Are Central Banks independent? Central Banks, Covid 19 and the era of President Trump and the German Constitutional Court

Yesterday, I delivered a talk about the independence of central banks. I am reproducing the slides from my lecture below:

Four assertions to test

- Central Banks are not independent, and never have been. They are the agents of the state or regional grouping they serve
- Euro area government bonds are not sovereign bonds as the governments which issue them cannot create money to repay them
- The Karlsruhe judgement underlines the lack of a transfer union in the Euro area to ensure smooth running of the currency and banking system
- National Central Banks are now working closely with national governments to try to offset the huge economic damage done by the anti virus lock down and social distancing policies

Independent?

- Central Banks are usually established by elected assemblies on the advice of governments. Their functions, objectives and constitutions can be changed any time the political sovereign wishes
- In Europe the doctrine of CB independence was strongly promoted as part of the creation of the Euro. It derived from the German CB set up after the war to create a low inflation stable currency the DM
- The UK also changed from a CB that worked with the Treasury to a narrow idea of independence based around the decisions on interest rates. The Labour government also gave the powers of the CB over the banking system away to a new Regulator

Collaborative?

- The Fed always had a twin objective of low inflation and decent growth or employment, and always accepted it had to be in sympathy with government policy
- The Peoples Bank of China makes a virtue out of working within the economic policy framework set out by the President of China

How independent was the Bundesbank?

- The German Central Bank enjoyed a long run making its own decisions about interest rates and general levels of money and credit. It was able to do so because it was successful in its remit and had no serious political opposition to what it was doing

- It proved to be anything but independent when East and West Germany merged. The Bank's advice on delayed timing and on the rate of exchange for the merger of the Ostmark and DM was ignored. The political imperative of union took priority
- The final irony of the so called independent Bank was when the German government decided to abolish the successful DM currency that the Central Bank was there to uphold and support
- The Bundesbank accepted most of the important monetary powers it possessed being transferred to the ECB

How independent was the Bank of England, 1997-2019?

- The Bank had to accept the loss of powers, including the power to regulate the commercial banks, and the power to issue government debt, in the legislation passed to create so called independence
- The Bank then had to accept a change of inflation target when it suited the Labour government to flip to the softer target of CPI from RPI
- The MPC agreed to an extraordinary meeting during the banking crash to lower rates as part of an international agreement brokered by the Chancellor
- The Bank accepted joint control with the Treasury over Quantitative easing
- The Bank then agreed to a change of powers from the Coalition government, who wished to give it back some powers over commercial banks

The battles between the Fed and the President 2016-20

- The Fed decided on a policy of raising interest rates which the President opposed in public. He favoured zero or negative rates like the EU with more QE
- In 2019 the Fed had to admit they were wrong and changed course to rate cutting, given the sluggish performance of the economy compared to forecasts and aspirations
- In 2020 the Fed altered their opposition to near zero interest rates and proposed more QE as the virus effects gave them good reason to do so

Sovereign bonds are treated differently in markets, usually commanding lower rates and higher prices than corporate bonds, for two main reasons:

1. The state that issues them can demand tax payments on threat of imprisonment to service and repay its debts
2. The state can require the Central Bank to create extra domestic currency to repay the debts if necessary. German, Italian French and Spanish government bonds no longer enjoy this latter characteristic. The ECB and the EU authorities determine money creation in the Eurozone

The ECB offers mixed messages on Euro government bonds

- Mrs Lagarde famously said the spreads or differential interest rates between say Italian and German state bonds was not a matter for the ECB to manage
- The sharp adverse reaction by markets led to the ECB announcing Euro 750

bn more QE, and spending some of it on trying to get the prices of Italian state debt up
- In practice the ECB partially manages the spreads, but allows Italian, Greek, Spanish and other weaker country debts to offer higher yields than German
- Intervention has been controlled by the so called capital key

The Karlsruhe judgement goes to the heart of whether the ECB should make it easier and cheaper for Italy and others to borrow, drawing on the strength of other member states finances:

- It says of QE “The more its total volume increases, the greater the risk that the Eurosystem becomes dependent on member states policies as it can no longer simply terminate and undo the programme without jeopardising the stability of the monetary union”
- The Judgement condemns QE saying the ECB “completely disregards the economic policy effects of the programme”

The constitutional battle for control of the ECB

- The German court asserts that the member states are “the masters of the Treaties” that embody the laws and constitution of the Union
- It dismisses the judgement of the ECJ, the EU’s Supreme court, as “a view”
- It asserts that the ECJ’s upholding of ECB monetary policy is “simply untenable”
- The Court however seems to give the final power to the German state which may well wish to confirm ECB power over QE

A new era of collaboration between Central banks and governments

- The advent of anti Covid policies closing down great swathes of the world economy and requiring new business models when lock down is relaxed has led to joint Bank and government action
- In the USA, the UK, Japan and elsewhere the government encourages the Bank to lend and create money on a huge scale, and the Bank encourages the government to spend and borrow on a huge scale
- Both have done so with the approval of each other
- In the Euro area the Bank has expanded QE substantially, but the lack of a clear single sovereign for the EU has limited the fiscal response at EU level and caused more debates about pooling of risks and EU borrowing levels
- Meanwhile member states have expanded their budget deficits greatly without EU demands to limit them to the 3% of the Treaties

The future

- How will the new era of collaboration work out?
- Can the pretence of independence be re created and should it be?