The LBMA/LPPM Precious Metals Conference 2013

Post-crisis challenges to central bank independence

Speech by Salvatore Rossi

Deputy Governor of the Bank of Italy

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First, let me thank the London Bullion Market Association and the organizers of this conference for their invitation to take part in such an important event. I was asked to speak about "post-crisis challenges to central bank independence". This is certainly a key issue, especially in these particular days. My speech will draw on some of the recent work of my colleagues at the Bank of Italy, and in particular from Franco Passacantando's remarks at the World Bank last April on a similar topic.[1]

Central bank independence yesterday and today[2]

Over the past two centuries reflection on the nature of central banks has been incessant, proceeding hand-in-hand with the spread of these peculiar institutions. Today, nearly every country has a central bank, but scholarly opinions still differ over the actual needs that central banks were intended to address. Whatever these needs and whatever the circumstances, however, independence has been almost universally considered as the economic and legal heart of central banking. The idea that paper money must be issued by an institution that is independent and distinct from the sovereign is an ancient one: explicit and still highly topical passages were penned two centuries ago by Henry Thornton and David Ricardo.

Though contested occasionally by advocates of all-embracing political sovereignty, this idea became rooted in economic thought and was incorporated, in varying ways and to varying extent, in the statutes of many central banks.

In the 1980s monetary theory "rediscovered" the independence of central banks. Economists, politicians and ordinary citizens had been frightened by the inflation of the 1970s, and also highly impressed by the differing ability of the leading countries to quell it. A special strain of economic literature emerged as part of the broader

[1] Franco Passacantando, "Challenging Times for Central Bank Independence", http://www.bancaditalia.it/interventi/altri_int/2013/Passacantando_23042013.pdf, April 2013.
[2] Based in part on Salvatore Rossi and Eugenio Gaiotti, "Theoretical and institutional evolution in economic policy: the case of monetary regime change in Italy in the early 1980s", *Storia del Pensiero Economico*, 2004.

theoretical school of "new classical macroeconomics" associated with Robert Lucas and Thomas Sargent. It was based on the concept of "time consistency" of economic policy, i.e. the idea that if a policy is to be credible in the eyes of private agents with rational expectations, it must be consistent over time. Since policy-makers may have incentives to deviate from their policies, some sort of institutional straitjacket is required to constrain them to time consistency.

The theory quickly came to be applied to monetary policy. It was argued that the only way to prevent policy-makers from exploiting the short-run trade-off between output and inflation and so to preserve price stability was to delegate the conduct of monetary policy permanently to an independent central bank.

This line of thought, lately labeled the "Jackson Hole consensus,"[3] exerted a profound influence on the reform, or initial design, of a number of old and new monetary institutions, first and foremost the European System of Central Banks. No one would have questioned it until the outbreak of the global financial crisis and the ensuing Great Recession.

Challenges from policies for financial stability

Now, in the post-crisis era, the independence of central banks may be threatened first of all by their increasingly important role in the pursuit of financial stability.

Until five years ago the vast majority of agents and commentators in the advanced world had never actually seen a systemic financial crisis; what knowledge of them they had came from history books. Almost everyone was firmly convinced that in advanced economies with well-developed financial markets the optimal course

[3] The tenets of the Jackson Hole consensus are summarized in C. Bean et al., "Monetary Policy after the Fall", *Federal Reserve Bank of Kansas City Annual Conference*, Jackson Hole, Wyoming, August 2010. See also Robert Barro and David Gordon. "Rules, Discretion, and Reputation in a Model of Monetary Policy", *Journal of Monetary Economics*, July 1983, pp. 101-22; Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit and Banking*, Vol. 25, No. 2, May 1993, pp. 151-162.

of action for central banks was to sit on the fence and then “mop up” after a financial bubble had burst. Five years after the collapse of Lehman Brothers, however, nobody still thinks that a “mop-up” strategy alone can be the best approach. The monetary policy authorities simply cannot ignore financial stability.

Price stability and financial stability are now seen to be complementary objectives: the achievement of one not only facilitates but actually requires the attainment of the other. Any short-term trade-off between them can be attenuated by macroprudential action.[4] Indeed, preventing the build-up of systemic risk through the use of both microprudential and macroprudential regulation and supervision is among the tasks assigned to central banks.

How deeply the central bank should be involved in such matters remains an open question, however.

There are naturally pros and cons, but in speculating on the issue, in my view one crucial fact must be borne in mind: financial instability can impair the transmission of monetary policy and prevent the central bank from achieving its price stability objective. This risk materialized in the euro area with the sovereign debt crisis. There are other fundamental arguments for central banks being fully involved in banking regulation and supervision. First of all their lender-of-last-resort function: only supervisory powers can enable the central bank to determine correctly and promptly whether a bank is illiquid or insolvent, as the Northern Rock case in the UK made dramatically clear in 2007.[5]

At the same time, putting more power in the hands of central banks is likely to increase the political pressure on them. And this is a serious challenge for these venerable institutions. Influencing asset prices and credit flows throughout the financial system makes them the perfect target for both lobbies and governments – and, of course, the ideal culprit if things go wrong.

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[4] Paolo Angelini et al. “Monetary and Macroprudential Policies,” Banca d’Italia Working Papers, No. 801, March 2011.
[5] BIS, *Central bank governance and financial stability,* May 2011.

It was argued in the past that an institution in charge of both monetary policy and banking supervision may be tempted to be softer in setting the monetary stance in order to avert a banking crisis. The global financial crisis has dispelled this argument. On the other hand, the historical experience of countries like Italy, where monetary policy and banking supervision were concentrated in a single institution – the central bank – shows that the independence attributed to the two functions by law and by social norms tends to be mutually reinforcing when the two are put under the same roof. The monetary-policy independence of a central bank – enshrined in statute, confirmed in practice and strengthened by hard-earned reputation – can powerfully support the independence of banking supervision, which is essential to its effectiveness according to international principles.[6]

Another challenge to central bank independence comes from the resolution of banks that are no longer viable. If the central bank is in charge of banking supervision it obviously cannot abstract from bank resolution. But more often than not resolving a bank implies the use of taxpayers' money, and a non-elected institution dealing with it may find itself in an uncomfortable position, unless proper institutional arrangements are in place.

This is why the Banking Union in Europe is not a threat to central bank independence. A well-designed Banking Union will break the perverse feedback loop between sovereigns and banks, not undermining but strengthening the independence of the ECB and the national supervisory authorities. The Banking Union must contain both ingredients: a single supervisory mechanism and a single resolution mechanism, flanked by a single deposit insurance scheme. The recent proposal by the European Commission points precisely in that direction[7].

[6] Independence is also a requirement for the supervisor, as is stated in the IMF's Financial Sector Assessment Program: "The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources."

[7] European Commission, COM/2013/520/FINAL, July 2013.

The Banking Union will be an important step towards the completion of fully integrated European Union.

Challenges from unconventional monetary operations

The global financial crisis prompted central banks in most of the advanced countries to adopt a wide range of unconventional monetary measures, ranging from purchases of public and private assets to currency swaps and much more. While these measures undoubtedly avoided the collapse of the financial system and a devastating depression, in the perception of public opinion there was, and there still is, a risk of undesirable side-effects. Compared to standard monetary instruments, unconventional operations may have substantial fiscal and re-distributional effects. A technocratic institution engaging in such operations may be perceived as lacking in democratic legitimacy, and its independence may be challenged.

In a democracy the constant support of public opinion is the ultimate safeguard for a central bank. On this, I would like to quote Paul Volcker:

> In concept and practice, an informed citizenry, acting through a constitutional process and its elected representatives, can and does assign certain of its sovereign powers to a duly constituted authority. The corollary of that provision is also relevant: that delegation of authority can be withdrawn. In other words, the exercise of important governmental powers is ultimately dependent on maintaining the consent of the body politic.[8]

Central banks must accordingly pay increasingly close attention to defining and explaining the objectives of their action. Communication to the public and to political institutions is far more important today than in the past.

Another possible unintended consequence of unconventional monetary policies is fiscal dominance. It is sometimes argued that large-scale purchases of government bonds by the central bank could blur the distinction between fiscal policy and

[8] Paul Volcker, *Il centenario della Banca d'Italia*, (Milan, Libri Scheiwiller, 1994), p. 126.

monetary policy and so undermine central bank autonomy, which rests on the Ricardian notion of separation between the power to create money and the government's power to spend it. But in gauging the risk that a central bank making unconventional bond purchases is actually creating money to finance the public sector, one must attentively consider motivations and institutional safeguards.[9]

In the 1970s a number of central banks, including the Bank of Italy, acted as buyers of last resort of government bonds on the primary market. In that case there was no possible doubt that among the central bank's motivations price stability had a good deal less importance than other, more properly governmental objectives, or that institutional safeguards were scant. Italy eliminated these anomalies in 1980 with what was dubbed the "divorce" between the Treasury and the Bank of Italy. Today, by contrast, it is clear that the Fed and the ECB, which have both made substantial recourse to unconventional measures, though differing in scale and modalities, were simply pursuing their own statutory objectives, by providing stimulus when short-term interest rates were at the zero lower bound or by restoring the viability of the monetary policy transmission mechanism.

Future exit, when it is decided (but it is not yet time in the euro area, as the President of the ECB has recently made clear), will have to be cautious not only for macroeconomic reasons but also in order to reduce the risks to financial stability. Cooperation among central banks will be crucial, as it was in other phases of the global financial crisis.

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[9] Eugenio Gaiotti and Alessandro Secchi, "Monetary Policy and Fiscal Dominance in Italy from the 1970s to the adoption of the euro," Banca d'Italia Occasional Papers, No. 141, November 2012.

Challenges from asset management

Financial autonomy is an essential pillar of central bank independence. The unconventional measures have expanded central banks' balance sheets enormously; the exposure to risk inherent in these asset purchases has increased accordingly.

Central banks need to preserve their loss absorption capacity, but the very fact of suffering protracted financial losses, even though the reserves remain ample and can easily absorb them, implies reputational risks that could undermine the confidence of the public in the central bank's ability to deliver on policy targets, and could lead to government interference.[10]

Central banks have deployed a broad set of tools to safeguard their financial autonomy and credibility. However, the objectives of portfolio management for pure investment purposes and for monetary policy functions may conflict with one another, especially in times of financial turmoil. For instance, the liquidation of assets in order to reduce the risk of the investment portfolio may exacerbate market stress and be procyclical from the monetary policy standpoint.

In order to deal with procyclicality, risk management techniques should focus on longer time horizons and be extended to the central bank's entire balance sheet. This is one of the main recommendations of the IMF's new Reserve Management Guidelines published in April 2013.[11]

Probably the most common response is diversification. Foreign reserve managers are increasingly interested in market segments and currencies that until recently would not have been considered. The value of central banks' foreign assets other than gold has now reached $11 trillion, roughly 15% of world GDP.

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[10] David. Archer and Paul Moser-Boehm, "Central bank finances," BIS Papers, No. 71, April 2013.

[11] IMF, *Revised Guidelines for Foreign Exchange Reserve Management,* February 2013.

I don’t need to remind you of the special role that gold plays in central banks’ official reserves. Not only does it have the valuable characteristic of allowing diversification, in particular when financial markets are highly integrated. In addition it is unique among safe assets owing to the fact that it is not “issued” by any government or central bank, so its value cannot be influenced by political decisions or by the solvency of any institution.

These features, coupled with historical, political and psychological reasons, tell in favour of gold’s importance as a component of central bank reserves, both in developed and in emerging countries. As an element that enhances the resilience of reserves to abrupt falls in value in times of stress, gold underpins the independence of central banks and their ability to act as the ultimate guarantor of domestic financial stability.

Conclusion

One lesson the history of central banking is teaching us, applicable to the pre-crisis years of the “great moderation” as well as to the Great Recession, is that monetary policy works better when it follows a well-defined strategy, since the economy feeds on both its current and its expected future stance. To attenuate time inconsistency, central banks need to be independent but at the same time accountable and transparent. These two requisites are mutually self-reinforcing: a well-defined strategy implies greater transparency and accountability, and viceversa.

The Outright Monetary Transactions announced by the ECB Governing Council last September are an excellent case in point. Communication was essential: we had to explain that the OMTs were legitimate and compatible with the Treaty, since their aim was to preserve the functionality of markets and thus restore the monetary policy transmission mechanism. The conditionality and enforcement mechanisms were such as to prevent moral hazard for both borrowers and investors. Effective

communication and the sound design of the programme helped to confirm the regime of monetary dominance that is at the heart of the Treaty.[12] Had OMTs been considered the prelude to debt monetization and the loss of independence by the Eurosystem, the market reaction would have been dire indeed; instead, it was promptly positive.

Why are clear strategies, transparency and accountability crucial? Because they are the key features of the most valuable asset that a central bank can produce: trust.[13] Ultimately, a central bank's independence is in jeopardy when it no longer satisfies the public need for trust. Ignazio Visco, Governor of the Bank of Italy, in a recent lecture at the Imperial College in London quoted Curzio Giannini, a brilliant Bank of Italy economist who passed away prematurely nine years ago, who said: "The legitimacy of central banks does not lie in their policy activism, or the ability to generate income, or even [...] their efficiency. Rather, […] it derives from competence, moderation, the long-term approach, and the refusal to take any tasks beyond their primary role"[14].

In August 2012, in London, a central banker said: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough". A few days later the Governing Council of the ECB decided to launch OMTs. The public believed them. They had produced trust.

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[12] Benoît Cœuré, *Outright Monetary Transactions, one year on,* http://www.ecb.europa.eu/press/key/date/2013/html/sp130902.en.html, September 2013.

[13] Ignazio Visco, "The Financial Sector after the Crisis", 5 March 2013, http://www.bancaditalia.it/interventi/integov/2013/05032013/Visco_05032013.pdf.

[14] Curzio Giannini, *The Age of Central Banks*, Cheltenham, UK, Edward Elgar, 2011, pp. 258-59.