Global Political Drivers

CENTRAL BANK DETHRONING

Christopher Granville/ Constantine Fraser

- **Trump's trolling of Jay Powell and Mario Draghi breaks a taboo. Trump's style may be inimitable, but on the substance, he may prove a harbinger: politicians' dissatisfaction with central banks is set to grow.**
- **Questions of blame are neither here nor there: the cause is simply that central bank independence in carrying out inflation targeting mandates is a construct designed for a vanished era.**
- **The economic and financial market instability caused by political backlashes against central banking arrangements will vary according to countries' institutional flexibility. The US and Eurozone look vulnerable on this count, with the UK somewhat better placed.**
- **That is just as well, since the UK is on the brink of serious political upheaval – and, in the perfectly plausible scenario of a Labour-led government, could well become a laboratory for change to central banking. This could even apply to the opposite scenario of a hard Brexit Conservative government.**
- **We think Labour would refrain from pre-emptively changing the BoE's mandate to accommodate looser fiscal policy. It will more likely launch into its socialist ownership and credit agenda, perhaps recruiting the BoE as a mega-agency along the way. Politicization, perhaps, but not as you know it.**

Trumpzilla

It was only a matter of time before central bankers found themselves in Donald Trump's sights, seeing as his presidency has become a bonfire of conventions. His public sallies against his 'own' Fed Chairman, Jay Powell, began last year; but last month the trolling reached a pitch that will have made an impression on even the most inured Trump-watchers. Perhaps the most striking moment of all came on 18 June, when Trump trained his "bad job" and "insane policy" fire away from Powell and towards Mario Draghi. Within a couple of hours of Draghi finishing his annual Sintra conference speech that day signalling a strong renewed dovish turn at the ECB, Trump was tweeting his critique of this move as a ruse to weaken the euro to the disadvantage of the US – "they [Europeans] have been getting away with this for years, along with the Chinese and others."

Trump has broken the taboo on political leaders attacking the Fed. Consistent with his calling into question traditional alliances and free trade, Trump has thus broken what former US Treasury Secretary Lawrence Summers has called the quarter-century taboo on political leaders passing any comment whatsoever on the Fed's activities (let alone Trump's attack-dog style of 'commentary'). Summers made that remark in his review of a book entitled *Unelected Power* by Paul Tucker, a former senior BoE official. Tucker's theme is the problem of accountability as regards institutions like central banks entrusted with roles which, however technical, have powerful effects on people's lives.

Balancing central bank accountability with minimising risks requires institutional flexibility. To the extent that politicians – refracting public grievances – become dissatisfied with central banks' performance, the first risk to consider has to do with institutional flexibility. In other words, as and when sufficient political will existed to make central banks more accountable, the more smoothly that could be done, the lower the transitional risks to economic and financial stability. The unsurprising answer here is that the degree of risk here varies widely across the world.

Modern central banking begins with New Zealand. The story begins in the aftermath of the 'Great Inflation' triggered by the 1970s oil shocks; and the natural starting point is New Zealand, which pioneered formal inflation targeting (as opposed to intermediate targets such as monetary aggregates as policy "anchors"). The RBNZ Act of 1989 enshrined the central bank's operational independence in pursuit of the target. The idea was that politicians having to think about the next election (never more than a few years away) would always lack the credibility required to bring about stably low inflation by anchoring the public's inflation expectations.

That New Zealand version had a distinctly technocratic flavour, since it gave the central bank governor equal status with the government in setting the inflation target – and even the right to initiate a re-negotiation of the target. Variants on this model were widely adopted across the world during the following two decades, though few imitators were found for a striking accountability feature of that Kiwi approach: the governor was liable to salary deductions or dismissal for failure to hit the defined target.

When the UK came up with its version of central bank independence and inflation targeting in 1997, the accountability was purely political. Unlike its New Zealand counterpart, the BoE has no co-decision role in defining the target. Instead, it receives passively the target handed down to it by (in practice) the Treasury – but, in principle therefore, the government that owes its existence to a parliamentary majority. To the extent consistent with its pursuit of that target, the BoE is also required to support the economic policy of the government of the day.

The UK construct seems reasonably balanced and flexible compared to some others we will come to. The flexibility offered by the Bank of England Act is even excessive to real-world requirements, since it allows the Treasury to vary the target once a year – which would be incompatible with stabilizing inflation expectations. At least in the UK, political pressure to change monetary policy could be accommodated with minimal institutional upheaval. The extent of the resulting economic and financial market turbulence would depend, of course, on the substantive choice of replacement policy – a topic we return to below when considering the prospective actions of a Labour government in this area. At the margin, however, the institutional smoothness made possible by the UK approach would help reduce any such disruption.

The Eurozone sits at the opposite end of the spectrum. Here, the ECB has near-total independence in setting its own targets. In the tradition of the Bundesbank, its mandate is simply to pursue "price stability", and the Bank has the final say on how to interpret and pursue this goal. The ECB Governing Council has chosen to define this objective as inflation "below, but close to, 2% over the medium term". The fact that its mandate is written into treaty law, moreover, gives it a quasi-constitutional status: it cannot be changed, or indeed further specified, without a full consensus of EU member states.

This cast-iron independence afforded to the ECB by its treaty-based mandate reduces the flexibility to deal with shocks and crises in a way that minimizes costs and losses. This reality was on painful display during the Euro sovereign debt crisis in 2011-13. Eighteen months after Mario Draghi calmed markets in the summer of 2012 with his "whatever it takes" rhetoric and unveiling of Outright Monetary Transactions (OMT), Germany's Constitutional Court ruled that OMT was prima facie incompatible with the treaty but deferred to the ECJ for a final decision. The ECJ deliberated for another eighteen months before finding – to no one's surprise – that OMT was fine. The German court responded by confirming the legality of OMT – subject to certain conditions.

The consensus among Eurozone experts appears to be that the stipulations of these German judges would not be a problem in practice. But that may prove wishful thinking. In any event, we will only find out after the outbreak of the next Eurozone crisis; and this rigidity, and resulting uncertainties, is one aspect of the wider rigidities that make the Eurozone prone to periodic crises.

Coming back full circle to the US, the Fed looks on paper to be operating in an environment of flexible political accountability. But the present dual mandate – to pursue price stability and full employment – dates back to the 1977 Federal Reserve Act, which passed thanks to that dual formula offering something to both sides of the aisle. In practice, therefore, the political scope for pragmatic amendment to the mandate looks minimal. That scope shrinks further to vanishing point after factoring in rivalry with the executive branch. Even under a less polarizing presidency than Trump's, White House dissatisfaction with the Fed would naturally make the Congress defensive about its prerogatives.

The reality, however, is that the political system has little ability to control the Fed. Just as the US political gridlock has made the Supreme Court seem increasingly like a legislature, the Fed, in an analogous mission creep, has supplied its own definition of the price stability part of its mandate as being a 2% inflation target. In theory, Congress could change this mandate or specify some other definition of price stability; but the paralysis of Washington politics makes that all but impossible. Meanwhile, the Fed's "unconventional" operations under the QE heading have drifted into areas such as buying mortgages which, like fiscal policy, have distributional consequences and thus would normally be reserved for elected officials. In its own way,

therefore, the US framework seems no less inherently vulnerable to blockage and destabilizing pressure than the Eurozone.

Central banks backlashed

That mention of politically fraught distributional questions raises a more fundamental question than the one we have been looking at so far. Beyond a comparative analysis of risks to stability in the event of a political backlash against central banks lurks the question of why politicians might become dissatisfied with independent central banks in the first place.

This is not the place to discuss the validity of politicians' grievances against central banks or rehearse in detail their possible reasons for deciding to curb central bank independence. Our global macro team have covered these topics in several recent reports, notably Policy Supercycles by Dario Perkins, and our just published compendium of answers to clients' questions, where our Chief Economist Charles Dumas sums up the effects of over-reliance on monetary policy (backed by supply-side mantras such as flexible labour markets) in the pursuit of post-GFC recovery:

- If governments globally pursue balanced budgets, they will find that they cannot have, on the one hand, acceptable levels of growth and employment, and, on the other, 'normal' interest rates, especially real rates
- Stimulus confined to monetary policy only – i.e, excluding budget deficits in the normal run – leads to ever widening inequalities since monetary stimulus operates by boosting asset prices
- The 'trickle down' from the wealth effect of asset-price gains to general economic activity is indirect, often weak, and has large sectoral biases

Real income stagnation drives a disorganised backlash. In the light of this picture of mixed responsibility, political backlashes against central banks will not flow from coherent grievance, let alone carefully considered conclusions on the futility of targeting 2% inflation or any inflation at all, and a subtle understanding that central banks – however conscientious and well-intentioned – are helping to aggravate inequalities. The political driver here lies instead in the reality that real income growth has been so lacklustre (or in Italy's case actually declining). Political mandates are likely to be sought and won on the basis that "we cannot go on like this".

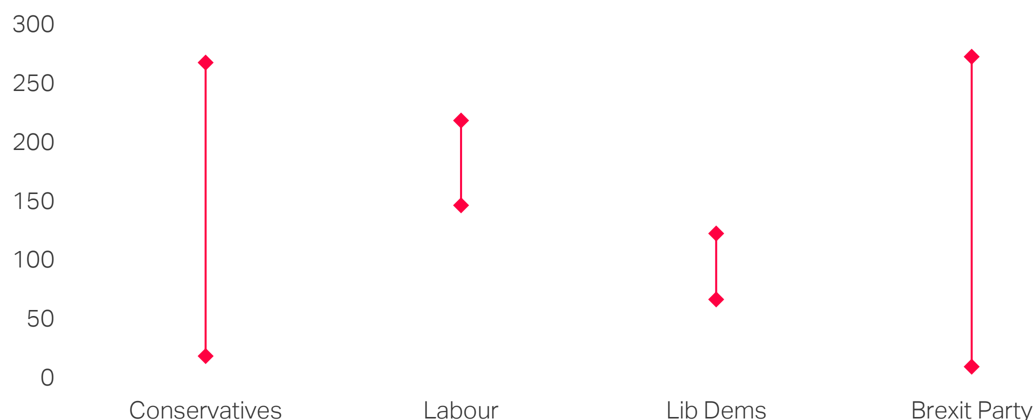
UK laboratory

The UK may become a test case. For asset allocation purposes, this political risk may seem to belong in the category of "only worth thinking about as and when it looks like it might arise in a concrete country situation". As it happens, there is just such a situation: the political crisis in the UK. In a recent note in our Global Political Drivers series, we argued that a 'no-deal Brexit' shock this October remains very unlikely despite the imminent change of prime minister. But a high degree of political turbulence culminating in some combination of a general election and/or referendum is probable.

A Labour government is a real near-term possibility. Polling in recent weeks suggests that UK politics is in a state of serious flux, with the Conservatives, Labour, the Liberal Democrats and the Brexit party all hovering within the margin of error from one another. This volatile electorate and rapidly changing party landscape, when combined with UK's idiosyncratic first-past-the-

post electoral system, makes it very hard to predict what will happen in the event of a general election: small changes in parties' vote share and distribution will fundamentally change the balance of power in the Commons (see chart below). But a Labour minority government – with the external support of other Remain-leaning parties – is one of the most plausible outcomes. Such a government could emulate what New Zealand did forty years ago in leading the way into a new era for central banking.

UK general election: anything could happen
Range of possible seat distributions implied by recent polls



Source: TS Lombard; Lord Ashcroft electoral model; 4 most recent published UK opinion polls

We see two possible routes Labour could take. The UK's Labour party is a centre-left parliamentary party, which due to a more radical grassroots membership is led by its far-left wing. We see two possible different routes the Labour party could take in government to undo or mitigate some of the effects of central banking's current impasse.

The high road: direct interference

One option would be that of direct government interference with the main functions of the central bank, in such a way as to transform its mandate or even compromise its independence in conducting monetary policy. This 'route' has been the subject of a considerable amount of investor attention, ever since Corbyn floated the idea of introducing "People's QE" – i.e. monetary financing of public investment projects via a national investment bank.

A subtler form of direct government interference could come if the Bank of England attempts to react to a debt-funded fiscal expansion (Labour is promising an extra £25bn a year of public investment) by raising interest rates. A Labour government could simply decide that it is prepared to tolerate slightly higher inflation, and change the Bank's mandate accordingly using the existing legal framework, as discussed above.

However, we are quite sceptical of Labour going down this road. All the signs are that the prospective Labour 'Chancellor' (i.e. finance minister) John McDonnell intends to be relatively conservative on macroeconomic issues. He dropped the idea of "People's QE" as soon as he could. At least, we doubt that Labour would pre-emptively change the BoE's mandate. The threat might, instead, be left hanging – in the expectation (reasonable, in our view) that the BoE's Monetary Policy Committee would self-censor in the sense of being ultra-cautious and avoiding pre-emptively hawkish reactions.

The low road: roundabout mitigation

A more plausible starting strategy would be for Labour to steer clear of meddling with the UK's macroeconomic policy framework, and seek other ways of mitigating the effects of the current paradigm of low income growth and high asset price inflation. This seems to us the likeliest scenario: not only because it is less risky, but because it fits better with the current Labour leadership's ideological preoccupations with supply-side and ownership issues.

After all, the government has a variety of other legislative and regulatory levers it can pull. Over the last few years, the Labour leadership has either issued formal policy proposals concerning, or less formally expressed an interest in, the following kind of menu: encouraging cooperative models of ownership and forcing companies to hand over shares to their employees; nationalising the utility industries; and expanding collective bargaining. Finally, this approach points to higher taxation on wealth and on corporates.

Take renter protections – a subject close to the heart of many Labour voters, who tend to be young and asset-poor. Labour has proposed introducing open-ended tenancies, making it considerably harder for landlords to terminate leases without good reason and a formal legal process. Depending on how radical the changes were, this could have significant consequences for the buy-to-let market and for sections of the property and banking sectors exposed to it: similar changes were introduced in Scotland in 2017 with no ill effects, but some ideas Labour has floated go rather further. The recent Labour-commissioned policy report Land for the Many makes a sweeping range of radical proposals, from tenants' rights to rent controls.

A common thread which runs through many Labour policy documents is that of "credit guidance": that is to say, government agencies taking steps to direct investment towards ends the state (rather than the market) considers productive. This was a feature of UK policymaking in the 1960s and 1970s, when banks faced lending ceilings and were encouraged to lend money towards export promotion and manufacturing, rather than personal uses and property development.

The BoE could find itself dragged into directed lending. The central tool Labour has in mind here is a new National Investment Bank, "to deliver £250bn of lending power" via a network of regional development banks with centrally allocated funding. The party claims that the proposal is modelled on Germany's KfW, although it also echoes Harold Wilson's 1975 National Enterprise Board.

But the party is also considering getting the central bank itself involved: a 2018 report for the Labour party by the McDonnell-friendly economist Graham Turner proposed giving the Bank of England a productivity growth target and taking "a more active role in the allocation of credit in the economy". More recently, McDonnell has floated a "green mandate" for the Bank. Finally, the whole credit guidance programme would be overseen by a Sustainable Investment Board – a troika of Chancellor, Business Secretary and BoE Governor.

Labour is also looking at these same levers as potential answers to the UK's housing crisis. As recently as this spring, Labour have floated the idea of giving the Bank of England a "house price inflation target", to be pursued via macroprudential regulation – such as raising the risk-weightings on mortgage lending, and tightening loan-to-income and loan-to-value ratios. This isn't yet a formal policy pledge, however, and the party is also considering the alternative of adopting a government house price inflation target, and pursuing it in a looser fashion with planning laws and housebuilding.

Paradoxically, Labour may yet end up politicising the Bank of England in a very different way to that which investors expect, without undermining its independence at all. Such is the mystique of the modern central bank – and, perhaps, the lack of trust in politics – that the party seems to be considering turning the Bank into an arm's-length mega-agency, with ever more responsibilities to juggle. A beefed-up Bank of England will be asked to clean up a whole bunch of different problems.

Summing up

Pressure on the BoE could come just as easily from the political right as from the left. The possibility of the UK central bank being transformed into a mega agency is not the last of the possible paradoxes. As Trump is busily showing, pressure on central banks can come just as easily from the political right. The Conservative leadership contenders have been trailing their emergency "no-deal budgets", promising tax cuts to boost the economy in the event of the UK leaving the EU without a deal this October. But what if the Bank of England decides that these demand-boosting measures – against the background of a supply shock and a drop in sterling – threaten to drive up inflation? Given the frequency of Brexiteers' attacks on the allegedly Remain-aligned Bank over the past few years, it isn't hard to see a future Conservative Chancellor turning up the pressure on the Governor to keep rates low.

One way or the other, the UK looks set to become a laboratory in which political pressures on central banks may start to have practical effects. One way or the other, the central bank mystique will fade. While institutional inertia in other countries (or, in the EA case, group of major countries) may delay change for longer than in the 'revolutionary' UK, a turbulent transitional period for central banks is dawning.

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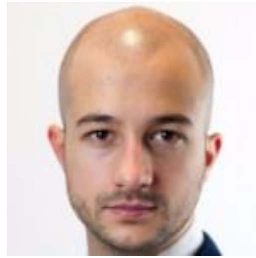

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