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"Mission creep, democratic accountability and central bank independence"

Let me start by thanking SUERF and the Oesterreichische Nationalbank (OeNB), in particular Governor Holzmann, for inviting me to address this distinguished audience on a subject close to my heart. Let me also congratulate Donato Masciandaro on his appointment as SUERF president. I have been intrigued by the challenge of how to reconcile the delegated mandates of independent central banks with the requirements of a democratic society since 1990, when I was writing my PhD thesis on central banking working with Charles Goodhart at the London School of Economics. While the emphasis in the early 1990s was on the need for monetary independence based on a narrow model of central banking, in line with the Tinbergen rule, the emphasis today is on a broader model, one in which central banks are called upon not only to keep inflation under control but also to act as crisis managers in the context of financial crises, sovereign debt crises, the Covid 19 pandemic and now climate change. And they are also asked to confront the challenges of digitalisation and innovation.

The subject of my presentation is not just of academic interest but of great importance for the welfare of our citizens and communities and for the smooth running of the financial system and the economy at large. Central banks are very powerful institutions and, as their remit has grown *de facto* and *de iure*, we must ensure that any expansion in powers is accompanied by adequate mechanisms of accountability. I have had the great honour of serving as Specialist adviser to the of the House of Lords in the UK in 2021 and 2023. In 2021 the inquiry of the Economic Affairs Committee of the House of Lords examined in depth quantitative easing (QE); the final report *QE, a dangerous addiction?* discussed the intended and unintended effects of QE including on inequality and the boundaries between monetary policy and fiscal policy. In 2023 the Economic Affairs Committee examined how well the framework of operational independence of the Bank of England has functioned over the last 25 years, since the Bank of England Act 2008 transferred monetary policy powers from elected representatives to unelected officials. The final report at the conclusion of the inquiry, *Making an independent Bank of England work better* criticised groupthink, tackled modelling failures and recommended enhanced parliamentary accountability and scrutiny.[1]

[1] See House of Lords Report (2023) here. This presentation is based on a forthcoming article entitled 'Central Banking in a Time of Crisis. The Bank of England' to be published in 2025 by the Wisconsin International Law Journal, following the 2024 Symposium on *Central Banking in a Time of Crisis: An International & Interdisciplinary Perspective*.

My presentation, **Mission creep, democratic accountability and central bank independence** considers the past, present and future of central banking and is divided into three parts. First, I review the narrow model of independent central banks based on the intellectual consensus that prevailed from 1990 till 2008. Then, I talk about the broadening of central bank mandates since 2008. Finally, I discuss the need for adequate accountability mechanisms and better communication.

THE NARROW MODEL

The first central banks, the Riksbank in 1668 and the Bank of England in 1694, were founded to finance the government needs mostly in times of war. Despite this rather unromantic rationale, an aura of mystique soon developed around central banking. The Royal Charter that established the Bank of England in 1694 stated that its mission was to promote the public Good and Benefit of our People: '*Now know ye, that we being desirous to promote the public Good and Benefit of our People'.* This is actually still used in the mission statement today, which refers to 'Promoting the good of the people of the United Kingdom by maintaining monetary and financial stability'.

Leaving aside the early history of central banking, the 'narrow model' has a specific meaning. It refers to the granting of a governmental delegated mandate to an independent central bank to achieve price stability in the conduct of monetary policy. This narrow model led to the adoption of legal limits preventing the central bank from supporting the sovereign in its fiscal needs.

The genesis of the narrow model is well known by this audience. Following the inflationary excesses of events in the 1970s, Governments needed a brake to avoid taking inappropriate actions when confronting inflationary temptations, like Ulysses at the mast. Central bank independence in the pursuit of price stability provided such brake. The arguments of time inconsistency, political business cycles and the vertical Phillips curve together with the available empirical evidence in the early 1990s, provided the economic justification of the narrow model. This in turn influenced a wave of legislation around the World granting independence to the Central Bank, including the Maastricht Treaty of 1992. The International Monetary Fund made it often a 'condition' attached to the programs of reform that countries submitted in order to get access to Fund conditional financial assistance. Central bank independence became a kind of 'graduation issue' for countries wishing to exhibit or consolidate their credentials in monetary stability and fiscal restraint.

THE BROADENING OF THE MANDATE

During the global financial crisis, a black swan event in the words of Nassim Taleb, Central Banks faced unprecedented challenges, from the massive provision of lender of last resort assistance to the expansion of their balance sheet through the extraordinary provision of QE. These challenges also created new and complex dynamics between monetary, fiscal, and sovereign debt policies.

Having overlooked financial stability considerations in the years prior to the GFC, the pendulum shifted and financial stability became again an overarching consideration for central banks and, in the case of the Bank of England, a statutory objective. Of course, financial stability has always been a key central banking goal, often in the guise of other expressions: effective supervision of the banking system, sound banking, prevention of financial crises, smooth running of the payments system, etc. (even though it is only a contributory task for the ECB according to Art. 127 (5) TFEU!). The late Tommaso Padoa Schioppa referred to financial stability as a land in between monetary policy and banking supervision.

The law relating to the supervisory role of central banks diverges across jurisdictions and changes over time, with the pendulum shifting, bringing supervision in and out of the central bank depending on economic and political circumstances. Post GFC the pendulum has now shifted towards keeping supervision in. The Bank of England is the most significant example given the range and scope of its responsibilities in the areas of micro and macro prudential supervision, supervision of Financial Markets Infrastructures (FMIs) and resolution. In the US, though the Fed has always been in charge of supervising depository institutions, its role in the pursuit of financial stability is implied, and the role of macro-prudential policy is entrusted to the Financial Stability Oversight Council, set up by the Dodd Frank Act 2010. In the case of the ECB, the activation of Article 127 (6) of the Treaty for the Functioning of the European Union (TFEU) transferred responsibility for the micro-prudential supervision of significant credit institutions from the national competent authorities to the ECB/Single Supervisory Mechanism (SSM) via the Single Supervisory Mechanism Regulation, adopted in 2013 and entered into force in November 2014.

The broadening of the role of central banks as 'crisis managers' continued during the COVID-19 pandemic. The challenge for central banks is to move from the extraordinary, from crisis mode - to the ordinary – to stability mode. The BIS Annual Report 2022 questioned the consistency between fiscal and monetary policy and proposed a 'region of stability', that it defined as 'the region that maps the constellation of the two policies that foster sustainable macroeconomic and financial stability, keeping the inevitable tensions between the policies manageable'.

The tension between objectives is also present as central banks confront other challenges in particular climate change and sustainability, as well as digitalization with the advent of CBDCs and the potential for disintermediation. Reconciling the primary objective or objectives with supporting the Government's economic policies is not an easy task. A German legal expert in 1989, Klaus Stern, referred to the independence of the Bundesbank in the conduct of a price stability oriented monetary policy while supporting the Government's economic policy as the 'squaring of the circle'.

With regard to climate change, in an article entitled *Sustainable Central Banking*, Christina Skinner and myself have questioned what should be the best distribution of tasks between political authorities and independent central banks with narrower mandates and more limited tools, concluding that it depends on the central bank function and that the answers vary depending on the central bank mandates. While the US Federal Reserve System has been rather skeptical so far, with Fed Chair Jay Powell stating that it is not its role to be a climate fighter, the European Central Bank has embraced the green agenda. The Bank of England follows the Government's economic policy agenda in this regard, according to the remit letters; however, the enthusiasm for the green agenda has lost a bit of its sparkle following the return of inflation in 2021. A broader central banking mandate brings the institution closer to the political agenda, as Otmar Issing told the Economic Affairs Committee of the House of Lords in 2021.

ACCOUNTABILITY

Independence gives officials a degree of discretion (freedom to act) in the pursuit of the delegated mandate, subject to a framework of rules and to accountability. In 1942, in the context of the proposals that led to the establishment of the IMF, Keynes famously noted that the perhaps the most difficult question is how much to decide by rule and how much to leave to discretion. This is an issue that is ever present in monetary policy, supervision and in administrative law.

The intellectual building of central bank independence was constructed around the conduct of a price-stability oriented monetary policy (monetary independence). But if independence is predicated of other central bank functions (such as supervision) we need to reassess its foundations.

Monetary independence is not the same as supervisory independence, nor is monetary accountability the same as supervisory accountability, given the closer links with the political authorities that central banks have in the management of banking crises.

When answering the question of independence from whom, monetary independence is conceived as independence from political instruction. But independence from the banking and financial institutions to avoid regulatory capture is also relevant in particular in the case of central banks entrusted with supervisory responsibilities.

In democratic regimes, the law must ensure that the powers of the central bank are clearly delineated and carried out in a manner that is consistent with the existing checks and balances, to avoid an undesirable undemocratic state within the state. That is why accountability is always of the essence.

Back in 1992 I developed the model of accountable independence, likening the procedural and substantive guarantees that frame the structure and powers of central banks to the chains that the Lilliputians placed to restrain Gulliver. The first edition of Hobbes' Leviathan in 1651 portrayed in the front page an absolute sovereign overlooking his kingdom, a powerful image of the power of the State. In a democracy this power must be restrained and constrained. Independence without accountability would be like freedom without responsibility. When I lived in New York a dear friend remarked that the Statue of Liberty should have been accompanied by another statute of Responsibility in Ellis Island. With power comes responsibility; with extended powers there should be commensurate measures of accountability.

If the central bank oversteps its mandate, or if it is perceived to do so, credibility is damaged and legitimacy can be endangered, thus undermining the trust in the commitment of the central bank to keep inflation under control. If this trust is eroded, it will only be a question of time until the degree of independence gets questioned. After all, independence is not a goal in itself but an instrument in the pursuit of a goal (or set of goals).

In particular, when central banks fall short of achieving their primary mandate (like their failure to identify the return of more persistent rather than transitory inflation since 2021), they need to explain and justify in front of Parliament why and how they failed. Was it the result of groupthink? Was it a failure of the models? Was it because of ignorance of money supply considerations? Or what other elements influenced their decisions?

The optimal balancing act between independence and accountability varies from country to country, depending upon the political structure of government, the existing system of checks and balances, the level of development of the financial system and the respect for the rule of law. Central banking in ordinary times is not the same as central banking in extraordinary times. And history is full of exceptional circumstances.

Lord Bridges, the Chair of the Economic Affairs Committee of the House of Lords stated in the parliamentary debate on May 2nd that operational independence should mean just that: politicians stay out of Bank's day to day decisions. But it does not mean that Parliament should not hold the bank to account. Accountability *per se* does not politicize a central bank. With the 'mission creep', the growth in the central banks' balance sheets during QE and the distributional impact of monetary policy decisions, the only way to address a potential democratic deficit is via accountability.

The future of accountability requires a combination of the old and the new. The mechanisms of accountability should always be commensurate with the nature and extent of the delegated powers. We need enhanced parliamentary accountability, via in depth thematic parliamentary reviews, hearings and appearances of the Governor or President and central bank officials, reports, audit control and transparency. We need to ensure there is adequate scrutiny, asking the difficult questions, with a diversity of views and backgrounds represented in the central bank boards. And we also need 'new paradigms' of accountability—such as consultations with consumers, industry groups or the public in general, reviews by Independent Evaluation Offices, and others.

Finally, we also need better communication to enhance transparency and democratic legitimacy. Central banks need to manage the expectations of financial markets and households and explain the reasoning leading to their decisions. Such reasoning and proportionality assessment become crucial in jurisdictions where central bank monetary policy decisions are justiciable, as is the case with the ECB (FOMC decisions by the way are not justiciable).

Janet Yellen recalls that *"Montagu Norman, governor of the Bank of England in the early 20th century, reputedly lived by the motto never explain, never excuse, and that approach was still firmly in place at the Federal Reserve when I went to work there as a staff economist in 1977."*[2] A lot has changed since then. Clear and effective communication is part and parcel of the job of today's central bankers. 'Security through stability' (the opening words you find in the OeNB website) offer a clear message of what central banking is all about.

Many thanks again Governor Holzman for inviting me.

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[2] Janet Yellen , *"Communication in Monetary Policy"* speech at the Society of American Business Editors and Writers 50th Anniversary Conference, Washington, D.C, 4 April 2023.

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