Political Central Banking

Get ready for the end of central bank independence.

BY MARIO I. BLEJER

The global financial crisis has raised fundamental questions regarding central banks' mandates. Over the past few decades, most central banks have focused on price stability as their single and overriding objective. This focus supported the ascendancy of inflation targeting as the favored monetary policy framework and, in turn, led to operational independence for central banks. The policy was a success: the discipline imposed by strict and rigorous concentration on a sole objective enabled policymakers to control—and then conquer—inflation.

But as a consequence of this narrow approach, policymakers disregarded the formation of asset- and commodity-price bubbles, and overlooked the resulting banking sector instability. This, by itself, calls for a review of the overall efficacy of inflation targeting. Moreover, after the financial crisis erupted, central banks were increasingly compelled to depart from inflation targeting, and to implement myriad unconventional monetary policies in order to ameliorate the consequences of the crash and facilitate economic recovery.

With advanced economies struggling to avoid financial collapse, escape recession, reduce unemployment, and restore

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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growth, central banks are being called upon to address, sometimes simultaneously, growing imbalances. This has triggered a search for a radical redefinition of central banks' objectives—and has cast doubt on the appropriateness of maintaining their independence.

In particular, central banks' behavior during the crisis has called into question whether inflation targeting is an effective framework in the presence of systemic shocks, and, more broadly, whether it can be sustained throughout economic cycles. After all, a policy regime that sets aside its only goal during a crisis seems to lack the ability to cope with unexpected challenges. Critics identify this "crisis straitjacket syndrome" as the main problem with single-minded inflation targeting.

While theoretical arguments can be made to justify recent departures from policy, the reality is that in the post-crisis world, advanced-country central banks' goals are no longer limited to price stability. In the United States, the Federal Reserve has essentially adopted a quantitative employment target, with nominal GDP targets and other variations under discussion in other countries. And financial stability is again a central bank responsibility, including for the more conservative European Central Bank.

This shift toward multiple policy objectives inevitably reduces central bank independence. Some analysts have recently claimed that this is because the 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 (increasing money supply by buying government securities) 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.

But this argument neglects an important point. While it is true that multiple policy targets tend to increase the political sensitivity of central banks' decisions, concentrating only on price stability also has important distributional consequences and political implications. In fact, politicization is a matter of scale, not a substantive transformation of monetary policymaking.

The real reason why central bank independence tends to create a democratic deficit under a multi-target monetary policy regime, and why it has become increasingly vulnerable, is that the two main arguments in favor of it no longer apply.

The first argument in favor of central bank independence is that, without it, politicians can exploit expansionary monetary policy's positive short-run effects at election time without regard for its long-run inflationary consequences. (By contrast, fiscal and exchange rate policies rarely imply comparable temporal tradeoffs, and thus are difficult to exploit for political gain.) But this argument becomes irrelevant when ensuring price stability is no longer monetary policymakers' sole task.

The second argument for institutional independence is that central banks have a clear comparative advantage in dealing with monetary issues, and can therefore be trusted to pursue their targets independently. But this advantage does not extend to other policy areas.

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Given that central banks are likely to continue to pursue multiple objectives for a long time, their independence will continue to erode. As long as governments do not encroach excessively on central bank decision-making, this development will restore balance in policymaking and support policy coordination, particularly in times of stress.

To ensure a positive outcome, policymakers should develop a fully transparent framework with well-defined "rules of engagement." A strict framework for allowing, and at the same time limiting, government's involvement in central bank decision-making is particularly crucial in emerging markets, given that in most of them, central bank independence has contributed not only to the eradication of inflation, but also to institution building.

Central bank independence is a peculiar institutional innovation. Seemingly irrefutable theoretical models underlie a paradigm that has changed in significant ways, and that, if preserved, is bound to cause serious political problems. Like it or not, policymakers must accept that central bank independence will continue to weaken, and they should prepare to cope with the consequences. ◆