Raghuram Rajan: Central banks are the fall guys

For decades, the freedom of monetary policymakers to make difficult decisions without having to worry about political blowback has proven indispensable to macroeconomic stability. But now, central bankers must ease monetary policies in response to populist mistakes for which they themselves will be blamed, **writes Raghuram G. Rajan**

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The theory and reality of central bank independence

Central-bank independence is back in the news. In the United States, President Donald Trump has been berating the Federal Reserve for keeping interest rates too high, and has reportedly explored the possibility of forcing out Fed Chair Jerome Powell. In Turkey, President Recep Tayyip Erdoğan has fired the central-bank governor. The new governor is now pursuing sharp rate cuts. And these are hardly the only examples of populist governments setting their sights on central banks in recent months.

In theory, central-bank independence means that monetary policymakers have the freedom to make unpopular but necessary decisions, particularly when it comes to combating inflation and financial excesses, because they do not have to stand for election. When faced with such decisions, elected officials will always be tempted to adopt a softer response, regardless of the longer-term costs. To avoid this, they have handed over the task of intervening directly in monetary and financial matters to central bankers, who have the discretion to meet goals set by the political establishment however they choose.

Central-bank independence became a mantra for policymakers in the 1990s

This arrangement gives investors more confidence in a country's monetary and financial stability, and they will reward it (and its political establishment) by accepting lower interest rates for its debt. In theory, the country thus will live happily ever after, with low inflation and financial-sector stability.

Having proved effective in many countries starting in the 1980s, central-bank independence became a mantra for policymakers in the 1990s. Central bankers were held in high esteem, and their utterances, though often elliptical or even incomprehensible, were treated with deep reverence. Fearing a recurrence of the high inflation of the early 1980s, politicians gave monetary policymakers wide leeway, and scarcely ever talked about their actions publicly.

The three developments

But now, three developments seem to have shattered this entente in developed countries. The first development was the 2008 global financial crisis, which suggested that central banks had been asleep at the wheel. Although central bankers managed to create an even more powerful aura around themselves by marshaling a forceful response to the crisis, politicians have since come to resent sharing the stage with these unelected saviors.

Second, since the crisis, central banks have repeatedly fallen short of their inflation targets. While this may suggest that they could have done more to boost growth, in reality they don't have the means to pursue much additional monetary easing, even using unconventional tools. Any hint of further easing seems to encourage financial risk-taking more than real investment. Central bankers have thus become hostages of the aura they helped to conjure. When the public believes that monetary policymakers have superpowers, politicians will ask why those powers aren't being used to fulfill their mandates.

It is no surprise that populist leaders would be among the most incensed at central banks

Third, in recent years many central banks changed their communication approach, shifting from Delphic utterances to a policy of full transparency. But since the crisis, many of their public forecasts of growth and inflation have missed the mark. That these might have been the best estimates at the time convinces no one. That they were wrong is all that matters. This has left them triply damned in the eyes of politicians: they failed to prevent the financial crisis and paid no price; they are failing now to meet their mandate; and they seem to know no more than the rest of us about the economy.

It is no surprise that populist leaders would be among the most incensed at central banks. Populists believe they have a mandate from "the people" to wrest control of institutions from the "elites," and there is nothing more elite than pointy-headed PhD economists speaking in jargon and meeting periodically behind closed doors in places like Basel, Switzerland. For a populist leader who fears that a recession might derail his agenda and tarnish his own image of infallibility, the central bank is the perfect scapegoat.

The importance of transparency

Markets seem curiously benign in the face of these attacks. In the past, they would have reacted by pushing up interest rates. But investors seem to have concluded that the deflationary consequences of the policy uncertainty created by the unorthodox and unpredictable actions of populist administrations far outweigh any damage done to central bank independence. So they want central banks to respond as the populist leader desires, not to support their "awesome" policies, but to offset their adverse consequences.

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A central bank's mandate requires it to ease monetary policy when growth is flagging, even when the government's own policies are the problem. Though the central bank is still autonomous, it effectively becomes a dependent follower. In such cases, it may even encourage the government to undertake riskier policies on the assumption that the central bank will bail out the economy as needed. Worse, populist leaders may mistakenly believe the central bank can do more to rescue the economy from their policy mistakes than it actually can deliver. Such misunderstandings could be deeply problematic for the economy.

Furthermore, central bankers are not immune to public attack. They know that an adverse image hurts central bank credibility as well as its ability to recruit and act in the future. Knowing that they are being set up to take the fall in case the economy falters, it would be only human for central bankers to buy extra insurance against that eventuality. In the past, the cost would have been higher inflation over the medium term; today, it is more likely that the cost will be more future financial instability. This possibility, of course, will tend to depress market interest rates further rather than elevating them.

What can central bankers do? Above all, they need to explain their role to the public and why it is about more than simply moving interest rates up or down on a whim. Powell has been transparent in his press conferences and speeches, as well as honest about central bankers' own uncertainties regarding the economy. Shattering the mystique surrounding central banking could open it to attack in the short run, but will pay off in the long run. The sooner the public understands that central bankers are ordinary people doing a difficult job with limited tools under trying circumstances, the less it will expect monetary policy magically to correct elected politicians' errors. Under current conditions, that may be the best form of independence central bankers can hope for.

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