

AERIAL VIEW

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CENTRAL BANKS ARE UNDER ASSAULT

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CENTRAL-BANK INDEPENDENCE HAS BEEN TAKEN FOR GRANTED FOR DECADES.

Conventional wisdom, supported by nearly a century of economic history, indicates that independent control over monetary policy—insulated from the direct interference and control of political leaders—delivers better economic outcomes.

Recently, however, that independence has been threatened, as political leaders have criticized monetary authorities, and in some cases inserted themselves into the conduct of monetary policy. In the broader trend towards populism, such institutions have been characterized as opaque structures where unelected technocrats make decisions that affect the lives of millions of people.

If taken too far, such ill-advised meddling could shake investors' nerves and give rise to crises of credibility.

To be sure, central banks have no sacrosanct right to remain above

examination, or even to avoid having their operational guardrails come under review. Their roles in allowing significant financial imbalances to build up in recent years, and their subsequent enactment of unorthodox measures to combat the 2007-2009 global financial crisis, are all worthy of scrutiny.

Nevertheless, recent years have seen a notable rise in critical rhetoric. The biggest headlines have been generated in the US, where President Donald Trump has made numerous critical statements about the Federal Reserve, telling the news media that the central bank has “gone crazy” and calling for a rate cut.

Most recently, his two nominees to fill current vacancies on the Fed's seven-member Board of Governors have spurred controversy and opposition from institutionalists across the

political spectrum. Fed Chair Jerome Powell and others have underscored their commitment to the central bank's independent decision-making process.

Such developments are not restricted to the US. Elsewhere:

- **Turkey's** President Recep Tayyip Erdoğan, who was sworn in for another five year term last July, has submitted the Turkish Central Bank to withering pressure to keep rates low to stimulate the economy and has claimed unassailable power to appoint officials at the Bank. Soon thereafter, spooked investors sold their lira, shaving off about a third of its value in a single week last August.

- In **India**, Urjit Patel, then-governor of the Reserve Bank of India, resigned following sustained pressure between the central bank and the Indian government, which—among other things—reportedly wanted the RBI to transfer bank reserves to the finance ministry's fiscal account and pushed to ease lending restrictions on state-run banks.

- In **Frankfurt**, the closely watched succession of European Central Bank President Mario Draghi will command attention. Mr. Draghi's successor will have a full plate of issues - whether

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or not to champion moves to more centralized fiscal and financial policymaking; how supportive the ECB should be towards profligate countries in the union; and how aggressive monetary policy should be in combatting low inflation, to name a few.

It should be noted that disagreements—and even open tensions—between political leaders and central banks have surfaced before. Famously, there were tensions between former US President Ronald Reagan and then-Fed Chair Paul Volcker over the central bank's highly restrictive monetary policy in the early 1980s as the Fed set out to quash a decade's worth of excessive inflation.

Furthermore, the incongruity between politicians' agendas and those of their central banks is not always misguided. Historians often cite the Fed's reticence to loosen policy after the stock market crash of October 1929 as a major contributing factor to the Great Depression.

Legitimate questions also surfaced around the Fed's behavior during the mid-2000s and whether or not it was too sanguine in confronting the housing bubble and banking sector excesses that led to the eventual collapse in 2008. Its response to the crisis, first in buying up distressed assets and then in engaging in subsequent rounds of quantitative

easing, are the subject of lively debate even today—both within and outside of the central bank itself.

Politicians have different incentives than do central bankers, and exploiting the currency to meet short-term political objectives is a tempting lever for them.

But in an era of floating exchange rates and fiat currencies, the value of a country's money—and ultimately the living standards of the populations that use it—is determined by its ability to be credibly managed, with a stable foreign exchange value and free from erosion by domestic inflation.

In fact, the domestic laws which give statutory life to central banks in many countries prescribe some combination of price stability and maximum employment (and in some cases responsibility for the stability of the domestic financial system as well) as the monetary authorities' objectives.

If central banks err on the side of slightly above-target inflation in order to ensure the economy is on solid footing, for example, that would be an entirely different question from whether or not the central bank should avoid policies that weaken the stock market and potentially hurt the political executive's popularity.

Getting it right, especially when balancing potentially conflicting policy

remits, is in fact the crux of study and commentary on central banks.

Nevertheless, the consensus around central bank independence hasn't had to envision the breadth and intensity of the current assaults from politicians and markets. It may very well be that we are entering an era in which that consensus goes unheeded by government leaders.

Central banks are not ignorant of the threats to their operational independence. In fact, the independence they do enjoy is bestowed upon them by political masters, and it can always be circumscribed or diminished—even to the point of being withdrawn altogether.

One way to mitigate the criticisms is for central banks to display their own political alacrity. They have taken steps in recent years to be more transparent and to stay above the fray, often while being the only policymaking bodies with the operational flexibility and tools to confront economic difficulties.

Chair Powell admitted in February Congressional testimony that the independence of his institution is a fragile thing, saying that Americans and the government “can hold us accountable.” This give and take is always present and financial market participants are mindful that central banks give just enough, lest more be taken away from them. ●

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