



Policy Brief

The End of Central Bank Independence?

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Since the financial crisis that began in the United States in 2007 has spread worldwide central banks have been in a race to the bottom to the zero lower interest rate bound in order to loosen monetary policy conditions, and ease credit bottlenecks by providing liquidity where necessary, in an attempt to instill confidence in their ability to manage an increasingly difficult economic situation. Somewhat belatedly, governments have joined in the effort to stave off a financial and economic collapse by promising a return to large deficits to offset the fall in private sector spending. Of course, there is also the recognition that, once the crisis has passed, and sober assessments of what went wrong and how to repair the damage can be considered, governments, central banks, and supervisory authorities will embark on the creation of a new regulatory regime. Ben Bernanke, the Fed Chairman, said as much in his London speech on January 12th, 2009 though he skirted the thorny question of whether the outcome would amount to a form of cooperation with other countries as opposed to a coordinated set of policies, the latter a much more difficult aim to achieve. Obviously, a new era is about to unfold but, curiously, few have questioned the future role of central banks in a brave new financial world.

While analysts have emphasized the importance of global finance, and the nearly universal scale of the impact of the financial shock emanating from the US – with Asia so far less impacted by the crisis – there has been less attention paid to the fact that monetary authorities worldwide have been permitted to act aggressively because of another global phenomenon that predates somewhat the globalization of financial markets. Arguably, a legacy of the stagflation of the 1970s was the spread of central bank independence, a misnomer since the central bank, generally an institution wholly owned by the State, can never be truly independent. Instead, central banks around the world were given the freedom, often though not always enshrined in law, to decide the short-term course of monetary policy while the overall strategy of monetary policy would be left either for governments to decide, or in concert with the advice of the central bank. Central bank independence became one of the canons of good monetary policy making. International institutions, including the IMF, insisted on it when requiring governments to reform their economies. History, however, does teach us that a crisis, especially when it is as large as the one the global economy is currently facing, calls into question previously accepted principles. The same is true of the ideal of central bank independence.

Consider the situation faced by the Federal Reserve. For a variety of reasons, including reluctance by the previous Bush Administration to engage in active intervention to calm fears inside and outside financial markets partly for ideological reasons, the Fed took it upon itself to actively respond to market failure in the financial sector. In spite of Chairman Bernanke's claims



that the ‘explosion’ of its liabilities, the result of an alphabet soup of programs to offset the collapse of credit markets, can be easily reversed once the crisis is past, questions are being raised about the so-called exit strategy. Certainly, some of the added liquidity can be absorbed via changes in reserve requirements, increases in interest rates, and the like, but there is a good chance that only if the Treasury cooperates can the situation be completely reversed and a return to a semblance of normality become possible. Faced with a sharp rise in debt, governments in the industrialized economies will choose to inflate their way out of the problem rather than, say, try their hand at defaulting on their obligations, an option more likely to be taken by emerging markets. Political pressure to moderate interest rate increases once aggregate demand picks-up will also rise so as not to prevent an economic recovery from taking hold. The situation is more difficult still for the 10 year old euro area where the European Central Bank does not have the tools to bail itself out in the event of default on advances made, in some cases based on collateral of questionable quality. The recent downgrades of Greece’s debt and the watch placed on Spain’s debt raises somewhat the prospects of default in the eurozone.

It is important to recall that, in spite of their autonomy, central banks are ultimately accountable to the public via the mandate provided to their elected government. Governments can, therefore, instruct, perhaps in subtle fashion, the monetary authority to relax concerns over inflation until the moment is once again ripe for a return to the low inflation environment that defined the 1990s and the early years of this Century. This ought not to be difficult in the US where the Fed’s operational independence has changed over the years as political conditions required. It is a more difficult matter for the Bank of Canada, and other inflation targeting central banks, because they have agreed, with the tacit support of the governments that negotiated these arrangements – not necessarily the governments that will have to deal with the aftermath of the crisis – that low and stable inflation is a desirable social objective. Surely, the experience of the stagflation some thirty years ago ought to have taught us the inadvisability of high inflation. Yet, in 2011, when the current inflation target agreement is slated for renewal and the consequences of current policies will hopefully become clearer, it remains to be seen whether the government of the day will renew the existing inflation targeting agreement, or pay lip service to it, thereby threatening the credibility of the regime that took years to build. Perhaps the British economist, Jonathan Kay, is correct when he wrote in 2007: “Each generation repeats the experience of its predecessors, not in broad outline but in considerable detail.” We may yet repeat the experiment of central banks once again beholden to a State that is determined to overreach and, as a consequence, abandon its conversion to the belief that low and stable inflation is a worthwhile economic objective.



In the meantime, economists will need to revisit a whole series of issues in the wake of the foregoing developments. First, existing models used to forecast inflation and economic activity will have to incorporate a far more realistic view of the links between financial and real sides of the economy. Second, the much vaunted theoretical benefits of inflation targeting may well have to be revisited, especially the question of how expectations can be anchored post-crisis if and when the global fiscal stimulus finds its way into creating excess aggregate demand that feeds into higher inflation. Third, central banks must think far more deeply about how to communicate potentially rapid increases in interest rates, and how possible conflicts with their respective governments will be addressed. If the stag-deflation scenario suggested by Nouriel Roubini does become the black swan that leads into a spiraling deflation then not only will central banks have to develop tools to communicate a return to a moderately higher prices but they must improve tools to explain how quantitative easing promotes the idea of a looser monetary policy. Needless to say the diminished role of interest rates in this crisis may also have potentially crucial implications for models that rely on an interest rate as the representative, and sole, instrument of monetary policy.

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