Why Central Bank Independence Could Become a Thing of the Past

Declining credibility and the rise of populism pose significant challenges.

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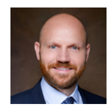

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KEY INSIGHTS

- Central banks across the world are facing challenges to their independence amid declining credibility and attacks from politicians.
- Economically, the likely impact of reduced central bank independence is higher inflation and a more volatile business cycle.
- The similarities with the economic conditions of the 1970s suggest that stagflation trades, such as gold and inflation-linked securities, could be effective.

After a decade of extraordinary monetary policy stimulus, it was almost too predictable that, at the first sign of a monetary headwind to growth, U.S. President Donald Trump would take aim at the U.S. Federal Reserve (Fed). "Germany sells 30-year bonds offering negative yields," Trump tweeted on August 22. "Germany competes with the USA. Our Federal Reserve does not allow us to do what we must do. They put us at a disadvantage against our competition." He had previously accused Fed Chairman Jerome Powell of being "clueless" and displaying a "horrendous lack of vision."

President Trump's comments sparked fears that the Fed's status as an independent central bank is under threat. However, it remains a fact that, despite the trillions of dollars of monetary stimulus it has injected into the U.S. economy, the Fed has failed to hit its 2% inflation objective. Central banks in other parts of the world have also failed to deliver their mandates and similarly find themselves under pressure from frustrated politicians. So is the era of the independent central bank coming to an end?

A New Concept

The idea that modern economies require independent central banks is relatively new. It grew in the 1970s and 1980s out of the work of economists advocating the "rational expectations" school of thought, most notably Finn Kydland and Edward Prescott, who jointly won the 2004 Nobel Prize for their work. One of their key contentions was that if monetary policy is left in the hands of politicians, it will become a hostage to the electoral cycle because incumbent administrations will always seek to stimulate economic activity to get reelected. As a side effect, inflation will rise. However, as rational citizens would anticipate their government's behavior, inflation expectations would rise and politicians would have to pump even

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more money into the economy to get the same boost to growth. Consequently, Kydland and Prescott argued that monetary policy should be delegated to an independent institution to keep inflation under control.

Most modern “independent” central banks are prohibited from financing their governments directly. Theoretically at least, this creates a clear dividing line between fiscal and monetary policy: The central bank can impose fiscal discipline upon the government precisely because it does not fund it. Typically, the central bank will be given a narrow tangible mandate, such as an inflation target, against which it will be held accountable to the public. Independence is further cemented by giving central bank governors fixed terms that cannot be terminated by the government. This combination of job security, accountability to the public, and a clearly defined mandate is intended to ensure that the governor can make decisions that serve the central bank’s purpose even when they are not popular with the administration. In other words, monetary policy is directed toward a well-thought-out, time-invariant objective that was determined at a time of economic tranquility.

So much, at least, is the theory. In reality, central banks’ independence is sometimes exaggerated. In the U.S., the president appoints governors to the Federal Reserve Board and Congress sets laws that affect the powers of the central bank. In Europe, the European Central Bank (ECB) became heavily involved in the eurozone crisis, as ECB President Mario Draghi admitted in 2012 when he said that the ECB would do “whatever it takes” to preserve the euro. Even so, there is a clear difference between a central bank that is influenced by government policy and one that is controlled by politicians.

Populist Politicians Challenge Central Banks’ Mandates

It remains to be seen how long the politicians can be kept at arm’s-length. A world of low growth, falling inflation, and chronically low interest rates has helped to fuel the rise of populism, which in turn has placed the role of central banks under renewed scrutiny. The challenge is not just coming from right-wing populists such as President Trump—the progressive left also harbors ideas about central banking that do not leave much room for truly independent central banks. Modern monetary theory (MMT), supported by many left-leaning populists, argues that the institutional constraints that prevent a central bank from providing direct finance to its government is an un-useful legal hurdle that should be dismantled. Supporters of MMT believe that monetary policy should be set as accommodative as possible and that fiscal policy should be used to ensure that the economy delivers its potential—a potential that it most often defined as full employment with only secondary regard for the level of inflation.

In the U.S., the independence of the U.S. Federal Reserve is currently protected by institutional rigidity. It will take time for any incumbent president to convince Congress to change the central bank’s mandate. However, institutional rigidity wears down under years of attrition. At the current juncture, it seems likely that the administration that occupies the White House after the 2020 elections, left or right, will have an economic agenda that, on the face of it, will benefit from an agreeable central bank. If popular support favors politicians that disregard central bank independence, it seems likely that Congress’s view on central bank independence will start to change as well. After all, Congress is nothing but the representatives of the people.

Why Central Banks Are Vulnerable

Central banks are not well positioned to withstand these attacks, for three

24%

Policy rate set by the Central Bank of Turkey in 2019.

main reasons. First, their calibration of monetary policy helped to facilitate the imbalances that gave rise to the global financial crisis; second, central banks have failed to deliver on their inflation mandates for years; third, events over the past decade have challenged the notion that the monetization of public deficits leads to excessive inflation. In short, central banks have lost credibility with political decision-makers and the public at large. In addition, central banks are victims of their own success: The painful lessons from the days of rampant inflation followed by disinflation in the 1970s and early 1980s have been long forgotten by most.

As central bank independence is clearly under threat, it is worth asking: How important is it that central banks are independent? In my view, respect for the broad lines of central bank independence are very important for the performance of the economy and asset markets, but minor infringements on central bank independence are probably less important. However, the line between minor and major infringements is blurred, and to avoid a gradual deterioration of the institutional independence, good central bankers will articulate that any minor violation of central bank independence is an infringement that can have major implications.

The Consequences of Less (and More) Central Bank Independence: Turkey and Russia

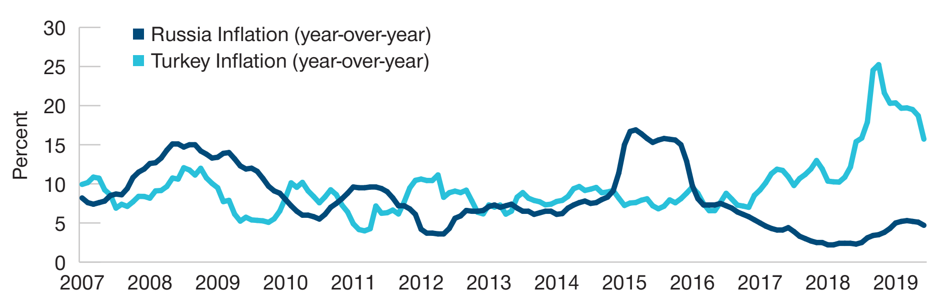
The Republic of Turkey is a good example of what can happen when central bank independence deteriorates. In theory, the Central Bank of Turkey is independent to set monetary policy to hit its 5% inflation target. In practice however, the Turkish administration prioritizes growth over inflation and will direct the central bank to follow the party line. Consequently, inflation in Turkey rose from an average rate of 7.7% in 2010–2011 to an average rate of 17.1% in 2018–2019 (see Figure 1). In parallel, the Central Bank of Turkey had to hike the policy rate from around 5.75% in 2012 to 24% in 2019. A major infringement on the independence of the Central Bank of Turkey caused the Turkish administration to face ever-rising interest rates—exactly the opposite of what the administration wanted. The dismissal of the governor of the Central Bank of Turkey in July 2019 because he failed to follow instructions on interest rates is a testament to the non-independence of the Central Bank of Turkey.

By contrast, Russia is an example of an emerging market country that has taken decisive shifts toward greater central bank independence. Historically, the Central Bank of Russia has had a dual mandate of managing inflation and the exchange rate. The commitment to the

(Fig. 1) Contrasting Fortunes

Inflation in Turkey and Russia

January 1, 2007, to June 30, 2019



Sources: Turkish Statistical Institute and Russian Federal State Statistics Service.

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inflation portion of the mandate was quite limited. Following the turmoil of the global financial crisis, the operating mandate of the Central Bank of Russia was simplified, and the central bank was equipped with a single inflation target of around 4%.

As time has passed, the operational independence of the Central Bank of Russia to pursue this mandate has only increased. As a result, to address excessively high inflation, the monetary policy stance has been tightened: The real policy rate in Russia today is around 3%—one of the highest among the emerging economies. In comparison, prior to the global financial crisis, the policy rate in Russia was most often deeply negative. Few Russia observers will dispute that, sanctions notwithstanding, the performance of the economy has improved significantly. Inflation has fallen from an average of 11.25% in 2005–2006 to an average rate of 3.7% in 2018–2019. Over time, the anchoring of inflation and inflation expectations will permit the Central Bank of Russia to implement a very substantial reduction of the policy rate.

Stagflation Trades May Deliver

Economically, a world of reduced central bank independence is one of higher inflation and a more volatile business cycle as uncurbed economic booms during election years turn into busts. This is an environment that permits a more pronounced presidential cycle: Equity markets rally into elections as the economy is primed for the incumbent to be reelected only to retrench after the election as the monetary stimulus starts to fade. The similarities with the economic conditions of the 1970s suggest that stagflation trades could be effective: Politically motivated central banks keep policy rates too low, which, in combination with rising inflation, will lead to a steepening of the yield curve. Across the cycle, greater volatility of the real economy and rising inflation could mean that equity markets struggle to keep up with an ever-rising rate of inflation. Higher inflation, lower real yields, and greater volatility of the real economy leave gold and inflation-linked securities as the major beneficiaries. Over time, rising inflation expectations and overzealous monetary accommodation result in currency depreciation.

WHAT WE'RE WATCHING NEXT

The U.S. Federal Reserve could find itself under increasing pressure to cut rates more aggressively if President Trump maintains his Twitter campaign against it—it will be interesting to see how the central bank responds. Neither is there likely to be any letup in political pressure on central banks in other parts of the world, particularly in countries where populist parties have been elected. If central bank independence is further eroded, we expect higher inflation and increased volatility to follow swiftly.

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