Central banks: Too big to fail, but failing yet again

Critics say it's high time central banks were rethought, reformed and pulled back under more political control.

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For most of last year, the West's central bankers were convinced that spikes in prices were transitory and manageable. They believed that rising inflation would ease once pandemic-related supply-chain disruptions and labor shortages shook out.

The price increases for goods, rent, food and energy were one-offs, so the argument ran. Simply the consequences of economies struggling to recover from the induced coma of COVID-19 lockdowns and restrictions. But now, with inflation reaching 40-year highs, and the specter of stagflation looming, central bankers are coming under sharp criticism for their complacency.

And the ferocity of the attacks on bankers, as well as the prominence, influence and political variety of their critics — ranging from left to right — all suggest this is no squall but a tempest, which may have enduring consequences for the governance of central banks.

So far, critics say that by not raising interest rates sooner, the banks have failed to act quickly, or boldly, enough to restrain surging prices, and they should have quickly turned back from quantitative easing, which was used to inject money into their economies.

Some argue that the prime pumping wasn't necessary, that increasing domestic money supply has become an addiction for central banks since the 2008 financial crash — one they have been unable to wean themselves off.

And the criticisms are only getting rougher and louder, with some foes saying it is high time central banks were rethought, reformed and pulled back under more political control, where they could at least be held democratically accountable.

"The Bank of England last year was forecasting a 3 percent or so blip in inflation, now it is forecasting a 10 percent level that may not go away. In essence they thought the problem was going to be easily manageable, and now it is turning into a nightmare," wrote former Conservative Cabinet minister David Davis in the Daily Telegraph on Saturday.

He added: “So there is a real question as to whether the ‘independence’ of the Bank of England is worth maintaining. It has been in place since the early Blair years, but that has been a largely benign inflationary environment. Today its mistakes are beginning to have large consequences.”

Writing in POLITICO Europe last week, former chief economist and board member of the European Central Bank (ECB) Otmar Issing fired a broadside at central banks — the ECB included — for having placed themselves “in the ‘transitory camp,’ expecting inflation to return to prior low levels via self-correction, so to speak, seeing no need for action to counter the risk of higher inflation.”

“Probably one of the biggest forecast errors made since the 1970s,” he lamented.

The U.S. Federal Reserve has also come under fierce fire from luminaries, notably Larry Summers — former President Bill Clinton’s Treasury secretary and the head of former President Barack Obama’s National Economic Council — and Mohamed El-Erian, a closely followed bond-market strategist and chief economic adviser at Allianz, the German financial services giant.

El-Erian warned that the Fed is losing credibility with the markets and the American public. He had predicted last July that inflation, then running at a 5.4 percent annualized pace, wouldn’t be as transitory as the Fed was reassuringly projecting.

U.S. headline inflation hit 8.5 percent in March.

So, will the criticism of central bankers be as transitory as they were predicting inflation would be?

Much will depend on how they handle themselves from here on out as they try to contain rampant inflation, which has been made worse by the war in Ukraine.

So far, the explanations offered by central bankers for why the models were so wrong aren’t placating critics, who say interest rates should have been hiked and monetary policy tightened sooner.

The bankers say the pandemic and the war in Ukraine are black swan events that would defy any modeling, however sophisticated. Nor could they have foreseen China’s decision to continue to pursue a zero-COVID policy, ordering lockdowns that continue to disrupt production.

“A sequence of shocks like this, which have come really one after another with no gaps between them, is almost unprecedented,” Bank of England (BoE) Governor Andrew Bailey told lawmakers earlier this month.

But critics say there were plenty of warnings issued early last year by other authoritative sources — and they should have been heeded.

The seeds of doubt regarding central bank independence — which “only became a cornerstone of central banking in the late 20th century,” according to American economist Paul Wachtel and former President of the Central Bank of Argentina Mario Blejer — were actually planted more than a decade ago.

In a 2020 paper for the Cato Institute, a libertarian think tank, the pair noted: “While the overwhelming majority of academic and central bank practitioners continue to support central

bank independence, it is clear that, while independence continues to be protected, its golden age ended with the crisis a decade ago, and it did not end gently."

Some critics blamed the central banks for fueling the credit expansion that resulted in the crash. But, as noted by Wachtel and Blejer, they escaped political consequences as "one way or another, the crisis was controlled and central banks were instrumental in avoiding — with huge help from government and regulators — the complete collapse of the financial system."

But others worry that the role of central banks has been expanded to an insupportable degree. Aside from inflation targeting, they have been loaded with numerous other tasks, as they are meant to support the economic policies of their governments, ensure growth, police their banking sectors, and now are also being charged with ensuring financial resilience as countries aim to reach net-zero climate goals.

Are all these roles appropriate for unelected bankers?

Ed Balls, chief economic adviser to the treasury when Gordon Brown was Britain's chancellor of the exchequer, is no longer so sure. In 1992, Balls wrote a pamphlet advocating BoE independence, a policy Brown adopted when chancellor in 1997. But in 2018 he, too, started to question the role of the BoE and its governance. The dramatic expansion of the objectives and powers of central banks had taken them away from their main role of targeting inflation, he suggested.

"As these unelected, technocratic institutions become increasingly powerful, the pre-crisis academic consensus around central bank independence — put crudely, 'the more, the better' — has become inadequate," he wrote with others in a working paper.

Writing when former U.S. President Donald Trump was launching attacks on the Fed and then BoE Governor Mark Carney was coming under assault from Brexit supporters, Balls warned against throwing "the baby out with the bathwater," suggesting "a more nuanced approach to central bank independence, with political accountability in terms of mandate-setting and appointment of officials, and oversight of wider financial stability powers."

Nuance, though, is frequently a rarity in politics. And it will likely be in short supply as criticism of central banks mounts for what foes label yet another calamitous misstep — one comparable to the sub-prime lending disaster that scarred economies and blighted lives, just as inflation will.