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Feature

Clipping central bankers' wings

Willem Buiter argues that central banks should "stick to their knitting" and become minimalist monetary authorities

Author: Willem Buiter

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The European Central Bank (ECB) is the world's most independent central bank: its operational independence is enshrined in the treaty establishing the European Community and can only be amended through a treaty revision requiring the unanimous consent of the member states of the European Union. The ECB also sets its own operational objectives. The treaty does not specify a numerical inflation target, nor does it spell out which institution should set such a target, if there were to be one. In practice, this meant that the ECB simply went ahead and declared that an annual inflation rate of "below but close to 2% per annum on the CPI index" would be compatible with price stability. Neither the European Parliament nor the Council of Ministers were consulted.

The range of questions raised by this unusual degree of autonomy has been expanded by the ECB's determined engagement in mandate and mission creep. Ever since its birth as a monetary authority in 1999, the ECB has adopted advocacy roles in areas such as budgetary policy and structural reform, which are beyond its mandate and competence. More seriously, it has tried and continues to try to broaden the scope of its formal power and influence to areas beyond monetary policy - areas where a much smaller degree of operational independence is appropriate than that enjoyed by the ECB in the realm of monetary policy.

Political backlash

Due to this unnecessary enlargement of the democratic deficit through central bank mandate and mission creep, of all the leading central banks, the ECB is most at risk of a political backlash against its independence. In this article, I propose to address these concerns by suggesting that the operationally independent, full-function central bank be transformed into a minimalist operationally independent monetary authority. Although my main focus is on the ECB, the analysis and proposals can apply to all operationally independent central banks.

Two types of accountability

Accountability is often considered to be the other side of the independence coin. In thinking about accountability arrangements for modern central banks, it is useful to distinguish between formal and substantive forms of accountability. "Formal accountability" is the aspect of responsibility involving giving, ex post, a statistical or judicial explanation for events, actions and outcomes. "Substantive accountability" means that, following this, judgment and action may follow. There is substantive accountability if the reporting, explanation and justification can lead to punishments, sanctions or rewards for those deemed responsible for actions or outcomes.

As is clear from its website, the ECB has a minimalist interpretation of accountability as formal accountability only: it is the written and oral reporting obligations to the European Parliament, the European Commission and the European Council. The same holds for the Bank of England (which also has oral reporting obligations towards the British Parliament) and all other operationally independent central banks.

This narrow focus on formal accountability is not surprising - a lack of substantive accountability is a price one has to pay for operational independence. The delegation of the state's responsibility for price stability to the operationally independent central bank has to mean that those in charge of monetary policy cannot be fired except for incapacity or serious misconduct, and that financial remuneration and working conditions likewise cannot be used to reward or punish them. It ought to mean also that monetary policy makers cannot be sued in civil courts or be dragged into criminal courts for actions taken in their capacity as monetary policy makers.

However, the fact that a high degree of operational independence is inconsistent with substantive accountability should be recognised openly. The sight (and sound) of the ECB describing itself as the most accountable central bank in the world, when the truth is zero substantive accountability and a minimal and inadequate set of formal reporting duties, is not a pretty one. The status quo is also not politically sustainable. Either the ECB will become more open, or its independence will be taken from it.

Partisan participant

There is another problem with the status quo. The absence of substantive accountability for delegated authority can be rationalised and defended when there are clear performance gains. But that legitimacy of the delegation is undermined when the range of actions and decisions that is delegated to a substantively unaccountable authority is greater than is strictly necessary. It is here that the ECB is especially vulnerable because it has become a vocal and highly partisan participant in wider economic policy debates that are well beyond its mandate and competence. To make matters worse, the ECB has tried and continues to try to broaden the scope of its formal powers and responsibilities.

A pertinent example is the ECB's role in decisions on the admission of new eurozone members. It was a mistake for the treaty to grant the ECB an official and public (albeit only) advisory role in this process. The institution has neither the political legitimacy nor the analytical competence to play such an important part in a quintessentially political and economic decision. The issue is all the more serious because the 13 governors of the national central banks (NCBs) that are currently members of the ECB's governing council face a potential conflict of interest when making recommendations on enlargement: once the number of eurozone member states exceeds 15, it will no longer be the case that each NCB governor has a vote in each interest rate decision. Instead, they will rotate and thus have their voting power diluted. If turkeys don't vote for Christmas, the governors of eurozone NCBs are less likely to vote for enlargement!

Similar concerns may be raised about central bankers' tendency to comment and engage in public advocacy on matters of fiscal policy, structural reforms and broader economic policy issues. Of course, central banks have a duty to explain their reaction function given the economic environment in which they operate, which typically includes the fiscal authorities, the government and "social partners" engaged in structural reforms. But this fact does not justify the frequent normative judgments made by central bankers in areas well beyond their competencies. In the words of Alan Blinder: central banks should "stick to their knitting".

Minimalist monetary authority

An independent monetary authority needs to have few of the functions historically associated with the central bank. Take, for example, the current issue of systemic financial instability, which may make it desirable that any or all of the following speak out publicly and coordinate their actions: the financial regulator, the providers of payment, clearing and settlement services and/or the lender of last resort. However, neither the supervision and regulation of financial institutions and markets, nor the provision of payment, clearing and settlement services, nor the active part of the lender-of-last-resort function need be the responsibility of the central bank. Because the degree of independence of an operationally independent monetary authority has to be much greater than that of a regulator, a provider of payment, clearing and settlement services or a lender of last resort, there is a strong accountability argument for not bestowing any of these functions on the central bank. To minimise the legitimacy problems inevitably associated with the complete lack of substantive accountability of the operationally independent central bank, I would favour stripping the monetary authority of all responsibilities and competencies other than the pursuit of price stability.

In addition to significantly curtailing the central bank's voice in the public policy debate on matters other than monetary policy and the institutional arrangements surrounding its conduct, I would therefore deny the monetary authority the following functions: (i) financial supervision and regulation; (ii) ownership, control and management of interbank and securities clearing and settlement, and (iii) any active role in relation to individual distressed financial institutions in the prevention and mitigation of financial instability. I will now briefly discuss these in turn, which special emphasis on the activities of the ECB.

Financial supervision and regulation

The ECB has always had ambitions to become the leading regulator of banks and other financial institutions and of key financial markets in the eurozone.1 There is a strong case for an EU-wide (not just a eurozone-wide) supervisor and regulator of banks and other financial institutions, especially as and when such institutions are established under European statutes. There is no case for the ECB fulfilling this role.

The prospect of the extreme degree of substantive unaccountability of eurozone monetary policy being extended to financial supervision and regulation is deeply unattractive. This important but murky area is at the same time highly technical and deeply political. It involves often intense distributional conflicts and fierce fights over property rights. Expertise in monetary policy is no qualification for that job. The notion that it should be discharged by an institution without any substantive accountability is unacceptable.

Clearing and settlement

Central banks often play a role in the provision of clearing and settlement services, despite there being no fundamental efficiency argument for it. I would argue, therefore, that the ECB should "outsource" its monopoly in the provision of real-time gross settlement through TARGET to another regulated entity (public or private) - one which has no monetary policy functions and much greater substantive accountability. However, instead of reducing its role in settlement and clearing, the ECB's systematic mandate and mission creep is in fact leading it to propose that its monopoly in clearing and settlement be extended to eurozone transactions in financial securities through TARGET2-Securities, which will be owned, controlled and run by the European System of Central Banks.

Again, a eurozone-wide platform for clearing and settling securities transactions is highly desirable as it would lower transaction costs and promote further market integration. But there is no efficiency argument for having the monetary authority provide such a platform. It is important for the political health of the European Union that any attempt by the ECB to muscle in on this activity be resisted. Of course, in practice, the bodies running TARGET and TARGET2-Securities do need access to the liquid liabilities of the ECB to fulfil their clearing and settlement roles at least cost. They therefore need an account with a generous balance or an overdraft facility or credit line with the ECB or the NCBs. Such a facility should be guaranteed by the eurozone national treasuries in proportion to their contributions to the ECB's capital. But there is no logical or even practical reason why the ECB itself should provide, own or indeed manage payment, clearing and settlement services.

Financial stability and lender-of-last-resort functions

The argument for limiting central banks' active involvement in both the prevention and the mitigation of financial distress experienced by individual banks and other financial institutions is based on three observations.2 First, despite the financial kerfuffles of the summer and autumn of 2007, the scope and incidence of systemically important financial instability is limited. Second, the irreducible minimum financial stability role in relation to individual banks and other financial institutions that does indeed exist for public sector institutions can be performed perfectly well without the active participation of the monetary authority. Third - as is the case in two previous examples - from the point of view of democratic legitimacy, it is undesirable to grant additional tasks and responsibilities to operationally independent and therefore substantively unaccountable monetary authorities. The monetary authority does retain a key role in providing liquidity to systemically important financial and money markets. This market-maker-of-last-resort function is, however, quite distinct from the lender-of-last-resort function, the financial support function aimed at individual distressed financial institutions that are deemed systemically significant.

Some central banks, including notably the ECB, favour a definition of financial instability that encompasses just about any inefficiency in the financial intermediation process. But financial intermediation, whether through long-term client relationships institutionalised through banks or through markets, is shot through with features that can plausibly be interpreted as inefficiencies. Therefore, using an all encompassing definition of financial instability, it is easy to paint a picture of pervasive financial instability and threats to financial stability. The call by a number of prominent members of the ECB's executive board for a greatly enhanced role of the central bank in financial supervision and regulation should be resisted. Financial sector inefficiency is not a financial stability issue - it represents, at most, an issue to be addressed by the regulator, not by the monetary authority.

What about the traditional lender-of-last-resort function, which is typically performed by central banks? There is a widespread view, relating back to the original arguments of Walter Bagehot[3] that the central bank is the natural lender of last resort. It is true that, through its monopoly of the issuance of legal tender, the central bank can issue effectively unlimited amounts of default-riskfree financial liabilities of the highest liquidity at little or no notice and at little if any cost. This fact is, however, not sufficient to conclude that the central bank needs to be the active lender of last resort. All it implies is that the active lender of last resort - whichever institution plays that role - has to have a very large overdraft facility with the central bank, guaranteed by the treasury.

Again, there is a strong case for allocating decision-making responsibilities for lender-of-last-resort functions to an institution that has greater substantive accountability, such as an independent regulatory body, which in practice will also have greater access to the deep, institution-specific information and knowledge only the regulator has.

Untouchable

Modern central banks have a higher degree of operational independence than virtually any other agency to which the state delegates some of its responsibilities. Such a high degree of operational independence implies that the only form of accountability imposed on it by its political masters is formal accountability - the reporting obligations through which the principal can monitor the actions of the agent. There is effectively zero substantive accountability: the central bank cannot be "touched".

Although there are good reasons for the lack of substantive accountability in the area of the central bank's main delegated function - monetary policy and maintaining price stability - it is a feature that weakens the central banks' legitimacy and puts it at risk of a political backlash that could impair its operational independence. This risk is greater when, as in the case of the ECB, the central bank is actively engaged in mandate and mission creep.

For this reason I propose a significant and substantial scaling down of the functions typically performed by modern, operationally independent central banks. Specifically, operationally independent central banks should not be involved in areas that demand a higher degree of substantive accountability than the effectively zero degree of substantive accountability bestowed on operationally independent central banks. A minimalist monetary authority sets the policy rate (a short, risk-free nominal interest rate) in the pursuit of price stability and acts as market maker of last resort when systemically important financial instruments threaten to become illiquid. That is all. A minimalist monetary authority is in a much better position to withstand the inevitable political backlash that will result from the co-existence of delegated functions, operational independence and minimal substantive accountability.

Notes

1. See Padoa-Schioppa, T. 1999. "EMU and Banking Supervision", lecture given at the London School of Economics, 24 February 1999.

2. See Allen, W. and Wood, G. 2005. "Defining and Achieving Financial Stability", Financial Markets Group Special Studies, No. 160, April 2005 and Davies, H. 2006. "Two Cheers for Financial Stability", William Taylor Memorial Lecture Number 9, Washington DC, 25 September 2006.

3. See Bagehot, W. 1873. Lombard Street: A Description of the Money Market. London: H.S. King.

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