Central bank's independence in question

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In the depths of the financial crisis the central banks emerged as saviours, with miraculous injections of liquidity and soothing interest rate cuts. With their unlimited capacity for creating liquidity, the US Federal Reserve and the European Central Bank played the leading roles in the escape from the Lehman and euro crises respectively.

Yet now, just a few years on, paradoxically, that very protagonism risks being turned against central banks, as their independence comes in for increasing criticism on both sides of the Atlantic. In the US, some of Trump's supporters want to clip the Fed's wings drastically, while in Germany there is open criticism of the ECB, which a large section of public opinion sees as working for debtor countries.

So why this criticism? Perhaps we are asking too much of central banks: we expect them to maintain monetary stability, stimulate the economy, ensure financial stability and the solvency of the banking system, to channel capital from savers to investors and lately even to act as agents for income redistribution policies, by means of negative interest rates that bring relief to debtors and penalise savers. An independent institution can render account to society if it has a clear objective, but this becomes much more difficult if there are multiple objectives whose relative weights keep changing with discretionary criteria.

The historical development of central banks is in itself paradoxical: created to finance the state, they evolved into independent bodies that ended up being prohibited from financing the Treasury. Their independent status is supposed to avoid the opportunistic use of monetary policy to help the government of the day win elections by means of expansive policies that lead to harmful inflationary tendencies. But that independence is of no use if the central bank is obliged to finance the Treasury. German hyperinflation between the two world wars ended not when the Reichsbank was granted formal independence in 1923 but one year later when it was prohibited from financing the state.

There are significant variations in this independence: for example the ECB has autonomy to set monetary policy objectives (more precisely its statutes include a general objective of price stability, which the ECB itself has defined as "inflation below but close to 2%"), whereas the Bank of England has autonomy only to adjust interest rates to attain an inflation target set by the government.

The independent central bank model has worked relatively well since the move to floating currencies in the 1970s, and has spread to emerging countries, but it has recently sprung a leak. As well as supporting activity and employment, quantitative easing policies and negative interest rates also have strong side-effects in the shape of redistribution of income between debtors and creditors. Together with inflation, capital controls and debt restructuring, they form part of the so-called "financial repression" policies. And in Europe they are particularly dangerous, because they involve transfers of income not just among individuals but among countries (from creditors to debtors, from north to south).

It has even been suggested recently that central banks replace banknotes - which cannot pay interest - with virtual currency, as a mechanism for going deeper into negative interest rates. These kinds of proposals are dangerous to central banks, because they exacerbate the problem of legitimacy that they already have. In a democracy, transfers of income must be decided in parliament, with the approval of the people's representatives. Monetary policy cannot replace fiscal policy, and the central bank has no mandate to embark on these kinds of policies.

We should protect central banks, which have fulfilled their objectives over many years, limiting their mandate to the objectives they can reasonably be expected to attain and that it makes sense to entrust to an independent body. And transfers of income should be debated in parliament, where they belong.