

## SAFE Finance Blog

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### Central banks – independent or almighty?

Otmar Issing: Today, numerous central banks worldwide enjoy their independence. Historically, this was by no means standard. There are important reasons for this



**F**irst, it is questionable whether in a democracy such an important task as setting the central interest rate for the economy should be placed in the hands of “technocrats”, who are unelected and unaccountable to parliament.

Second, for a long time, most economists were against the independence of the central bank. Some of them wanted to see fiscal policy and monetary policy combined in the hands of the government in the interest of efficient macroeconomic global management. The others, mainly liberal economists, did not want monetary policy decisions to be subject to the will of individuals.

The decisive turning point came with the experience of the Great Inflation of the 1970s in the United States.

Numerous empirical studies following this period provided convincing evidence for many countries: there is a clear inverse relationship between the degree of central bank independence and the level of inflation. As a result of this finding, many countries granted their central bank independent status. Around 1990, this development reached its peak.

#### The Bundesbank’s independence as role model for the ECB

Around the same time, discussions began on the statute of the future European central bank. In addition to the empirical findings mentioned above, the example, or role model, of the independent Deutsche Bundesbank and the globally admired stability of its currency played a decisive role. Although all other national central banks were not independent at the time, it was agreed after quite difficult negotiations to grant the future European central bank the status of independence.

The period that followed was characterized by low inflation and stable growth worldwide. This positive development was generally attributed to the successful monetary policy of now independent central banks. Their reputation was further enhanced by their role in combating the consequences of the global financial crisis of 2007/8. With their decisive monetary policy, they played a major role in ensuring that a severe recession did not turn into a depression on the scale of the 1930s.

Not least because of these achievements, many countries transferred further competencies in the field of microprudential and macroprudential policy to their central banks. More and more, central banks themselves also pushed to expand their mandate beyond their genuine responsibility for monetary stability. Two policy areas are worth mentioning here. The first is the granting of loans at special conditions to certain sectors and the general pursuit of distribution policy objectives. In recent years, central banks have also increasingly committed themselves to contribute to the fight against climate change.

#### Central banks are overburdened

The European Central Bank has also assumed responsibility for the cohesion of the European Monetary Union at the latest with the “whatever it takes” of its president in 2012.

Central banks are overburdened in two respects. First, because of exaggerated expectations, which lead to disappointment and thus loss of confidence. Second, by extending their mandate, they have entered terrain that is the responsibility of governments, which must be accountable to their parliaments and ultimately to the electorate. Thus, the independence of central banks inevitably comes under criticism.

In a democracy, central bank independence can only be justified on the basis of a clear and narrow mandate.

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