Central banks – saving the system comes first

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The past five years have seen central banks in many overseas countries step outside the narrow remit of price stability, getting deeply involved in financial stability. In the process they have ventured into sensitive areas, supporting government debt and working in tandem with governments. To what degree has this compromised their independence or politicised them?

During the previous couple of decades central banks in most countries had the luxury of being able to concentrate on just one task: price stability. If there was a debate about this task, it revolved around the role of output: should central banks also help to stabilise the business cycle?

In the background, however, there was always a clear understanding that central banks were also guardians of financial system stability, even where the micro-task of prudential supervision had been shifted to a separate authority (as was the fashion in the 1990s).

Walter Bagehot set out this lender-of-last function in the nineteenth century: 'lend to solvent banks against good security at a penalty rate'. It was also accepted, quietly, that if the financial sector as a whole got into trouble, a courageous central bank would do whatever it could to keep the overall system afloat, even if this went beyond its formal remit.

Bagehot made it sound too easy. In practice it's difficult to distinguish between illiquidity and insolvency in real time. Saving the financial system usually involves helping some who don't repay. If the central bank is left with a big loss, it has to be back-stopped by the national budget. The central bank acts as surrogate or agent for the government.

This is clear in principle. However it takes central banks into sensitive territory. Centuries ago, the precursors of today's central banks were formed in order to finance the sovereign's spending and this usually turned out badly. Thus a modern central banks' First Rule has been to resist any demands to fund the government.

The United States Fed's Quantitative Easing (QE) operations helped budget funding by purchasing government bonds just about as fast as the budget issued debt. The principal objective of QE was to lower the yield curve. This not only fostered economic activity, but also kept budget funding costs down.

The Bank of England has gone further. As a result of its QE operations, it now owns 30 per cent of the outstanding stock of gilts, and recently decided to purchase more.

The European Central Bank faces complex unresolved problems which have taken it into murky territory. It has purchased debt of the teetering Mediterranean governments and provided liquidity to their central banks. It is under pressure to do more, underwriting all euro-government debts in the face of an increasingly sceptical market. The European Financial Stability Facility is too small for the task at hand. The ECB alone has the fire-power to restore stability.

When the dust settles, will central banks have compromised their independence and been politicised?

The US looks fine. Much of the money lent by the Fed to support financial institutions has been repaid. The Fed is still at risk of capital losses on its large bond holdings if interest rates rise, but this should be manageable.

Whatever criticism former Chairman Greenspan receives for low interest rates beforehand and naïve faith in the self-regulatory qualities of financial markets, the Fed is generally perceived as having done a competent job during the GFC. Policy was boldly pushed to the limit with QE, but Bernanke held back from a 'helicopter drop' of money, which would have clearly been trespassing on fiscal territory. Without compromising its independence, the Fed worked closely with the administration, and the latter will get most of the fall-out of any perceived inadequacies. If Wall Street was too cozy with Congress, there is no suggestion that this extended to the Fed.

There is a recognition, too, that the Fed stepped in forcefully when the administration's ability to use fiscal policy (potentially the more powerful instrument) was hamstrung by the democratic process.

For the Bank of England, the situation is less clear. The Financial Services Authority is seen as the main culprit and some of its functions will be returned to the Bank. But governance changes at the Bank will see it brought under tighter external over-sight, crimping the Governor's independence. The Chancellor during the 2007-8 turmoil has described the Governor as 'some kind of Sun King around whom the Court revolves'. The Bank may have been too ready to strenuously assert its independence.

For Europe and the ECB, the story is still playing out. The ECB can be faulted for its inflation phobia in pushing up interest rates as recently as July. But it will be judged on the fate of the euro. If the euro survives more-or-less intact, many will see the ECB as its saviour. If the euro implodes history is likely to judge the ECB harshly, but by then the institution's reputation may not matter.

In the 1920s and 1930s, central banks in Europe and the US lost independence and influence not because they went beyond their mandates, but because they made serious errors of judgment. Like Napoleon's generals, central bankers need to be both smart and lucky, with policies that succeed.

What are the lessons for central bankers? When the financial system is at risk, they can't sit on the sidelines, and can't stay within the Bagehot formula. They have to cooperate with governments in tackling the problems and can't be too precious about the idea of independence.

Above all, they can compensate for the dithering of the democratic process as it struggles with complex urgent problems. They can offer a policy perspective which is longer-term and apolitical. There will be time, after the crisis, to return to the narrow task of price stability.

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