FTfm Central Banks

Central banks: Peak independence

After a post-crisis surge in central bankers' power, some politicians want to rein in their role

Heavyweights: Mario Draghi, president ECB; Janet Yellen, chair US Fed; Mark Carney, governor BoE

NOVEMBER 8, 2015 Ferdinando Giugliano in London, Sam Fleming in Washington and Claire Jones in Frankfurt

In the early 19th century, the British economist David Ricardo said central banks should never in the "slightest degree" fall under government control. Today many of the biggest central banks are operating closer to his ideal than ever before.

Central bankers around the world — from the US Federal Reserve and the European Central Bank to the Bank of England — are exercising power and independence that their predecessors would have struggled to achieve.

Since the global financial crisis they have brandished new tools, such as the ability to purchase trillions in assets to prop up their economies, while acquiring deeper regulatory responsibilities over banks and markets. These freedoms have opened central bankers up to new criticisms, including claims they are hubristically attempting to tame the business cycle while storing up threats of bigger crashes down the road.

Their crisis-fighting interventions have also propelled these unelected technocrats into politically charged debates over income distribution and inequality. And they have left them operating on the perilous boundary between monetary policy and budgetary policy following the purchase of vast amounts of government bonds in "quantitative easing" schemes.

The political mood surrounding central banks has accordingly become rancorous. In the US, the rightwing of the Republican party has turned the Fed into a whipping boy, with Ted Cruz, who is seeking his party's nomination to run for presidential candidate, last month accusing the Fed of "juicing" the economy with low interest rates. He argues in favour of tougher Congressional oversight and a return to the gold standard.

Speed read

- **Monetary managers** Critics say central banks should concentrate on their care task – keeping inflation on target
- **Bailout backlash** A bill to further limit the Fed's ability to give emergency loans in a crisis is worrying officials

In the eurozone, the ECB has come under fire for its involvement, alongside the International Monetary Fund and the European Commission, in the troika of institutions handling the bailouts of Greece, Portugal and other weaker EU members. And in Britain, Mark Carney, governor of the BoE, has been accused of over-reach for his speeches on sensitive topics such as climate change and Britain's membership of the EU, which he believes were consistent with the BoE's remit.

In this febrile atmosphere, some experts say central banks' cherished independence is at risk. "Central

- **Transparency push** Some authorities are working on measures that would brush off their reputation for secrecy

bankers are punching well above their weight," says Willem Buiter, chief economist at Citi and a former member of the BoE's Monetary Policy Committee. "This could lead to a backlash and to central banks losing their operational independence, even where this independence makes sense — in the design and conduct of monetary policy, narrowly defined."

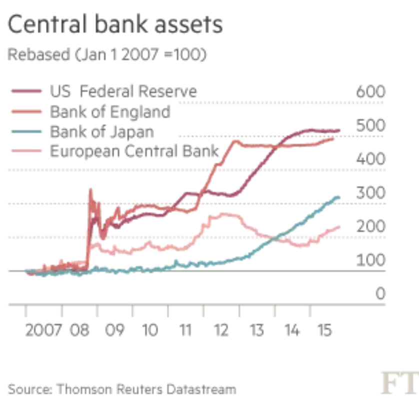
Ricardo's ideal of central bank independence — the ability for a central bank to set monetary policy without interference — has taken hold only in recent decades. The attractions are clear. Keeping interest rate-setting at arm's length from politics, rates are set in the name of low and stable inflation, not short-term political convenience.

Outsized role

Until the crisis, it looked like they had hit on a magic formula. For much of the 1990s and 2000s leading economies enjoyed low and stable inflation, along with relatively steady growth in an era known as the Great Moderation.

Those conditions turned out to be a chimera. In the 2000s, most central bankers failed to highlight — or even acknowledge — the risks building up in the banking system, an omission that had disastrous consequences when a financial collapse triggered the world's worst post 1945 recession. Yet ironically, central banks emerged from the crisis more powerful than ever.

The question being asked on both the left and right is whether central banks' policy fiefdoms have become too expansive. Many say the monetary authorities should concentrate on their core task — keeping inflation on target — an objective they are struggling to meet.



Several central bank watchers believe the very notion of independence needs to be updated in light of the tools the monetary authorities have acquired.

The more powers and responsibilities central banks are given, the more they risk making politically charged choices, argues Stephen King, HSBC's chief economic adviser. "A central bank is more likely to be perceived to have failed if it is burdened by a multitude of conflicting objectives," he says. "The result is there will be demands for greater accountability to elected legislatures."

In the US, the Fed faces a barrage of legislative challenges to its independence from Congress, where many lawmakers are troubled by its multi-trillion dollar crisis-era interventions. The proposals range from enhanced reporting requirements to more significant constraints on how the Fed conducts monetary policy and emergency lending.

While few of these initiatives are likely to become law, they come amid a polarised political climate that is proving treacherous for central bankers to navigate. Roger Lowenstein, author of *America's Bank*, a new book on the Fed, says its political legitimacy is at its weakest in decades. "If the Fed had failed to effectively intervene and rescue the system — as was the case in the 1930s — you could understand why the Fed would be unpopular," he says. "But in fact, the Fed is unpopular today because it did vigorously intervene."

That scepticism has been reflected in Congress, where lawmakers have found that railing against the Fed is popular with their constituents. In 2013, the number of new congressional bills seeking to constrain the Fed outnumbered those empowering it by 45, a record margin, according to research by Sarah Binder and Mark Spindel in a forthcoming book on Congress and policy making.

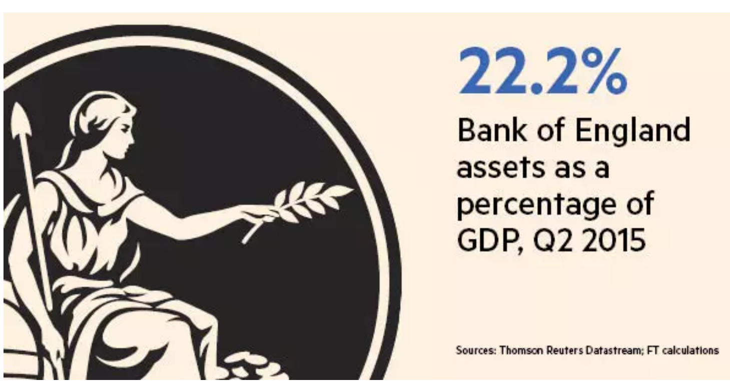
In the eurozone, the structure of the ECB has left it exposed to an onslaught of criticism from politicians and protesters who accuse it of being undemocratic and unaccountable in its handling of the sovereign debt crisis. This April a 21-year-old student working under the moniker Josephine Witt doused Mario Draghi, ECB president, in confetti in protest at its handling of the Greek crisis. Mr Draghi is adamant that rules, not politics, have dictated its approach to Greece and other member states.

The German political and economic establishment, including Chancellor Angela Merkel, has railed against some of the ECB's policies, especially when — like the €1.1tn quantitative easing programme — they have involved buying other governments' bonds. The rise of populist parties, from Italy's Five Star Movement to Syriza in Greece, has also increased criticism of the ECB.

Vanguard views

In Britain the BoE's cherished independence came under pressure during the recent Labour party leadership election, with Jeremy Corbyn, who won the contest, advocating that the central bank should be forced to fund government infrastructure — a policy called "people's QE".

John McDonnell, shadow chancellor, has since stated that central bank independence is "sacrosanct". However, he has put together a group of experts, led by former BoE rate-setter Danny Blanchflower, to reconsider the mandate of the MPC, which primarily targets inflation.



"Independence is a good thing, but it is unclear whether, since 2005, the MPC has done better than the Treasury would have done," Mr Blanchflower says. "Would a different remit [for the BoE] have made things different since the crisis? That's not an unreasonable question to ask."

Last week Stanley Fischer, the Fed's vice-chairman, set forth his most detailed defence of monetary policy independence since he joined the central bank, warning that new fetters from politicians would be dangerous when inflation is quiescent. He acknowledged the independence debate is being complicated by new financial stability goals on top of inflation targeting, and that it can be appropriate to have political involvement in stability issues such as property booms.

The legislative challenge that most worries Fed officials is a bill backed by Elizabeth Warren, a Democratic senator, and David Vitter, her Republican counterpart, to further limit the Fed's ability to give emergency loans in a crisis and stop "backdoor bailouts" to failing banks.

Simon Johnson, a professor at MIT Sloan School of Management, draws a distinction between attempts to rein in the Fed's discretion on monetary policy and possible reforms to its financial stability operations. Attempts by some Republicans to "clip the Fed's wings on monetary policy" were a bad idea, he says. However, matters were different on the emergency lending side, where he argues there was insufficient clarity in the Fed's own rules on interventions.

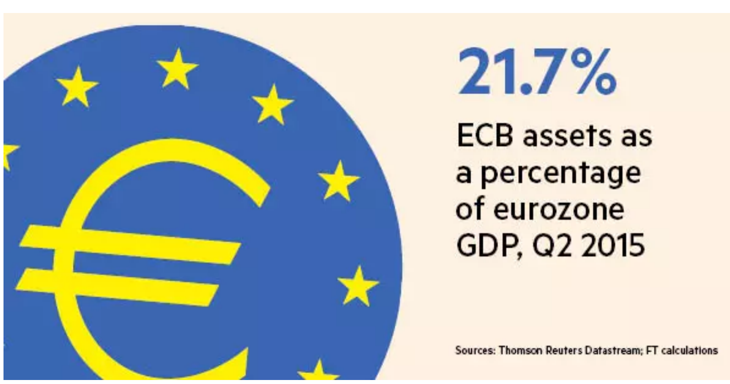
Last year, the BoE, which had come under attack for its handling of the crisis, sought to brush off its reputation for secrecy. The measures, which include publishing the minutes of MPC meetings alongside the decision instead of two weeks later, have been broadly welcomed. But critics fear that these plans do not go far enough, as they restrict the role official auditors would play in scrutinising the effectiveness of the BoE's operations, for example.

Industry ties

The other area where central banks face pressure to display greater transparency is over their ties with the financial industry. The BoE has come under fire for allowing its newest rate-setter, Gertjan Vlieghe, to retain a passive stake in his former employer, Brevan Howard, a hedge fund that bets on the direction of interest rates. He has since cut his ties with Brevan, but lawmakers asked the BoE to review its code of conduct.

The ECB's executive board is facing scrutiny after one member, Benoît Cœuré, detailed plans to front-load some bond purchases to a private gathering of hedge fund managers, bankers and academics. Because of what the ECB dubbed an "internal procedural error", the remarks did not appear on its website until the morning after the talk. The ECB has since set out guidelines forbidding board members from making sensitive remarks at events unless these statements are immediately available to the public.

The board's diaries, details of which were revealed by the FT last week after a freedom of information request, showed that several members had met bankers and asset managers days before — and in one case hours before — major policy decisions. The ECB says it will begin publishing the diaries of executive board members with a three-month lag.



Beefing up the rules on accountability could go a long way towards ensuring that the public continues to trust central banks even as they assume new powers, critics say. Central bankers are already subject to extensive political scrutiny — for example in parliamentary hearings — but this may need to be broadened.

“Central banks have become supremely powerful and if power corrupts, absolute power corrupts absolutely. We need to be more innovative in designing accountability,” says Rosa Lastra, a professor of monetary law at Queen Mary University in London.

The answer may rest with the central bankers themselves, who need to stay above the political brawls to avoid complaints of over-reach. “Central banks should be fine provided they can truly explain everything they do in terms of stability, stability and stability,” says Sir Paul Tucker, former deputy governor of the BoE. “If they can do that, the public is less likely mistakenly to think of them as all-powerful agencies capable of solving all economic challenges.”

“There is a danger of central bankers talking too much,” says Lucrezia Reichlin, an economist at London Business School and a former ECB official.

“You should be careful about talking beyond policy, if you want to retain independence.”

Audit: Holding powerful technocrats to account

With a shared interest in financial stability and rigorous accounting, auditors and central bankers seem natural allies in the fight against economic trickery. But as the monetary authorities grow ever mightier and politicians seek greater oversight, tensions are simmering over whether official book-keepers should be allowed to audit the central banks.

The fight underscores the difficult balancing act between the desirability of retaining central bank independence and the need to ensure powerful technocrats are held to account.

In Britain, the Treasury has drafted plans to allow the National Audit Office into the doors of the Bank of England for the first time in its history. However, following complaints from the BoE that this arrangement could compromise its independence, the Treasury watered down its earlier proposals and gave the central bank’s Court of Directors a veto over the NAO’s investigations.

This climbdown was slammed by Sir Amyas Morse, controller-general, who said “the legislation proposed by the government . . . would create an impression of increased public accountability without the reality”.

In the eurozone, the Netherlands’ Court of Audit wrote to the Dutch House of Representatives in February to complain about the likelihood the European Cental Bank will refuse the European Court of Auditors access to information on banking supervision.

While the ECB releases all of the information it is required to, it must also protect the banks — and their owners — by ensuring that it does not breach rules on confidentiality.

The US Federal Reserve has been trying to fend off legislative proposals that would subject its monetary policy deliberations to examination by the Government Accountability Office. The Fed’s financial statements are already audited, and the GAO can examine a range of Fed activities. But the agency is excluded from evaluating monetary policy decision-making. A bill championed by Republican presidential candidate Rand Paul would change that.

Fed chair Janet Yellen has warned the bill would allow short-term political pressures to be brought to bear on the central bank. As part of its campaign against the measure, the Federal Reserve Board's homepage carries a prominent box saying: "Does the Fed get audited? Yes."

Letter in response to this article:

Central banks must be made accountable / From Alex J Pollock