Recovering from the Global Financial Crisis: achieving financial stability in times of uncertainty

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Introduction

"Experience has shown that political institutions often do not maintain stable prices. They have several powerful incentives to expand the money supply beyond the rate of real growth in the economy. In non-democratic societies, the control of the money supply is an important instrument of economic policy that can address various political needs, most notoriously the financing of government needs. It is against this background that independent central banks find their contemporary justification: central bank independence is conceived as a means to achieve the goal of price stability. Central bank independence has been the preferred institutional arrangement to promote monetary stability since the end of the 1980s and beginning of the 1990s. A number of factors have contributed to this development."[1]

—Rosa Maria Lastra, *Legal Foundations of International Financial Stability*, 2006

How Independent Are Highly Independent Central Banks?

Theories that appear to suggest that absolute independence exists (i.e., "the theory that recognizes no limits on central bank independence, so long as the bank itself is reliably pre-committed to achieving price stability"[2]), indeed, cannot be sustainable.

A sufficient and appropriate degree of central bank independence is definitely necessary for the goal of achieving price stability. However, despite the levels of independence claimed to be enjoyed by several central banks, recent events indicate shifts in focus of monetary policy objectives by various central banks, notably, that of the Fed Reserve.

The impact of political and government influences on central banks' monetary policies has been evidenced from the recent financial crisis and in several jurisdictions. Many central banks have adjusted monetary policies having been influenced by political pressures that have built up as a result of recent financial and sovereign debt crises. However, such lack of absolute independence (from political spheres) could prove symbiotic, in the sense that, despite the need for a certain degree of independence from political interference, certain events which are capable of devastating consequences, namely, a drastic disruption of the system's financial stability, need to be responded to as quickly and promptly as possible. Is it possible for a central bank with absolute independence to operate effectively, particularly, given the close links between many central banks and their Treasury in several countries?

It may be inferred that central banks' crucial roles in establishing a macroprudential framework provide the key to bridging the gap between macroeconomic policy and the regulation of individual financial institutions. This however, on its own, is insufficient—close collaboration and effective information sharing between central banks and regulatory authorities is paramount.

Consequences of lack of close collaboration, coordination, and timely exchange of information between tripartite authorities, such as the relationship which exists between the United Kingdom's Financial Services Authority (FSA), the Bank of England, and the Treasury, were witnessed during the Northern Rock Crisis. The Bank of England could not effectively perform its traditional role as lender of last resort for a limited time without such a role being made public.

The need for the establishment of "bridge banks" and special resolution regimes (SRRs) has also been acknowledged in various jurisdictions. Hence, whilst a certain degree of independence from political interference is necessary, as well as an affirmation of the commitment to monetary policy objectives, absolute independence could also result in a process whereby the necessary coordination required between regulatory and government authorities exacerbate problems which they (the authorities) were designed to solve.

Here, Rosa M. Lastra's observation does appear to be manifesting itself ever increasingly:

> Perhaps in the twenty-first century we shall witness the emergence of a rebalanced framework of macroeconomic policy (with fiscal policy regaining part of its earlier role) that may lead to a

realignment of the goals to be pursued by the monetary authorities, which in turn will lead to a new wave of legal reforms.

Other consequences of the recent financial crisis include increased implementation of fiscal policy measures—in respect of taxing and spending activities [which are distinguished from proposals relating to quantitative easing measures (an inflationary policy measure)—in respect of the need to address the Eurozone sovereign debt crises].

As regards the implementation of fiscal policy measures, caution is to be had to the implementation of fiscal measures which are such that whilst they generate corrective effects, they do not impede the prospects of growth and development of the economy.

Even though the Fed Reserve is not involved in determining fiscal policy measures (the Congress and the Administration being responsible for this), fiscal policy measures impact the Fed's monetary policy decisions. The indirect effect of fiscal policy on the conduct of monetary policy through its influence on the aggregate economy and the economic outlook and the impact of federal tax and spending programs on the Fed Reserve's key macroeconomic objectives—maximum employment and price stability and "in making appropriate adjustments to its monetary policy tools"—is notable in several situations and instances.

Hence, how independent is the Fed really from government and fiscal policy influences? Could it not be said that the government really has a dual role in fiscal and monetary policy setting? As indicated initially, an appropriately and sufficiently independent central bank has a crucial role in ensuring price stability objectives.

The following remark highlights the level of impact as well as the influence of political pressures on the Fed's monetary policy objectives:

> … for several decades, a generally healthy monetary policy balance produced good results. The Fed's focus has shifted dramatically to the short-run objective of lowering unemployment and recently the willingness to (temporarily?) set aside its inflation target.[3]

In view of such political interference, would it be wise to thrust more powers into the hands of the Fed Reserve, namely, through a widening of its scope of powers since the executive (Government), as well as Congress, have a degree of influence over the decision-making capacities of the Fed Reserve. Further, and addressing the issue independently of political influences on the Fed Reserve, would it really be in the interest of accountability to delegate more powers to an already relatively powerful Fed Reserve?

Recent changes in the delegation of supervisory responsibilities in the United Kingdom, namely the transfer of bank supervision from the FSA back to the Bank of England, and the resulting increased scope of the Bank of England's powers, would appear to suggest that in certain cases, regulatory bodies as well as central banks should assume greater functions in certain capacities. Accordingly, jurisdiction specific cases have to be viewed individually and based on prevailing circumstances.

Hence, ensuring that absolute independence is achieved, in respect of central bank financial independence, constitutes a difficult task. Is it possible for a central bank to operate effectively—given the presence of absolute independence? Close collaboration and exchange of information between the tripartite authorities in the United Kingdom (the FSA, the Treasury, and the Bank of England), as highlighted by the Northern Rock Crisis, if effective as it should have been, could have helped, not only in identifying the problems which existed at Northern Rock, but more importantly, facilitated timely intervention which would have averted the scale of the crisis.

Crisis faced by IKB, Landesbanken, and Hypo Real Estates not only revealed an absence of an SRR for banks, but also raised the issue of optimal measures which could be implemented to control (in part) privately owned but publicly sponsored or (in part) publicly owned financial enterprises.[4]

Jurisdictional Approaches to Central Bank Independence and Monetary Policy

Mervyn King's reference[5] to central bank independence in the United Kingdom highlights the importance being accredited to the ever increasing and significant role of monetary policy. He adds: "How much