Political Power in Central Banks Is Essential to Avert Future Economic Crises

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Abstract: In the era of globalization, central banks have posed important impacts in the global economy. The central bank plays an important role in managing financial stability and capital flow, and avoiding economic crisis. Every central bank plays an important role in the country or region where it is located. The role of central banks in the global economy is examined below. As a functional department of a country or a region, the central bank inevitably embraces political power. In the process of argument, this paper takes the European central banks as an example to determine that the central bank should exercise its political power when facing the problem of avoiding the possible economic crisis in the future.
***Keywords*:** central banks, political power, economic crises

1. Introduction

After the globalisation, the world has become a single market. Economies across the world have become interconnected through the increase in cross-cultural movement of wealth, goods, technologies, labour and other services. Global economy benefits different countries in various forms, such as the movement of labour, free trade, increased investment, and improved economies of scale [1]. However, one of the main factors in the global economy is the financial systems through which it is more or less governed.

The central banks across different nations affect the global economy and are considered to be a key player in managing financial stability, flow of money, and averting crises. In this regard, the following essay focuses on discussing the role that central banks play in the international economy. The following discussion examines as to which power of the apex institute. That is, central banks is dominating in the global economy. That is, the political power that it holds or the potential of apex banks in avoiding economic crises in the foreseeable future. However, the author's argument in this context is that no central bank can work in a political vacuum [2]. Even though political power is relevant to central banks, but it is their power to avoid economic crises that might occur in the near future.

2. Central banks and the global economy

2.1 Central banks and their functions

In every nation, it is the central banks that serve as the foundation of a country. Being a vital tool for economic development in a nation, the central bank controls the money supply in an economy and its credit condition in order to achieve the broad objectives of economic development [3]. It can be described as a financial institution, which enjoys a privileged control or is responsible for the production and circulation of credit or money for an economy or a group of economies. While considering the modern economy, regulation of banks and formulating monetary policies are considered the prime responsibilities of the apex institute.

Central banks are anti-competitive and non-market-based institutions, which are often regarded as politically independent institutions. However, one of the most significant characteristics, which differentiate a central bank from other banking institutions, is the legal monopoly status, according to which the bank has the right to issue notes and cash (currency). As it is the highest banking establishment in the economy, it has the privilege of issuing currency while its member banks only have the permission to issue demand liabilities. While carrying out its operations, various functions are performed by central banks, which are broadly classified and discussed under the following heads.

2.1.1 Monetary stability functions

The main aim of such banks is to manipulate and regulate the money flow in an economy, which includes determination of interest rates for bonds and loans and issuance of currency [4]. While in a general scenario, central banks tend to increase interest rates in order to avoid inflation and slower the growth, it decreases the rates on loans and bonds with the objectives of inciting the growth, consumer spending and industrial activities [5-6]. By making changes in the interest rates, central banks manage the monetary policy and guide the nation to accomplish economic goals.

2.1.2 Financial stability functions and regulatory functions

Central banks ensure financial stability in an economy by ensuring the stability in the financial institutions of the nation. There are various tools through which central bank regulate and manage the member banks. It usually lists down the requirements for maintaining a particular level of capital, deposit guarantees, and reserves (the amount that is permitted for lending to customers and the amount, which is mandatory for member banks to keep on hand). They not only regulate the member banks but also offer loans to them and the government at the same time managing their foreign exchange reserves [7-8].

2.1.3 Lending functions

The central bank acts as an emergency lender for other banks and financial institution, which are in distressed conditions in some scenarios. For instance, when the objective of a government is to increase its revenue, instead of opting for taxation, an attractive alternative available with the government is to sell its debt obligations to the central bank [5].

2.1.4 Case study of the federal reserve

Apart from the functions and power discussed above, a central bank also has various other powers. Considering the case of the USA, its apex banking institution is the Federal Reserve System, which is governed by The Federal Reserve Board (FRB). This governing body can change the reserve requirements and influence the supply of national money [5]. Being a powerful economy, any decision made by this financial institution is likely to affect the global economy. With the increased globalisation and cross-border transactions, there is a significant impact of any financial decision made by the central bank. For example, if the Fed decides to normalise its interest rates, the developing economies across the world might experience capital outflows [9].

2.2 Globalisation and world economy

The advent of globalisation has blurred geographical boundaries between nations. Various globalisation trends have resulted in an increased interdependence among different economies. One of its major effects is visible in the form of increased cross-border transactions in the form of labour, goods and services, capital, and resources. A combination of factors such as availability of information and communication technologies have not only increased the significance of globalisation for organisations but have also facilitated a free exchange of concepts and different ideas among institutions, non-trading companies, and other organisations across the border.

Not only the economies have opened up, but they have also lifted the trade barriers to facilitate international trade. There has also been a growth in the FDI (Foreign Direct Investment) which have contributed significantly to the expansion of manufacturing facilities across different countries and adoption of innovative business models abroad for minimising input costs [10].

Globalisation has enabled emerging economies to be a part of the international market. While measuring the impact of globalisation on an international level, it is noteworthy that the availability of labour force in the global market after the opening up of emerging economies such as India and China have doubled, that is from 1.5 billion, it has reached to 3 billion.

The same observation is made in case of global trade openness, which has also doubled in the last two decades. Measured as exports and imports of goods and services of the world as a proportion of GDP of the world, it has increased from 33.9 per cent of world GDP in the year 1986 to 60 per cent of world GDP in the year 2006 [10]. Globalisation trends have also affected the financial systems across the world. The incentives for investors to hold diversify and spread their financial risks internationally and to hold different foreign assets in their portfolios have grown.

Consequently, the impact is visible in each element of the system, be it institutions, marketplaces or infrastructures. Considering the statistics in this matter indicates certain impressive developments. The measure of financial openness, which is the portion of gross international asset holdings in GDP of the world, has also increased significantly. In the past 25 years, there has been an eightfold increase and it is currently 130 per cent of total world GDP [10]. Considering the global capital flows, it is noted that while international equity flows and FDI dominated the capital flows, more and more people are indulging in international transactions, which concerns liquid assets. Sharing international risks and transferring net saving across different countries have become an integral part of this process.

Globalisation has changed the economic interface; it helps in fostering nation prosperity and improving the standards of living in an economy. Not only there is a better transfer of knowledge and technology across economies, but it has also led to increased international competition. It is improving the overall global economic growth and productivity gains at the same time providing better efficiencies to institutions for lowering their costs and prices of goods and services that are tradable.

However, there are also various risks and challenges that are associated with globalisation which might affect the global economy at large. Due to the interdependence of economies and their closer integration, international financial institutions are not more exposed to and sensitive towards sentiments of investors. The increased cross-border trade and links between financial systems might intensify the impact (shock or surprise) of one economy to another and magnify the cross-border spill over [10]. In such cases, the responsibility of the apex institute increases significantly to mitigate crises. They need to pre-empt the trends and adopt a proactive approach in anticipating and avoiding the foreseeable economic difficulties.

2.3 Central banks and crisis management

When ensuring financial stability in a country, the role of apex institute is crucial. With the advent of economic crises, their conventional roles that are, being the emergency lender for ensuring market liquidity to insolvent companies have been transformed dramatically. The composition of assets and liabilities and the size of balance sheets have replaced the significance of policy rates as the key instruments of central banks [11].

Central banks are given various power and responsibilities, which helps them in regulating the economy and ensuring economic development. During a crisis, these powers vested with the central banks come into force to mitigate the risks. The formulation of the monetary policy by banks allows them to achieve price stability. Increasing or controlling the money supply allows central banks to regulate the money market and ensure price stability [12].

During critical situations, central banks have the power to use their open market operations for providing liquidity to banks. Based on the liquidity crunches, its expected longevity and the nature, central banks may extend its open market operations in terms of their maturity or relax them in the context of their tender procedures. Similarly, central banks can continue to offer more liquidity in the market through their collateral policies [13].

In addition to these responsibilities, central banks also play a pivotal role while managing systemic risks. Adopting a proactive approach towards crisis or risk management helps central banks in identifying the vulnerabilities that are present across the financial system. With their panoramic and detailed understanding of the system, they can join the dots and identify as to which area is vulnerable by identifying the cause and effect chain throughout the system. Identification of such vulnerabilities enables them to rank and prioritise the risks present and prepare for them.

In addition to this, while ensuring liquidity in order to prevent any banking crises or panics the role of banks is commendable [14]. By boosting the money supply, not only it stabilises the prices in the market but also increases the liquidity. Even though acting as the emergency lender does not help a nation in avoiding economic shocks altogether, it minimises its impact, that is, it neutralises the secondary repercussions of such events. Central banks are coming up with the innovative type of liquidity solutions to mitigate systemic risks, which include a wide range of counterparties, longer terms, and increased eligible collateral. Furthermore, it acts as a protective shield for the global system in case the impact of individual bank failures is severe. They do it by boosting financial infrastructure and systematically managing significant clearing and settlement systems [14].

2.4 Case study of the ECB (European Central Bank)

European Central Bank (ECB) is the apex institute of the euro zone, which is a group of 19 countries that uses euro as a common currency. The core function of the bank is to manage money flow and key interest rates in the euro area for maintaining price stability. The euro zone has faced many economic crises, which are effectively managed by ECB through its aggressive monetary policies.

These measures have not only managed the crises but have also redefined the original mandate of ECB [15]. After the sovereign debt crises faced by the Euro area during 2009 to 2011, with the use of unorthodox monetary policies, ECB has initiated a controversy. This has divided the policymakers between those who agreed to the use of aggressive measures and those who believe that ECB has overstepped its authority while mitigating the crisis [16-17]. The unconventional policies formulated by the central bank such as negative interest rates, unlimited bond-buying, and a huge quantitative easing plan have sparked a debate about the political power that the apex institute holds in the market.

The debt crisis and the decision of ECB to purchase government bonds started a debate about its position. The Maastricht Treaty does not allow the bank to directly finance any national government. The fiscal union absence further complicated the role of ECB as the contingency lender. With Mario Dragh as the head of ECB, the bank reduced its benchmark rate initially by 0.25 per cent, making it 0 per cent and even making it negative, which continues [16]. In 2012, the bond yields reached unsustainable levels due to the fear of the potential breakup of the EU. The OMT (outright monetary transactions) allowed ECB to buy unlimited bonds across the euro zone.

Even though this step helped in calming the investors, it was claimed to be an illegal practice. This was followed by discussions about setting up a euro zone banking union, which would be a primary responsibility of ECB and would further enlarge its authority over Europe. Moreover, in 2015 where the area was still facing economic headwinds, the central bank came up with its unorthodox monetary policy with the introduction of quantitative easing [16]. This step followed the unusual decision of the institution to launch a negative interest rate. Many of the economists considered ECB not aggressive and considered quantitative easing a delayed action.

2.5 Discussion

There has always been a debate about the status of apex institute, that is, whether it is independent or politically dependent. A central bank is said to be independent if there is no influence of the government while formulating monetary policy and such policy development is done by officials who are not appointed or nominated by the government. However, in reality, it is not possible. Every apex institute have government involvement, there is no vacuum. Government officials and central bankers frequently meet and have informal meetings for discussing different policies including fiscal and monetary policies. Depending on the level of development of the economy, this political pressure varies.

For example, in case of developed economies, such political power might not be visible, but whereas the influence of government on the bank in determining monetary and fiscal policies might be observed more in underdeveloped or developing economies. The political pressure can be due to several reasons, such as to boost output for a short duration due to electoral reasons, to finance the spending of the government, or time inconsistency issue of formulating monetary policy [2,18]. The policymakers are usually not credible due to which there is a need to delegate fiscal and monetary policies to independent central banks, which can not only keep the inflation low but also ensure economic development.

On the contrary, considering the other power of the bank, it is apparent initiatives are taken repeatedly during different crises situations by banks, which have helped the global economy survive economic shocks. Measures taken by various central banks concerning their individual economies have helped in their restructuring and minimising the impact of crises. For example, during the 2008 economic crises, various apex institutes, including the US Federal Reserve (Fed) and the ECB took significant steps in mitigating the crises.

Due to the growing uncertainty, and lack of movement in the Euro area's money market, ECB adopted non-standard refinancing operations through which it increased the money flow in the market. In the later phase of the crises, the downfall of Lehman Brothers further escalated the uncertainty in the financial market. The interbank money came to a standstill, which regulated the liquidity of the banks. Central banks in such situation used their policy rates to mitigate the crisis. The policy rate was cut to 1 per cent by ECB while by the end of the year 2008, the Feb cut its interest rates to just 0.25 per cent [19]. Central banks on a global level cooperated and worked together to help the world economy recover.

The Fed and ECB adopted large swap lines, which allowed the latter to acquire the US currency for Euros, and lent it to the banks operating in the Euro area. The central banks took additional steps apart from interest rate changes. They worked towards safeguarding the liquidity of banks, measures such as full allotment policy, extending credit with longer maturities, and longer-term refinancing operations allowed banks to deal with their liquidity issue. Apart from the 2008 economic crisis, there have been various other crises, which were successfully managed by central banks [19].

Thus, considering both the aspects, that is, the political power that it holds and the potential of apex banks in avoiding imminent economic crises, it is concluded the latter power holds more significance in the present context. Indeed, there is always a political power associated with the central bank, which might have an impact domestically, but on a global, such political power is insignificant. It is its responsibility to pre-empt the global conditions and take a proactive approach to take measures, which might avert the future economic crises.

3. Conclusion

Considering the above discussion about the identification of the dominant force of the central banks, which is the political power that it holds, or the potential of apex banks in avoiding imminent economic crises, it is concluded the latter power holds more significance in the present context. Considering its role in the world economy, it facilitates price stability, setting up of monetary and fiscal policies, regulation of member banks and ensuring liquidity in the market.

The advent of globalisation has made world economies interconnected due to which an economic crisis of one country has the potential to affect the global economy or economy of other nations. In such scenarios, it is the central banks, which mitigate risks and take necessary measures for minimising the adverse impacts of crises.

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