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When Central Banks buy Bonds - Independence and the Power to say No

In comments at the Barclays Capital 14th Annual Global Inflation-Linked Conference in New York today, Adam Posen counters those who argue that the large-scale purchases of government bonds or private-sector securities by central banks compromises their independence from elected officials, their reputation and thus their counter-inflationary credibility. Dr Posen argues that central bank independence is not primarily a matter of reputation, but of reality.

He says, "The substance of central bank independence is giving monetary policy setting committees the legal autonomy to refuse demands to purchase debt instruments..." But that does not mean central banks should not purchase bonds when it is right to do so. He says, "...the counter-inflationary credibility of central banks is not fragile to voluntary purchases of bonds, public or private, made with reference to clear economic (as opposed to political) justification."

He synthesizes the research on central bank credibility, independence and inflation outcomes and rejects the view that central bank independence works primarily through its reputational effects. "Deeds matter, not institutional appearances", he says, adding that "Central bank independence is about the ability to say no to demands for bond purchases when they are economically unjustified, no more, no less. Central banks maintain that ability to say no by delivering best possible economic results, not by minding their reputation for seeming independent." He adds that: "Getting unduly caught up in protecting the appearance of central bank independence is doubly mistaken: first, it will not do any good because it is not that appearance which delivers desirable results; second, it will prevent pursuing the right policy option."

In this way, when the nominal interest rate is already at or close to zero, and the financial transmission mechanism is damaged, Adam Posen believes that buying bonds is the only means central banks have of trying to deliver price stability against deflationary pressures. He states: "Not only saying yes to, but initiating the right kind of bond purchases under the right circumstances is part of being a responsible adult policymaker. I am glad that the decision-makers at the major independent central banks today were too mature to get hung up on their appearances." Posen believes that because of these policy measures "the major central banks will have enhanced their credibility and independence for the future."

Key Resources

When Central Banks buy Bonds - Independence and the Power to say No - Full speech

<http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech436.pdf>