Central bank independence: it's not only about interest rates and price stability

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Abstract

Discussions of central bank independence usually centre around monetary policy, specifically the freedom of central banks to use interest rates to tackle inflation. However, as the financial crisis showed, financial stability is also important, and this requires robust supervision/regulation of banks. This can only be achieved if central banks are politically independent and free of regulatory capture.

Keywords: central bank independence, financial crisis, lax bank supervision, financial stability, regulatory capture

JEL Classification: E58, L51

Introduction

Debates about central bank independence have traditionally focused on monetary policy, specifically the setting of interest rates. A central bank, it is argued, should be free of government influence when setting interest rates, thus allowing it to maintain price stability[1]. However, the temptation to meddle with interest rates for political gain is hard to resist. During her premiership, Margaret Thatcher was not averse to picking up the phone to the governor of the Bank of England (BoE) and trying to persuade him to alter rates. According to the BoE's former chief economist:

"*The best predictor of interest rates was not GDP or inflation. It was whether Mrs Thatcher…had recently suffered a bad by-election. Policy played second fiddle to politics"* (Haldane, 2021).

It was partly to stop such blatant political interference that the BoE was granted operational independence in 1998. A more recent example is the Central Bank of Turkey. President Erdogan has an unorthodox view of monetary policy, believing that in order to tackle inflation interest rates should be cut rather than raised. Differences over monetary policy led Erdogan to sack three central bank governors between July 2019 and March 2021 (Erkoyun et al., 2021). In October 2021, he sacked three senior policymakers at the central bank, two of whom were opposed to the bank's interest rate cut in the previous month. The rate cut resulted in a significant depreciation of the Turkish lira, further adding to strong inflationary pressures (Butler et al., 2021).

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1 For a recent discussion on the importance of central bank independence with regard to monetary policy, see Dall'Orto Mas et al. (2020)

So, yes, interest rates matter and who sets them matters just as much. However, we should remember that central banks do a lot a more than conduct monetary policy[2]. Most central banks are also responsible for bank supervision/regulation (including anti-money laundering) and financial stability. In the light of the financial crisis, these functions have taken on greater significance.

Pre-crisis period

The causes of the financial crisis, which affected the global economy between 2007 and 2014, were many and have been well documented[3]. One of the main contributing factors was the lax supervision and regulation of the financial sector, particularly banks. In 2017 the University of Chicago published the findings of its survey of leading American and European economists on the main contributing factors of the crisis. Duffie (2019) reports:

"The factor receiving the highest average importance rating…was 'flawed financial sector regulation and supervision'" (p82).

The obvious question that arises is: why was supervision and regulation so lax?
The answer is an undue reliance on market discipline and/or regulatory capture.
The reliance on market discipline, or 'light touch' regulation, was based on the assumption that any excessive risk taking would be reined in by self-correcting market mechanisms. Undue faith in market discipline meant that, in practice, central banks underestimated the importance of financial stability. As we saw, market discipline failed and it failed spectacularly. Duffie (2019) states:

"*Leading up the crisis, the core of the financial system was not prepared to withstand a significant shock. An undue reliance on market discipline had left the largest financial firms undercapitalized, and this was exacerbated by a failure ….to prioritize financial stability"* (p101).

As alluded to above, the regulatory capture of central banks was also an important contributing factor to the crisis. The capture was widespread, from small central banks to large ones (see Caprio, 2013).

Capture can take a variety of forms:

- appointment of governors based on narrow political criteria
- appointment of board members for reasons other than fit and proper[4]

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2. In the eurozone, where the ECB is responsible for monetary policy, the issue of who sets interest rates has become redundant.
3. For a comprehensive discussion of the crisis which takes into account the broad geopolitical context, see Tooze (2018).

4. For example, political expediency or as a personal favour.
5. Caprio (2013) refers to the cosy relationship between the regulator and the regulated as a form of 'psychological' capture.

- ‘revolving doors’ from the regulator to the banks
- close personal or political relationships which lead regulators to ignore or downplay regulatory infringements[5]
- conflicts of interest of board members or staff
- appointment and promotion of staff based on political criteria
- in extreme cases, bribes.

The above are either a form of corruption or, at the very least, highly unethical.

Of the many examples of lax supervision and regulatory capture in Europe, there are three particularly glaring ones: Iceland, Ireland and Cyprus. In the case of Iceland, a combination of regulatory capture of the Financial Supervisory Authority and very lax supervision by the central bank allowed the banking sector to balloon. The consolidated assets of Iceland’s three largest banks grew from 170% of GDP in 2003 to 900% of GDP by the end of 2007 (see Wade and Sigurgeirsdottir, 2007 and Gudmundsson, 2010). The supervisory failures of the central bank led to the dismissal of the governor, David Oddsson.

In the case of Ireland, in 2010 the then governor of the Central Bank of Ireland, Patrick Honohan, published a damning post-mortem report on the role of his own institution in Ireland’s financial crisis. The report sums up the central bank’s deficiencies as follows:

“a regulatory approach which was…excessively deferential and accommodating; insufficiently challenging and not persistent enough. This meant not moving decisively and effectively enough against banks with governance issues. It also meant that corrective regulatory intervention for the system as a whole was delayed and timid” (Honohan, 2010, p16).

This can be illustrated by the fact that between 2003 (the year the Financial Regulator, then a constituent part of the central bank, was established) and October 2008, not one bank had been fined following an inspection by the regulator (see Clarke and Hardiman, 2012).

In Cyprus, the size of the banking sector, like Iceland’s, became disproportionately large. Between the end of 2004 and mid-2010, the consolidated assets of the banks grew from 388% of GDP to 953% of GDP[6]. This, together with excessive credit growth (between December 2005 and April 2009 bank lending increased by 200%), set the scene for an eventual crash which threatened Cyprus' membership of the eurozone and the EU[7]. None of this would have occurred had it not been for the regulatory and supervisory failures of the Central Bank of Cyprus (CBC). As Lascelles et al. (2013) state:

“That there were supervisory failures at many levels, including poor co-ordination between the Central Bank of Cyprus and the Ministry of Finance over the mounting risks to the system, and the ineffectiveness of the supervisory agencies when it came to controlling the banks and the co-ops, due mainly to lack of firm leadership, influenced by a prevailing attitude in political circles…. that all was sufficiently under control” (p23).

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6. These figures are quoted by Demetriades (2017) and are based on Central Bank of Cyprus data.
7. For a first-hand account of the crisis, see Demetriades (2017).

And they continue:

"Although many of the necessary powers and processes existed in the CBC to supervise the banks and ensure that they were operating prudently, the record shows that banks were able to proceed without serious regulatory challenge until it was too late…. Furthermore, ***governance flaws in the Central Bank of Cyprus*** (my emphasis) *meant that the supervision function was not independently assessed, and that the CBC itself was not explicitly required to account politically for its handling of its supervisory responsibilities"* (p26).

Post-crisis period

Following the crisis, central banks across the world strengthened their supervisory powers and, in some cases, expanded their financial stability departments. There were also indications among some central banks that any perception of regulatory capture, especially in the form of conflicts of interest, was no longer to be tolerated. Two good examples of this are the Bank of England and the US Federal Reserve.

In March 2017, the deputy governor of the Bank of England, Charlotte Hogg, resigned when it transpired that she had failed to disclose that her brother worked at Barclays, one of the banks regulated by the BoE. This was in breach of the BoE's code of conduct (Treanor, 2017). More recently, the president of the Boston Federal Reserve, Erik Rosengren, and the Dallas Federal Reserve president, Rob Kaplan, had to resign when it was revealed that they had engaged in the trading of shares and property-linked assets during the height of the Covid pandemic, when the US Fed was attempting to stabilise markets (Guida, 2021). In response to the scandal, the US Fed chairman, Jay Powell, introduced new rules banning officials from trading in shares, derivatives and individual bonds (Ponti, 2021).

Although progress has been made with regard to both supervision and regulatory capture there is still some way to go. In the case of Cyprus, Lascelles et al. (2013) state that:

"*It is important for the effective discharge of the CBC's…supervisory duties that the central bank's independence be recognised and respected"* (p73).

Unfortunately, nine years after it was written the above statement is still valid.

Some proposals

In countries like Cyprus, where regulatory capture has resulted in a serious erosion of central bank independence, we propose the following:

1. The appointment of the governor should be based on open competition. There should be an independent appointments committee comprised of five individuals, three of whom would be nationals from other countries with central banking experience and no connections to the host country.

2. The appointment of the governor should not be confined to the nationals of the home country[8]. Two examples of central banks that have had, or currently have, a foreign national as their governors are the Bank of England and the Central Bank of Ireland[9].
3. Members of the central bank board should be recommended by an independent nominations committee and be subject to stringent fit and proper tests.
4. At least three members of the board of directors should be nationals of other countries. In the case of the CBC, the appointment of foreign nationals would be consistent with the recommendation of Lascelles et al. (2013) who state that:

   *"Important appointments should be made on merit rather than personal connection. ….Ireland's banking recovery was aided by the appointment of non- Irish people to senior positions in the Central Bank of Ireland and the major bank*s"(p33).

5. Financial stability should be upgraded to a separate and self-contained department/division and the head should be a foreign national. In Ireland, for example, financial stability is headed by a non-Irish national who spent most of his career at the Bank of England.
6. In order to discourage 'revolving doors', senior staff in the central bank's bank supervision department/division should be prohibited from working for a bank or a financial services company (including joining the board of directors) for at least four years after they leave or retire.
7. The codes of conduct governing the board of directors and staff should be strictly adhered to and be prominently displayed on the homepage of the central bank's website, thus allowing easy access to members of the public and other stakeholders.

The independence of institutions such as the central bank, the office of attorney-general and the office of the auditor-general, is paramount for the proper functioning of any modern democracy. However, independence requires transparency and accountability. In the case of the CBC, Lascelles et al. recommend that:

"*the CBC provide as full as possible a public account of its actions and the reasons behind them, consistent with the needs of appropriate confidentiality"* (p75).

This recommendation applies to all central banks.

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8. In the case of Cyprus, the Constitution stipulates that the Governor of the central bank should be from the Greek Cypriot Community and the Deputy Governor from the Turkish Cypriot community. The Constitution would thus need to be amended.
9. In the case of the BoE, the former governor, Mark Carney, was a Canadian. The current governor of the Central Bank of Ireland, Gabriel Makhlouf, is a British national born in Egypt to a Cypriot-British father and a Greek-Armenian mother.

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