Reconsidering Central Bank Independence

Central bank independence has become one of the most widely accepted tenets of modern monetary policy. According to this view, the main role of independent central banks is to maintain price stability through the adjustment of short-term interest rates. *Reconsidering Central Bank Independence* argues that the global financial crisis has undermined confidence in this view as central banks increasingly have to address concerns other than price stability, such as financial stability, the need for output recovery and other broader policy goals. Large balance-sheet expansion by central banks followed the global financial crisis, which overlapped considerably with the financial policy of their respective governments. Exploring the consequences of this shift to a more diverse set of policy challenges, this book calls for a return to the consensus role for central banks and analyses what this might mean for their future independence.

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Preface

Until recently, and for a generation, inflation had been dispelled from the developed world and from much of the developing world too. This benign era followed periods of high inflation all over the world, often leading to chronically high inflation in many developing countries. But inflation returned in the wake of the COVID-19 pandemic and the Russian invasion of Ukraine, reaching levels not seen in the developed world for forty years. The precise causes of this latest inflation remain to be determined at the time of writing in September 2023.

Fifteen years ago, the world economy was rocked by the Great Recession, the most significant peacetime disruption of economic activity internationally since the Great Depression of the 1930s. Pierre Siklos (2017), in his book *Central Banks to the Breach*, gives a very detailed and highly readable account of the monetary policy that led to the Great Recession as well as the policy responses to the crisis. It is at this point that we pick up the thread. We tell the story of monetary policy decisions following the Great Recession by focussing on the rules of conduct for monetary policy, or what economists call the institutions of monetary policy. This narrative is complemented by consideration of various theoretical approaches to the role for central banks as well as the extensive empirical evidence of the consequences of different institutional arrangements.

We place the concept of central bank independence (CBI) at the centre of the analysis, as this institutional development was decisive for the benign outcomes of monetary policy, including low inflation, in the early 1990s. By contrast, the relationship between central banks and governments has evolved over the past fifteen years, endangering the independence of central banks, as central banks have become increasingly drawn into a broader policy agenda. It is the contention of this book that the current surge in inflation is related to this deterioration in the independence of central banks and the associated confusion of their policy mandate.

With the benefit of hindsight, central banks appear to have been complacent in the run-up to the Great Recession, contributing to the asset bubbles (notably, but not exclusively, in US residential property) through excessively accommodative monetary policy. Having contributed inadvertently to the asset bubble, central banks came to the rescue of the faltering international system when the bubble burst. They did so by conventional means, that is, by lowering their policy interest rates as well as by unconventional means through the use of their powerful balance sheets.

The European Central Bank (ECB) was called on to do even more within a few years of the Great Recession as fears of fiscal collapse threatened the integrity of the single currency. And just more than a decade after the onset of the Great Recession, a global pandemic asked for yet greater policy intervention to mitigate the consequences of a massive international demand shock together with unprecedented disruption to the international supply system. In this decade and a half, monetary policy has become overburdened with policy objectives. Central banks have been called on to help stimulate real economic activity and job creation, finance the state, secure price stability as well as financial stability, and even ease the transition to greener economies. In the course of this process, central bank balance sheets enlarged, and distortions in asset markets again resulted in banks assuming more risky activities, as materialised in the problems of two major banks in the United States (Silicon Valley Bank and the First Republic Bank) and in Switzerland at Credit Suisse in March 2023.

On the one hand, this evolution gave central banks more power, as they are responsible for a wide array of topics. During the last fifteen years, observers got the impression that central banks were increasingly responsible for the economic success of the Eurozone or the United States. Central bankers became political superstars. On the other hand, this prominence made central bankers more dependent on political events and decisions. With government finances under severe strain in many countries, pressure for monetary accommodation of fiscal policy mounted, and it became harder for central banks to move away from the extremely low interest rates of the last decade and more. This policy evolution was encouraged by what was presented as new theoretical ideas in monetary economics, which offered intellectual cover for a permissive monetary policy to finance higher public deficits. Such a free lunch would indeed be a startling discovery in economics.

The consequences of these developments in monetary policy are far-reaching. Observing economic stagnation, governments may see the need for economic reforms, but are well aware of the political costs of a reform process, with the cost of economic disruption at the start of the reform process and the sought-after improvement only in the subsequent years, a trajectory economists call the J-curve. As this process may last too long for a potential re-election in the coming general elections, governments in democracies may prefer the apparently easy option to lean on public spending in support of short-run output gains. Since the Great Recession, this extra spending has been financed through public debt that carried barely any interest cost on account of the central bank's interest rate and balance sheet policies.

These low interest costs along the yield curve may, in addition, repress structural change via commercial banks, whose profits shrink through lower and lower interest earnings. In these circumstances, banks prolong their support for ailing companies that would find it hard to secure finance in more normal circumstances. At the same time, banks become reluctant to lend to more risky new enterprises. The combined effect is that the banking sector supports less dynamic enterprise, lowering the prospects for productivity growth in the economy as a whole. This may be particularly difficult in ageing societies, in which people want to invest in secure assets, but see no interest-bearing supply. If low-income savers do not pursue an aggressive investment strategy in more risky assets, they face the prospect of inadequate retirement provision.

It is an oversimplification to trace the evolution of central bank conduct to the central bankers alone. Against this background, we analyse the politico-economic trends that have emerged in the past decades to understand the dynamics of the relation between central banks and other political actors in industrialised countries.

The book consists of three parts, with three chapters in each. In Part I, we lay the 'Theoretical Foundations'. We start it with a brief historical overview of the emergence of independent central banks (Chapter 1). In Chapter 2, we briefly discuss the causes and consequences of inflation to lay the foundation for a detailed analysis of the relation between monetary policy and other policy fields in Chapter 3. We show that different schools of thought (Chicago, Virginia, Freiburg) come to similar conclusions, although their methodological starting points are very different.

Part II analyses and relates 'Balance Sheet Operations in Different Times and CBI'. Chapter 4 is dedicated to the more recent history of monetary policy in the period labelled the Great Moderation. We focus on the Federal Reserve Board (Fed), the Bank of England (BoE), the Bundesbank and its successor, the ECB, as well as the South African Reserve Bank, which offers an interesting and contrasting perspective. Chapter 5 offers a description and an interpretation of the policy responses of four leading central banks (Fed, ECB, BoE and the Bank of Japan) to the Great Recession. This is followed by a more general analysis of balance sheet operations of central banks against the background of CBI in Chapter 6.

Finally, Part III changes the focus to the 'Political Economy of CBI in the Real Economy'. Chapter 7 takes an Olsonian perspective. We ask what drives central bank balance sheet policies in democracies. This development is understood from the perspective of Mancur Olson's groundbreaking theory of the 'rise and decline of nations', which accounts for the increasing difficulty of reform as distributional coalitions impose the slavery of the rent-seeking society (as according to the framework of the former chief economist of the General Agreement on Tariffs and Trade, Jan Tumlir) on democratic societies. In light of these considerations, the factual degree of CBI might be lower than it appears at first glance. Chapter 8 adds to a clarification of this confusion by discussing the need for transparency and accountability in light of a growing literature – mainly driven by political science – on the perceived democratic deficit of technocratic policy solutions. We show that this literature overlooks important aspects of CBI. In the final chapter (Chapter 9), we discuss the latest reactions of central banks to the rise of inflation, which can be interpreted as an attempt to safeguard their independence against governments. We consequently argue for a return to a division of labour in line with the Tinbergen rule of economic policy, which can be translated as one objective, one instrument, one agency. This shift would place much more responsibility for broader economic outcomes on the shoulders of governments, leaving central banks to tend to the narrower agenda of monetary stability.

Acknowledgements

The plans for this book began in 2014 when Stan and Andreas presented a few ideas for a policy-oriented study at the Monetary Policy Group of the Economics Department at Stellenbosch University. We received so many interesting questions and comments that we sat down for a coffee directly afterwards, almost overwhelmed. As a consequence, we decided to think about a book. For this impulse, we like to thank our colleagues in Stellenbosch. Over the coming years, we repeatedly met these colleagues to discuss our progress. In particular, we would like to mention Monique Reid and Hylton Hollander. We also want to thank a number of – partly unknown – colleagues in many places with whom we discussed the topic on various occasions: academic conferences, policy-oriented workshops or arbitrary meetings over a meal or coffee.

Despite this head start, the progress we made in the following years was modest, not least because of significant career developments Stan experienced. When Dawie finished his PhD on a related topic and joined the Economics Department in Stellenbosch, the two original authors invited him to team up with them – with much benefit for the book. Stan and Andreas are well aware of the challenge that a book project represents for a young scholar who needs to settle and find his place in the academic world.

When we were almost finished with the manuscript, the COVID-19 crisis hit and demanded much energy for teaching. In addition, it did not allow for personal meetings between the authors for almost two years. That said, these are all cheap excuses. The main responsibility for the long production process is ours.

We, nevertheless, see some benefit in the delay. Had we finished the book in 2019 it would have been outdated within a couple of months, as the most interesting and decisive developments in monetary policy were still unknown then. With the benefit of hindsight, we are happy to have experienced the delay. In fact, while the multiple crises went on, we did not see the need to hurry. The events were too exciting!

This is the time to thank Phil Good and his team at Cambridge University Press who without any complaints accepted our repeated requests for more time. Their endless patience always served as encouragement. We hope the final product can justify our slow speed and their patience. In Jena, Friederike Karl and Henri Bisch-Chandaroff supported us with editorial work, the value of which cannot be overestimated.

Abbreviations

APF	Asset Purchase Facility
APP	Asset Purchase Program
BIS	Bank for International Settlements
BoE	Bank of England
BoJ	Bank of Japan
BVAR	Bayesian vector autoregression
BVG	German Constitutional Court of Justice
BWS	Bretton Woods System
CA	current account
CBI	central bank independence
CBPP	Covered Bond Purchase Program
CBS	currency board system
CEO	chief executive officer
CME	comprehensive monetary easing
CPFF	Commercial Paper Funding Facility
CPI	consumer price index
DSGE	dynamic stochastic general equilibrium
DWF	Discount Window Facility
EAPP	Extended Asset Purchase Programme
ECB	European Central Bank
ECS	Enhanced Credit Support
EEC	European Economic Community
ELTRs	extended collateral long-term repos
EME	emerging economy
EMS	European Monetary System
EMU	(European) Economic and Monetary Union
ERM	II European Exchange Rate Mechanism II
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision

ESM	European Stability Mechanism
EU	European Union
Fed	Federal Reserve Board
FDI	foreign direct investment
FLS	Funds for Lending Scheme
FOMC	Federal Reserve Open Market Committee
FRFA	Fixed Rate Procedure with Full Allotment
FROs	fixed rate operations
GDP	gross domestic product
GFC	global financial crisis
GMT	Grilli, Masciandaro, Tabellini
GSE	government sponsored enterprise
GVCs	global value chains
HBOS	Halifax Bank of Scotland
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
JGB	Japanese Government Bond
KfW	German Kreditanstalt für Wiederaufbau
LLR	lender of last resort
LSAP	large-scale asset purchase
LTRO	longer term refinancing operation
Mo	balance sheet of a central bank
MBS	mortgage-backed securities
MEP	Maturity Extension Program
MMT	Modern Monetary Theory
MROs	main refinancing operations
N	employment
NGO	non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transaction
PAP	principal–agent problem
PDCF	Primary Dealer Credit Facility
PEPP	Pandemic Emergency Purchase Programme

PSPP	Public Sector Purchase Programme
QE	quantitative easing
QE1, 2, 3	first, second and third quantitative easing, respectively
QEP	quantitative easing programme
QQE	quantitative and qualitative monetary easing
QVAR	Qual VAR
R&D	research and development
S	seigniorage
SARB	South African Reserve Bank
SFSO	Special Funds-Supplying Operations to Facilitate Corporate Financing
SGP	Stability and Growth Pact
SLS	Special Liquidity Scheme
SMF	Sterling Monetary Framework
SMP	Securities Markets Programme
SOE	state-owned enterprise
SVAR	structural VAR
TAF	Term Auction Facility
TALF	Term Asset-Backed Securities Loan Facility
TLTRO	targeted LTRO
TSLF	Term Securities Lending Facility
TVP-VAR	time-varying parameter vector autoregression
VAR	vector autoregressive model
ZIRP	zero interest rate policy
ZLB	zero lower bound