Central banks' role, objectives and accountability

Svein I. Gjedrem
The author is former Governor of the Central Bank of Norway and currently has a part–time position at the Norwegian School of Economics and Business Administration

1 Introduction

Central banks' mandates have shifted through history, along with economic developments and new knowledge about how the economy works. Monetary and financial stability have nevertheless been at the core of the mandates in most cases. Changes of the mandates are often triggered by new challenges or crises facing the economic policy framework. Partly as a result of the latest financial crisis, the responsibilities of central banks have been much discussed also in recent years.

I am currently heading a Government Commission in Norway with a mandate to design a new law for Norges Bank.[1] The current Norwegian central bank law is from the period of financial repression and needs to be modernized. However, the most important reason for reviewing the law is the presumption that the board of the bank has a workload that is too heavy.

The board has the main responsibility for all activities in the bank, including the traditional central bank tasks and the management of the Government Pension Fund – the oil fund: The fund is now close to 900 billion US dollars in size or almost three times our mainland GDP. It is invested in bonds, equities and real estate worldwide.

Norges Bank's responsibilities are broad and its duties heavy, but I guess overloading boards, governors and senior staff members is also an issue in other central banks.

In his Adam Smith Lecture in 2006, former Bank of England Governor Sir Mervyn King laid out four criteria for a good institution.[2] The institution should have:

1. clear objectives
2. tools and competence to meet these objectives
3. accountability
4. a design that reflects history and experience

These were considered to be timeless characteristics.

2 The institutions should be designed to reflect history and experience

Let me start with the last criterion. The institutions should be designed to reflect history and experience. A country's constitution and legal system are part of its history. These differ between countries. Since the central bank must fit into the country's legal and political traditions, this also has consequences for the central bank laws.

The Scandinavian countries may give an illustration. These countries are all modern parliamentary democracies. To an outsider, I presume the countries look very much alike. But looking closer, you will find some striking differences which are relevant for the set-up and functioning of their central banks.

In Denmark and Norway, there is what we call ministerial rule. This means that a minister has a constitutional right to instruct in all matters within the portfolio of the ministry or one

1 The views expressed here are my own and not necessarily shared by the Commission.
2 See King (2006) and Haldane and Ovigstad (2016).

of its subordinate agencies, unless otherwise specifically provided for in law. This right to instruct is mirrored by a corresponding responsibility for the minister. She cannot free herself from her responsibility by delegating to subordinate agencies.[3]

According to the constitution in Sweden, on the other hand, individual cabinet ministers do not bear any individual ministerial responsibility for the performance of the agencies within their portfolio. The directors-general, and other heads of government agencies, report directly to the government as a whole; and ministers are prohibited from interfering in matters handled by the agencies, unless otherwise specifically provided for in law.

Sveriges Riksbank is also in a different position to its Scandinavian sister central banks by the fact that it is "owned by" the Parliament, the Swedish Riksdag. The bank is accountable directly to the Riksdag. In Denmark and Norway, the operating bodies of the central banks are appointed by their respective ministries or governments, and the banks get their remits from them as well.

An implication of these differences has been that the central bank's road to independence in monetary policy has been rockier in Norway than in Sweden.

The Scandinavian case illustrates a more general point: when it comes to writing a central bank law, one size does not fit all. And although there is much to be learned from others, there is probably not a single best international practice for the regulation of these institutions.

3 Clear objectives

The central bank objectives can and should be formulated in broad terms in the law, and then made more specific and operational through separate remits or secondary laws.

Over the years, central banks have been delegated the task of maintaining a well-functioning and stable *monetary* and *financial system*. Monetary policy also aims to stabilize production and employment.

There is usually a hierarchy between the objectives, specifying which objective should have the highest priority.

These objectives are, by themselves, rather imprecise. In a world of delegated responsibility, they need to be made operational and, ideally, measurable. Targets for monetary stability have evolved considerably. Operational targets for the stability of the financial system have been less easy to specify, at least in clear, quantitative terms.

Another question is whether price stability, financial stability and economic stability/growth are three separate objectives. They are integrated and rely on each other. The stable value of money and economic growth rely on a strong and stable financial sector. A broken financial system can undermine the transmission mechanisms for monetary and financial policy, as the crisis in 2008 illustrated too clearly. That is one reason why central banks' pursuit of financial stability is intimately linked to their pursuit of price stability and stability in the real economy. The three elements merge into each other.

Also under more normal circumstances, monetary and financial market authorities should take into account the risk a potential future financial instability may represent to price stability. The authorities must be aware of the potential debt and real estate bubbles developing partly as a result of the low interest rates we have today.

In my view a central bank setting interest rates cannot run away from its responsibility when a bubble bursts in real estate and debt markets and a financial crisis arises. Too much borrowing leading up to the crisis will be associated with too low interest rates. The finger will be pointed at the governor and the committees. Also for this reason, central banks should have and are well served by an explicit responsibility for financial stability written in law.

3 See Smith (2002, 2009).

4 Central banks should have tools and competence to meet these objectives

A central bank must have an appropriate set of policy tools to meet its objectives. The tools need to have an effective impact on the final objective. And the central bank needs to be competent in using them.

The effectiveness of the instruments has implications for how strictly we should formulate the central bank's obligation to meet its objectives, whether in the central bank law or in the remits. Should the central bank "ensure" stability and growth or should it "contribute to" meet these targets?

- On price stability, the tools are – under normal circumstances – quite effective. However, as I mentioned above, central banks do not operate in a vacuum and cannot by themselves ensure monetary stability. Our economies are repeatedly affected by unforeseen, unpredictable shocks and disturbances. In a time with interest rates at zero or below, monetary policy is not necessarily equipped to ensure price stability. Stability and confidence in public finances and a well-functioning financial system may also be a precondition for price stability.
- On the objective of financial stability, central banks are well positioned to be given and take responsibility for new macroprudential tools in addition to the traditional lender of last resort role. But these new tools are soft as is often the case also for microprudential policies. It is also a challenge in my view that the current international and European requirements for banks' capital are far from sufficient. Neither are the new resolution mechanisms necessarily helpful to stabilize a banking system under severe stress and to avoid creditors running away. These regulations are the responsibility of governments and parliaments. For a small open economy, we have the additional challenge that the stability of the financial system depends on the quality of rules, regulations and supervision in other countries, as we learned from the breakdown of Icelandic banks in the autumn of 2008. The quality of the supervision and regulation in Sweden and Denmark is of particular importance for financial stability in Norway since their banks have large market shares in Norway. The Swedish regulation of its banks' capital might be a concern in Norway. As compared with Norwegian banks, Swedish banks have a high risk-adjusted equity ratio but much lower leverage ratio. The differences can hardly be explained by the composition of assets or by the track record of actual losses. They probably reflect a generous acceptance by the Swedish financial authorities of individual banks' risk models.

  All this said, I believe that central banks should aim for financial stability. In addition to conducting its own available instruments, central banks should have a legal obligation to speak out when they judge that new measures should be introduced also by other authorities.
- Central banks have a particularly important role to preserve a stable and effective payment system. Stable and effective payment systems are crucial for financial stability. The development of new types of money beyond the control of central banks may change the central banks' future role in this area.

5 Accountability

Central Banks should be accountable. According to the textbook, central bank accountability is a necessary condition for sustaining its operational independence.[4]

Nevertheless, I believe there is a tradeoff between independence and accountability.

The central banks should be transparent so that their assessments and decisions can be monitored by the authorities and by society at large. Central banks also have to report and communicate to the political authorities and the public. Then they can be evaluated and also criticised for misjudgements or errors. Is this sufficient to be fully accountable?

A CEO in a company is clearly accountable to its board. The board can overrule decisions taken by the CEO, withdraw delegated authorities and at the end of the day the board can fire him. By the same token, a minister or a government in a parliamentary system is accountable to the parliament who can change her decisions and, if not followed up, issue a vote of no confidence.

Independence, on the other hand, protects against such an outcome for a central bank. To be independent and at the same time fully accountable is therefore not possible. There is a tradeoff, and the question should perhaps be where to find the right balance between these two qualities.

Transparency helps. Monetary policy may also be more accountable and better anchored politically, when political authorities decide both the overall objectives in law and the operational target. The bank will then be instrument-independent and not goal-independent.

In summary, when building institutions, it is helpful to have clear criteria to reach for. For central banks and other institutions, however, one size does not fit all; the institutional setup must fit into national traditions. And even the best designed central bank cannot do the job all alone, when it comes to achieving monetary and financial stability. To get the best out of central banks, one also need good institutions and policy frameworks surrounding them.

4 See among others Fischer (1994).

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