ISSUE 81 | August 8, 2019 | 4:50 PM EDT

TOP of MIND

CENTRAL BANK INDEPENDENCE

The US Federal Reserve's sharp pivot toward easing amid substantial White House pressure has raised concerns about central bank independence, as have developments in other advanced and emerging market economies alike. How worried we should be about this threat—and its implications for policy, the economy, and markets—is Top of Mind. We feature interviews with former central bankers Donald Kohn and Sir Paul Tucker who explain why central bank independence is critical to maintaining price and financial stability—even today when too little, rather than too much, inflation is the main problem. But while Kohn is concerned that Trump's overt pressure could undermine Fed credibility, Tucker worries more that over-reliance on central banks since the GFC has left them vulnerable to politicization. We argue that political pressure is already influencing Fed policy through indirect channels such as bond market pricing and trade policy, but think this in itself shouldn't inflict too much harm on the economy or markets unless inflationary pressures rise materially.

"Central banks should have constrained missions centered on maintaining monetary system stability... The more they stray into other areas, the greater the distributional effects, and so the greater the temptation—or even the need—to re-politicize them by the back door.

- Sir Paul Tucker

It is crucial to have a group of people who analyze the economy with respect to the long-run goals of economic policy... politicians have a much shorter timeframe in mind than is consistent with achieving these goals.

- Donald Kohn

While I don't think the Fed is cutting rates because the White House is telling them to, you can't completely separate the politics from the market signals feeding into the Fed's decision-making.

- Jan Hatzius"

WHAT'S INSIDE

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Interview with Paul Tucker

Sir Paul Tucker is chair of the Systemic Risk Council and Research Fellow at the Harvard Kennedy School. A career central banker, he served as Deputy Governor at the Bank of England (2009-13). He recently published *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State*. Below, he argues that central bank independence is critical, but that their missions should be constrained to avoid creeping politicization and preserve legitimacy.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: In your recent book, *Unelected Power*, you voice some concerns about central bank independence. What are they?

Sir Paul Tucker: Let me take it at two levels. At the level of high principle, it matters for our system of government that independent central banks are now incredibly powerful. They have quasi-fiscal powers and law-making powers, which we call regulation. Yet, in contrast with our rich understanding of the place of the judiciary or military, there is a rather thin set of principles about how central banks and other independent agencies should fit into a constitutional democracy. I regard central banks as a "third pillar" of unelected power, which has much less well-articulated constraints.

On a practical level, advanced economies have relied far too much on central banks since the Global Financial Crisis (GFC). The best measure of this is not the actions of the central banks; it is the relative absence of elected fiscal authorities. I often ask people what face they associate with the efforts to pull the West out of the Great Depression in the 1930s, and the answer is almost always President F. D. Roosevelt. What faces do people associate with the response to the GFC in the US? Ben Bernanke, Tim Geithner, and Hank Paulson. The invisibility of both Presidents Bush and Obama is extraordinary. That tells us that something important has changed in our societies.

Allison Nathan: Are central banks to blame for taking on too much responsibility since the GFC?

Sir Paul Tucker: Up to a point, their mandates have left them with little choice, so I don't want to be overly critical of them. But there has been a nasty dynamic whereby fiscal authorities have assumed that central banks will just have to do more if they, the politicians, do less—so why bear the political costs of taking action? But central banks can't solve all of our problems. They don't have the tools to improve productivity growth, increase dynamism, or cure inequality; only elected politicians do. So the central bankers found themselves a bit trapped. What's more, once you look as though you're in charge, people start expecting you to perform miracles. If you're the only game in town, it's important not to seem like you're enjoying it, because that fuels unrealistic expectations.

Allison Nathan: Should central banks be less independent?

Sir Paul Tucker: No—independent central banks are critical in maintaining price stability and a stable banking system, which are some of the basic preconditions for prosperity. Some critics argue that there's not much evidence that independence cured the inflation problem in the 1980s because inflation declined all over the world, not just in the countries with independent central banks. I don't accept that. I think independent central banks in Germany and the US basically did the heavy lifting in killing inflation—and, in a world of floating exchange rates, everybody else was then forced to get their house in order. That said, I believe that independent central banks should have constrained missions centered on maintaining monetary system stability. They should also exercise self-restraint. The more they stray into other areas, the greater the distributional effects, and so the greater the temptation—or even the need—to re-politicize them by the back door.

Allison Nathan: What policy tools should an independent central bank have at its disposal?

Sir Paul Tucker: Interest rates should remain the key tool, but vanilla Quantitative Easing (QE)—buying government bonds in the pursuit of price stability and stabilization of the business cycle—is appropriate. I'd note that QE should never have been described as "unconventional"; central banks have been operating in government bond markets for 200 years, and some had employed variants of QE over recent decades. As for purchases of other assets, there should be no favoritism, and they should not lead to the central bank effectively owning the business sector. Central banks should be aiming to return to much smaller balance sheets when they can, because the distortions to asset prices matter.

On the financial stability side, central bank policy should be more clearly rooted in their balance sheet role. So, they should be obliged to act as the lender of last resort, which would have avoided problems in the UK during 2007/08, but only to sound borrowers—not to prop up fundamentally insolvent businesses. I now think it would be helpful for banks and bank-like organizations to be required to cover 100% of their short-term liabilities with assets that can be discounted at the central bank. Through their excess collateral—i.e. haircut—policies, minimum equity and long-term debt requirements would de facto be set, which could help to simplify much of today's rather elaborate prudential-regulatory apparatus.

Finally, central banks should not be forced to provide monetary financing to government because those are fiscal measures, which should be decided by elected politicians, and used only if independence is suspended by law.

Allison Nathan: So there shouldn't be fiscal and monetary coordination?

Sir Paul Tucker: No, there can be. There's a difference between coordination and politicians being able to tell you what to do. Some situations, particularly in a crisis, call for cooperation. For example, when the BOE embarked on QE in early 2009, we asked the government to pledge publically that they would not extend the duration of their debt issuance to take advantage of—and, by doing so, at least partially undo—the lower yields, and they agreed. That cooperation did not dilute independence at all. The US failed to do the same. But, while there can be some coordination, the central bank should not be forced to lend money to the government. That would be a monetary policy mistake—it would become inflationary and so self-defeating—and a violation of our deepest political values as only the legislature has the power to tax, and surprise inflation is a redistributive tax.

Allison Nathan: Could the institutional construct of the Fed learn something from other countries?

Sir Paul Tucker: To some extent, yes. In the UK, a couple of key differences have left the BOE's monetary policy less controversial politically, even though Britain hasn't enjoyed better economic outcomes for other reasons. For example, the elected government, through a parliament-endorsed process, decides the BOE's detailed objectives such as the 2% inflation target. In contrast, the Fed sets its own targets. I think the UK approach is healthier and less prone to controversy. I realize that's not easy under the US system of government, and I applauded when, under Ben Bernanke, the Fed set itself an inflation target. But they could have consulted the public more, not least to help public understanding. So I think Chair Powell is taking a big and healthy step in consulting publicly on the monetary policy framework.

More broadly, if central bank independence is essentially institutional technology for making the commitment to price stability credible, that objective needs broad-based support and some involvement of the people's representatives in specifying what it means. That creates a better dynamic between elected politicians, the central bank, and the general public. By the way, it's how the US system has worked at its best. For example, when Paul Volcker became chair of the Fed with a view of killing the inflationary monster, we now know that he had the backing of President Carter. I don't think he could have achieved so much without the mood of the country behind him.

This is partly about clear communication with the public—the most important audience for central bankers. The Fed has sometimes seemed to treat Wall Street as its main audience, which up to a point is understandable given how quickly financial markets react to Fed-related news. But it's exceptionally important to explain your actions in language that the people you serve—the public—can understand.

Allison Nathan: Are you worried that current pressure from the White House is undermining the Fed's independence?

Sir Paul Tucker: Not so far—top Fed officials understand that they are independent under the law. Of course, it's unusual for pressure to be so open, overt and repeated. But, if I had to choose, I'd rather pressure be out in the open as it is today than hidden, as, for example, occurred when the Reagan Administration attempted to pressure Paul Volcker behind closed doors. That said, while short-lived and overt attacks are easily recognizable and therefore more easily resisted, a constant drip, drip, drip of overt criticism could end up slowly poisoning the well of American public opinion. If that were to happen, the dollar's international role and so US global power would erode. Fed independence is a geopolitical asset.

Generally, though, I worry less about crude and overt attacks on independence than about more subtle and covert ways of re-politicizing them. Let me elaborate. There are basically two means of undermining independence. One is through appointments. As recently occurred in the US, that's not easy when potential candidates fall well outside of the normal criteria for a central banker. More worrying are appointments that, on the face of it, seem reasonable, but turn out to be quiet but committed allies of the leading politicians. A well-documented case occurred in the US in the 1970s, when Arthur Burns was clearly prioritizing Richard Nixon's prospects in the run-up to the 1972 election. No one should think that was the last example of an ally being appointed to a central bank, which is one of the reasons central bankers need to live by an ethic of self-restraint; if central banks can be painted as political, it is easier to get away with politicized appointments.

The other means of re-politicizing the central bank is to change the mandate. The crude variant is elected politicians simply voting to reduce or repeal central bank independence. That's not easy. A more subtle way of achieving essentially the same goal would be to give the central bank more and more responsibilities—to the point where no decent central banker could do anything but consult political leaders on how to act. The more central banks are perceived as the only game in town, the more likely this becomes, which is another reason for self-restraint. A lot of politics is inevitably opportunistic, so how central banks conduct themselves affects politicians' opportunity set. As I say, I worry more about the subtle or covert approaches, precisely because they are more likely to go undetected. I wish people would look out for them.

Allison Nathan: Will the appointment of Christine Lagarde—a politician rather than a central banker—as ECB president harm the credibility/independence of the ECB?

Sir Paul Tucker: Madame Lagarde has a striking record of helping the IMF repair its standing around the world. The ECB faces even greater challenges—greater than any other major central bank—because of its unusual constitutional status—alone at the pinnacle of Euro area macroeconomic policy with no fiscal counterpart. With the next President as well as the recently appointed Vice President of the ECB having no central bank background, they will undoubtedly be highly dependent upon members of the ECB Executive Board and—crucially—key members of staff. But those staffers are unlikely to testify publicly. So the democratic deficit problem may increase.

More broadly, imagine a supreme court in which the judges weren't actually former judges or even lawyers, but were shrewd people advised by fantastically capable staff lawyers—it would be a very different system. Now, maybe this is right for the ECB given its peculiar constitutional role; the ECB has no choice but to do many things that would be inappropriate or irrelevant for central banks in national democratic states—like guarding against the breakup of the currency union. But what is good for the ECB cannot always be an example for central banks serving a normal constitutional republic. So this will be something to watch going forward, although I'm not optimistic that people will.