Central Bank Independence and challenges during the global pandemic: balancing monetary and fiscal policy objectives

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ABSTRACT

As well as highlighting why unconventional and conventional accommodative monetary policies have been propagated as being crucial to achieving dual mandates and goals of leading central bank economies, drawing from lessons and experiences whereby accommodative monetary policies have been instigated as a means of addressing prolonged periods of low inflation, this paper highlights how such experiences can also be used to bolster the proposition that "since monetary policy space is limited, and since many of the challenges faced are beyond mandates of central banks, these should be addressed through structural and fiscal policies. "

The concept and notion of central bank independence has been interpreted and applied differently across several jurisdictions over the decades. As the financial environment over the years, with the emergence of more complex trading and financial instruments, the traditional tools of central banking - as well as monetary policy tools and channels of transmission have adapted to cope with corresponding changes, challenges and demands of the financial environment. Why are interest rates at such historically low levels? These constitute some of the questions, amongst several research objectives which will be highlighted under the introductory section, that this paper aims to address.

Key words: counter-cyclical instruments, Effective Lower Bound, interest rate, accommodative monetary policies, asset purchase program, quantitative easing, uncertainty, government bonds, negative interest rates, inflation

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Introduction

As well as highlighting developments which have taken place since the change in the monetary policy framework of the UK, to that of an independent central bank, Bailey (2021:1) also accentuates, amongst other observations, the following points:

- The need for monetary policy's adaptation to the current world of larger shocks – within an environment where the Effective Lower Bound (ELB) has become a "pertinent" matter given the tendency to sustained lower equilibrium interest rates, globally.
- Leading from the afore-mentioned observation, the shift in the task of monetary policy, from that of being a choice on a "single dimension" (as he puts it, the "official interest rate"), to that of a more multi dimensional choice involving decisions on which tools to use, which to develop…..

In supporting his argument for the need for a counter-cyclical relationship between fiscal and monetary policy, particularly given prevailing pandemic conditions, as well as addressing the criticism that central bank independence has been compromised through the Bank's purchase of government debt – as a means of lowering the government's cost of borrowing, he responds by adding that " in a world where the Government has to manage the task of spreading the cost of the pandemic – which would otherwise have fallen on individuals at great cost to them, as well as a scenario where the central bank is acting counter cyclically, consistently with its inflation target", that it was hardly a surprise that Government would or should hugely benefit from such financing conditions (see 2021:2).

It needs to be recalled that one of the reasons why the relationship between the Bank of England, the Treasury and the then financial services regulator, the Financial Services Authority, was considered "flawed" is attributed to the problems identified and highlighted during the Northern Rock Crisis whereby the inability of the Bank to act as lender of last resort for a limited time – without such a role being made public, was revealed (see Ojo, M, 2009:8). As highlighted and raised in that paper, is it possible for a central bank to operate effectively – given the presence of absolute independence? Further, the importance of close collaboration and exchange of information between the (then) tripartite authorities in the UK (the FSA, the Treasury and the Bank of England) , as identified during the Northern Rock Crisis, if effective – as should have been, could have helped, not only in identifying the problems which existed at Northern Rock, but also facilitate timely intervention which would have mitigated the scale of the crisis.

Given this backdrop which highlights the importance of effective communication between regulatory and monetary policy institutions, what are the challenges faced by central banks in the prevailing global environment? More importantly, how can such challenges be addressed? These, amongst other observations, constitute some of the questions and issues which this paper aims to address.

Literature Review and Background to the Topic

The use of unconventional monetary tools, and particularly the resort by central banks to asset purchase programs instigated as a means of addressing prolonged periods of low inflation, has not only heralded times during which new and innovative approaches to regulation can be expected, but also highlights the significance of a growing acknowledgement that changes in financial instruments, payment systems and trading platforms are significantly altering the financial landscape and also the need for monetary policies to adopt more accommodative approaches to regulation since traditional tools and inflation targeting mechanisms are not as relevant as they used to be - particularly against the backdrop of the impact of crypto currencies and the need to ensure that financial stability can be guaranteed where such assets, which have great potential to trigger systemically relevant risks, and more specifically, stable coins which are backed by a basket of commodities or government bonds, are in operation.

Central Bank Independence

How has the definition been impacted by the role assumed by central banks, regulators, other actors - particularly non financial organizations and non governmental actors over the years? How have lessons learned from other jurisdictions following financial crises shaped the notion and definitions to be attributed to central bank independence? Why has it become increasingly popular to engage the government- particularly in matters relating to financial and price stability?

Central bank independence: Concepts and definitions

Operational Independence

This is defined as "……the freedom or ability of a central bank to pursue its objectives (regardless of who sets them) as it sees fit, without interference or pressure from third parties". In order for such independence to be effective, it is also argued that freedom from political influences is vital (see Buiter:2009,5). To bolster his argument, Buiter adds that where operational independence exists, excessive interest rate cuts resulting from political pressures could be avoided (see Buiter, 2008).

"Central bank independence is not an end in itself. Its purpose is to ensure that the central bank is credible in its pursuit of price stability while making sure that monetary policy is never subservient to fiscal policy - what is known as monetary dominance. .....central bank independence does not preclude communication with governments when it is clear that mutually aligned policies would deliver a faster return to price stability......It only imposes limits on what such alignment could entail. Specifically, it means that alignment between policies where needed must serve the objective of monetary stability and not work to its detriment. " (Draghi: 2019)

From the above mentioned definition, the following points can be drawn:

Firstly, it can be inferred that central bank independence should serve as a tool in ensuring that the over arching goal of price stability- a fundamental objective of monetary policy, is achieved.

Secondly, that central bank independence should be adopted in such a way which whilst ensuring that the central bank is "credible in its pursuit of price stability" also does so in a manner which does not make monetary policy "subservient " to, or superseded by fiscal policies.

Thirdly, as fiscal policy is considered a tool whereby the goal of price stability is achieved, this implies communication between governments - in particular, where mutually aligned policies would clearly facilitate, more effectively, a favorable outcome for price stability.

Finally, necessary checks should operate to ensure that alignment between fiscal and monetary policies are restricted and permitted to the extent necessary to ensure that when undertaken, this should be done when and where needed - and ultimately working to the benefit of monetary policy - not against it.

In his paper, "How to Starve the Beast: Fiscal and Monetary Policy Rules ", findings by Martin (2019:2-4), can be summarized as follows:

- When fiscal and monetary policies are conducted by a discretionary and profligate government, such that revenue ceilings significantly outperform debt, deficit and monetary rules; both in respect of;

- Effectiveness of curbing public spending and;
- Welfare for private agents;
- That effective revenue ceilings induce an increase in deficit debt and inflation ;
- That austerity programs should be sudden - rather than gradual - focusing on lowering revenue as a means of reducing spending instead of raising revenue to lower debt.

In illustrating some of the benefits of institutions that constrain government actions (namely, cost effectiveness and feasibility) - rather than "dictating" (direct control of governments) to governments, reference is made to the United States federal debt ceiling, the German balanced budget amendment ("debt brake"), as well as the "convergence criteria " for joining the Euro. On a broader term, he also lists fiscal consolidation and austerity programs recommended by supranational entities in exchange for economic assistance.

Clearly there are monitoring costs associated with direct monitoring or regulation of governments - as well as agent costs. Monitoring on its own, hence, does not serve as a reliable tool or mechanism of accountability. Forecasting techniques - namely the incorporation of machine learning techniques are assuming growing importance as regulatory and macro prudential policy tools.

In relation to counter-cyclical instruments, The need to adopt counter cyclical instruments, was brought to the fore as a result of the flaws inherent in Basel 2. And as highlighted by Goodhart (2008), " Central banks cannot achieve price and financial stability with one instrument (interest rates). A counter-cyclical regulatory system is needed to dampen asset booms and to smooth busting bubbles".

The need for an "expansionary monetary policy" needed to stimulate the economy – given the ongoing pandemic, is also highlighted by Oystein Olsen (2021:11) who adds that this reduces the risk of unemployment becoming sustained at high levels and stating that persistently low interest rates, simultaneously, present and embody the risk of build-up of financial imbalances. Further, he notes that the future monetary policy stance will be impacted by the timing and means of fiscal policy normalization – to which he points to the importance of close collaboration between both authorities in addressing what he considers to be a "difficult balancing act." (Olsen:2021,12).

Main Issues to be Addressed

In highlighting the need for a "successful interaction" in the relationship between monetary and fiscal policy, as being critical to addressing shocks, namely those such as, economic fallouts of the pandemic, Holzman makes reference to the following points (2021:1,2):

- That with appropriate design and interaction, monetary and fiscal policy, are not only limited in scope as strategic substitutes, but also complements – with inherent possibilities of expanding the policy space of each other;
- More importantly, he further adds, accommodating monetary policy with low rates of interest allows fiscal policy to expand its policy scope – and that conversely, fiscal policy actions could help the economy to recover – consequently alleviating the burden from central banks to restore the economy to potential and inflation back to target.

However, in contrast to accentuated importance of forward guidance policy tools, in the first of his recommended options (2021:2), he notes that " monetary policy will have to remain unconventional since conventional policy (based on interest rate policy and forward guidance only) will not work. Within the context of this first option, he is also of the opinion that a consideration of r* , namely, the hypothetical and estimated equilibrium interest rate, as exogenous and low or even negative into the future, whereby fiscal policy is facilitated in remaining "generous" whilst retaining interest payments at low levels, will be required.

In proposing ways of using inflation targeting in a world of larger shocks, Bailey (2021:3) recommends: i) the adoption of an averaging over-time mechanism to estimate the relevant target – hence an allowance being provided as "catch-up" to account for past inflation short-falls; ii) allowing inflation to return to target over a longer period of time where there a “trade-off” between weaker activity and above-target inflation; and finally, using forward guidance.

With Holzman’s second option, the consideration of r* as an “endogenous” variable that is “accessible to policy interventions and that can be raised back to levels witnessed in the past” is highlighted – a procedure which in his view, would allow for a return to conventional monetary policy, without the side effects attributed to unconventional policies whilst also allowing for reduced central bank balance sheets.

Challenges Faced By Central Banks

According to Borio, central banks are confronted with three types of challenges (see Borio: 2011, Borio 2019: 2), namely: i) Economic ii) Intellectual iii) Institutional

He further classifies the third category (institutional challenges into three branches, namely:

- Policy measures
- Policy outcomes
- Policy perceptions

The effects of lower interest rates on the central bank's inflation targeting policies - as well as consumer expectations, constitutes a subject of contentious debates. Whilst lower interest rates are needed to stimulate economic activity - even where it appears that reasons for doing so are not immediately apparent, there are also concerns that such actions may impact consumer expectations by delaying spending in the hopes of lower rates, or even worse, trigger concerns amongst investors.

In his opinion, “economic and intellectual challenges facing central banks have taken root in the seismic developments that have yielded most of the economic gains since the early 1980s – and particularly in their profound impact on inflation and the business cycle - such developments including the wave of globalisation as reflected in open trade and financial markets” (Borio: 2019:3). He relates the business environment as characterized through globalization by attributing this to lower levels of inflation and large expansions and contractions in financial cycles.

Conclusion

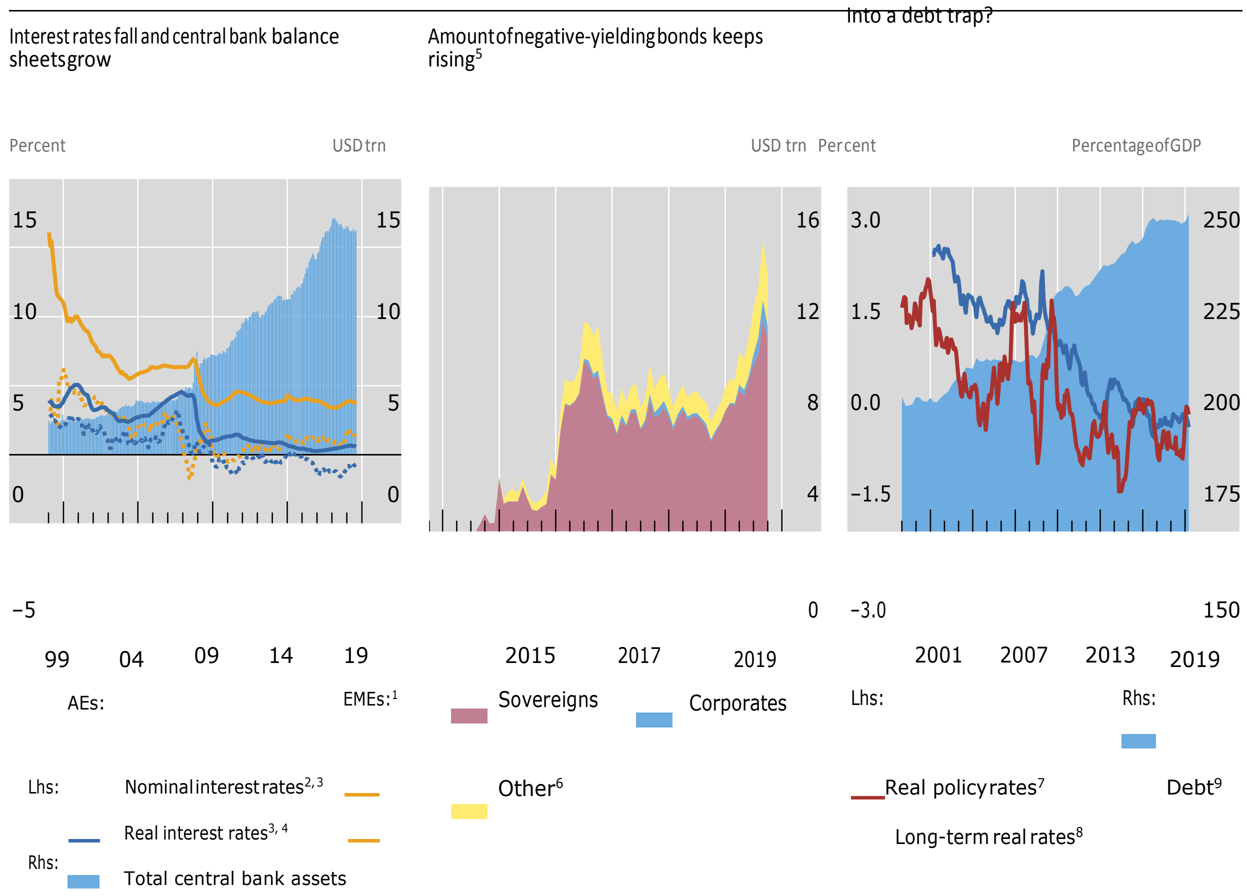
Balancing monetary and fiscal policy measures, particularly during the ongoing global pandemic constitutes a difficult task. As rightly concluded by Buch (2020:2) , if fiscal support is withdrawn prematurely, economic recovery and financial stability might be at risk. On the other hand, she further adds, if support is sustained for too long beyond the emergency period, fiscal sustainability and longer term growth possibilities may be endangered.

The importance of greater coordination, communication – in a timely, consistent, transparent and effective manner, has never been more crucial in ensuring that policy objectives are realized and in a complementary manner which alleviates pro cyclical complications and for which counter cyclical measures were designed to target. Whilst absolute independence for central banks may ultimately present and generate problems in the ability and capacities to function at optimal levels, a degree of operational independence is also necessary to ensure that monetary policy objectives are not influenced by political pressures.

The adoption of unconventional monetary policy stances has become necessary given the restrictions in scope placed on central banks in exercising their monetary policy functions in respect of the Effective Lower Bound rates. Though unprecedented and uncertain, sometimes unconventional monetary policy decisions and more importantly, timely and pro active monetary policy decisions may be justified than potentially costly and "reactive" delayed monetary stimuli.

Source: Borio, C. (2019).“Central Banking in Challenging Times” Speech by Claudio Borio Head of the Monetary and Economic Department SUERF Annual Lecture Conference on “Populism, Economic Policies and Central Banking” SUERF/BAFFI CAREFIN Centre Conference, Milan, 8 November 2019 at page 2

The room for monetary policy manoeuvre keeps narrowing **Graph 1**



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