3 KEY CHALLENGES TO CENTRAL BANKS – AND HOW THEY ARE RESHAPING THE GLOBAL ECONOMY

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The governance of central banks is being challenged.

They have lost the clarity of their mandate, they are structurally losing their independence, and they are expected to fulfil social and quasi-political responsibilities without corresponding legitimacy and power.

These three key challenges to central bank governance may well trigger a monetary or currency regime shift that could transform economies and markets in the generation to come. All central banks, from the Federal Reserve and European Central Bank to the Bank of England, from Africa and Asia to Latin America and Oceania, face this triple challenge. We explore this evolution (erosion?) of governance quality in central banks.

Let's explore this evolution – or perhaps more accurately, this erosion – of the quality of governance in central banks in more detail.

Ambiguity of mandates

The aim of central banks used to be clear: to keep prices stable in order to hit a target of, for example, 2% inflation. Then this mandate began to change, and evolved towards dual mandates, like economic growth and job creation, often without precise targets.

So is the mandate stability or fostering a dynamic economy? Stability in a world where disruption has become a positive value has taken on an unexpected hue: it has become the stability of the graveyard.

The former governor of the Central Bank of Brazil talks about smoothing the cycle, hoping to reconcile dynamism and stability. But this became even more unclear during the financial crisis when the actions of central banks appeared to favour elites, such as bankers and shareholders and led to a rise in inequality.

There is a rising suspicion that mandates can no longer be purely technical, as the side-effects are all-encompassing. Social wellbeing, sustainability and environmental action and even industrial policies are indirectly influenced by central bank policies and the unelected officials who lead them.

Central banks are creating winners and losers in the socio-economic world, and this is making their mandates increasingly complex and ambiguous.

Erosion of independence

The independence of central banks used to be sacrosanct. It guaranteed a technocrat perspective with full responsibility and accountability around a well-defined, technical and non-political objective.

The rise of authoritarianism and the questioning of liberal democracies applied huge amounts of pressure on central bankers, with the politizisation of appointments and even removal from office a possibility.

Some of this politicization is justified due to the lack of clarity in central bank mandates, as discussed above. Indeed, the philosophy of markets and economics has moved away from the Chicago spirit of pure markets.

Some individual central bankers also seem to aspire to the political role and the grandstanding that comes with it. These forces fundamentally transform what good governance should be, by necessarily shifting power internally to boards rather than the individual. It also enhances system governance through new bodies such as financial stability committees, or gives more power to other institutional forces, such as the courts. An immediate consequence is also the loss of power of the typical central bank, ironically at the very time they are considered the most powerful economic actors in each country.

Rise of social and political responsibilities

The actions of central banks can no longer be considered socially or even politically neutral. Keeping interest rates low for a long time has given some central banks comfort, but it has also deeply affected the sustainability of the pension funds belonging to a large number of people, while favouring those seeking yield-seeking private actors.

Emergency actions cannot be seen as neutral either, hence the sudden social responsibility of lenders of last resort. Social trust in central banks, and in central bankers, has thus been affected and expectations are for them to act responsibly in terms of maintaining the financial health of the population, consumer protections, climate change mitigation and to prevent social inequalities.

This expectation of social responsibility has emerged at a time when central banks are losing their economic clout. The Phillips Curve has flattened, the massive balance sheets of central banks are not used strategically, and low interest rates have revealed the asymmetry of their power with the limitation of the Zero Bound (and the risk of cash herding and inefficiency with negative rates).

Despite these challenges, central banks can play an important role in our social and economic future, notably in terms of our economic wellbeing and the sustainability of our ecosystems. The best-in-class will act decisively, often in unfamiliar territory. The art of quality decision making is central to good governance. Hence the need for central bankers to address these governance challenges and to engage in a sincere and accountable conversation with the population – and their role in our future.