level of inflation.

Two theoretical explanations were offered for inflationary bias. The first was the time, or dynamic, inconsistency of governments, and the second was governments' efforts to introduce an "inflation tax" to reduce public debt. Time inconsistency occurs when policymakers announce that they will pursue a particular policy in the future but then follow a different one in reality because their preferences change in the meantime. The "today's actions = tomorrow's regrets" problem arises because time-inconsistent decision-makers value the present more than the future. The general solution to this problem is not to allow decision-makers to make discretionary decisions, but to impose certain rules on them instead. This was the conclusion reached by Kydland and Prescott in a pioneering paper published in 1977, which later won them the Nobel prize for economics.

The theory evolved in two directions. In 1985, Kenneth Rogoff developed the rules argument by introducing the concept of a conservative central banker. According to Rogoff, society can sometimes make itself better off by appointing a central banker who does not share the social objective function, but instead places a larger weight on inflation rate stabilisation relative to employment stabilisation. Although the conservative central banker resolves the trade-off between inflation variance and employment variance by opting for more stable inflation, the costs of keeping inflation stable are lower thanks to the reputation earned by the central banker over many years. The second line of theory attempting to prevent inflationary bias was the principal-agent approach developed, for example, by Carl Walsh in 1995. In this framework, the government (the principal) contracts the central bank (the agent) to deliver the required rate of inflation and penalises it if it fails. This was the route followed, for example, by New Zealand, which in 1990 became the first country in the world to adopt inflation targeting, followed in 1998 by the Bank of England.

These two theoretical approaches define and determine the field for the two main forms of

central bank independence: goal independence and instrument independence. While Rogoff's conservative banker can define her own objective function almost without restriction because she enjoys both goal and instrument dependence, a central banker (agent) working for the government (principal), usually represented by the minister of finance, has no freedom to choose the goal and is only free to decide how to achieve the goal set by someone else.

Empirical findings

The theoretical research was accompanied by empirical studies attempting to prove a causal link between central bank independence and the rate of inflation. The first such study dates back to 1980, but probably the best known and most cited article of its era is the 1993 one by Alesina and Summers. Although their analysis was by no means sophisticated, the authors cautiously concluded that central bank independence promotes lower inflation and its benefits probably outweigh its costs in the form of output volatility. In later interpretations, there was even talk of a “free lunch” for economies and governments that opt for an independent central bank.

This article represented the mainstream view. Later studies refined the methodology but did not change anything fundamental about the finding, so it began to be accepted as the prevailing paradigm. The view that goal independence plays the main role gained a broad consensus. In the two decades leading up to the GFC, one central bank after another gained some form of independence and, hand in hand with that, low inflation was established in advanced economies.

Alongside various forms of central bank independence, inflation targeting became the second pillar of optimal rule-based monetary policy. It introduced a high degree of transparency and predictability into monetary policy. Inflation targeting became a disciplining mechanism for central banks and simultaneously a tool for governments and the public to make central banks accountable. It marked a radical departure from the long-standing practice of “never explain, never excuse”.

Yet critics can be found in every field. As early as 1993, for example, Adam Posen asserted that there was no reliably proven causality between independent central banks and low inflation. Using the example of Germany, he argued that the primary common cause of low inflation and an independent central bank is society's aversion to inflation. However, this did not change the consensus that independent inflation-targeting central banks were the most effective solution to the problem of inflationary bias. Central bankers enjoyed a growing, broad-based esteem. Charles Goodhart described these two decades as the NICE years – non-inflationary continuous expansion. The triumph for central banks was the widely accepted description of this era as the Great Moderation. This suggested that independent central bankers had delivered mankind from the age-old scourge of inflation.

Central banks and supervision before the Global Financial Crisis

The consensus that formed in the early period of central bank independence predominated prior to the Global Financial Crisis (GFC). In 2018, Ed Balls identified the following main features.

1. A central bank should focus on meeting a price stability objective, usually defined by an explicit inflation target. The concept of “divine coincidence” introduced by Blanchard and Gali in 2007 implied that the central bank's focus on low and stable inflation was closely linked with keeping output at its efficient level and maintaining full employment. The central bank therefore had primary responsibility for stabilising the business cycle. Monetary and fiscal policy could operate in isolation because the former could offset much of the latter's macroeconomic impact. Financial stability was left within the purview of supervisors and regulators, rather than that of monetary policymakers.
2. Supervision and regulation of financial institutions was, by and large, a micro-prudential undertaking. Supervisors examined the resilience of individual institutions rather than that at

the systemic level. They were typically independent of the central bank.

3. The central bank provided a safeguard for the financial sector as the lender of last resort. It was assumed that this would protect solvent financial institutions from contagion, as failed firms were resolved.

Much of the pre-GFC academic literature rested explicitly or implicitly on the belief that central bank independence was an unalloyed good. The more independent a central bank, the more effectively it could pursue its core price stability mandate.

However, the GFC revealed weaknesses in each of these assumptions.

1. In order to meet their inflation targets, central banks needed to dramatically expand their toolkits and add numerous unconventional tools to them. The universal validity of divine coincidence broke down, because central bankers needed to choose between inflation at target and the economy at full capacity. As interest rates neared the zero lower bound, it started to become clear that central banks alone could not guarantee price stability or return the economy to full factor utilisation. This opened up room for fiscal policy and restored its key role in demand management, suggesting the need for coordination between the government and the central bank. What's more, new unconventional monetary policy such as quantitative easing had fiscal implications, involving new risks for the state's consolidated balance sheet and affecting the management of government debt. The crisis demonstrated that financial conditions matter much more for the transmission of monetary policy than previously thought.
2. The crisis demonstrated that the modern financial system is very complex and vulnerable to systemic risks that are missed by microprudential supervisors focused on specific institutions. Such risks might build up over time: for example, herding behaviour can lead to pro-cyclical investment strategies. The crisis showed that supervisors lacked the necessary macroprudential tools.
3. The crisis also demonstrated that the central bank's traditional lender of last resort function alone could not stem a crisis. Governments provided fiscal resources into recapitalising failed institutions in order to prevent financial contagion. Many jurisdictions also set up new resolution mechanisms for large interconnected and systemically important financial institutions.

Changes in the paradigm

As soon as these weaknesses appeared in the pre-crisis paradigm, countries all around the world started to redesign their regulatory frameworks. Governments explicitly included financial stability in central banks' mandates and equipped them with a range of macroprudential tools to achieve that objective. Central banks thus gained new powers and their influence grew significantly. However, this did not happen in a single unified way; different countries applied different approaches.

The far-reaching and rapid expansion of central banks' powers, coupled with a consistent failure to achieve inflation targets due to persistently low inflation, has exposed central banks to growing criticism from many quarters in recent years. Central banks are increasingly entering the political arena and making decisions that have large distributional effects. Their critics say they are deciding on matters that should be left to democratically elected representatives. Some have even questioned central bank independence itself, the pillar of central banking over the last few decades.

There are two types of concerns about central bank independence. The first is that central banks have gained too much independence, something that is at best irrelevant but at worst damaging to the economy. The fact that central banks are struggling to raise inflation demonstrates that they are unable to fulfil their mandate, so it would clearly be better to subordinate them to the

government, even to the extent of financing its budget. Central banks have been criticised for failing to predict the sustained post-GFC weakness of the economy and for being incompetent. Other brickbats relate to financial stability, an objective that is much more blurred and difficult to grasp than price stability. If, for example, a central bank were to succumb to the temptation to impose too stringent requirements on the financial sector, it would at the same time put excessive demands on society as a whole, without sufficient accountability to the government.

Conversely, the second worry is that broadening central banks' responsibilities could undermine their core monetary policy function. In the pursuit of its financial stability mandate, a central bank could be drawn into politically contentious areas such as housing policy and income inequality. Greater coordination with fiscal policy could also cause the central bank to be pressured into monetary financing or even fiscal dominance. On a general level, combining monetary policy and financial stability may bring back the time inconsistency problem, which is exactly why central banks were granted independence in the first place.

The post-GFC situation of central banks can be summed up as follows. The fiscal consolidation and only partial structural reforms undertaken by many governments made central banks more or less the only game in town. And as economies weren't running satisfactorily, this game wasn't cast in a good light. The long period of exceptionally low nominal and real interest rates spurred an intensive examination of the possible consequences. These include growing indebtedness, overvalued asset prices, underestimated risks, misallocated loans and resources, and lower productivity. However, it will take a long time to properly assess the impacts of other unconventional instruments. To quote Charles Goodhart: "Central bank independence was nice while it lasted, but it owed a great deal to the supporting conditions that enabled it to achieve such great success in its early years. Rest in peace."

The rebirth of the fiscal-monetary mix?

It's probably a little soon to bury central bank independence as we've known it over the last two to three decades. Yet there's no ignoring the fact that the economic environment began to shift even before the GFC. I'm referring to the steady – one might even say tectonic – decline in the equilibrium real interest rate, which has naturally reduced the room for manoeuvre in terms of the stabilising role of monetary policy. This trend got a strong new boost during the GFC and has strengthened even further during the coronavirus crisis.

The decline of the equilibrium real interest rate to or even below zero has far-reaching implications. The first is that monetary policymakers have to use unconventional instruments, whose long-term consequences have not been analysed sufficiently. It also encourages governments to borrow, especially if the real interest rate is lower than the rate of growth of the economy. It is worth noting that from the long-term perspective the debt levels of most advanced economies are very high, but debt interest payments are meanwhile very low. Relying on debts repaying themselves may be safe only as long as the current favourable conditions persist. If the relationship between the two variables were to invert, debt financing could get a lot more expensive.

The second implication is a blurring of the boundaries between monetary and fiscal policy. As monetary policymakers resort increasingly to targeted unconventional instruments, they get more and more involved in the redistribution process. This means, among things, that monetary policy is substituting for policies that are traditionally the domain of governments.

All this is shifting the focus of the debate from "How deeply negative can interest rates be?" to how to make the two policies work in a particular desired harmony or mix. The former paradigm where they could be independent of each other and hence be regarded as substitutes is turning into one where they complement and reinforce one another. For example, the central bank can help the government by keeping interest rates low, which will facilitate government financing, while fiscal policy can financially support the central bank as lender of last resort, curbing growth

in its balance sheet and giving it more room for manoeuvre and greater credibility in the pursuit of monetary policy.

New remits

Besides changes in the central bank paradigm, some central banks have been taking on new, secondary remits in recent years. The Federal Reserve has begun to pay more attention to income inequality, while the ECB and other European central banks are starting to go green.

Looking first at income inequality, I should point out again that redistributive policies used to be the sole preserve of elected politicians. Despite this, Federal Reserve Chair Jerome Powell recently announced that the Fed will closely track the shortfalls of employment from its maximum level. It is well known that low-income and low-skilled workers from ethnic minorities are the last to enter the labour market. Instead of expressing its goal of maximum employment in purely technical and macroeconomic terms, the Fed has come out in favour of collective efforts to combat poverty. Maximum employment may be a legitimate Fed goal alongside price stability, but the plan phrased in this way marks a departure from the previous world in which the Fed isolated itself from political influence.

The ECB is unlikely to follow the same path as the Fed when it completes its monetary policy review. It is prevented from doing so by European law and by the limited appetite of EU citizens to reduce social disparities in this way. Instead, central bankers are increasingly voicing support for climate protection. This comes in the wake of a speech given by the former Bank of England governor Mark Carney, who in 2015 drew attention to the risks to financial stability from climate change and the responsibilities this implies for financial regulators. The ECB, however, is going even further: Christine Lagarde says she wants “to explore every avenue available in order to combat climate change”.

In a sense it's understandable that central banks are subscribing to broader government policies, whether at national or EU level. After all, it's something that's written into the laws governing their activities. One might also accept that if they want to maintain their influence, they need to move with the times and embrace the values that are increasingly driving world affairs. However, there are many big risks associated with this approach. Environmental pollution is a typical example of market failure, and central banks should not be at the forefront of efforts to correct such failures. It's not their job. What's more, going green implies abandoning market neutrality, a principle which ensures maximum monetary policy effectiveness. It's hard to imagine central bankers deciding whether bonds issued by a nuclear power station are green or not. And finally, in pursuing such remits, central bankers would again be entering the political arena, where there are many potential political traps that could undermine their independence and decision-making in the areas that need to stay of primary, if not exclusive, importance to them. This is a topic that would certainly warrant a separate presentation.

I have tried to show at least briefly that central bank independence may not be as cast in stone as it seemed before the Global Financial Crisis. The new remits that central banks are starting to take on likewise indicate that opinions are changing. After the GFC, the former exclusive focus on price stability was widened to encompass financial stability. And new goals – or at least items – are gradually being added to the contemporary remits of central banks. All this shows that, beneath its seemingly placid surface, the world of central banks is a very lively, dynamically developing and extremely interesting place.

What is interesting Czech central bankers at the moment?

As I said at the start, in the second part of my address I will talk about our main macroeconomic and monetary policy considerations during the coronavirus crisis. From a purely technical perspective, this crisis has been fascinating and inspiring. It also took us completely by surprise. Its main feature is that it was a typical exogenous shock: it hit the economy from the “outside”.

The GFC was caused by endogenous economic processes linked with huge levels of subprime lending, widening imbalances and unprecedentedly high risks building up in the financial sector, whereas the coronavirus pandemic is more like the plagues of Egypt.

It has often been said that this crisis has drawn a sharp dividing line between the sectors and industries which have profited unexpectedly and sometimes even wildly from it, and those which have been hit extremely hard or even wiped out by it. Unlike typical cyclical crises, which tend to have a synchronised effect on most industries, this crisis is characterised by contrasting impacts. This feature has manifested itself in relatively smooth flows of employees between industries, so structural unemployment has stayed quite low. I should add, though, that strongly expansionary fiscal policy has been a major mitigating factor. At the price of sharply rising public debt, fiscal expansion has made it easier for the private sector to adjust structurally at the microeconomic level. There are, of course, many criticisms one could make of the specific inadequacies of the fiscal support that has been provided and the timing of the various measures. Nonetheless, it is fair to say that fiscal policy has fulfilled its stabilisation role in the Czech Republic and elsewhere during the crisis.

Inflation has surprised us quite significantly during the Covid crisis. Shortly after the pandemic broke out, we at the CNB cut our interest rate in three steps almost to zero in order to reduce the expected demand slump at least partially. At the time we were worried that inflation would fall quickly and sharply, as it has done in past crises. Our decision was guided largely by economic intuition, because it is extremely difficult to draw up quantitatively reliable forecasts at critical junctures under large and complex uncertainties. In the year since the crisis erupted, inflation has declined from above the upper boundary of our inflation target to close to the target, but that's about all.

Looking back, we can see two main reasons why inflation did not fall significantly lower. The first is that our economy was strongly overheated before the coronavirus crisis and the crisis merely tempered the overheating. Unfortunately, I have to admit that if we'd been better able to estimate future inflation in 2019 and had not been so unsettled by the risks associated with Brexit and trade wars, we'd have taken interest rates higher at that time. Had we done that, inflation would have been closer to the target last year and we'd have had a little more room to ease the interest rate component of the monetary conditions.

The second reason is rather more complex and technical and relates to our gradually evolving perception of the relationship between the supply and demand-side factors of inflation. At the start of the coronavirus crisis we felt that the potential output level would not fall significantly and that the sharp drop in demand would cause the output gap to widen and have a disinflationary effect. However, core inflation did not fall very far in the months that followed. So, we gradually re-appraised this picture, lowering the potential output level and proportionately reducing the size of the output gap. Not only was the persistently high inflation consistent with a relatively small output gap, but the decline in potential output matched our growing conviction that the coronavirus crisis was primarily a supply shock. This is apparent from a closer inspection of the supply side, where remarkable changes were and still are going on. The coronavirus crisis saw unprecedented interactions between the supply and demand side. As various services and leisure activities – such as theatregoing, sports events and travel – were closed in waves, household demand switched to activities that could still be carried on despite the anti-epidemic measures and to goods that were previously not in such high demand, such as computers for working from home, and sports equipment, which people suddenly had much more time to use.

Most of the items in high demand are of an industrial nature and are made in globally interconnected production chains. However, the changing anti-pandemic lockdowns are causing bottlenecks in international supplies of raw and semi-processed materials and in transport capacity. This is disrupting the overall production logistics and fuelling growth in prices of temporarily scarce items. As a result, we are now seeing robust growth in prices of many

tradables all around the world. This is being reflected in growth in foreign producer prices and ultimately in non-falling domestic inflation.

Another interesting feature of the coronavirus crisis relates to savings. During a cyclical downturn, it is usual for households and firms to start creating precautionary savings for worse times. However, the lockdown of many activities, especially in services, has made it physically impossible for people to spend on such services, and their savings have been rising as a result. Once the lockdowns are lifted, these forced savings are expected to return to the market and help revive the currently dormant sectors. As with practically everything else, this assumption is associated with uncertainties that only the future can resolve.

One of the biggest surprises of the coronavirus crisis concerns the property market. The memory of the post-GFC house price slump is still fresh in our minds. But we have seen nothing like that over the last year or so. The long-running rise in house prices has slowed but not gone into reverse. On the contrary, the property market has been boosted by soaring demand for housing in rural and mountain areas, fuelled by low interest rates. This is really not what an economy on its knees looks like. If we at the Czech National Bank erred in any of the forecasts we made in the dramatic days of last spring, when the pandemic struck with unforeseen force, it gives me some satisfaction to say that we were by no means alone.

Obituary

The coronavirus has sadly left a trail of economic, social and human devastation in its wake. Each of us no doubt knows someone who has been struck down by it. I'd like to take this opportunity to remember the well-known Czech economist Michal Mejstřík, who tragically lost his life to COVID-19 earlier this year. We always rightly admired Michal for his broad range of expertise, his intellectual curiosity and energy, and his ability to present interesting information and formulate fresh ideas. I'm sure that at this time, and perhaps even at this conference, his voice would have been heard and he'd have been offering us imaginative insights into the coronavirus crisis. Michal, we miss you.

Ladies and gentlemen, thank you for listening. I hope you find the conference interesting and inspiring.

♦