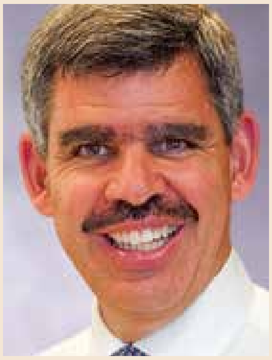
A SYMPOSIUM OF VIEWS

On the Subject of Central Bank Independence...

The global economic and financial policy community is in the midst of a feverish debate over two related questions. First, are central banks globally losing their independence? And second, what would the loss of central bank independence mean for the future workings of the global economy?

But there's the other side of the coin. With a government-controlled central bank, how reliable would long-term bond yields and other financial market indicators be in warning of the need for policy change? Certainly, financial markets have hardly been a perfect indicator of coming financial instability as shown during the global financial crisis. Would financial market indicators do better at forecasting coming macroeconomic trends including issues related to price stability? To what extent is the Federal Reserve—because of the global role of the dollar—a special case in addressing these questions?

We are living in a world where things we thought would never happen are happening. What would be the significance of a global economy with central banks, including the Federal Reserve, *de facto* or otherwise under government control?



Go beyond what is expected from you and you risk people expecting even more. If you fail to deliver on such elevated expectations, they will remember you less for what you achieved and more for what you failed to.

MOHAMED A. EL-ERIAN

Chief Economic Advisor, Allianz; Chair, President Obama's Global Development Council; and author, **The Only Game in Town: Central Banks, Instability, and Avoiding the Next Collapse** ***(Random House, 2016)***

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In a way, this is the story of central banks in the last eleven years; and it's one that could have repercussions for their effectiveness going forward, as well as for the overall wellbeing of economies.

Having responded boldly to the global financial crisis and helped the world avert a multi-year depression, central banks now are increasingly victims of their own courage—the courage to go beyond their traditional tools and, some would say, narrowly defined mandates to take on almost single-handedly the broader policy responsibility to deliver higher growth.

Yet even innovative unconventional tools could not get to the heart of an economic malaise many years in the making, and that was spilling over into the political and social domains. And by being limited to the asset channel for promoting economic growth, the best this policy approach could hope for was to buy time for the economies in anticipation that less polarized domestic politics would open the way for more comprehensive policy responses. Moreover, the benefits were not without costs and risks.

The hope of a more policy-enabling environment has given way, particularly in Europe, to the realization of a protracted period of political polarization, complicating the central banks' exit.

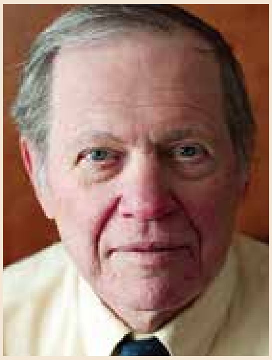
Having found it easier to rely on central banks rather than come up with the needed policy responses, a growing number of politicians are now blaming central banks for every dip in growth momentum. Highly indebted economies, such as Italy, expect their monetary authorities to continue to support the price of their bonds. Many point to how their use of the asset channel contributed, albeit inadvertently, to higher wealth inequalities.

Others now argue that there is no visible limit—whether in inflation, high interest rates, or worsening sovereign risk indicators—to direct large-scale central bank funding of government deficits (the extreme of this view being advocated by some proponents of MMT, or Modern Monetary Theory). And elsewhere, worries continue to mount about the unintended consequences of unconventional policies, including the $10 trillion in bonds that now is trading at negative yields and challenging the provision of essential long-term financial protection products to households (such as life insurance and pensions).

If they are not careful, central banks could soon face a daunting coalition of critics united by varied complaints but hugely dispersed when it comes to what the banks should do. Already, nominations for influential central bank policy committees have included people with limited economic and financial expertise. Indeed, on the current trajectory, it would only be a matter of time when outright political appointments become a high probability event. With that comes direct threats to operational autonomy, a hard-fought feature of modern central banking that is critical to both defense and offense for economic wellbeing.

Policy autonomy is why central banks have established themselves as credible and effective first responders to economic and financial crises. It is also why destabilizing and, at times, irresponsible monetary financing of persistently large government deficits became much less of a threat to economic wellbeing. Now both are increasingly at risk.

There isn't much that central banks can do other than hope that good political sense will ultimately prevail. Their fate remains in the hand of politicians. The more-timely adoption of a comprehensive pro-growth policy approach, particularly in Europe, would help reduce the operational risks to institutions that are often not well understood even though they play such a critical role.



One can imagine an ECB run by more rigid and dogmatic persons presiding over a financial collapse. More "political interference" would be desirable.

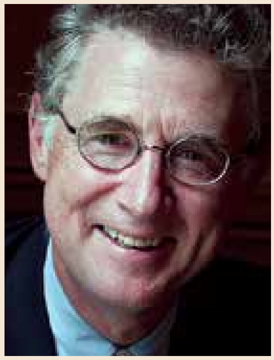
RICHARD N. COOPER

Maurits C. Boas Professor of International Economics, Harvard University

We have made a fetish of the independence of central banks. There are good reasons for the "independence" of central banks, but also good reasons against it. The best reason is not "time inconsistency" as some economists claim—we could put monetary policy on autopilot to achieve that, but that would be dangerous, and absurd. Any social or political institution should be able to change its position when relevant circumstances change—including, in a democracy, when public sentiment changes significantly. The fetish reflects a particular theory about how monetary policy works in all modern economies, for all time.

The Federal Reserve system is independent of the sitting president of the United States, in that he cannot order the Fed to respond to his wishes. But it is not independent of the Congress, which with suitable majorities could change the laws which govern the Fed. There are usually many proposals (bills) for changing the law, but fortunately actual legislation is rare. Presidents have tried to influence monetary policy over the decades. Richard Nixon privately urged Arthur Burns, chairman of the Fed in the early 1970s, to pursue easy monetary policy before the 1972 election. Ronald Reagan, we learned recently, privately urged Paul Volcker not to tighten in the early 1980s. Donald Trump very publicly urged Janet Yellen and then Jerome Powell to lower interest rates. The Fed should pay attention to such sentiments, and others, but in the end should make its own decisions, following its interpretation of its legal mandates. (For example, it has interpreted its mandate to preserve "price stability" as targeting an annual rise of 2 percent of its choice of a suitable index—sensibly, in my view, in part on grounds of a serious upward bias in the consumer price index, the most widely used index of prices.)

"Independence" has gone too far in the case of the European Central Bank, established by the Maastricht Treaty of 1993 and amendable only by unanimous agreement of the now twenty-eight members of the European Union. And its mandate, unlike that of the Fed, is only to preserve price stability (also sensibly interpreted with some flexibility). It includes nothing about economic growth, high employment, or even an injunction to support stability of the financial system. The ECB has so far been managed by experienced financial officials who have employed a degree of common sense in attempting to stabilize the European financial system during the so-called euro crisis of mid-decade. But one can imagine an ECB run by more rigid and dogmatic persons—they exist in Europe—in which it presided over a financial collapse. More "political interference" would be desirable on such an occasion. The European Council of Ministers should have a voice in ECB decisions, or its mandate should be amendable by the European Parliament.



Greater candor and humility would be good first steps.

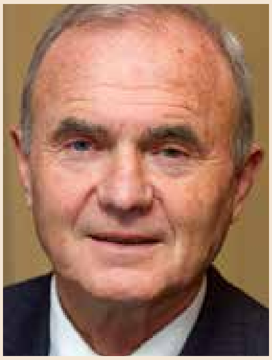
PETER R. FISHER

Tuck School of Business, Dartmouth College, and former Under Secretary for Domestic Finance, U.S. Department of the Treasury

In an important sense, the central banks have already lost their independence; we just have not yet had a chance to observe it. Having volunteered themselves with quantitative easing to conduct quasi-fiscal policy with their balance sheets, they will not have a principled basis on which to resist the request or the legislative directive of their governments to do more of the same. The central bankers' recent silence in response to the growing academic consensus that QE and lower for longer cannot be shown to have generated a meaningful increase in aggregate demand will open the door for governments to rely on the "QE next time" that the central bankers have already promised.

We have already lost much of the useful signal from long-term interest rates as a consequence of the central banks' relentless efforts to compress term and credit premia, and to keep them compressed, with their big balance sheets, their yield curve control, and their negative interest rates. More worrisome is the decay in the monetary transmission mechanism that the central bankers have wrought.

Having misled the public and the politicians that the exit from QE would be easy, central bankers are likely to find that they have overpromised what they can do with an ineffective instrument. Greater candor about the limited efficacy of QE in stimulating aggregate demand and greater humility about the uncertainties of the transmission mechanism would be good first steps away from the fiscal trap that the central banks have set for themselves. We are likely to regret their loss of effectiveness and their loss of credibility much more than the loss of their independence.



Loss of independence would likely lead to a higher inflation risk premium, impacting long-term interest rates.

OTMAR ISSING

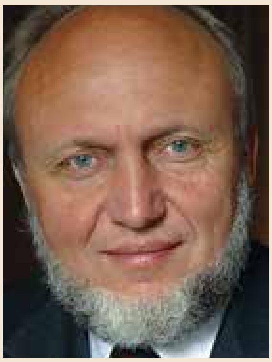
President, Center for Financial Studies, Goethe University Frankfurt, and founding Member of the Executive Board, European Central Bank

Against the backdrop of the Great Inflation in the 1970s and deeper understanding of the mechanism of monetary policy—time inconsistency and the importance of credibility—a broad consensus emerged: the optimal statute for a central bank should be founded on the principle of independence and a clear mandate for price stability or low inflation. This consensus had a great impact on the legislation of central banks. While the index for central bank independence had remained low and stable between 1972 and the late 1980s, it saw a strong surge thereafter. Central bank independence came to be seen as a permanent state of affairs, a kind of "end of history." This view was supported by the subsequent Great Moderation, a period of low and stable inflation, and satisfactory growth and employment. The reputation of these independent central banks peaked during the course of the financial crisis of 2008, when they were applauded as the rescuers of a global economy that risked falling into a depression of a magnitude last seen in the 1930s. (There are, however, also critical voices questioning the policy of the Fed in the run-up to the crisis.)

In the meantime, the winds have changed. The independence of central banks is disputed and politically threatened. There are a number of reasons behind this change. Exaggerated expectations of what central banks can achieve and overburdening banks with additional responsibilities are key factors, as well as actions by unelected central bankers which should remain in the domain of politics responsible to the voters. Central banks are not innocent bystanders in this development. One argument is that some of their actions have crossed the threshold into fiscal policy and as a consequence central banks *de facto* lost their independence. The emergence of initiatives to go a step further and change their statutes thus comes as no surprise. What would be the consequences?

Fundamentally, for major central banks to lose their independence would constitute nothing short of a regime shift. Confidence in the monetary policy of independent central banks was an important factor in stabilizing financial markets. Would central banks deprived of their independence resist political pressure to implement a more expansionary monetary policy? Uncertainty would be increased by new—or rather old—ideas that public expenditure should be directly financed by the money-printing machine. In such an environment, the international monetary system would lose its anchor. Nobody can predict how financial markets would react to this regime shift. However, it is very likely that a higher inflation risk premium would have an impact on long-term interest rates. Higher uncertainty would be accompanied by greater volatility in financial markets.

In the long run, this experiment might bring about precisely the situation that triggered the desire for independent central banks in the past. Would financial markets also be influenced by such expectations?



Central bank independence combined with tough written rules is no guarantee against taxpayers being taken hostage.

HANS-WERNER SINN

President Emeritus, Ifo Institute for Economic Research, and Professor of Economics and Public Finance, University of Munich

Nearly thirty years ago, when the euro was designed, central bank independence was a dominant issue. France and southern Europe wanted the euro to share in Germany's low interest rates, but Germany insisted on central bank independence combined with rules that would prevent the European Central Bank from financing governments as conditions for giving up the deutschmark. Germany firmly believed that the ECB could not act like the central bank of a state, which would guarantee the state's credit-worthiness, and it seemingly got its way. Central bank independence was assured at the expense of providing each national central bank—whether for a large economy such as that of France, Italy, and Germany, or a tiny one such as Malta and Cyprus—with an equal vote in the ECB Council. And Articles 123 and 125 of the TFEU even contained assurances that the ECB would not finance or bail out governments.

Reality, however, could not have been more removed from these assurances. In fact, the ECB has since allowed the national central banks to print about €2 trillion—nearly two-thirds of the euro monetary base—to buy government bonds from local governments, thus turning itself into Europe's most active bail-out institution. To help struggling banking systems and states, the ECB council took a myriad of separate decisions, ranging from the full-allotment policy and a persistent lowering of collateral standards for refinancing credit, to tolerating asymmetric and arbitrary money printing by the local central banks under the emergency liquidity assistance and rules established by the Agreement on Net Financial Assets, as well as special credit programs such as the Public Sector Purchase Programme, longer-term refinancing operations (LTROs), and targeted longer-term refinancing operations (TLTROs). With these decisions, it effectively rescued over-indebted banks and states by undercutting the capital market through extremely favorable credit conditions. Target 2 balances of about €1 trillion are only the tip of the iceberg.

Arguably, an even more important bail-out decision was the Outright Monetary Transactions program of 2012—ECB President Mario Draghi's famous "Whatever it takes"—promising buyers of local government bonds unlimited warranties at the expense of European taxpayers. This program has rescued over-indebted governments, but in doing so it has undermined the functioning of the European capital market by separating a country's creditworthiness from its own financial behavior, making it possible for the European states to borrow nearly unlimited funds without ever facing the risk of being punished by markets with significantly rising risk spreads. Even Italy nowadays is able to borrow at lower rates than the United States.

Small wonder that the governments of southern Europe and France have disregarded all those debt constraints they once accepted in exchange for the safety that the common currency in general and ECB's rescue programs in particular provided for investors.

Vítor Constâncio, who was ECB vice president during the crucial years of the euro crisis and formerly served as secretary of Portugal's Socialist Party, has triumphantly remarked that the ECB ultimately won the right to act like other central banks—despite Germany's fierce opposition. He overlooked, however, that even the U.S. Federal Reserve would not buy the government bonds of sub-federal states. What a treat it would have been for California, Illinois, or Minnesota if the Fed were to buy their government bonds. They could issue more and more of such bonds without ever having to make the effort to convince their creditors that they would be able to repay.

All of this shows that central bank independence combined with tough written rules limiting the scope of bail-out policies is no guarantee against taxpayers being taken hostage by central banks to serve the needs of immoderate governments and their greedy creditors. The access to the money printing press is so tempting and lucrative that it cannot easily be limited by contractual rules.

Independent? The Fed's behavior during 2016 was curious.

LAWRENCE B. LINDSEY
Former Governor, Federal Reserve

The current discussion about the independence of central banks focuses too much on formal arrangements set in law. This is misplaced. At a minimum, the law can always be changed. No central bank can ever be completely independent of the government which it serves.

What matters is the independent-mindedness of the governors of the central bank. When the national leader puts pressure on the bank, the central banker must say, "Thank you very much. We value your opinion of course. But we are going to do it this way." Or words to that effect.

Of course, the leader of the nation can always fire the central banker one way or another. So the central banker must be prepared to lose his job. But the central banker has an ally in the capital markets. Leaders are deterred from acting rashly if they know that their governments will pay a high price for acting as if the central bank is there to serve their interest and not that of the country as a whole.

There is also the possibility that the political interests of the central bank and the government are identical, either because of shared ideology or fear that the opposition might be difficult to deal with. A case in point is the behavior of the Federal Reserve during 2016. After repeatedly projecting four rate hikes for that year in 2015, the Fed only raised rates once—and that was after the election.

This does not necessarily mean that they acted purely from political motives. Monetary policy is judgmental, and data is usually ambiguous. But it was certainly the case that in 2016 the Fed shared the ideological position of the governing party and that the opposition candidate was highly critical of the Fed as an institution. When ideological and institutional interests combine and the central bank acts differently than the way it had said it was going to act, it is quite natural to be suspicious of the true independence of the bank.

There is one other aspect of independence that is summed up by a story within the Fed. In the 1960s and 1970s, the chairman of the House Banking Committee was Wright Patman who represented a rural Texas district where folks hated high interest rates. He would give stemwinding speeches on the House floor against the Fed.

Once, when he was having lunch with Fed Chairman William McChesney Martin, Martin asked why, despite the speeches, he never let an anti-Fed bill out of committee. Patman answered, "If we didn't have you to blame, what would we do?"

Thus, even overt political criticism of the institution is not an attack on the central bank. Politicians must do what politicians must do. Truly independent central bankers know that, politely thank the politician for his or her "thoughtful" advice, and do precisely what they were going to do anyway.

It is very costly to reestablish confidence in money when it is lost.

THOMAS MAYER
Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank

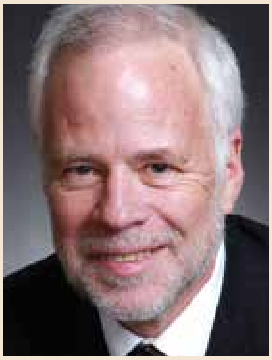
The abuse of the money printing press as a means to fund government expenses has unleashed inflation and wrecked economies like the abuse of alcohol has wrecked lives. And like followers of Alcoholics Anonymous have renounced alcohol consumption, enlightened politicians have renounced the use of monetary financing of government expenses by making central banks independent.

But what if the consumption of alcohol all of a sudden appeared harmless even to the most dedicated member of Alcoholics Anonymous? Surely, the organization would be disbanded and its former members would return to their previous habit. In the same vein, the perceived death of inflation has raised doubts about the need to keep central banks independent from government policy. Life would become so much easier for politicians if there were no longer any sanctions for monetary financing of public expenses in the form of rising inflation. Central banks could be turned into money creation machines for the funding of activities aimed at securing political office until the well-deserved retirement of the office holders. Is this story too good to be true? Common sense suggests that it is.

Like a healthy body can resist the excessive consumption of alcohol for a time, a healthy economy, where competition keeps inflation low and people believe in the purchasing power of money, can resist excessive money creation for political purposes for a time. At some point, however, it tips over. People lose confidence in the stability of money and prices rise in a self-reinforcing spiral. Subordinating central banks to government policy is the surest way to creating this spiral. As history and the contemporary examples of several developing economies show, it is very costly to reestablish confidence in money when it is lost.

Critics of common sense would of course argue that the most important central banks of the world have for years failed to raise inflation to meet their objective. If even they cannot get inflation up, it surely must be as dead as a doornail. But these central banks have statutes that commit them to price stability and give them independence from political interference. Perhaps they have become such strong bastions against monetary recklessness that people don't believe that they can be even a little reckless. Compare this to central banks under government control. They have no problem engineering double-digit inflation rates or more. Moreover, advocates of Modern Monetary Theory would argue that governments could control money supply and inflation through taxation, lowering taxes to increase monetary funding of government spending when inflation is low and raising them when it is high. But this is tantamount to saying that the alcoholic will drink less when he sees signs of his health deteriorating and resume drinking when he is recovering.

Independent central banks have succeeded in establishing a high level of confidence in the purchasing power of money. It is a bitter irony that their success now seems to kill them.



"Under threat" is not the same as "fatally compromised."

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

To paraphrase Winston Churchill on democracy, an independent central bank is the worst possible arrangement except for all the others. That independence is under threat, predictably given the blame central banks received, rightly or wrongly, for the global financial crisis ("blame the fire brigade") and the extreme, proto-populist coloration of a growing number of political leaders and governments.

That said, "under threat" is not the same as "fatally compromised." Central banks from India to Turkey to the United States have been able to beat back the worst threats to their independence so far. Of course, past performance is no guarantee of future success. But there remains a deep and abiding appreciation in most countries of the advantages of delegating monetary policy decisions to an independent agency and avoiding the worst distortions that would otherwise precede elections.

I agree with the proposition that were central banks forced to take marching orders from governments, long-term bond yields and related financial variables might become less accurate and reliable indicators of future macroeconomic conditions—which is not to say that they are highly reliable indicators at the moment. Bond market participants rely on clear communication from central bankers, which they combine with other information. If forward guidance becomes less reliable and more politically freighted, markets will find those communications more difficult to process. The same is true of policy rates: they provide a benchmark off of which bond yields are priced and expectations of future inflation are formulated. Again, were those policy rates set not with future economic conditions in mind but rather in an effort to advance political objectives, their information content for the evolution of macroeconomic variables would diminish.

From this point of view, the Federal Reserve is not a special case, but it is an especially important case. The European Central Bank is in a better position: its independence is guaranteed by an international treaty and therefore can't be fundamentally undermined by the actions of any one government. Thank goodness for that.

De jure independence is no guarantee of de facto independence.

CATHERINE L. MANN
Managing Director and Global Chief Economist, Citigroup

Have central banks lost independence? Independence is the ability of central banks to respond to changing economic conditions and adjust policy in light of risks to macroeconomic performance and achieving of the stated objectives. Rhetoric (even if harsh) does not change independence so long as it does not affect the analysis and tools at the hands of those within the institution. Even bringing central banks under a broader government umbrella might not hurt independence.

De jure independence is no guarantee of *de facto* independence, however, which is achieved via the quality of the individuals making the decisions as part of the governing body. But constraints on mechanisms to achieve the stated objectives or to respond to risks in the economy do threaten independence. Take away the tools of monetary and macroprudential policy and the central bank de facto loses independence.

One way to take away tools is via restrictive legislation. But a rigid policy rule for monetary policy also robs the central bank of independence because no rigid rule can possibly encompass the complexity of the real and financial sectors. In the end, a governing body comprised of independent people who make considered judgements about the economy underpin the independence of the institution and its policy mechanisms and stance.

The second issue to address is how a change in central bank independence might affect the degree to which financial markets effectively allocate resources and signal future real economic performance. A collaborative monetary and fiscal policy stance, effectively communicated to financial markets, improves the signal-to-noise ratio. Presumably such clearer signals would allow both financial markets and real investors to plan and finance longer-term objectives with positive rates of return to both.

On the other hand, conflicts between fiscal and monetary policy make it more difficult for the investors in the real economy to make forward-looking investment plans. The timetable of appointments and elections feeds into this uncertainty.

A third possibility is that monetary policy alone or in concert with fiscal policy is so chaotic that real investors stay on the sidelines, while financial investors arbitrage the chaos in a zero-sum game. In this case, financial markets would not be signaling the state of the real economy, but rather reflect the state of politics.

The thought that this administration would also take control of the Fed and monetary policy is scary to contemplate.

MARTIN NEIL BAILY

Bernard L. Schwartz Chair in Economic Policy Development and Senior Fellow and Director of the Business and Public Policy Initiative, Brookings Institution

The case for central bank independence is that it discourages short-term decision-making. Politicians want to be re-elected, it is argued, and will favor policies that stimulate economic growth while ignoring the longer-run impact on inflation.

President Trump made excellent appointments to the Federal Reserve early on but became unhappy when interest rates increased and economic growth showed signs of slowing. He criticized Chair Jay Powell and nominated political allies for open seats on the Board. Trump inherited an economy close to full employment and then supported expansionary fiscal policy and easy money. He wants as much growth as possible and he wants it now, never mind inflation warnings and exploding budget deficits.

A confounding factor is that inflation is not a problem and interest rates have stayed low. Monetarism is a dead letter as huge growth in the money supply failed to ignite price pressures. The Phillips Curve is on life support, at best, as unemployment has dropped below estimates of its sustainable level, and still there is no acceleration of inflation. Maybe inflation is waiting in the wings and will roar into life, but there are few signs this is happening so far.

Humility is in order, recognizing that economists do not understand inflation very well, but the case for central bank independence should not be abandoned. An independent Federal Reserve under Paul Volcker and Alan Greenspan conquered inflation and steered the U.S. economy through a period of stability and growth. An independent Federal Reserve under Ben Bernanke played an essential role in dealing with the financial crisis and the recovery. The independence of the European Central Bank allowed it to ignore strident criticisms and work towards recovery after the financial and euro crises. Mistakes were made, notably the failure to see the danger of mortgage-backed securities and the weakness of the banks. On balance, though, central bank independence has paid off for the global economy.

Donald Trump has a shrewdness that enabled him to launch a quixotic campaign for president and win. However, his knowledge of economics is suspect. He lacks a basic understanding of international trade. He has captured the Republican party and encouraged it to ignore its one-time distaste for huge budget deficits. Tax cuts and deregulation have powered surprisingly strong growth for now, but U.S. fiscal policy is dangerous. Global interest rates are very low, and this has allowed the Treasury to borrow massive amounts at low cost with little burden on the U.S. economy. That situation may continue for several years, but eventually interest rates on U.S. Treasuries will rise, unless fiscal policy is put on a more sustainable path. The favorable debt dynamic will break down and the risk of a financial crisis will rise. We do not know when this might happen, but it is folly to take the risk of a loss of confidence in U.S. financial assets. There are unfortunate echoes of the last financial crisis when rising house prices created a favorable debt dynamic that supposedly made the over-borrowing safe, until it wasn't.

The thought that this administration would also take control of the Federal Reserve and monetary policy is scary to contemplate. The strength and stability of the American economy and the dollar have been the bedrock of the global economy since 1945. There is no alternative. China would like to play a larger role and compete with the United States for influence, but it does not have an open economy or a convertible currency and cannot be a global financial leader any time soon. Neither the European economy nor the euro are strong enough to survive a U.S. monetary crisis.

American fiscal policy already poses a threat to global stability while the Federal Reserve remains a haven of expertise and good, measured judgment. It is vital that monetary policy remain independent and sound.

History has shown that global currency markets are suspicious of currencies that fall under government control.

GREGORY D. HESS
President, Wabash College, former staff member, Federal Reserve, and Member, Shadow Open Market Committee

Central banks are certainly having their independence questioned—in some cases, quite aggressively. Of course, this challenge to the independence of central banking is most keenly felt in countries with democratic institutions, which have more often given operational independence to their central banks. This reduction in independence is not a positive development, though perhaps it is inevitable for the time being.

How did this happen? First of all, central banks of all shapes and sizes, at home and abroad, substantially reside in a domestic political framework. Just turn on the television or open your social media to observe that in most countries, domestic politics have become angrier, unrelentingly sharper, and polarizing. In turn, all domestic political institutions, and their relationships to one another, have been openly questioned and simultaneously taken to the woodshed. It's no wonder that central banks, which play essential roles in providing financial regulation and oversight, as well as monetary policy support to enhance economic well-being, are being questioned. It is simply central banks' turn at the institutional accountability inquisition.

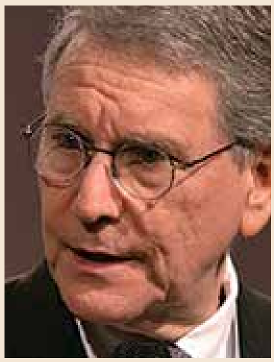
To a certain degree, central banks have made this problem worse for themselves. During the financial crisis, central banks played an outsized role in the immediate management of the crisis, and many continued to do so during the extended period of monetary policy support. Perhaps this was due to the fact that central banks have a short inside lag for decision making and implementation, or because legislatures were unable or unwilling to pass expansionary fiscal policy given domestic policy polarization.

Since then, central banks have continued to implement aggressive interest rate policy and balance sheet expansion by purchasing long-dated government debt (and even private debt such as mortgage-backed securities). These decisions further exposed the central banks to questions about their operational independence. Indeed, once they broke operational rules for monetary policy, a flood of questions emerged about the rules that establish the governance and operational independence of monetary policy.

Moreover, central banks' own philosophizing about whether they have the right objectives (for example, nominal GDP level and growth targeting, raising the target inflation rate to 4 percent, and so on) begs the question of whether they should have latitude and independence in interpreting their short- or medium-term goals. Given the current institutional accountability inquisition, central banks would be wise to adopt a more conservative and traditional approach to policy, and not introduce too many new issues.

Ultimately, the consequences of more central banks being placed directly under government control would be negative and severe. The resulting increased threat of manipulation of monetary policy to satisfy short-term political or other objectives would create excessive financial volatility. To the extent that government-controlled central banks participate directly in capital market allocation to the private sector, these large economic inefficiencies will lead to lower growth and reduced living standards.

Finally, history has shown that global currency markets are suspicious of currencies that fall under government control. A less independent central bank will see its currency's status diminished on a global scale. Little of this is good.



It comes down to political unity.

ROBERT H. DUGGER
Managing Partner, Hanover Provident Capital

Central bank "independence" as we know it was made possible by the political unity of the United States and the other Western democracies following World War II. During the conflict, however, central banks weren't independent. They aligned policy with government priorities. They capped official rates and compliantly bought whatever debt governments needed to sell.

On close examination, current fears of diminished central bank independence are actually responses to changing conditions. Political unity is disintegrating, familiar macroeconomic relationships are in flux, and inflation is curiously elusive. Elevated and increasing total debt-to-GDP levels appear unsustainable, and the risk of a significant debt crisis is rising.

Expert attention is increasingly on disinflationary forces, which have been immune to monetary policy. These include population aging; market concentration; inadequate investment in infrastructure and climate change mitigation; technological labor displacement; "bridges to nowhere" political gridlock that encourages malinvestment including tax policies that favor elites; and, most importantly, underinvestment in human capital, young families, and education, which locks in rising long-term economic inequality. These concerns cry out for changes in government spending and tax policies that reflect twenty-first-century concerns.

Increasingly, the lens for seeing how to accomplish this is modern monetary theory, or MMT. Its attraction grows despite criticisms from experts such as conservative Ken Rogoff, centrist Larry Summers, and progressive Paul Krugman, who argue that MMT is a political, not an economic, argument and that countries may not face debt limits but they do face inflation limits. Pragmatist Ray Dalio sees things differently.

For Dalio, MMT—what he calls MP3, or third-generation monetary policy—is real and, more to the point, inevitable. In his book *Principles for Navigating Big Debt Crises,* Dalio draws findings from forty-eight major debt cycles to document the steps central banks take when their previously booming economies crumple under the weight of overleveraging. The first step is MP1—reduce short-term official rates to stimulate credit expansion. The second is MP2 (Quantitative Easing)—buy market assets to prevent uncontrollable debt deleveraging. MP3 follows when the earlier steps become ineffective. In MP3, central banks cut rates, buy assets, and finance the priorities of political decisionmakers.

In the early 1940s, the priority was winning World War II. The Federal Reserve in full MP3 mode set short- and long-term Treasury rates and bought whatever government debt the war required. The key ingredient enabling MP3 was the war's politically unifying effect. The result was a broadly accepted Rooseveltian authoritarianism.

The core weakness of today's MP3/MMT advocacy is the utter absence of any explanation of how to build the political unity necessary to implement it. Total U.S. debt-to-GDP is at levels associated with past debt crises and rising. Political partisanship and talk of populist authoritarianism are increasing.

If a meltdown occurs and MP2 can't stop it, political fragmentation will worsen, and effective MP3 implementation will be impossible until some kind of political order is established. We have "living wills" for systemically important institutions. To help assure that in any new order democracy is central, don't we need something similar for "systemically important debt contractions"?

The cost of loss of independence is steep.

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Central bank independence has been established to ensure that monetary policy is conducted in a credible way towards the primary objective of price stability. Without independence, monetary authorities are tempted to target other objectives, such as sustained growth and low unemployment, taking advantage of the fact that monetary policy can produce strong effects on these variables in the short run, while it impacts inflation only in the medium term. However, if the central bank systematically tries to stimulate economic activity, especially before elections in order to please the political authorities, market participants anticipate that such a strategy can be repeated over time. Inflation expectations thus rise and make it more difficult for the central bank to keep inflation under control. In short, achieving price stability is more costly if the central bank is not independent.

In an integrated global economy, the temptation to use monetary policy for other objectives than price stability is particularly strong in light of its impact on the exchange rate, which reflects the relative price of different currencies. An expansionary monetary policy tends to have a positive effect on the domestic economy and a negative effect on the foreign one, even though these effects may not last long if inflation rises over time as a result of higher import prices.

A central bank that is not independent would be led to maximize the impact of monetary policy on the domestic economy, independently of the consequences on domestic inflation and of the possible negative spillover effects on the rest of the world. The exchange rate would become a target of monetary policy to improve competitiveness against the rest of the world. If such an attitude was followed by the other countries, in retaliation, an exchange rate war would most likely explode. This would trigger competitive devaluations and depreciations that would generate higher inflation and fuel trade protectionism.

The attempt to reduce the independence of central banks is ultimately the attempt by the political authorities to increase their ability to implement policies that have a short-run effect on the economy. The cost for the economy, in the form of higher inflation and greater trade tensions at the global level, tends to be underestimated, or neglected.

However, since financial markets are forward-looking, the anticipation of such a development would lead to an increase in inflation expectations and asset price volatility. Countries that would follow that path would ultimately suffer from higher interest rates. Those, like the United States, which currently benefit from the status of reserve currency and have a large market share in international portfolios, could be under the illusion that they would be spared from such developments. However, history shows that financial markets adjust rapidly, and the cost of reduced central bank independence is ultimately borne by the offenders. ◆