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Central Bank Independence: At the Crossroads?

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Synopsis

On 1 July 2013, the Bank of England took a milestone decision by installing a foreigner at its helm. Does this mark a new era for central banking or the end of independent central banking?

Commentary

MARK CARNEY, the former Governor of the Central Bank of Canada, was installed as the new Governor of the Bank of England (BoE) on 1 July 2013 after a long period of courtship by the UK Chancellor of the Exchequer George Osborne.

Governor Carney has been mentioned by many as the world's best central banker. In introducing him during the pre-appointment hearing in the House of Commons, Mr. Osborne, the man who was most responsible for the choice, unabashedly stated that his candidate was simply the best.

A rarity, though not unprecedented

It is indeed a rarity for an advanced country to entrust the helm of its central bank to a foreigner. It is even more so since this has happened in conjunction with the new status of the BoE. In the face of huge challenges after the global financial crisis, the BoE on 1 July was given a very wide mandate across monetary policy, system-wide financial stability and the regulation of individual banks.

Banking supervision, which was moved previously to the Financial Supervision Authority (FSA), the all-encompassing supervisory institution, was moved back to the central bank. This was due to the experience from the crisis which involved the bailout of the Northern Rock Bank.

However, in spite of its rarity, installing a foreigner as central bank governor has had some precedents. The recently-retired Governor of the Bank of Israel is an American. Even though not for the very top post, Asian economies have had cases of foreigners serving as deputy managing directors, such as in Hong Kong and Singapore.

Central banking in a flux?

There is a more important issue than the appointment of a foreigner to head a country's central bank. This is

the recent practice of central banks employing unconventional monetary policy in different forms. Some primary instances are the lowering of the benchmark rate close to zero or zero interest rate policy (ZIRP) for an extended period; applying a variety of techniques as central bank purchase of securities; long-term refinancing operations (LTRO); and most controversially of late, what is known as quantitative easing (QE). All these were not known before to be part of central bank policy.

These techniques of monetary policy are indeed unconventional. Recently the European Central Bank (ECB) Governor Mario Draghi even considered the possibility of implementing a negative rate of interest, which literally means that the lender has to pay interest to the borrower. This sounds like a desperate move by ECB in an effort to give a real push to the stubbornly weak demand to generate positive growth.

In the face of a protracted weak economic growth in the advanced economies following the global financial crisis – otherwise known as the great recession - central banks have been acting like rivals, competing with one another to show their respective resolve to resort to unconventional monetary policy.

It started with the US Federal Reserve's Ben Bernanke's quantitative easing, which has since evolved beyond several stages, the current form being the Fed's US\$85 billion-a-month purchase of securities. This was followed by others. Not wanting to be left behind, Governor Draghi implemented a similar policy with a vow to 'do everything necessary' to save the euro last year. The most recent to do the same was Governor Kuroda of the Bank of Japan (BoJ). He made a similar promise to double the money supply in two years and to increase the inflation target to two per cent to move the Japanese economy out of the liquidity trap and deflation in a prolonged lost decade and a half.

Copycat moves?

In the meantime the BoE also joined in, even though Governor Mervyn King was known as a tight guardian of the institution's independence during his leadership for the last ten years. He had never publicly made a similar statement. But new Governor Carney was known as wanting to use nominal GDP as the target for the monetary policy to aim for. The implication is that the monetary policy would try to deal with the monetary as well as real sector targets.

While he has not talked about implementing the idea, he had been quoted as saying that there was still space for monetary policy to contribute to stimulate economic growth.

The issue of independent central banks has actually been debated for some time. The context is the search for effective monetary policy in a market economy. After the Asian financial crisis of 1997/98 most Asian economies moved away from disallowing central bank independence. They either adopted new laws or amended existing ones with a clear stipulation for the central bank to be independent from any government intervention. Their specific responsibility is for monetary stability. In fact the independent status of central banks has since become a new conventional wisdom in combination with the adoption of inflation targeting as a new accepted practice.

However, the advanced economies chose a different tack, starting with the US, but immediately followed by the UK and the eurozone economies, and most recently Japan. Governor Kuroda leads the Bank of Japan with a completely different attitude from his predecessor by vowing to implement a monetary policy in support of Prime Minister Abe's economic policy, known as "Abenomics", to end deflation for economic growth.

It is without doubt that a new environment has forced the adoption of the new measures. This new environment seemed to have forced central banks to be more imaginative in designing monetary policy, pushing them to resort to the unconventional policies in monetary policy. They are crossing the boundary of conventional monetary policy; indeed these unconventional policies are more like monetary-cum-fiscal policy.

End of independent central banking?

There is another way of describing this new trend: By resorting to these steps in monetary policy, the central banks have been leaving the notion of central bank independence behind. If the general function of central banks is to manage both monetary stability and full employment, this is definitely in the jurisdiction of the central bank proper, like in the US system. But, in the central bank mandate in many Asian economies post-Asian Financial Crisis, the practice could compromise the independent status of the central bank.

Suggestive of this tendency to leave behind the notion of an independent central bank, some newly-installed central bank governors have their origins in the ministry of finance or even were former ministers of finance. Or in the case of the new governor of BoE, he was personally courted and chosen by the Chancellor of the Exchequer. Independent central banking is indeed at the crossroads.

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