The World Bank Treasury
Reserves Advisory and Management Program
Executive Forum for Policy-makers and Senior Officials

Challenging Times for Central Bank Independence

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Washington, DC – 23 April 2013

1. Introduction[1]

I thank the World Bank for giving me the opportunity to speak about central bank independence, an issue that has accompanied central banks throughout their history. Governments have often felt it was legitimate to put pressure on central banks in return for the privilege the State grants them of issuing means of payment that serve as legal tender. An excellent illustration of this point is the position taken by Napoleon with respect to the Bank of France, founded in 1800 as a bank of issue totally independent from the State, with privately held capital. In 1806 Napoleon altered its legal framework, so as to entrust the head of State with the appointment of the governor and of the two deputy governors responsible for the Bank's management. In justifying his actions he used the argument of compensation for the privileges granted by the State:

> "The Bank does not only belong to its shareholders; it also belongs to the State, since the State itself grants the privilege to coin money. … I want the Bank to be sufficiently under the Government's control, but not too much." [2]

In the late 20th century the principle of central bank independence became a cornerstone of monetary theory and policy. In that period the main need was to anchor inflation expectations, following the upsurge of inflation in the 1970s and 1980s. In order to do that, in many countries monetary policy had to be shielded from the pressures caused by large budget deficits.[3] While there were some significant financial crises, they were handled with traditional instruments: lending of last resort operations, state recapitalization, IMF interventions. The prevailing consensus was "a 'narrow' view of central banking, heavily focused on price stability and supported by a belief in the self-equilibrating properties of the economy."[4]

Central bank independence was strongly supported by the economic profession, public opinion and policy makers. Among economists the prevailing view was that monetary policy should follow

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[1] The opinions expressed are solely my own. I thank Eugenio Gaiotti and Raffaele Loffredo for their contributions and suggestions, Patrizio Pagano for his comments, and Roger Meservey and Manuela Pezzano for their editorial assistance.

[2] F. Crouzet, *La grande inflation. La monnaie en France de Louis XVI à Napoléon*, Paris, Fayard, 1993, p. 544; the passage is also cited in C. Giannini, *The age of central banks,* Edward Elgar, 2011, p.209.

[3] For the case of Italy see F. Passacantando, *Building an institutional framework for monetary stability. The case of Italy (1974-1994),* BNL Quarterly Review no. 196 March 1996; E. Gaiotti and A. Secchi, *Monetary policy and fiscal dominance in Italy from the early 1970s to the adoption of the euro: a review*, Questioni di economia e Finanza, Banca d'Italia, novembre 2012.

[4] C. Borio, *Central banking post-crisis: what compass for uncharted waters*, BIS Working Papers no. 353, September 2011, p. 8.

rigid rules to avoid time inconsistencies and should be delegated to conservative central bankers.[5] And public opinion too, after sustaining the extraordinary social costs of high inflation for years, favoured central bank independence. Meanwhile, policy makers came to see a strong commitment to anti-inflationary policies as the best way to improve the national reputation and attract investment. The result was that a good many countries introduced laws to strengthen the independence of central banks from the executive power.[6]

The recent crisis has changed attitudes towards central banks, not only because of the growing hostility of the public towards the world of finance, in an environment of low growth and high unemployment, but also because of concerns among economists and policy makers over the policies pursued during the crisis. One view is that central banks are doing too much, and too many different things. Quantitative easing, targeted asset purchases, including assets of non-financial institutions, and selective bail-outs all carry important fiscal and distributional implications. A body that engages in such operations without being democratically elected may put its independence at risk. Thus central banks should dismantle the armoury of instruments they have used during the crisis as soon as possible and revert to a narrower role.[7] The opposing view is that central banks have not done enough and that they should be much more ambitious in setting their targets. This argument has now been put forward forcefully in Japan, after years and years of deflation.

Without going into the specific merits and costs of alternative policy approaches, I will concentrate on the risks to central bank autonomy posed by current economic and policy conditions.

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[5] F. Kydland and E. Prescott, *Rules rather than discretion: The inconsistency of optimal plans,* The Journal of Political Economy, Volume 85, Issue 3 (June 1977) 473-492; K. Rogoff, *The optimal degree of commitment to an intermediate monetary target,* Quarterly Journal of Economics, no. 4, november 1985.

[6] G. Pittaluga and G. Cama, *Banche centrali e democrazia. Istituzioni, moneta e competizione politica*, Hoepli, Milano, 2004; A. Cukierman, *Central Bank Independence and Monetary Policy making institutions: past present and future,,* Central Bank of Chile Working Papers N° 360, April 2006.

[7] This view has been recently very well summarized by Mario Bleier, former Governor of the Bank of Argentina: "This shift toward multiple policy objectives inevitably reduces central-bank independence….. [T]he pursuit of GDP growth, job creation, and financial stability, as well as the establishment of priorities when there are tradeoffs, clearly requires political decisions, which should not be made by unelected officials alone. Moreover, by pushing interest rates toward zero, the current policy of quantitative easing ….has strong, often regressive, income effects. Opponents of central-bank independence contend that, given the allocational and distributional consequences of current monetary-policy interventions, central banks' decision-making should be subject to political control." M. I. Blejer, *Central Banks' Outdated Independence*, Project Syndicate, 17 April 2013.

2. Risks for central bank autonomy: lessons from the Great Depression

For purposes of comparison, it may be useful to see how the principle of central bank independence evolved during the Great Depression. In the decades before World War I and again in the 1920s, central banks had great operational autonomy to pursue a very narrowly defined target. The yardstick was the parity of the currency against gold at a level decided by the government.[8]

With the Depression the attitude towards central banking changed radically. Although opinions on what factors had caused and aggravated the Depression varied, eventually the blame was put chiefly on central banks for their inability to foresee the deflationary impact of their policies.

> "The Great Depression and the accompanying collapse of the gold standard represented a huge failure for central banks. Their objectives, their models and their mental framework all fell apart. …Certainly there was not much theory behind the government takeover of monetary policy; it was pragmatic. Initially, with continuing depression and deflation, governments pressed for low interest rates once the gold standard had been abandoned, and with that for devaluation, at least against gold."[9]

Many governments accordingly moved to limit the central bank's powers or directly influence its policy stance. In the United States new legislation empowered the Secretary of the Treasury to carry out open market operations in government securities without the approval of the central bank. The President was also given the power to assume direct control over credit policy in an emergency.[10] In Italy the 1936 Banking Law allowed the Bank of Italy to extend extraordinary advances of unlimited amount to the Treasury and gave the Treasury the power to set limits on the interest rates on government securities issued on the market. The autonomy that the 1926 law had granted to the central bank was curbed significantly. Developments in other advanced economies were similar.

One of the most striking signs of the political pressures of the time was the change in attitude of Montagu Norman, the illustrious Governor of the Bank of England from 1920 to 1944 and originally a fierce advocate of central bank independence and orthodox monetary theory and policy.[11] In testimony before Parliament in 1936 he said:

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[8] "The return to gold convertibility increased *de facto* central bank independence" to use the words of G. Toniolo, *What is a Useful Central Bank? Lessons from the Interwar Years*, Oslo, 18 November 2010, p. 19.

[9] C. A. E. Goodhart, *The changing role of central banks*, BIS Working Papers 326, November 2010, p. 12.

[10] C. Giannini, *The Age of Central Banks,* Cheltenham UK, Edward Elgar, 2011, p. 134.

[11] Norman and his colleague and friend Benjamin Strong, the Governor of the New York Fed, "became the self-styled apostles of central bank independence on the international arena. They managed to have the principle of independence proclaimed at every economic conference and eventually engraved in the tables of the League of Nations.", G. Toniolo, *What is a Useful Central Bank? Lessons from the Interwar Years,* Oslo, 18 November 2010.

"I assure Ministers that if they will make known to us through the appropriate channels what it is they wish us to do in the furtherance of their policies, they will at all times find us willing with good will and loyalty to do what they direct us as though we were under legal compulsion."[12]

Today the situation is very different. The recent crisis, for most countries, has been nowhere near as severe as the Depression in terms of output loss or unemployment. And this time the monetary policy response has been much more aggressive. As a prominent scholar of the Depression, Ben Bernanke was well aware of the consequences that the disruption of the credit channel would bear for the economy as a whole. All the major central banks adopted highly expansionary policies, although with instruments that differed from country to country. While in the 1930s there was a strenuous defence of the gold standard, in recent years the change in the monetary policy framework has been much more rapid. However, even with the exceptional use of unconventional policies growth remains very low and, especially in some countries, unemployment very high.

Today central banks are facing five main challenges to their independence: the pressures to promote growth through higher inflation; the risk of fiscal dominance; the implications of an explicit mandate for financial stability; the controversies surrounding their involvement to limit self-fulfilling debt runs; and the strains on their budgets due to the risks taken during the crisis.

3. Political pressures to promote growth through higher inflation

In the 1950s and 1960s the idea that higher inflation was the right price to pay for higher employment was very popular, as it was thought that by reducing real interest rates inflation would stimulate spending and output. New generations may find this thesis attractive again, having lost sight of how hard it is to tame long-term inflationary expectations once they have been loosened. For this reason the current events in Japan, the world's third-largest economy, are attracting so much attention, and concerns have been voiced over their implications for central banks' independence.

To be fair, the involvement of the government in setting the final objective of monetary policy cannot be considered, per se, a violation of central bank independence as long as it is consistent with the central bank's legal acts and as long as these acts are ruled by constitutional law and reflect long-term, entrenched values of the society. Furthermore, even the most convinced advocates of central bank independence draw the distinction between goal independence and instrument independence, and mainly support the latter.[13] In any case, deflation is a deviation from price

[12] Quoted by C. Giannini, *op.cit.* p. 134.

[13] Instrument independence means the power to set instrument variables at the level the central bank desires when other factors and agents affect the same variable. F. Passacantando, *op. cit*., pag. 84; V. Grilli, D. Masciandaro, G. Tabellini,

stability that is every bit as dangerous as inflation, if not more so. This has been made clear even by the ECB, whose institutional mandate is strictly for price stability. By defining stability as "inflation rates of below, but close to, 2% over the medium term," the ECB has made it plain that not only inflation above 2% but also deflation, i.e. a self-sustaining fall in the broad price index, is inconsistent with price stability.[14] So action to correct or avoid persistent deflation is consistent with the primary objective of central bank policy.

For such a policy to be successful, however, the public perception that the central bank is independent must be preserved. One of the main risks of a sudden change in inflation expectations is the repercussions on the financial markets. For a country with a large public debt, massive purchases of long-term government securities may not be enough to curb interest rates once inflation expectations have been unloosed. There is no better way to illustrate this point than to use the words of Keynes:

> "….a monetary policy which strikes public opinion as being experimental in character or easily liable to change may fail in its objective of greatly reducing the long-term rate of interest ..."[15]

But Keynes also indicated the conditions for success:

> "….The same policy, on the other hand, may prove easily successful if it appeals to public opinion as being reasonable and practicable and in the public interest, rooted in strong conviction, and promoted by an authority unlikely to be superseded."

I interpret this passage as supporting the view that the policy should follow "constitutional values", and should be conducted by an independent authority.

4. The risk of fiscal dominance

The whole principle of central bank autonomy rests on the need to separate the power to create money from the power of the government to spend it. The principle was first laid down by David Ricardo in a posthumous essay published in 1824, proposing to create a National Bank that would

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E. Malinvaud, M. Pagano, *Political and Monetary Institutions and Public Financial Policies in the Industrial Countries*, Economic Policy, Vol. 6, no. 13, October 1991.

[14] European Central bank, *The Monetary Policy of the ECB*, January 2011, p. 66

[15] J.M. Keynes, *The General Theory of Employment, Interest and Money*, Macmillan, London, 1936, p. 203. Quoted in P. Ciocca, p.10.

take over some of the functions of the Bank of England, which he considered to be too acquiescent to the executive power.[16]

> "It is said that Government could not be safely entrusted with the power to issue paper money; that it would almost certainly abuse it…If Government wanted money, it should be obliged to raise it in the legitimate way; by taxing the people; by the issue and sale of exchequer bills, by funded loans, or by borrowing from any of the numerous banks which might exist in the country; but in no case should it be allowed to borrow from those who have the power of creating money."[17]

Many consider that unconventional policy measures like large-scale purchases of government bonds, when public debts have reached record highs for peacetime, are themselves a form of monetary financing of public deficits. Certainly the figures are staggering. The Fed and the Bank of England now hold in their portfolio a tenth and a third of their respective countries' overall public debt. In Japan the recently announced policy envisages that within two years the Bank of Japan will hold government debt which, according to preliminary indications, could reach 40 per cent of GNP. The purchases of government bonds by the ECB with its Securities Market Programme have been more limited but not negligible.

In assessing the risk of monetization, however, one should consider the central bank's motivations, not the instruments used or the size of the operations.[18] The recent government bond purchases have been made in an economy characterized by large output gaps and strong deflationary pressures. In the United States, the main concern was the disruption of the money markets, which was impeding the transmission of monetary policy from short to long-term rates. In Europe, as I will illustrate later, the purchases of securities were intended to avoid the self-fulfilling prophecy of a sovereign debt crisis. The purpose was to restore the monetary policy transmission mechanism. To prevent any misperception of the motivation of their programs, both the Fed and the ECB extended their purchases to corporate as well as government bonds.[19] So it is hard to claim that the extraordinary monetary policy operations were intended to serve governments' funding

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[16] P. Ciocca, *op. cit.*

[17] D. Ricardo, *Plan for the Establishment of a National Bank,* London, John Murray, 1824, pp. 10-12, 13. In his proposal Ricardo recommended entrusting the power to create money to commissioners independent from the Government. His proposal articulated the three pillars of the principle of central bank autonomy which to a large extent inspired the Maastricht treaty: institutional separation between the power to spend and the power to create money; prohibition of monetary financing of the government budget; *ex post* political accountability of those entrusted with monetary management. See C. Giannini, *op.cit.*, p.131.

[18] D. L.Thornton, *Monetizing the Debt*, Federal Reserve Bank of St. Louis, Economic Synopses, No. 14, 2010.

[19] The ECB through its Securities Market Programme of outright purchases of bonds in secondary markets, the Covered Bond Purchase Program, and more recently Outright Monetary Transactions, which have not yet been activated, however.

requirements, at a time when both monetary and fiscal policy were used aggressively to prevent the threatened meltdown of the financial sector and to avert a deflationary spiral.

Even so, one must not underestimate the risks of fiscal dominance. Persistently large or sharply increasing deficits may put pressures on prices and worsen market perceptions of the solvency of the State. In these circumstances, monetary authorities might still be able to use their instruments, but with quite limited effectiveness. In extreme cases, central banks would face a dilemma: either monetize the debt or allow a potential catastrophe to unfold.

Italy is an interesting case in this respect. In the 1970s and 1980s the Bank of Italy gained full operational autonomy, and it is widely recognized that monetary policy succeeded in stabilizing inflation rates at low levels. However, increasingly independent monetary policy did not induce fiscal responsibility, and Italy is still paying an inordinate price, in terms of public debt, for not having resolved this strain in the 1970s and 1980s.[20] This further confirms that budgetary rules and fiscal discipline are a necessary complement to an independent monetary policy.

5. The implications for central bank independence of a mandate for financial stability

During the recent crisis, in the face of completely seized-up interbank markets and severely disrupted credit channels, central banks, as noted, conducted a wide variety of operations, ranging from traditional lending of last resort to illiquid banks to “market making of last resort” and support for entire sectors of the economy through targeted asset purchases, or even risk guarantees.

> “Out of necessity, sweeping powers have been exercised in a manner that is neither natural nor comfortable for a central bank.”[21]

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[20] “Those who claimed that less monetary accommodation would create the proper incentives for fiscal adjustment were disappointed. In the 1980s the fiscal authorities’ reluctance to implement their own ‘change of regime’ had dramatic consequences on public debt dynamics, setting fiscal policy on an unsustainable path, which was corrected only in the 1990s. The persistent imbalances in public finance were in turn a hindrance to the conduct of monetary policy, created upward pressures on prices, increased the costs of defending price stability, and introduced distortions in the Italian economy.” E. Gaiotti and A. Secchi, *Monetary policy and fiscal dominance in Italy from the early 1970s to the adoption of the euro: a review*, Questioni di economia e Finanza, Banca d’Italia, novembre 2012, p. 32.

[21] P. Volcker, quoted in A. Leijonhufvud, *Central banking doctrine in light of the crisis*, *Vox eu*,13 May 2008. Volcker “was referring to the $29 billion guarantee of Bear Stearns assets that had been extended to JP Morgan and the subsequent offer to swap $100 billion of Treasuries for illiquid bank assets”. Some Congressmen asked the Fed to give favourable treatment to student loans, allowing banks to go to the central bank and swap them for the safer T-Bills. Cfr Richard Baldwin, “Central bank independence under threat,” 30 June 2008, VoxEU.org. At the worst of the crisis the Bank of Italy created a Collateralized Interbank Market to relieve funding constraints on medium-sized and small banks. To minimize stigma concerns and counterparty risk, the Bank ensured anonymity and protection against the default risk. As soon as market conditions improved, the Bank abandoned its direct role in this market and turned management over to the Italian central counterparty, the Clearing and Guarantee House.

There are those who fear that central bank involvement in operations with such strong fiscal and political implications may put independence at risk. The concern is legitimate, but these programmes should be considered exceptional, temporary, operations to be dismantled as soon as financial conditions improve. Even lending of last resort, which almost everyone finds acceptable, has fiscal implications because of the risk of an illiquid bank's becoming insolvent and incurring losses not fully covered by collateral. The reason why lending of last resort is accepted is that it is temporary and very short-term and that taxpayers would certainly pay a much higher price if a problem of illiquidity were to trigger a systemic crisis.

Some central banks, the Bank of Italy and the Federal Reserve among them, have long had supervisory functions. In fact, these institutions were founded much more for reasons of banking stability than for the need to conduct monetary policy as we know it today. Some other central banks, such as the Bank of England and the ECB, have been assigned supervisory functions recently. A discussion is under way on how deeply central banks should be involved in macroprudential regulation. The extension and diversification of functions has stirred an animated debate on whether central banks are overstepping their essential mandate of price stability.

Central banks' involvement in banking supervision is justifiable on several grounds. First, lending of last resort necessarily entails some supervisory responsibility, in order to assess whether a bank is illiquid or insolvent and to make sure that it implements corrective actions. Second, financial instability can impair the transmission of monetary policy and affect the macroeconomic environment generally. Finally, thanks to their monetary policy functions and the management of the payment system, central banks have access to data and market intelligence that can be crucial to assessing threats to financial stability.[22]

The potential conflict of interest between monetary policy and banking supervision is now a hot issue, especially in Europe. The worry is that out of concern for banks' stability central banks could undertake monetary operations incompatible with price stability, and that in certain circumstances they would move interest rates in order to support banks rather than to pursue price stability. In reality, however, this has rarely occurred.[23] Tensions may of course arise between monetary policy, particularly lending of last resort, and banking supervision, but a well established body of comparative literature has generally concluded that no single model of division of supervisory responsibilities between the central bank and other authorities is unquestionably superior to possible

[22] BIS, *Central bank governance and financial stability. A report by a study group*, May 2011.

[23] "I would tend to argue that the main failures of central banks, as interest rate setters, have lain in taking too little account of financial conditions and monetary developments, not too much." C. A. E. Goodhart, *The changing role of central banks*, BIS Working Papers 326, November 2010, p. 23.

alternative models.[24] Moreover, sound organizational arrangements can be devised to separate the two functions, and it may very well be easier to reconcile these tensions, when they arise, within a single organization than between two different authorities.

The fact remains that ensuring financial stability requires some form of cooperation with the fiscal authorities. One possible solution is to distinguish between crisis prevention and crisis management.[25] In crisis prevention, the autonomy of those in charge of banking supervision and macroprudential policy is essential in order to shield them from short-term political pressures and undue influence from economic interest groups. In crisis management, government inevitably has a key role because of the potential implications for the taxpayer.

The extent and nature of collaboration with other public authorities will be determined by the allocation of responsibilities for supervision and regulation, bank resolution, deposit insurance, provision of public guarantees and solvency support. Inter-agency councils may be needed and have been created in many countries as forums for exchange of information and advice, or for joint decision.[26] Because close collaboration will be needed among the different agencies, arrangements to ensure autonomy should permit effective cooperation. A clear delineation of responsibilities is crucial to achieve the right balance between autonomy and cooperation.

6. Central banks' interventions to avoid self-fulfilling debt runs

Central banks' interventions to buy bonds to prevent a self-fulfilling run and to maintain orderly conditions on the market may further raise fears of inconsistency with price stability objectives. In a Monetary Union like the euro area, purchases of public bonds by the central banks may imply the risk of resource transfers between countries, via the central banks' balance-sheet disequilibria. The Eurosystem undertook these actions when financial markets in certain member countries were under exceptional downward pressures. Perceptions that those countries could lose market access because of growing risk of default pushed risk premia, and thus interest rates, higher. This in turn made it more difficult for governments to service their debts, thereby increasing the risk of default and threatening to make market concerns self-fulfilling.[27] This is the condition that

[24] J. Pisani-Ferry, A. Sapir, N. Veron and G.B. Wolff, *What kind of European Banking Union*, Bruegel Policy Contributions, n. 12, June 2012.
[25] "Operational independence is critical for both their monetary and macroprudential policy functions: it protects central banks from the political economy pressures that undermine their ability to take the punchbowl away as the party gets going. To be sure, this also calls for drawing a clear distinction between crisis prevention and crisis management, something which is often overlooked. In crisis management, the role of the government is inevitable; in crisis prevention, the autonomy of those in charge of macroprudential decisions is essential". C. Borio, *Central banking post-crisis: what compass for uncharted waters*, BIS Working Papers no. 353, September 2011, pp. 9-10.
[26] BIS, *Central bank governance and financial stability. A report by a study group*, May 2011.
[27] O. Blanchard, G. Dell'Ariccia, and P. Mauro, *Rethinking Macro Policy II: Getting Granular*, IMF Discussion Note, April 2013, p. 12.

economists call a "bad equilibrium", like a run on bank deposits. International financial crises have been analyzed extensively by economists and policy makers. If, in facing them, countries are left to their own initiatives, they will usually undertake a mix of restrictive macro adjustment policies accompanied by micro adjustments of financial institutions and private investors who will be asked to bear losses on their credits. "However, all such measures are likely in a panic to result in a considerable overshooting of the needed adjustment."[28] In the euro area, perfect mobility of capital and no exchange rate risk greatly amplify possible contagion effects. The debate over the policy response has tended to neglect the factors that generate these bad equilibria and the policies other than those of central banks that cause them.

First of all, perceptions of sovereign default risk may be legitimate for countries with large and growing public debt, or when major failures in the country's banking system could force the government to intervene. However, there is ample evidence that fundamental factors such as current and expected levels of debt only partially explain the levels and dynamics of interest rate spreads.[29]

Perceptions of default risk may be amplified by various exogenous factors. In Europe, erratic and often incoherent announcements by European authorities and officials have cast doubt on their willingness to support countries in distress, or even to defend the euro. Spreads were amplified by uncertainties about the involvement of the private sector, about the seniority of debt to official institutions and, most recently, about depositors' participation in the resolution of banks.

Furthermore, certain market mechanisms act as "automatic destabilizers": the lagged response of credit rating agencies, which typically downgrade sovereign and bank debt after – not before – market conditions deteriorate; the consequent pro-cyclical rise in the haircuts on collateral, which forces fire sales of distressed assets; the pro-cyclical adjustment of margins by central counterparties and other market infrastructures.

Finally, market illiquidity may lead to bank illiquidity, which in turn has a negative impact on growth by restricting credit and thus lead to a further deterioration in the country's risk profile.[30] In these conditions even very accommodative monetary policy has failed to improve credit conditions in the crisis countries, while in the "core countries" the inflow of funds from the periphery and the

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[28] S.Fisher, *On the Need for an International Lender of Last Resort,* The Journal of Economic Perspective, Autumn 1999,p. 95. Stanley Fisher was referring to countries experiencing external financing crises resulting in massive demands of foreign exchange which the central bank cannot produce. In these situations the IMF could play the role of the lender of last resort.

[29] See for instance A. Di Cesare, G. Grande, M. Manna and M. Taboga, *Recent estimates of sovereign risk premia for euro-area countries*, Banca d'Italia Occasional Papers, no. 128, 2012.

[30] U. Bindseil and A. Winkler, *Dual liquidity crises under alternative monetary frameworks – a financial accounts perspective*, ECB, 2012.

consequent downward pressure on interest rates provide strong support to growth, with possible tension on some categories of asset prices, and facilitate the financing of the public debt.[31]

A market liquidity problem stemming from initially legitimate concerns for a country's sovereign risk can thus spiral out of control and trigger a solvency crisis for sovereign borrowers and banks alike, with unpredictable contagion effects. The European response was excessively slow and tortuous, but in the end a number of reforms have been undertaken.[32] A wider global effort is also under way to better regulate the financial system, limit pro-cyclicality and avoid excessive reliance on credit rating agencies.[33]

Many of these reforms will help to avoid the next crisis, or at least to manage it better. In the current crisis, though, even highly restrictive fiscal policies and ambitious pan-European initiatives failed to calm the markets. A backstop facility for banks and countries in distress managed by the EFSF and ESM was eventually put in place. However the key turning point was the announcement by the ECB Governing Council in September 2012 of the Outright Monetary Transactions (OMT) programme. Central bank action was necessary and legitimate for a number of reasons. First, ample resource availability is crucial to restoring market confidence. Second, the origin of the problem is not a question of sovereign solvency but a liquidity strain on the sovereign borrower, which in fact has not lost access to the markets. Therefore the OMT program is totally different from the standard bail-out programs designed for countries that lost market access. Third, the epicenter of the crisis is the secondary securities market, a key component of the monetary policy transmission mechanism. Belying the critics, central banks' interventions in these markets, by providing the necessary lubricant, actually restore rather than suppress the important signaling function of prices in financial markets. And since the objective is to preserve the functionality of markets, bond purchases cannot be considered as monetary financing of deficits.

Furthermore, conditions and enforcement mechanisms have been designed to prevent and manage moral hazard for both borrowers and investors. Outright Monetary Transactions have been made conditional on compliance with an appropriate European programme managed by the EFSF

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[31] F. Passacantando, *Breaking the high-debt low-growth spiral in Europe* in Real and financial issues in the international economic downturn, University of Milan Papers and Proceedings of the IX Round Table of Costantino Bresciani Turroni Foundation", edited by Gianandrea Goisis and Paola Parravicini, McGraw-Hill 2011.

[32] These include budget and structural measures in the countries affected; a new European institutional framework to prevent and correct public sector and structural imbalances; and the creation of a single supervisory mechanism as the keystone of a Banking Union. Also under discussion is the creation of a single authority for the resolution of banks in crises (with a clear pecking order scheme for bail-in) and the integration or at least harmonization of European deposit guarantee schemes.

[33] An important issue is that of pro-cyclicality of market infrastructures' decisions on margins and collateral policy. The new principles of IOSCO and the Committee on Payment and Settlement Systems for financial market infrastructures and the European Market Infrastructures Regulation recommend that market participants and the Committee adopt conservative, forward-looking and relatively stable margin requirements in order to limit unexpected margin calls at times of market stress.

or ESM.[34] The IMF will also be involved in the design of country-specific conditionality and monitoring.

Are there risks for central bank independence? The main concern regards the participation of the European Central Bank, together with the Commission and the IMF, in the so-called Troika set up to interact with countries in crisis. It is feared in some quarters that the participation of a non-elected institution in political negotiations with governments may encourage political pressures on the Bank. But the ECB's role is mainly to provide expertise in the assessment of the country programmes and to exercise its independent judgment in evaluating the risks it takes. Again, collaboration with governments in times of crisis should not be viewed as a threat to central banks' independence if the limits of this collaboration are properly defined and disclosed. In fact, the market has reacted very positively to the approval of Outright Monetary Transactions. Had it considered the OMT as a prelude to debt monetization or a risk for central bank independence, the reaction on interest rates would have been diametrically opposite.[35]

7. The importance of central banks' financial conditions for their operational autonomy.

During crises, in order to ensure confidence in the monetary system, central banks often have to take risks that the private sector is not willing to shoulder. In the recent crisis, credit risk has been amplified by the relaxation of some collateral standards and, in Europe, by the correlation between banking risk and sovereign risk; purchases of assets at very high prices also imply significant interest rate risk.[36]

The question naturally arises of what financial buffers central banks should rightly have in order to conduct monetary policy successfully and independently. The greater the central bank's involvement in emergency action to support financial stability, the greater its risk-bearing capacity will need to be.[37] We all know that central banks can operate with negative net worth,[38] but they do

[34] This would take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line).

[35] . See C. Giannini, *Enemy of None but a Common Friend of All? An International Perspective on the Lender-of-last-resort Function*, Essays in International Finance, Princeton, 1999.

[36] Interest rate risk is particularly high for the Fed (QE, MBS, operation Twist), for the BoE, and for the BoJ, less so for the Eurosystem, where balance sheet expansion has mainly involved monetary operations with banks. But for the Eurosystem market risk has increased due to the appreciation of gold (which also increased revaluation accounts, however) from €123 billion to €453 billion between end of 2006 and end of 2012.

[37] BIS, *Central bank governance and financial stability. A report by a study group*, May 2011.

[38] A default is technically impossible except in the catastrophic circumstance of a joint sovereign and banking sector default. The proceeds of seignorage greatly increase the minimum magnitude of loss such as to compromise financial independence in a substantial way. For example, in the case of the Eurosystem, Buiter has estimated loss absorption capacity at €2.85 trillion in 2012. More conservative estimates done at the Bank of Italy with a lower inflation and zero growth rate put this capacity at €1.5 trillion. The central banks of Chile and the Czech Republic have operated effectively with negative net balance-sheet assets. While the former was recapitalized on several occasions by the

need to avoid the reputational risks that would emerge if they posted losses, especially in times of crisis when they should not be constrained by considerations of financial strength when deciding whether to undertake certain operations. Even small losses, if they stem from extraordinary operations that are at the borderline of the institutional mandate, can cost the central bank the confidence of the public and open the way to government interference.

An interesting debate is under way on the costs of a possible exit from current accommodative conditions. When interest rates rise, some central banks may suffer losses. Even if the action taken in response to the crisis over the years eventually proves to be a net gain, for some years there may be negative results and this could spark criticisms from the public. Adequate financial strategies and proper communication and disclosure of results are therefore crucial to ensuring continued support for central bank independence.

8. Conclusion

Let me conclude by addressing three questions. When the crisis has passed, will central banks go back to their pre-crisis approach of narrow-focus inflation targeting and limited discretion or will they adopt a broader mandate and framework for action? What are the main threats to central bank independence in today's environment? How will the concept and framework of central bank independence evolve?

On the first issue, there is no doubt that price stability will continue to be the primary objective. Central banks have undertaken a myriad of unconventional monetary policies, but no trade-off with price stability has materialized. A credible anchor for long-term expectations is the necessary condition for greater short-term flexibility, and central banks will not easily give up decades of investment in forging that anchor.[39] The real test will come if and when inflation expectations start to go above the long-term targets, if this happens when unemployment is still high.

However, "price stability has proven no guarantee against major financial and macroeconomic instability. Post-crisis, a shift back towards a broader view, more in line with the historical origins of the institution, has been gaining ground."[40] In particular, for the last six years central banks' primary aim has been ensuring financial stability. The debate whether or not to include financial stability in the mandate of central banks is a rather sterile one. The fact is that when central banks

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Treasury in order to bring the return to profit forward, the latter has relied, so far, strictly on future profits (the accounting value of seignorage) to restore positive balance-sheet assets. In the same way the governor of the Swiss National Bank stated, with reference to the losses provole by the cap on the appreciation of the Swiss franc: "In the case of the SNB there is no legal need to recapitalize the bank immediately. We will simply recapitalize the bank through future profits" (FT 2 February 2012, "Jordan vow to continue SNB intervention").

[39] And in this they will have the support of the aging societies of the advanced economies, because inflation affects the elderly more severely than the rest of the population.

[40] C. Borio, *op. cit.*, p. 12

are pressed by the events, they already behave, and have perhaps always behaved, as if they had that mandate. More meaningful, but beyond the scope of this talk, would be a discussion of how broad that mandate should be: whether, for instance, it should include both micro and macroprudential supervision, as well as bank resolution mechanisms.

Coming to the second question, a common argument is that while setting an inflation target is a relatively straightforward matter, defining "financial stability" and devising a proper monitoring mechanism for it is more difficult.[41] If central banks have excessive discretionary powers, politicians may be tempted to break central bank independence and take back decision-making powers.[42] This argument is an important one but up to now the main driver of the political pressure on central banks does not seem to have been the concern that central banks were pursuing too many objectives but that they were unable to restore the proper functioning of the credit channel. The experience of the Great Depression shows that what lead to a complete and rapid reversal of relationships between central banks and governments was concern over prolonged economic slump and unemployment. In a democracy it is the continuous support of the public opinion the only ultimate safeguard for central bank independence as Paul Volcker once stated:

> "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."[43]

Turning to the third question, most likely the overall framework for central bank independence will evolve, as a result of the crisis, along three lines First with respect to the relationship between central banks and governments, particularly Treasuries, in the area of financial stability. As I noted earlier, one possible evolution would be to differentiate primarily technical decisions from those that have a more political dimension, mainly in the area of crisis resolution. While for the former central banks could be granted wide autonomy, under a properly designed set of rules and procedures, for the latter they will necessarily have to define the procedures for cooperating with governmental authorities. Independence and cooperation are not mutually exclusive:

> "Even an independent central bank needs to get used to the idea of working cooperatively with the government in those areas that are of mutual concern, while jealously guarding its

[41] *Challenges for central banks: wider powers, greater restraints – The financial crisis and its aftermath*, Ernst&Young, Official Monetary and Financial Institution Forum, 2012, p. 8.
[42] G. Tabellini, *Why central banking is no longer boring,* Vox Eu, 23 June 2008.
[43] P. Volcker, *op. cit.*, p. 26

> independent right to make key decisions according to the authority granted it under the law. If not, the benefits of having a central bank that can take a longer term and apolitical view of what is good for the economy and take actions in support of that view will be lost – and that would be a costly mistake."[44]

A second line of evolution will regard the central banks' disclosure and communication policies as well as provisions concerning accountability. Although considerable progress on this front has already been achieved in recent years, wider responsibilities will require more transparency and better communication. Central banks need to preserve confidentiality on the policy matters whose immediate publicity could trigger destabilizing behaviour on the part of market participants. At the same time, however, they could make greater use of deferred disclosure and broaden the information they offer on less market-sensitive areas. It is comforting to see opinion surveys confirming the European public's continuing strong support for the principle of central bank independence. However, to preserve this support central banks will have to make a greater effort to justify their policies and must openly discuss the results achieved. New technologies can provide a wide new set of opportunities in this regard.

Finally central banks will need to pay more attention to their own financial and budget policies. During a crisis it is inevitable that they will take more risks and even suffer losses. But to avoid the implicit reputational costs, they have to design better investment and reserve management policies in advance, so that they can count on strong financial buffers in managing crises.

Having discussed the issue of central bank independence at some length, I would like to conclude by emphasizing that while independence is crucial for monetary stability, it is equally important that monetary policy be consistent with other economic policies. During the crisis central banks opened up so many different fronts and acted with such unusual intensity because they were the only institutions that could buffer the impact of unprecedented tensions in financial markets against the backdrop of an unusually large set of policy and regulatory failures. It is unlikely that central banks will return to normality unless those failures – in fiscal policy, structural policies, financial sector regulation – are corrected and unless international backstop facilities are appropriately strengthened. This is particularly true in Europe, where considerable progress has been made but where market fragmentation and uncertainty over the direction of reform persist. If pressure on central banks due to inconsistent external policies persists, there is a risk that their capacity to defend their independence will be progressively weakened.

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[44] S. Fisher, "Comment to C. A. E. Goodhart," p. 29.