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The dangerous politics of central banks

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THE sudden burst of stockmarket volatility last week follows a period of relative calm, as noted in the last post (http://www.economist.com.proxy.bc.edu/blogs/buttonwood/2015/08/investing) . Much of that calmness must be down to central banks and their willingness to interfere in the markets to suppress long bond yields as well as short rates. The low level of the Vix reflected the confidence of investors that the authorities were in charge. And thus the rebound of the Vix reflects a fear that things are getting out of control again. The struggles of the Chinese authorities to manage their currency, stockmarket and financial sector are well-known. But investors clearly feared that the Federal Reserve was underestimating the extent of the global slowdown or the impact of a rate rise; hence the strong recovery in equities at the end of the week when a September rate increase seemed less likely.

The role of central banks is so important now that, inevitably, they are being dragged into political controversy, albeit for different reasons. In America, the "audit the Fed (http://money.cnn.com/2015/02/11/news/economy/rand-paul-audit-the-fed/) " is worried about the expansion of the central bank's balance sheet and wants to know from whom the Fed bought its massive security pile. In Europe, the ECB is demonised for being part of the hated troika (http://www.economist.com.proxy.bc.edu/news/europe/21597972-stand-between-government-and-international-lenders-continues-troika-back) , deemed to be putting excessive pressure for fiscal austerity on Greece. And in Britain, the likely Labour leader Jeremy Corbyn's economic adviser wants to do away with the Bank of England's independence altogether as part of the "people's QE (http://www.economist.com.proxy.bc.edu/blogs/buttonwood/2015/08/economic-policy) " policy.

It is hardly surprising that central banks have come into the firing line. For the right, the willingness of central banks to buy government debt has allowed spendthrift governments to get away with running huge deficits. For the left, central banks have bailed out the banks and the finance sector via quantitative easing, but not done enough to help the ordinary worker.

And it is surely a reasonable point that so much economic policy is being administered by bodies that are outside democratic control. Central bank independence was introduced as a way of preventing politicians using interest rates to affect the electoral cycle; creating pre-poll booms. Putting technocrats in charge of the timing of rate decisions was akin to allowing scientists to approve drugs via the Food and Drug Administration; you wouldn't want some senator to control a drug approval if it were produced in his state.

But QE, and indeed the whole raft of measures introduced during the EU debt crisis, mean that central banks are involved in decisions that can redistribute wealth on a grand scale, between classes and between nations. There is political control, of a sort. The mandate of the central banks is set by governments and they appoint the head of the bank. This still gives the banks a lot of latitude in terms of implementing policies. And, once appointed, central bank heads are pretty safe; for a government to dismiss the likes of Janet Yellen or Mark Carney for policy reasons would precipitate a financial crisis.

Richard Murphy, Jeremy Corbyn's ever-quotable adviser, thinks this notion of independence is a charade (http://www.taxresearch.org.uk/Blog/2015/08/24/why-the-bank-of-englands-independence-is-just-a-charade/) . And indeed he thinks that central banks should be under the control of politicians; a Bank of England governor who refused to carry out people's QE would be sacked (http://www.telegraph.co.uk/news/politics/Jeremy_Corbyn/11820156/Jeremy-Corbyn-will-sack-Bank-of-England-governor-if-they-refuse-to-print-free-money.html) . It is hardly surprising that politicians should regard the powers of modern central banks with envious eyes; why go through all the potential unpopularity of raising taxes to fund your spending plans when you can get a compliant central bank to do it for you?

However, this creates a paradox. The enhanced powers of central banks mean that it would be more dangerous than ever were politicians to take control. This is not just true of QE; what might have happened to the banking system in 2008 if politicians had been deciding whether to inject liquidity? Decision-making could have been frozen while the system crashed.

Central banks are now major creditors of western governments, guarantors of the financial system, set the cost of borrowing, potentially control access to housing finance (via macroprudential policy) and, at the ECB, mediate between the claims of creditor and debtor governments. Their heads are well and truly over the parapet; they can expect years of being shot at.