P I M C O

Macro Perspectives *May 2016*

The Downside of Central Bank Independence

JOACHIM FELS

Mr. Fels is a managing director and global economic advisor based in the Newport Beach office. He co-leads PIMCO's quarterly Cyclical Forum process and currently serves as a rotating member of the Investment Committee and a member of the Americas Portfolio Committee. Prior to joining PIMCO in 2015, he was global chief economist at Morgan Stanley in London. Previously he was an international economist at Goldman Sachs and a research associate at the Kiel Institute for the World Economy.

Here's a secular question for you: What if central banks weren't *independent?*

At PIMCO we have just wrapped up our annual Secular Forum, where we discuss the forces driving the global economy and formulate our outlook for the three- to five-year horizon, along with risks to that baseline view. (Click here for more information about the forum, including an essay by Rich Clarida and a list of speakers.) Inspired by the free-thinking, forward-looking debate at the forum, I would like to address the status of what has been a given: central bank independence.

Central bank independence is widely accepted as a necessary prerequisite for successful monetary policies. But considering political sentiment these days, along with the decline in inflation over the past few decades, there is a chance that this independence could come into question. If so, that scenario is not as scary as you might think. Hear me out …

Independence from government and the political process is obviously helpful when the main enemy is high inflation, as it enhances a central bank's credibility and helps monetary policymakers do tough things without political interference. One example is the "Paul Volcker recession" of the early 1980s, which was necessary to end the Great Inflation.

But what happens when the main enemy is not inflation, but deflation, debt overhangs and financial crises – in other words, the world since 2008? Critics point out how the need or desire to defend their independence often hinders central banks from swiftly addressing these problems in the most direct and effective way (say, helicopter money or overt lender-of-last-resort action to underwrite troubled financial institutions or sovereigns). Instead, independent central banks have had to deploy second-best interventions such as quantitative easing (QE) or negative interest rate policy (NIRP), which distort financial markets and can have severe distributive consequences. This actually has exposed central banks to severe criticism on two fronts – criticism of the second-best policies with their unforeseen effects and diminishing returns, and criticism for making decisions that the observers say belong in the hands of elected officials.

THE NOT-TOO-DISTANT PAST

It is worth remembering that central bank independence is a relatively new phenomenon. In the large majority of cases, central banks in the developed world gained independence in setting monetary policy only in the 1980s or as recently as the 1990s. The Bank of England was founded in 1694 but only gained operational independence to pursue a 2% inflation goal (set by the government) in 1997, which was year 303 of its existence. The main rationale for making central banks independent was to enhance the credibility of inflation-targeting monetary policy, which became the standard approach to monetary policy after the demise of the gold standard and the ensuing Great Inflation of the 1970s and early 1980s. High and volatile inflation had become the economy's main enemy, and the solution was to focus monetary policy exclusively on stabilizing inflation at low levels, with independence making that task easier to achieve.

But there's an asymmetry in monetary policy – central banks can do more to restrain inflation than they can do to stimulate it. The main problems today, and most likely also over our secular horizon, are continuing disinflationary or even deflationary global forces, public and private sector debt overhangs and the potential for new financial crises. Many observers ask whether central banks have exhausted the capacity of the ordinary and extraordinary policy tools they have deployed since the financial crisis. Some of those observers may go on to say that central banks would be better equipped to counter the challenges in today's economy if they worked in close collaboration with *and under the control of* a democratically legitimized government.

One argument for direct government involvement and responsibility is that many of the decisions that are required to address today's greatest problems have *significant distributive consequences* and are thus in the realm of fiscal policy rather than monetary policy. Think of the decision to save one major financial institution or let another one go bust (many names spring to mind from the 2008–2009 financial crisis). Think of the decision to serve as lender of last resort to weak sovereigns (several names spring to mind from the more recent eurozone crisis). Or think of the decision to buy large amounts of public and/or private sector assets and introduce negative interest rates to (try to) bring inflation back up to target. All of these decisions are tough ones to make for an independent central bank that, if it decides to make them, will be harshly criticized by those who lose out in the redistribution that follows.

Independent central banks also often serve as easy scapegoats for politicians who balk at making tough decisions themselves. Again and again during the eurozone crisis, governments shied away from solving the sovereign debt and banking crises once and for all with fiscal instruments. Rather, they relied on the European Central Bank to step in, only to criticize monetary policy later for having overstepped its boundaries.

EYES ON THE PRIZE

If the (nearly) unthinkable came to pass and central banks came back under government oversight in setting policy, what would it mean in practical terms for the economy and markets? An almost immediate effect would be to raise inflation expectations as the government expands influence in monetary policy. Also, central banks could bypass the entire financial sector by endowing the government directly with freshly created money (e.g., crediting the Treasury's account at the Fed) that the government could then distribute to the public through tax-rebate checks or increased public spending – helicopter money. This could be a much more direct and effective way to overcome a demand deficiency and raise inflation expectations than using QE to remove financial assets that are in high demand (i.e., government bonds or high quality corporate bonds) or embarking on NIRP, which is an experiment with an uncertain outcome.

True, there are other ways to implement helicopter money than doing away formally with central bank independence. Former Fed Chair Ben Bernanke has made a very interesting proposal of how this could work. Essentially, the idea is for the independent Fed to decide how much money injection would be needed to achieve the mandated employment and inflation objectives and to credit the Treasury account with this amount. It would then be up to the government to distribute the money in any way it deems fit.

TARGETING TODAY'S PROBLEMS

Critics contend that the main problem with central bank independence is that it was invented to solve a problem – high inflation – that no longer exists. Does their independence hinder central banks from pursuing the most direct and efficient solutions to today's problems? Trust me, for an economist born and raised in Germany to believe that the independent Deutsche Bundesbank should be the benchmark for all central banks, this is not an easy question to ponder. But the reality remains: Aggressive independent monetary policies across the world haven't yet delivered inflation, and fiscal foot-dragging persists. A union of fiscal and monetary policy may become an option if the economy continues along this path.

PIMCO

Newport Beach Headquarters
650 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

Amsterdam

Hong Kong

London

Milan

Munich

New York

Rio de Janeiro

Singapore

Sydney

Tokyo

Toronto

Zurich

pimco.com
blog.pimco.com

PC135_44714

CMR2016-0516-187927