Special Feature C

The Roles of Central Banks — Evolution, or Demand and Supply?

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This Special Feature reviews some of the key forces driving central banks' changing roles over the past half-century. In the 1980s, a powerful consensus emerged across the global economy for making central banks independent in pursuit of price stability. Policy institutions adjusted and over the ensuing decades, billions of people around the world saw dramatic improvement in well-being from changes in the level and stability of their inflation experience. However, in the new millennium, a series of large disturbances—among them the 2008 Global Financial Crisis, populism-driven discord alongside a rise in inequality within many economies, increasingly fractured globalisation, the global climate crisis, technological disruption in finance and the coronavirus pandemic—rightly or wrong, resurfaced division in views on what monetary policy institutions should do. How immutable is the consensus of central bank autonomy? Is that consensus a plateau of evolution in logic, so that it is sustainable, or is it the result of demand and supply that can continue to shift, so that adjustment is not just possible but appropriate?

1 Introduction

This Special Feature analyses the changing roles of central banks in light of their successes and challenges, ongoing research, and continuing disruption in the global economy. The article extrapolates and conjoins trends in monetary policy practice and research as well as other selected academic disciplines to inform on possible future challenges in central banking. The opportunity for this longer-horizon discussion arose from the Monetary Authority of Singapore (MAS) Golden Jubilee Conference (GJC) in November 2021, that brought together academics and central bank practitioners from around the world.

Independence to pursue the goal of price stability has, over the past quarter of a century, provided central bank practice and research with both a clear yardstick for success and a sharply focused organising principle. Inflation targeting is the operational representation. But the empirical reality is that, even while hewing to the independence/price-stability structure (or I/PS for short), central banks do more than just one thing, and central bankers speak to more than just one policy goal. Without an augmented framework that keeps its best features while incorporating necessary adjustments and augmentations, the I/PS structure might eventually lose relevance and credibility. Requiring central banks to consider larger questions might indeed invite "politicians to break central bank independence and take back decision-making" (Tabellini, 2008). Conversely, however, insisting on maintaining too narrow a focus might also not be sustainable: the public, not politicians, might seek recalibration of the institutional organisation of all large hegemonic agents such as central banks, should polities come to view central banks as inappropriately keeping too narrow a mandate. If that

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recalibration were to proceed badly, even the narrow mandate of monetary stability might no longer be attainable.

2 Provenance

Whatever else might be argued over what they do or not do, it is widely agreed that central banks conduct monetary policy for price stability. And in this, through the simple act of setting interest rates—or corresponding prices—central banks have, in recent times, become “the most powerful financial actors on the planet” (The Economist, 2017). Power does not always deliver success and approbation but, in this case, it did, resoundingly. In 2019, the continued rise of central banks over the previous half-century was celebrated widely:

“Critics of economics like to say that its abstract theories lack real world pay-offs. There is a glaring counter-example: the global rise of central-bank independence in the past 25 years. In the 1970s it was normal for politicians to manipulate interest rates to boost their own popularity. That led to a plague of inflation. And so rich countries and many poorer ones shifted to a system in which politicians set a broad goal—steady prices—and left independent central bankers to realise it. In a single generation billions of people around the world have grown used to low and stable inflation and to the idea that the interest rates on their bank deposits and mortgages are under control.”

-The Economist, 2019

In the background is the important understanding that this new method of operation does not undermine real economic growth. This implies that economies could enjoy both low inflation and economic growth, over the medium term. The key phrase, however, is “independent central bankers”: successful monetary policy flows out of a central bank’s autonomy from political pressures.

The events of May 1997 proved formative in this narrative. That was when the UK’s incoming Labour government tasked the Bank of England with stabilising prices and gave the Bank independence in setting the interest rate to accomplish the Bank’s assignment of price stability.

What happened in the UK in 1997 was part of a global trend that would see, over a short space of time, other national monetary authorities made independent and tasked to pursue price stability. I/PS grew to be the new orthodoxy. Academic and practitioner research refined central bank expertise on the technical questions of monetary control emerging from that new policy agenda. Central banks, assuming new responsibilities, developed communications programs to explain directly to the general public what they were doing.

With great success, however, comes great scrutiny. The Economist’s 2019 celebration of central bank achievement attached the following warning: “Today this success is threatened by a confluence of populism, nationalism, and economic forces that are making monetary policy political again.” What are those forces that seek to undermine such improvement in the well-being of the world’s population?

An informal poll I conducted at the MAS GJC suggests, completely unsurprisingly, that the great majority of academics and central bankers supports the I/PS architecture. If the alternative to central bank independence is—as suggested in the quote above from The

Economist (2019)—politicians manipulating "interest rates to boost their own popularity" leading to "a plague of inflation" then, certainly, everyone should mount stiff resistance to I/PS revisionism. No one favours returning to the nightmare scenario of runaway global inflation.

At the same time, however, the surest way to guarantee the right outcome must be to argue against the opposition's best case, not its worst. With a standard model comprising only these two hypothesised decision-makers—one, monetary authorities seeking to advance the social good; and the other, self-serving, manipulative politicians—the choice is obvious. A more nuanced model hypothesising greater symmetry and balance across important, responsible actors might be useful, not least in parts of the world where political leadership is accountable and responsive to its polity. Calibrating parameters so that the model configuration is less binary can open up space for better informed discussion of alternative, more-textured goals and policies.

Importantly, a more balanced model allows into the discussion a third actor, not made explicit in the discussion so far. Think of political leadership and monetary authorities as being alternative, rival providers of monetary policy. If these two are competing on the supply side, who sits on the demand side? Who is the consumer of monetary policy? How much influence should the demand side have on monetary policy outcomes? An economic marketplace model—where demand and supply both operate—would say that producers and consumers jointly influence outcomes, with neither side decisive. A model that only makes explicit the contention between two alternative producers can shed light on just the supply side, and its focus can only be how one player on the supply side seeks dominance over the other. The question of what any policymaker should do (as opposed to what they are doing) is best answered by someone other than either the policymaker themselves or their intellectual opposition. This is not an argument for populism; rather, it is just demand and supply.

Such a view was, in fact, already in the original Royal Charter of the Bank of England in 1694, describing the Bank as founded to "promote the public good and benefit of our people". This focus on providing services demanded by the public remains in the Bank of England's present-day mission statement, "promoting the good of the people of the United Kingdom by maintaining monetary and financial stability".

In keeping with this, Section 4 presents the argument against a strict I/PS framework from the perspective of someone seeking to solve large problems in society and using the best technical tools possible to maximise social well-being.

Before that, however, Section 3 describes the confluence of developments that have driven so strongly unanimity of views on central bank independence. Those developments are both academic and practical. They combine evidence-based, historical, and analytical reasoning. Their combined impact is compelling: An observer might wonder why it has taken over 300 years to arrive at the position favouring central bank independence, and indeed why today there might be dissent at all.

Finally, Section 5 concludes the Feature with a brief restatement of the key arguments for and against the strict I/PS structure.

3 Central Bank Independence

What were the immediate drivers for I/PS and what have been its successes? The case for central bank independence had been building since the 1970s. The rational expectations revolution in macroeconomics (Lucas, 1973; Sargent and Wallace, 1974; Kydland and Prescott, 1977) together with accumulating theoretical and empirical evidence on central bank performance (Rogoff, 1985; Alesina and Summers, 1991) led many observers to conclude that central bank independence would lead to more stable prices without jeopardising economic performance.

By the early part of the new millennium, the data on inflation told a remarkable story (International Monetary Fund, 2003). Between the mid-1990s and 2003, global inflation fell from 30% a year to 4%. In advanced countries, annual rates of inflation declined from an average of 9% in 1980–1984 to 2% in 2000–2003. The fall was even sharper elsewhere in the world. Between 1990 and 1994 the average rate of inflation was 230% in Latin America, 360% in transition economies, and 40% in Africa; by 2003 average inflation in all three regions had plunged to single digits. In 2003 the highest inflation rate for any significant economic bloc was 13% for developing countries in the Middle East, but even that was a reduction from 30% in 1990–1994. In developing Asia—where inflation was only a comparatively staid 10% between 1990 and 1994—average inflation had decreased to 2% in 2003. Singapore's inflation experience aligned with this global trend, with inflation declining from an annual average of 6% in the 1970s, down to 3% and then 2% in successive decades after, and further to under 1% between 2000 and 2003.

Multiple causes undoubtedly factored into this dramatic decline in global inflation: the information technology revolution; globalisation and other forms of heightened product and labour market competition; better fiscal policy. However, many observers will likely agree with the judgement given in Rogoff (2003) on inflation's key driver:

"Without question, a large part of this breathtaking drop in inflation has to be attributed to improved central bank institutions and practice: enhanced central bank independence, a greater prevalence of more conservative anti-inflation oriented central bankers, better communications strategies, and improved monetary control capabilities."

These changes came alongside two significant developments in academic and practitioner research. First, improved clarity on the technical relationships between instruments and goals: monetary aggregates and interest rates; price stability, expectations, and inflation targeting. The key outcome from this work was to put in sharp relief the single target of price stability against the background of the single instrument, the short-term interest rate. The operational mechanics of inflation targeting connected a single instrument to a single target.

The second significant development was greater insight into the political economy of institution design, leading to heightened emphasis on central bank independence. Critical in this second set of writings is the idea that central bank independence means autonomy from political pressures. It is not just the Economist newspaper but academics too who find it natural that the central tension is between technical economic capability and political interference.

Walsh (2008) defined central bank independence to be "freedom of monetary policymakers from direct political or governmental influence in the conduct of policy". In perhaps the earliest call for central bank independence, Friedman (1962) sought "a monetary

structure that is both stable and free from irresponsible government tinkering". While Debelle and Fischer (1994) drew a valuable formal distinction between "goal independence" and "instrument independence"—the former being potentially set by government, with some permanence or fixity, with the second left to the central bank to determine, Grilli, Masciandaro, and Tabellini (1991) referred to these instead as "political independence" and "economic independence" respectively.

Session I of the MAS GJC considered how both targets and instruments continued to evolve for central banks, leading to the possibility of broader mandates. For small open economies, there was agreement among the speakers that the relation between exchange rates and inflation needed to be explicitly brought into monetary policymaking. However, the overall direction of discussion confirmed that veering too far from the I/PS framework would potentially open up the possibility of political interference.

Central banks, appropriately, worry about the risks they take on should they expand excessively their portfolio of roles and responsibilities. Overreach will mean central banks might be unable to complete whatever they are assigned to do, thereby diminishing their credibility, reputation and authority. Facing a complex combination of tasks will mean they might be confronted with not complementary but irreconcilable assignments, thereby guaranteeing failure. The greater range of tasks might mean central bankers have insufficient skill and bandwidth to get their job done. The technical expertise that central banks have accumulated on interest rates and price stability does not mean they will be similarly well-equipped to deal with yet other policy challenges. Central banks should not take on tasks for which fiscal authorities are in a better position to deliver. This is particularly important for policies for which societal buy-in through the political system is required, such as redistribution and taxation of externalities. After all, by being asked to take on tasks that are historically the domain of politically determined governments, central banks would be opening themselves up to political scrutiny.

This conclusion was stated ever more forcefully in the final session of the MAS GJC, where concerns were expressed over the distraction of central banks away from their core mandate. The key concern is that whatever large challenges arise—whether inequality, COVID-19, or global climate change—central banks always need to ask if a monetary policy response is needed. At the same time, the question was raised as to whether gaps in central banks' traditional mandates might have appeared because implicit assumptions about the environment in which they operated no longer held. Structural changes in the economy, which may lead to the absence of a well-defined steady state in the economy amid recurring crises, may call for substantial changes to the use of monetary policy, potentially involving large operations even during peacetime. Such an evolving economic landscape should factor into whether the I/PS framework might actually need adjustment.

4 New Accountability: Demand and Supply

When narrow populism or self-serving political gain drive those who would do central banks harm, it is easy to agree that the right thing to do is to preserve central bank independence. Obviously, little confidence can be placed in any system where political leadership overrules the nation's central bank to overexpand credit creation. Revisionist arguments against I/PS have a long history and can dangerously undermine improved monetary policymaking.

However, without relaxing the hypothesis that proposals for change come only from those seeking self-gain to the detriment of social well-being, it is simply not possible to take forward any measured discussion of potential changes in the roles of central banks.

In his contribution to the MAS GJC, Wolf (2022) pointed out that the need for large-scale coordinated global policy has only grown more urgent. Wolf's lecture pointed explicitly to prosperity, peace, and protection from pandemic and environmental crises as central challenges. Embedded in his article, however, are references to other global problems including international financial and economic contagion, erosion of social cohesion, and political and economic shifts away from openness.

Wolf's discussion turned to what economists recognise as positive externalities in the provision of global public goods. Everyone agrees these goods should be made available, but when left to individual calculation, such goods are always under-provided. Historically, multilateral cooperation and a collaborative world economy induced by globalisation have helped raise supply. Unfortunately, the current situation of a troubled global economy and disrupted geopolitical order will worsen excess demand, as supply falls even further and needs become more pressing.

Rational expectations analysis carried the important message "If rules change, people's behaviour do as well." In political-economy analysis of central banking (and other institutions of governance) the counterpart might be "If the environment changes sufficiently, and people's needs do as well, so too should rules."

The question is how the boundaries of central banking should adapt, not to self-serving political interference, but to legitimate shifts in society's demand for policy.

Certainly, central banks should not take on jobs that markets can do better. But historical experience is that those boundaries do shift, and not always in ways that damage society. Fischer (2021) pointed out that many advanced economy central banks seek to ensure "price stability, sustainable growth, and maximum employment". The I/PS framework is contained in that rendering of the overarching mission, but does not exhaust it.

In his Welcome Remarks at the MAS GJC, MAS Managing Director Ravi Menon described MAS' 1971 beginnings as not even including the right to issue currency, but to only operate as part of a currency board. Yet, a scant five decades later, MAS is a "full-fledged central bank, conducting monetary policy, issuing currency, overseeing the payment system, and managing the official foreign reserves". This is on top of functioning as "an integrated financial supervisor: a prudential regulator of the banking and insurance industries, and a securities commissioner responsible for the capital markets", while being "responsible for the growth and development of Singapore's financial sector: promoting jobs and skills, innovation and technology, and sustainability". If the I/PS perspective on a narrow mandate is widespread, MAS' broad remit is a striking counterexample that nonetheless retains credibility and effectiveness.

Obviously, MAS' circumstances differ from those of many large, advanced economies. But that might be the point: the roles of central banks need to vary depending on context. There is no universal model. Ravi Menon described MAS as applying "a judicious blend of orthodoxy and unconventionality". If there is no universal model across space, neither need there be one across time.

Session IV of the MAS GJC provided an ASEAN central banks' perspective on the place of eclecticism for addressing macro-financial risks. Inflation targeting is a core pillar of policy but is augmented by a wider menu of policy instruments and targets.

The situations in smaller, open developing economies fill out more of the space on possible economic challenges and institutional responses. Such national experiences can help illustrate the trade-offs even in more advanced, industrialised nations, especially if they have begun to see greater challenges from non-traditional fronts. Also, ASEAN central banks may face problems that are correspondingly large relative to their economies' capabilities, so they need to finetune how policymaking is undertaken. Capital flows are large and abrupt; financial markets shallow; risk premia high and variable. These have driven ASEAN central banks to be pragmatic and flexible in their approaches. As elsewhere, inflation targeting is the core of their monetary policy framework, but in seeking financial and external balance stability, ASEAN central banks augment that inflation-targeting core with macroprudential policy, foreign exchange intervention, and capital flows management.

Is the ASEAN approach of pragmatism and broader mandate unusual in the world? How successful does it continue to be? Zhou Xiaochuan, former governor of the People's Bank of China, reflected on the situation of such central banks in his IMF Michel Camdessus Central Banking Lecture (Zhou, 2016). Zhou noted that in China, as in many other economies around the world, much remained incomplete in its monetary and financial dimensions. A large credible institution like the PBOC could therefore be an important authoritative agent to aid that development. The PBOC, like other proficient central banks, could help build human capital and provide an example for how to improve policy management and governance, beyond just maintaining price stability. So, Zhou concluded, while "the single objective of maintaining price stability is an enviable arrangement ... it is not yet realistic for China".

What the PBOC has done is that it has weighed the costs and benefits of different approaches to central bank conduct—among them I/PS inflation-targeting—and settled on what it considers a multi-objective policy framework that works for China. This obviously resonates with what ASEAN's central banks are doing for reasons of pragmatism.

There is a reason beyond just this, however, to unpack more carefully the policy frameworks of successful, effective central banks that sit outside the advanced, industrialised economies. These central banks' considerations of costs and benefits of alternative approaches might provide a useful model for central banks more generally—even those in the advanced economies—when new significant, global challenges come their way. To develop this point, I turn now to the recent experience of central banks in the US and Europe.

The Transatlantic economies have provided for the rest of the world valuable lessons on the success of independent central banking under the I/PS framework. But the Federal Reserve (henceforth Fed), the Bank of England, and the ECB too have in more recent years faced exigent circumstances that tested their commitment to the narrow mandate advocated under I/PS.

In both the 2008 Global Financial Crisis and the COVID-19 pandemic, fiscal policy took on most of the burden of countercyclical support in the Transatlantic economies. Nonetheless, these economic crises saw expanded use of monetary policy instruments beyond just interest-rate setting. The unconventional elements of monetary policy that were added include direct liquidity and credit programs, quantitative easing (QE) with significant expansion of central bank balance sheets, and forward guidance. In the public eye, QE was

the most obvious of these. Over the course of the 2008 GFC and the COVID-19 pandemic, QE resulted in the Fed's balance sheet growing to 33% of annual US GDP by the beginning of 2021; the Bank of England's, 43% of annual UK GDP; the ECB's, 60% of annual Eurozone GDP. Fischer (2021) describes extensive use of such non-I/PS monetary policy, including direct lending to non-financial sectors of the economy.

Obviously, conditions were extreme. In both the 2008 Global Financial Crisis and the COVID-19 pandemic, real output plunged precipitously, unemployment rose sharply, and short-term interest rates quickly reached the zero lower bound if they were not already there. It was not at all inappropriate for the world's most powerful central banks to go beyond an I/PS model of operations, both in goals and instruments during these periods. Under exigent circumstances, deliberate and successful central banks are not averse to expanding their toolkit of instruments and considering urgent goals beyond price stability. In support of this view, Fischer (2021) argues that these "unprecedented actions of central banks to stabilize markets and offer generous support to their economies played a crucial role in halting the downward spiral of markets, lessening the pandemic-driven losses of businesses, and jump-starting the economic recovery." If, as conjectured, the Global Financial Crisis and global pandemic are only a harbinger to more frequent crises to come, then there is all the more reason to clarify the circumstances under which different parts of the space of central bank policy will be activated, rather than maintain an orthodoxy that contemplates only a narrow I/PS mandate. At some point, the exceptions could end up more numerous than the cases of normal operations.

An argument often made is that circumstances of the 2008 Global Financial Crisis and the COVID-19 pandemic drew central bank response the way they did because inflation would, otherwise, have undershot, and so all this continues to be in keeping with the narrow goal of price stability. However, as Carney (2019) and others have argued, so too large economic challenges such as the global climate crisis and the erosion of social cohesion.

5 Conclusion

This Feature has considered the role of central banks over a period of history when the I/PS perspective developed and proved both its power and success. However, the view that I/PS must remain the orthodoxy, with an associated narrow mandate for central banks, might need recalibration as economic and financial challenges continue to evolve.

It is in line with historical norms that the role of central banks evolves. The macroeconomic and monetary environment in the decades running up to the early 2000s might well have suggested the notion that the I/PS structure could be a steady-state evolutionary-optimal plateau in the space of possible institutional organisations. However, global circumstances since then have called for exception after exception to I/PS practice narrowly defined. For many observers, in a great number of these exceptional cases, deviation from the narrow mandate was not wrong. However, continuing to maintain that central banks keep to only I/PS orthodoxy might undermine credibility when observers realise the rules can indeed be changed, but no explicit framework is provided for when they do.

As in the Debelle-Fischer distinction between goal independence and policy independence, suggesting that central banks might want to broaden their mandate is not to suggest that central banks should start deciding on goals for, say, social cohesion and climate change. Instead, as with price stability and inflation targeting, it should be a government with broad political legitimacy that sets those goals, while central banks, using

monetary and financial instruments, help establish policy environments that would improve society's well-being. This seems to me to keep to the same logic as in the narrow I/PS orthodoxy, but allows space for reasoned flexibility and adaptation as great global challenges of the future continue to unfold.

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