The changing nature of central bank independence

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It is a great pleasure to participate in this panel on the occasion of the 20th anniversary since autonomy was conferred on the Bank of Mexico. This anniversary happens to fall at a time when the central banking community is at a crossroads. After more than five years of extraordinary monetary easing and unconventional measures, tough questions are being asked about the potential for rising costs and declining benefits, and their effects on central bank independence. As recent events have shown, the normalisation of monetary policy will be fraught with complications, however deftly central banks may approach the problem. Yet timely normalisation will be the key if central banks are to retain or enhance their credibility.

My main message is that the nature of the challenges to central bank independence has evolved in recent years. Traditionally, central bank independence has aimed at insulating monetary policy from undue political pressure. Now, however, we need to think of that autonomy in broader terms. Against the backdrop of extraordinary monetary easing, central banks will need insulating from a new set of forces if they are to achieve a timely normalisation of policy, when that is required.

The first set of forces emanate from financial markets and the highly indebted parts of the private sector. One may think of this as the threat of "financial dominance", broadly defined. This is akin to the more traditional concept of fiscal dominance. And, of course, the threat of fiscal dominance also looms large, unless governments get their finances under control.

The second set of forces reflects unrealistic expectations about what central banks can deliver. It stems from the view that prolonged monetary accommodation is the only answer to the pathologies we currently face. One may term this "expectations dominance".

Central banks should be in a position to decide the timing and pace of the inevitable normalisation without being unduly constrained by these pressures. What is ultimately at stake is their credibility in fulfilling their mandates.

Let me elaborate on this point by considering, in turn, the consequences of prolonged monetary accommodation and the implications for the normalisation process.

Consequences of prolonged monetary accommodation

Post-crisis, the hallmark of monetary policy in the core advanced economies has been unprecedented accommodation. Central banks cut policy rates sharply and kept them extraordinarily low; in fact, effectively at zero in several jurisdictions.

In addition, reflecting unconventional monetary policy measures, central bank balance sheets have ballooned. Since late 2007, central bank total assets in the major advanced economies have more than doubled to exceed $9 trillion, more than a quarter of GDP. And the maturity of these assets has lengthened. Prolonged interventions of this magnitude would have been unthinkable even as late as in 2008.

These measures certainly played a pivotal role in containing the crisis and softening the blow of the recession. This success has increased expectations about what monetary policy can do, but, now, five years on, questions arise about the limits to such measures.

First, accommodative monetary policy measures can buy time for the balance sheet repair and structural reforms that are critical to restoring strong, balanced and sustainable growth. But it cannot substitute for them. Worse, excessive monetary accommodation can make it too easy to postpone necessary repairs and reforms.

Here, the picture is mixed. There has been some progress on the repair and reform fronts. Economies that have made more progress on private sector deleveraging and bank recapitalisations appear to be on a more favourable trajectory. But persistently high unemployment in many advanced economies indicates that we still have a long way to go in addressing labour rigidities and sectoral rebalancing. Moreover, the relentless rise in total debt is not reassuring. Since the end of 2007, the total debt of the G20 non-financial sector, both private and public, has risen by almost $35 trillion dollars.

Second, prolonged monetary policy accommodation has ended up overburdening central banks and posing longer-term risks to their reputation and credibility. There are signs of a widening gap between what central banks are expected to deliver and what they actually can deliver. This gap may ultimately undermine confidence in their ability to fulfil their mandates for price and financial stability, with consequences also for their operational independence. Such unrealistic expectations can lead to pressure on central banks to keep monetary policy too lax for too long. This is why we should worry about the effectiveness of central bank policymaking in the current environment.[1]

And while we do so, we should not lose sight of the risks that prolonged monetary accommodation in the advanced economies raises for economies elsewhere. This policy stance has led to difficult policy choices for both emerging market central banks and others. Both pre- and post-crisis, low policy rates in the core advanced economies have put upward pressure on emerging market economies' exchange rates, downward pressure on their bond yields and have encouraged dollar borrowing and capital flows. Partly in response, their authorities have kept policy rates lower than otherwise and they have intervened heavily in currency markets. This has been one factor behind financial booms that in some cases resemble those seen earlier in the advanced economies.

In mid-year we saw this process in reverse. The mere discussion of a prospective tapering by the Federal Reserve triggered a sell-off in global markets. Equities and domestic bonds in emerging market economies initially registered abrupt and sizeable losses, exchange rates depreciated and, in some cases, policy had to be tightened despite weakening macroeconomic conditions. That said, and importantly, economies with stronger fundamentals fared better – a testimony to the importance of sound policies. Mexico is a case in point.

All this underscores the importance of normalising monetary conditions in a timely fashion and avoiding the problems associated with getting behind the curve. To do so, central banks will have to strike the right balance between the risk of normalising prematurely and the risk of acting too late and too slowly. Much of the debate lately has focused on the former, but we should not underestimate the consequences of the latter.

[1] On the limits of prolonged monetary accommodation in a post-crisis period, see Raghuram Rajan's *Andrew Crockett Memorial Lecture* entitled "A step in the dark: unconventional monetary policy after the crisis", 23 June 2013.

The normalisation process

As the latest market gyrations have confirmed, the normalisation process is likely to be bumpy. And spillovers will propagate globally. The extraordinary support central banks have provided for markets has been too pervasive and prolonged for the adjustment to proceed entirely smoothly. In some cases, central banks are now seen as the marginal buyer of longer-term bonds. And even after bouts of financial turbulence this year, term premia moved only marginally, from deeply negative territory to around zero. In other cases, central banks have morphed, in effect, into pivotal intermediaries in interbank markets. Clearly, financial markets have become overly dependent on central banks, whose much-needed withdrawal will require adjustments in financial intermediation channels.

Moreover, the background of high debt levels – both public and private – will make economies more sensitive to policy rate moves than in the past, not least because much of that debt was issued at record low interest rates. Raising rates will provoke the ire of many constituencies – just as in all past tightening cycles, but louder.

In all this, clear communication and forward guidance can help; but, as we have seen, this is no panacea. Moreover forward guidance creates its own difficulties. For example, term premia will have to normalise, and this will occur regardless of how effective communication is, at a pace largely dictated by markets. All this has implications for the various parties involved.

As they normalise their policy stance, central banks will need to have a thick skin when facing the forces of financial and fiscal dominance. In other words, they will need to prevent their operational independence from being constrained by jittery markets and highly indebted constituents.[2] Decisions will be difficult, uncertainty will be high and it will not be possible to wait for incontrovertible evidence before acting.

Central banks and policy authorities at the receiving end of the spillovers will need to strengthen their defences, adopting prudent macroeconomic and financial policies.

Market participants will need to recognise that normalisation is inevitable and prepare accordingly, even if its timing and evolution are hard to predict. They need to behave prudently and stay aware that markets will not always remain liquid under stressful conditions.

Unconventional monetary policy tools in post-crisis frameworks

Looking further ahead, where will central banks be exiting to? More specifically, what should be the role of unconventional monetary policy tools in post-crisis operational frameworks?

In my view, there is a case for operational frameworks focused on controlling a short-term interest rate while keeping unconventional monetary policy tools in reserve for extraordinary circumstances. That said, there is also further room for adjustments. Let me highlight four points.

First, active use of central bank balance sheet measures blurs the boundary between monetary and fiscal policies. As regular tools for monetary policy, these measures could therefore burden monetary policy with tasks outside its realm. And this, in turn, could threaten central banks' operational independence in the pursuit of price and financial stability.

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[2] Reflecting on central banking history, Paul Volcker has emphasised the importance of acting with conviction in the face of predictable political opposition: see P Volcker, "The Fed & Big Banking at the Crossroads", *The New York Review of Books*, 15 August 2013.

Second, central banks have tight control only over short-term rates but not over other asset yields such as long-term government bond yields. Central bank influence on these yields through large-scale asset purchases can only be assessed within the context of the consolidated government sector balance sheet. By definition, this means that the central bank does not have full control over such policy instruments. It shares this, for example, with the government's debt managers. As a result, instrument independence would be jeopardised.

Third, unconventional monetary policy measures expose central banks to significant market and credit risk. While financial losses do not per se affect central banks' operational capabilities, the need for financial support from the government could compromise their operational autonomy.

Finally, there is room for evolution in some technical aspects of the frameworks. One could imagine greater reliance on the payment of interest on reserves as a means for improving control over short-term interest rates. One could also see some expansion in the range of acceptable collateral for monetary policy operations as a way of balancing various considerations, including the availability of high-quality collateral, regulatory reforms and the appropriate role of central bank liquidity in normal and turbulent times. And, given the state of uncollateralised lending markets, one could see a further shift towards targeting collateralised rates. All these changes, however, would have very little to do with central banks' autonomy and more with their operational effectiveness.

Conclusions

Let me conclude. Central bank independence has been critical for the success of stability-oriented monetary policy frameworks. In current circumstances, we need to broaden the concept beyond insulation from political pressures, including "fiscal dominance", to include insulation against pressures from financial markets and indebted agents ("financial dominance") and against unrealistic expectations of what central banks can do ("expectations dominance"). Central banks should be in a position to normalise policy without being unduly constrained. In the end, this form of independence will be crucial if central banks are to credibly and successfully pursue their price and financial stability mandates.