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WHEN CENTRAL BANKS BUY BONDS
INDEPENDENCE AND THE POWER TO SAY NO

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INDEPENDENCE AND THE POWER TO SAY NO

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Since the global financial crisis began in 2007, there has been a lot of hand-wringing about the independence of central banks. Some commentators today would suggest that the recent large scale purchases of government bonds by central banks inherently represent a compromise of their independence from elected officials. Others will assert that the central banks which purchased private-sector securities, thereby jeopardizing their balance sheets and supposedly making political asset allocations, are the ones which have put their independence at risk. The recent emergency actions of the European Central Bank [ECB] as part of the European Union's response to the Greek financial crisis have prompted a whole new round of recrimination and worry on the continent. An unfortunately sizable number of people seem to believe that central bank independence is largely a matter of reputation, and that any apparent fraternization with or accommodation of debt issuers imperils that reputation. That supposed reputational damage is then presumed to have significant costs for central banks' counter-inflationary credibility.

I am not one of those people, and I will try with my brief remarks today to persuade you that this set of beliefs is wrong on all counts. Central bank independence is not primarily a matter of reputation, but of reality – what matters is what central banks do, not whether they maintain an appearance of public disdain towards the messy realities of economic life. The substance of central bank independence is giving monetary policy setting committees the legal autonomy to refuse demands to purchase debt instruments - even when demands come at moments when

¹ This speech draws in part on research in progress with Kenneth Kuttner. The views expressed here, however, are solely my own, and not necessarily those of the MPC, of the Bank of England, or of PIIIE.

politicians are very anxious that those bonds be bought. The desirable reduction of average inflation outcomes associated with central bank independence thus comes from saying no at critical moments, not from ongoing deterrence effects on expectations.² As a result, 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.³

In contrast, always refusing to intervene in debt markets for appearance's sake alone, regardless of the economic circumstances, is a sign of immaturity or insecurity, not independence. Some adolescents define their autonomy by being resolutely contrary, and often do damage to themselves (and others) by being deaf to common sense or to appeals to common standards just to stay contrary. Independent central banks can and should behave more like responsible adults than that. Therefore, it is my contention that by acting responsibly to respond to the global financial crisis utilizing the tools available, including large-scale bond purchases, the major central banks will have enhanced their credibility and independence for the future.

What is central bank independence, really? –

Central bank independence was the hot institutional fix for monetary policy in the early 1990s, and soon became the global standard.⁴ Early empirical research on central bank independence mistakenly emphasized legal forms and long lists of attributes that were necessary to judge the degree of a central bank's independence, as though it were a finely calibrated matter.⁵

Subsequent investigations came to the conclusion that only two aspects – whether a central bank

² See Eijffinger and De Haan (1996), Posen (1998), Posen (1999), and Kuttner and Posen (2009) for evidence about which aspects of legal central bank independence have predictive power for inflation in support of this view.

³ The discussions in Blinder (1998) and McCallum (1995) are enlightening on this point (and several others).

⁴ Posen (1993) and Kuttner and Posen (2001) discuss this trend, made stronger by the strictures of EMU.

⁵ See the papers and references in Eijffinger (1997).

governor can be fired (without cause); whether a central bank can be forced to buy government bonds directly (i.e., monetize debt) – have all the predictive power for inflation associated with central bank independence. (Eijffinger and De Haan (1996); Kuttner and Posen (2001)) What is critical is that these are the two aspects that have to do with the power to say no when confronted with a demand to buy bonds. And these are what support from the society confers on a central bank.

Other trappings sometimes thought to be associated with independence do not matter for inflation outcomes. For example, a great deal of attention is sometimes paid to the official mandate of central banks – do they follow the example of the Deutsche Bundesbank, and have a solely price stability mandate? Differences in mandates turn out to have no predictive power for differences in inflation outcomes. (Posen (1999); Kuttner and Posen (2009)). This should not come as a total surprise, given that the Swiss National Bank and the US Federal Reserve have to both be classified as having multiple goal mandates, and yet both are clearly independent and have delivered consistent low inflation. Term of the governor and her appointment process, whether it is synchronized with electoral cycles, and the composition of the policymaking committee all similarly do no work in explaining differences in inflation outcomes.

The importance of the power to say no to demands to purchase bonds, narrowly defined by these two attributes of independence, is also demonstrated by what central bank independence does not do. For example, it was originally thought that a key channel through which central bank independence would lead to low inflation outcomes was through the prevention (or deterrence)

of ‘political business cycles’.⁶ Yet, there is no evidence that countries with independent central banks are less subject to political business cycles, and if anything, some evidence to the contrary relationship.⁷ The point is that central bank independence is about a specific form of autonomy, not some broad political process, and monetary policymaking remains politically challenging even for independent central banks. The famous ‘divorce’ of the Banca d’Italia from the primary debt purchasing obligations of the Finance Ministry is a classic example.

The only way that central banks can credibly commit to price stability over the long-term is to maintain a political constituency in civil society supportive of such a policy regime.⁸ That support from civil society, not any legal statute, is what protects central banks when they make a hard decision that angers politicians. Absent that support, laws regarding central banks can be changed or threatened to be changed until monetary policy is changed. Central bank independence is endogenous to that support, and it will be curtailed when such support is lost. I am not suggesting that independent central banks protect themselves by currying favor with elected officials. I am referring to the need for central banks to deliver reasonable economic outcomes recognized as in the interest of a politically effective consensus in society. This need holds even if sometimes it requires monetary policymakers to deviate from what is thought to be their reputational norm.⁹

A classic example of this dynamic is the Federal Reserve-Treasury ‘Accord’ that suspended the Fed’s independence in the US in the mid-20th century. While usually ascribed solely to the needs

⁶ In such cycles, monetary or fiscal policy would be loosened in time to enhance the chances of a given official’s election, or cyclical policy would otherwise be manipulated to suit the perceived electoral needs of incumbents.

⁷ See Berger, De Haan, and Eijffinger (2001), Faust and Irons (1999), and Posen (1995).

⁸ As I first argued in Posen (1993, 1995) and has been subsequently borne out in other empirical studies (though not necessarily with the specific sources of support I initially hypothesized). See Berger, Eijffinger and De Haan (2001), Hayo (1998), Kuttner and Posen (2009), and Miller (1998), and the references therein.

⁹ Drazen and Masson (1994) give a particularly insightful formal model of this phenomenon.

of war finance, the Accord actually was kept in place well after (until 1951). The right way to interpret this removal of independence is as a response to the Fed's failure to respond adequately to (in fact, to its actions to exacerbate) the Great Depression. A similar dynamic was underway in Japan at start of the 2000s when inaction by the Bank of Japan in response to deflation fed support for government proposals to curtail the Bank's recently granted independence (Posen (2000)); the more responsible policies pursued by the Bank from 2003 onward removed this pressure.

By the same token, central banks perceived to have delivered good performance, or at least to have had responsible policy priorities, have been able to withstand populist pressures. The experiences over the last 20 years of the independent Bank of Israel, Central Bank of Brazil, National Bank of Poland, and Reserve Bank of New Zealand, among others, in societies where populism previously directly influenced monetary policymaking, and where threats to change central bank laws arose, illustrate this.

Brazil is a particularly telling case. As discussed in Posen (1995), Brazil's central bank initially used its independence to accommodate high inflation, with influential sectors of society adapted to profiting in such an environment. It was only when the underlying politics and social conditions changed in Brazil more recently that the legally independent central bank became an inflation fighting central bank. Russia arguably had a similar dynamic for its nominally independent central bank in the 1990s (though the forms of pressure on the Russian central bank were extreme). These examples also bring home the importance of distinguishing between

‘goal’ and ‘instrument’ independence, as first articulated in DeBelle and Fischer (1994). In other words, it is the content of what central banks do, not the form of organization that matters.¹⁰

Earned reputations are not fragile –

Ignoring these realities, there is a widespread sense that central bank independence works primarily through its reputational effects. As a result, some believe that anything which gives the appearance of ‘softness’ towards fiscal policy or inflation, let alone of policy coordination or doing something politically popular, erodes a central bank’s credibility. The reputation is fragile to any short-term air of deviation, and price stability is fragile to any change in reputation. This view is shared by many in academia and in markets as demonstrated by much of the chatter about major central banks’ activities of late. This view is profoundly and completely wrong.

Seventeen years ago, I published my first economics article and it was on the topic of central bank independence (Posen (1993)). Among the formerly controversial points I raised in it and in the related research (Posen (1995, 1998)) was a reconsideration of reputational effects. The primary academic model for central bank independence, growing out of Rogoff’s (1986) seminal article, was one of the central bank playing a deterrence game against inflation bias, with a reputational trigger. Yet, what I pointed out was that central bank independence did not empirically have the impact via the channels it was expected to in the literature, assuming that a reputation for toughness was factor doing the work to lower inflation. I was not alone. As Blinder (1998) and McCallum (1995) argued, if a deep-seated fear of central bank ‘weakness’ were the source of the inflation difference between highly independent central banks and

¹⁰ In keeping with DeBelle and Fischer (1995), this is why many (including me) have advocated combining an inflation target with independence as a means of accountably setting the goal. See Bernanke, et al (1999).

dependent ones, it should not have been so easy to get rid of the inflation bias as it proved, and the differences in inflation rates delivered between central banks should not have been so small.

A key empirical result was that it was shown that greater central bank independence is robustly positively correlated with higher costs of disinflation.¹¹ All simple reputational based models of monetary credibility imply the direct opposite – disinflation should be quicker and less costly when people are thought to believe in the central bank’s toughness, and thus the Phillips Curve should be steeper, closer to supposedly vertical long-run natural rate. This prediction was directly contradicted. Relatedly, despite some initial empirical claims to the contrary, greater central bank independence has also been shown to be positively correlated with output volatility, even when taking into the account the decade of the ‘Great Moderation.’¹² Taken together, these results suggest that central bank independence is an indicator of the will to prioritize maintenance of low inflation, even at some cost, and is a partial means to implementing that will. That is fine, but that is another way of saying it is action not reputation that matters, and even that reputation is largely irrelevant.

Recent work in progress by Kenneth Kuttner and myself takes this point further.¹³ If what mattered was the reputation of the central bank, and it was independence that cemented that reputation, inflation in a country should drop as soon as a central bank is granted independence. Absent independence, the inflation bias should remain. Going back over the historical record, however, Kuttner and I find that predominantly the opposite holds: 70%+ of central banks in our

¹¹ Debelle and Fischer (1995), Posen (1993, 1998).

¹² See Kuttner and Posen (2009). Note that this result was predicted in Rogoff (1986). It was later academics who tried to claim that central bank independence offered a free lunch of lower inflation and inflation volatility at no cost to output stabilization through the credibility channel.

¹³ Preliminary results were presented at the 2009 ASSA Annual Meetings (hence Kuttner and Posen (2009)). We plan to make available a working paper with fuller results and data by the end of this summer.

(inherently) limited sample had brought down inflation significantly in the months and years right before independence was given, and no significant additional reduction in inflation levels took place upon central banks gaining independence. The Bank of England, where I now work, is a good example. After running successfully a price-stability oriented monetary regime of inflation targeting for five years between 1992 and 1997, the Bank earned enough credibility to be granted independence. Deeds matter, not institutional appearances.

Watch the news, not “Keeping Up Appearances” -

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. That being the case, I am quite sanguine that whatever the appearance given by independent central banks buying bonds, and how that appearance is hyped by some in the markets and the press today, there will be no credibility damage as long as it is the right thing to do economically. When the instrument nominal interest rate is already at de facto zero bound, and the financial transmission mechanism is damaged, buying bonds is the only means central banks have of trying to deliver price stability against deflationary pressures – some form of quantitative or credit easing is the right thing to do. 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.

As I indicated at the start, much of the hue and cry about central bank independence in response to the various sorts of bond purchases is awfully shallow. It is adolescent or worse to be so

preoccupied with how someone looks, and her supposed reputation among the self-appointed conformists, than with the substance of her actions and values. This holds true whether that someone is a high school student or a monetary policy committee. That has not stopped such preoccupations and nasty name calling from spreading of late regarding central banks. In imagery typical of the preening machismo of financial markets participants and those who report on them, a number of people of late have spoken about the ECB losing its ‘political virginity’ or purity last month.¹⁴

One is tempted to ignore or dismiss such idle chatter, but let us take it at its vulgar face value to show just how empty these characterizations are. Cultures which make a public fixation of virginal purity, of a stylized maiden’s reputation, tend to be backward superstitious cultures that impede people exercising autonomy and making responsible choices. For society, and arguably for the young persons themselves, what matters is not a young person’s ‘virtue,’ let alone any reputation for such. What matters for society and for the young person is whether they are promiscuous, engaging in unsafe behavior, or getting pregnant casually, that is whether they behave responsibly.

So it is, too, for the Old Lady of Threadneedle Street and all other central banks. What matters for our independence is our ability to say no and to mean it, and to be responsible about when we choose to say yes. In fact, sometimes responsible central banks will want to initiate such bond purchasing activity themselves. In the case of the Bank of England's program of Quantitative Easing, it was undertaken on the initiative of the MPC because it was consistent with our

¹⁴ Examples include: “Trichet Faces Growing Criticism in Europe Crisis” *New York Times*, Jack Ewing and Steven Erlanger, May 20, 2010; “ANALYSIS-ECB independence, succession in question,” May 11, 2010, *Reuters*, Paul Taylor, and “Farrell: Trichet—A Vestal Virgin No More,” May 24, 2010, *CNBC Guest Blog Vince Farrell* http://www.cnbc.com/id/37314343/Farrell_Trichet_A_Vestal_Virgin_No_More. Of course, attendees at this conference have heard many crude versions of such statements in off-the-record conversations.

mandate to deliver price stability.¹⁵ 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.

¹⁵ To assure our independence in so doing, the Bank of England asked HM Treasury for an indemnity against any losses suffered on our Gilt purchases. See: <http://www.bankofengland.co.uk/publications/news/2009/019.htm>

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