



**PIIE** PETERSON INSTITUTE FOR  
INTERNATIONAL ECONOMICS

# **In the Fray, Not Above It**

## **Observations on the Global History of Central Bank Independence**

Adam S. Posen

PIIE

Central Bank Independence Revisited

April 23, 2018



# Observations on the History of Central Bank Independence

## Empirical Policy Questions

1. What is experience with different CBI models?
2. What are the merits of different CBI political-legal arrangements?
3. How does CBI align with economic changes since spreading in 1990s?
4. How does CBI experience inform decisions about CB control of financial stability decisions?



# Observations on the History of Central Bank Independence

## Haldane Questions

1. What is experience with different CBI models?
2. What are the merits of different CBI political-legal arrangements?
3. How does CBI align with economic changes since spreading in 1990s?
4. How does CBI experience inform decisions about CB control of financial stability decisions?

## Evidence/Experience

1. CBI impact on economic outcomes overrated
2. Differences in legal structures have little consistent impact
3. Independence matters as insulation, not as counter-inflationary conservatism
4. Central bank will be held responsible. Time-inconsistency argument for rules better for financial stability than price stability

# Experience with CBI models



- Initial promise of political economy of CBI
  - Impose it anywhere, and it will work to ↓  $\pi$
- False premise led to varied results
  - Generally adopted *after* disinflation successful
  - Cross-national variation in CBI explains little of overall decline in inflation rates globally
  - Division between rule of law (respecting governors' autonomy/tenure) vs not is the key determinant of effectiveness
  - Even experiments with reduced CBI (e.g. BOJ) have not had impact on inflation expectations

# Experience with CBI models



- Every CB takes into account its political environment and risks to independence
  - Even the most independent central bank legally (ECB) has had to adjust its policies
  - Backlash against QE in the US led to curtailed capabilities of the FRB
  - Lohmann (1992) fixed cost of changing view combined with ongoing negotiations and coalitions
- Thus, there are no wider knock-on effects of CBI
  - Not on wage-bargaining, fiscal discipline, structural reform, price flexibility...

# Merits of different CBI political-legal arrangements



- What is the real meaning of CB independence?
  - Conservatism against inflation
  - Expertise and near-objectivity
  - Depoliticization of decisions
  - Seal of approval for markets and governments
  - Legitimacy of the institution to decide
- In each country, adoption of CBI and its specific form is context specific and requires support
  - Even at height of technocratic spread via EMU
  - A lesser version of ‘constitutional moments’
  - Tension of need to change with coalitions and times

# Merits of different CBI political-legal arrangements



- Instrument v Goal independence – blurry but useful
  - But even on this a wide variety of goal setting processes
- Aspects that should matter a lot do not seem to matter
  - Mandates are all over the place in focus and definition
  - Committee structure, relative power of monetary policy voters and degree of explicit voting do not change outcomes
  - Perhaps matter more for political legitimacy, less for economic
- Importance of context can be seen in what allowed to buy under duress
  - FRB could only buy public obligations, violation to buy private
  - ECB would prefer to buy private debt, violation to support public
  - Smaller central banks buy foreign assets not domestic



# Merits of different CBI political-legal arrangements

- Fiscal indemnity from government was fundamental
  - BOE had it for QE under successive governments
  - ECB and BOJ publicly fretted about vulnerability if CB ‘capital’ were eroded
  - FRB under attack by Congress for ‘spending our money’
  - Not foreseen as an issue in CBI
- Fiscal cooperation or criticism without rules
  - Often (in EM) seen as virtue of independence, if not duty, to critique government fiscal policy
  - Usually (in G20) CB criticism is an intrusion
  - Ability to willingly cooperate gets stigmatized, though evidence is that only involuntary primary debt purchases do harm (to inflation or expectations)

# CBI alignment with economic changes since 1990



- Lots of reasons to doubt simple inflation bias story
  - Including the ease of shedding it once done
  - And the stickiness of inflation expectations
  - And the flattening of the Philips Curve
  - Ended up with asymmetric models of CBI in a world of asymmetry in the other direction (incl. ZLB)
  - Low inflation as part of a syndrome, not neutrality
- Global trends and convergence beyond CBI
  - Seeming evidence for real (wage) driven inflation
  - Difficulty of using currency depreciation economically and politically to reflate
  - Link of capital inflows and financial instability

# CBI alignment with economic changes since 1990



- From money illusion to distribution illusion?
  - People cannot only notice distributional consequences of MP when in crisis or when using quantitative measures
- Information overflow reduces transparency
- Argument for return to ‘firefighting’ model for CBs
  - CB have broadening responsibilities/demands
  - No longer blinded by happy coincidence of one goal/one instrument/good outcome
  - Need for ongoing engagement in macroprudential
- Independence defined only in terms of inflation or even of monetary policy is no longer viable
  - At least the case for independence in other areas has to be fought separately

# CBI and the control of financial stability decisions



- As with CBI in practice, very wide range of institutional models, little difference in outcomes
  - Some of this due to international common trends, as with declining inflation
  - But placing supervision in or out of CB, shared or separate from other regulators, does not seem to matter to crisis incidence or financial stability
  - Again, shifts in reg/sup regime reflect perceptions and interest group of the time, not some inherent logic
- But an added layer of distrust regarding the intent and will of reg/sup, seemingly justified
  - In contrast to the higher trust in price stability for CBI



# CBI and the control of financial stability decisions

- Central bank control of financial stability seems to pursue *goal* independence
  - We know from CBI that this is a mistake
  - Too much discretion over too many instruments leads to distrust about motives
  - Not clear what interest is being insulated or which expectations are being anchored
- Strong case for unified regulator/supervisor is not necessarily a case it should be the CB
- If CBI was an intermediate point on rules vs discretion for inflation, probably should be closer to end point for rules for financial stability



# Suggestions for the Future of Central Bank Independence

## Evidence/Experience

1. CBI impact on economic outcomes overrated
2. Differences in legal structures have little consistent impact
3. Independence matters as insulation, not as counter-inflationary conservatism
4. Central bank will be held responsible. Time-inconsistency argument for rules better for financial stability than price stability

## A Way Forward

1. Replace false precision and credibility talk
2. Give MP voters autonomy, and the rest will follow – if CB has outside support
3. Make common cause with judiciary, military, climate technocrats for expertise
4. Reduce discretion by central banks in macro-pru and complexity in financial oversight. Shift accountability to results.