

Executive summary

Independent central banking is under threat in the advanced economies. The only way to preserve operational central bank independence where it makes sense, in the design and implementation of monetary policy, narrowly defined, is a return to 'narrow central banking'. Monetary policy, narrowly defined, concerns the setting of policy rates and/or the exchange rate, the size and composition of the low-credit-risk part of the central bank balance sheet, the terms and conditions of collateralized lending when there are no problems of funding illiquidity or market illiquidity, and forward guidance about these instruments. It also concerns the fire-fighting dimensions of financial stability - the lender-of-last-resort (LLR) and market-maker-of-last resort (MMLR) roles and their international dimensions, including the creation of intra-central bank swap arrangements. It may include countercyclical macroprudential policy.

Threats to central bank independence

The threat to independent central banks comes both from the wider political and social climate – the rise of populism and of anti-establishment, anti-expert and anti-technocratic sentiment – and from developments specific to central banks.

Since the start of the Great Financial Crisis (GFC) in mid-2007, central banks in most advanced economies have become more powerful and political. They have not become more accountable. Their mandates have expanded far beyond monetary policy narrowly defined. The regulatory and supervisory powers of many central banks have been restored (as in the case of the Bank of England), newly created (the ECB) or augmented (the Fed). In addition, many central bankers now routinely try to shape economic policies well beyond their mandates and competence and have become active participants in public policy debates far outside the realm of central banking. Very important from a political legitimacy perspective is the fact that many central banks have increased the scale and scope of their (quasi-)fiscal operations, including resource transfers to the national Treasuries, redistribution between central bank counterparties and tax payers and beneficiaries of public spending within the nation state and, in the case of the ECB, redistribution also between the tax payers and beneficiaries of public spending in different nation states...

In addition, when it comes to the design and implementation of monetary policy, narrowly defined, the performance of most leading central banks has been poor or worse since the acute phase of the GFC ended, systemic financial stability was no longer at risk and orderly market conditions were restored. This applies both to conventional monetary policy (policy rate changes and the associated forward guidance) and unconventional monetary policy (quantitative easing, and qualitative easing/credit easing and the associated forward guidance).

Many central banks persist in the delusion that they can set both price and quantity in the financial markets they operate in. They ignore the expectations hypothesis of the term structure of interest rates. They engage in forward misguidance and communication by committee. They exhibit excessive and/or asymmetric responsiveness to high-frequency asset market movements and volatility. They overestimate their capacity to boost aggregate demand. They have failed to prepare for the next cyclical downturn by not lowering (let alone eliminating) the effective lower bound on nominal interest rates. The Fed, the provider of the only serious global reserve currency, failed to arrange swap lines with leading EM central banks during the Taper Tantrum.

Narrow central banking

Narrow central banking means the end of central bank bloat and mission creep and greater transparency and accountability

1. Narrow central banking means a central bank that is in charge only of monetary policy, narrowly defined. It can contribute in an ancillary capacity to other policies aimed at enhancing financial stability.
2. Although the LLR and MMLR functions can only be performed by the central bank, there is no reason why the monetary policy making committee (MPMC) should be in charge of these functions too.
3. The narrow central bank only participates in “through the cycle” or structural macroprudential policy as a member of a financial stability oversight committee containing as members also the financial supervisors and regulators and chaired by the Treasury.
4. The narrow central bank stays clear of microprudential management, resolution, ‘conduct’, consumer protection, deposit insurance etc...
5. The size of the balance sheets of central banks should be shrunk to pre-GFC magnitudes, not for technical reasons or to counter inflationary threats but to reduce the quasi-fiscal role of the central bank. There should be no exposure to financial instruments with material credit risk except with the prior approval of the Treasury and with a full Treasury guarantee. For the Eurosystem this means full profit and loss sharing (risk sharing) by the national central banks and the ECB, the prior permission of the Eurogroup for the Eurosystem to acquire assets with material credit risk and a full capital-key risk sharing guarantee by the national ministers of finance.
6. The Eurosystem should end all own-risk activities of the national central banks: ANFA, ELA, NCB-specific, idiosyncratic own-risk collateral and the own-risk component of the PSPP. “Own-risk activities threaten the viability of the Eurosystem by turning it from an operationally decentralized central bank into a system of currency boards.
7. The size, composition, terms and counterparties of all central bank financial operations should be in the public domain (with a suitable delay to ensure that appropriate confidentiality is maintained).
8. Individual members of the MPMC other than the Chair don’t communicate with the markets and the public in ways that anticipate possible future policy actions by the MPMC.
9. Votes are taken on all MPMC decisions. Individual votes are in the public domain. MPMC members make individual forecasts of inflation, real economic activity and the policy instrument. All ‘dots’ or fan charts of dots are labelled.
10. The size of the MPMC should be between 5 and 9 members, with a single, non-renewable term of no more than 7 years.
11. Appointing foreigners to the MPMC would help to counter groupthink.

12. Central bankers should 'stick to their knitting' and not venture into public debates in areas beyond their mandates and competence.