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Overburdened Central Banks[1]

INSTITUTIONAL OVERBURDENING

Over decades, if not centuries, the reputation of central banks has gone through ups and downs. The Great Moderation marked a period in which inflation came down from rather high levels. Growth and employment were at least satisfying and output variability declined substantially. Was this "goldilocks economy" the result of mere luck due to a decline in exogenous shocks (Stock and Watson 2003); or did it stem from improved macro policies, especially monetary policy (Romer and Romer 2002)? The jury is still out on this question. But this period nevertheless significantly enhanced the reputation of central banks and central bankers. It was almost inevitable that expectations regarding the future actions of central banks and their ability to control the economy reached an unprecedented peak as a result; a peak that was to prove unsustainable. The prestige enjoyed by central banks was further enhanced in the context of the financial crisis when the latter saved the world from a rerun of the Great Depression of the 1930s.

The latest Annual Report of the BIS (2016) presents a concise assessment: "And yet the extraordinary burden placed on central banking since the crisis is generating growing strains. During the Great Moderation, markets and the public at large came to see central banks as all-powerful. Post-crisis, they have come to expect the central bank to manage the economy, restore full employment, ensure strong growth, preserve price stability and foolproof the financial system. But in fact, this is a tall order on which the central bank alone cannot deliver. The extraordinary measures taken to stimulate the global economy have sometimes tested the boundaries of the institution. As a consequence, risks to its reputation, perceived legitimacy and independence have been rising" (p. 22).

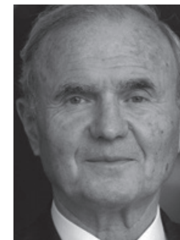
Disappointments with "politics" in general, combined with a loss of trust in politicians, helped to concentrate expectations on the competence of central banks. The crisis of the European Monetary Union (EMU) is a special case, which is characterized by the ECB being seen as the "only game in town". This phenomenon will be analyzed later.

TWO DIMENSIONS

"Institutional overburdening" has two dimensions: one arises from exaggerated expectations of what central banks can achieve ("expectational overburdening") – as explained by the BIS.

The other dimension is "operational overburdening" i.e., overloading the central bank with more and more responsibilities and competences. The biggest challenge is implied in the responsibility for financial stability. The financial crisis triggered an intensive discussion as to what extent central banks should be made directly responsible for financial stability and how they should act to deliver on this goal. A consensus has emerged that preserving price stability is not enough. As the phase of the Great Moderation demonstrated, huge risks to the stability of the financial sector can develop while low inflation is preserved. Following Minsky, a stable environment might even foster the build-up of financial fragility, ending in a collapse of the entire system.

Is there a trade-off between price stability and financial stability? This is the key question arising from the above consensus. While a short-term conflict cannot be excluded, there is no reason to sacrifice price stability over the medium to long term with the aim of fostering financial stability (Issing 2003). However, a central bank loses its reputation if it is perceived to have underestimated, or even neglected the challenge related to financial instability. This is basically true, almost independently of whether the central bank has an official/legal mandate in this field or not.



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THE ECB – A SPECIAL CASE

To date overburdening might be recognized to apply more or less to all major central banks. The ECB, on the other hand, is unique in the sense that it is the central bank of – in the meantime – 19 states. This arrangement puts the ECB in a special position that implies a kind of "extra institutional overburdening" which goes beyond the challenges identified above.

The establishment of the Single Supervisory Mechanism in 2014 extended the ECB's mandate, making it even more important than before. In the very short period of its existence conflicts between banking supervision and monetary policy have already emerged. This arrangement may negatively impact the behavior of financial intermediaries. The latter might be encouraged to take higher risks because they know that the supervisor does not want to lose its reputation and has the means to protect banks from running into serious trouble. However, taking responsibility for banking supervision also implies a substantial reputational risk.

An unprecedented degree of central bank overburdening has emerged in the course of the EMU crisis. This became obvious in May 2010 when the ECB started to take political responsibility by buying the government bonds of countries that would otherwise have experienced substantial increases in long-term interest rates. The ECB's action was widely interpreted as a kind of a guarantee for the membership of every country in EMU, as well as for the existence of the euro itself. This notion was driven to the extreme by the famous "whatever it takes" announcement by the ECB's president. Further monetary policy decisions by the ECB from which prob-

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lem countries and banks profited mostly support this view.

Decisions by the European Court of Justice and the German Constitutional Court in 2016 all in all have rejected the accusation that the ECB exceeded its mandate and violated the Treaty. It is difficult to understand the economic logic behind the legal argumentation. Mervyn King (2016), a prominent former central banker who is widely respected for his concise and well-founded observations, recently came out with this clear statement: "The proposal for outright monetary transactions is a transfer from countries that can borrow cheaply to countries that can't borrow cheaply. There's no point dressing it up with fancy language such as measures to improve the transmission mechanism of monetary policy. It's a straight transfer from countries that have credibility in their ability to run their public finances to countries that don't. From that perspective, it clearly violates the no-bailout clause of the European Treaty, and it runs completely counter to this vision of the monetary union" (King 2016, 47).

The more the policies of member states fail to fulfill their responsibility, the more the ECB is seen as the only institution within the EMU with the power and the ability to act, as well as the only body that disposes of the necessary instruments to do so. In this context it boils down to providing credit at low interest rates and buying government bonds to prevent the emergence of larger spreads in long-term interest rates. These actions undermine, and may ultimately destroy the functioning of financial markets as guardians of sound fiscal (and other) policies. As a result, member states can delay or even dismiss badly-needed reforms without the risk of losing credibility in the financial markets – at least for an extended period of time. The implicit and explicit strategy of the ECB has been to take additional expansionary monetary policy measures to compensate for missing structural reforms (Coeure 2016). The ECB has reacted to this criticism by emphasizing that it has no mandate to "punish" member states for a lack of structural reforms. But does the ECB have a mandate to suppress market reactions that would signal lack of confidence in national policies? Under these circumstances, how credible is the strong request for structural reforms in every Introductory Statement by the president repeated in testimonies to the European Parliament and in numerous speeches?

The perception of the ECB as the "only game in town" demonstrates an existential disequilibrium in the distribution of political power in EMU. It signals an extreme case of central bank overburdening in almost every respect – creating exaggerated expectations in its potential to solve all kind of problems, as well as assigning a political role for which a central bank has not, and must not have a mandate.

The extension of the ECB's tasks and its increasing political role will, and has already, triggered a debate on the legitimacy of such power given to an independent central bank in a democratic society. The irony lies in the fact that no matter whether the ECB's actions in the longer run prove successful or not, the status of its independence will be at stake anyway.

THREAT TO INDEPENDENCE

The status of the independence of central banks is increasingly being undermined by two developments. The first one arises from instruments with distributional consequences like cheap credit to special groups, banks or companies. It is true that any monetary policy decision will inevitably also have distributional consequences. These are normal side effects, whereas the instruments mentioned have direct, planned discriminatory effects. Decisions of this kind must remain in the domain of politics, which are ultimately controlled by voters, and cannot be the competence of an independent central bank.

The other conflict with the status of independence is implied in acts of coordination with fiscal policy. The more monetary policy measures are de facto an act of fiscal policy – see the case of the ECB – the more they are exposed to criticism that this does not comply with the central bank's status as an independent body. To the extent that the central bank yields to political pressure, independence might still exist "de jure", but is abandoned "de facto". This, in turn, leads to fiscal dominance.

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