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Economic Research

WEEKLY ANALYSIS

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Who really owns and controls the world's main central banks?

Several different models ensure central bank independence, but political power remains rooted. Federal Reserve pays U.S. Treasury $96 billion! What about the CHF 38 billion SNB profits?

Key Points:

- Central bankers are appointed by the political power
- Central banks can be held by governments, other national or regional central banks and private shareholders
- Independence of a central banks is a necessity to counter the risks of future conflicting interests, instability, fight against the consequences of inflation, ensure monetary and social conduct and control systemic risks
- Financial results are partly reversed on governments
- Global financial crisis tests the boundaries of central banks' independence

The establishment and the creation of central bank independence

The central banks' independence has probably its roots in the American philosophy, which considers independence as one of the main pillars of democracy.

History shows that the executive power might be tempted through demagogic manipulations into inflicting dramatic consequences on both a social and political scale. Executive power can, if not contained, trigger economic instability crises difficult to overcome. The U.S. and Swiss Constitutions have both echoed these concerns in the organization of the executive power controlled through the legislative power.

The United States and Switzerland adopted a centralized banking system at about the same time but in different ways, with the aim of ensuring the banks' independence from political power.

From a monetary policy perspective, fears of instability may arise from interests and ideals of single political groups, looking for their own specific interest and disregarding the country's welfare.

The organization of the current institutions, in order to ensure correct monetary policies, must take into account the risks of future conflicting interests and regulate them.

The independence of the central bank is therefore a necessity to counter the risks of instability that could be caused by policy changes causing economic inequalities.

At the basics of monetary policy there is obviously the fight against the effects of high inflation and the redistribution of wealth within society.

The central banks' independence was introduced to strengthen and reassure investors and the financial markets that the fight against inflation, which can surface without government reactions, has too often led to political excesses, social unrests and instability which often triggered regional or worldwide conflicts.

In the United States the Founding Fathers were totally aware of the effects of inflation and quickly addressed this issue in the Constitution by establishing the right **"to coin money, regulate the value thereof, and fix the standards of weights and measures"** (Article 1 – Section 8 – U.S. Constitution).

We must not forget that at the same time federal and state governments had no monetary role, the central bank did not exist, this being a sign of the distrust in the executive power, the right of coining money being a prerogative of the parliament. In the United States, the panics and bank runs of 1907, which culminated in the creation of the Fed, it became essential to protect the newly installed central bank from political and financial pressures, by ensuring its independence.

This concept of independence still prevails today and is often placed as a guarantee of success of the monetary policies for the unique interest of the people and the country.

Independence is however, not always that obvious on the national level and in the central banks' everyday actions given external pressures or government interference.

The most recent financial crisis has once again demonstrated that in some cases there is a clear interrelationship between political power and the action of central banks.

Enhanced Fed's political independence since 1978

In the **United States**, the Fed was formally created by the enactment of the Federal Reserve Act or Owen-Glass Act of December 23, **1913**, as a response to the financial panics of **1907**. Its independence was further reinforced consequent to the monetary instability of the late 70s. Before the Fed, the First Bank of United States in 1791 was responsible for issuing the U.S. currency and regulating credit. It was then replaced in 1816 by the Second Bank of the United States to put an end to hyperinflation after the second war with the United Kingdom. It was dissolved in 1830 before a new financial instability caused by regional monetary systems led to the creation by Congress of the National Monetary Commission, which had the historic role of establishing the founding act of the present-day Federal Reserve.

In 1913, the U.S. government placed the Fed under its control through the appointment of the Secretary of the Treasury as one of its members.

Following the 1929 crisis, the adoption of the Banking Act modifies the structures of decision-making and included the creation of Federal Open Market Committee (FOMC) as a separate legal entity, aimed at regulating credit and steering interest rates. **The removal of the Treasury Secretary from the Fed's governing board is considered as the central bank's emancipation. This is specifically the case since it functions as an independent entity within government and does not receive funding from Congress.** It will undergo a further change in 1978 with the « Full Employment and Balanced Growth Act », better known as the Humphrey-Hawkins Full Employment Act.

1907: crucial date for the Swiss National Bank (SNB)

In **Switzerland**, the situation is slightly different. If the SNB is a limited liability company since its inception in **1907**, and since the **Swiss Confederation does not hold any share capital**, its shares are owned by public institutions like cantons and cantonal banks, while the remaining shares are held by individuals and institutions. Since 2002, a special law regulates its operations and objectives. The SNB joined the IMF in 1992, its membership implied some changes among which the backing of the Swiss franc with the gold price in the SNB balance sheet which had previously been of 40% in the previous Constitution. **Article 99 of the Constitution ensured the independence of the SNB** and the obligation to provide sufficient monetary reserves, partly in gold, to reassure investors on the stability and value of the Swiss currency.

Bank of England enhanced independence since 1997

The **Bank of England** is undoubtedly one of the oldest institutions having complete monopoly of its currency to date. Established in 1694 by members of parliament and merchants, it was privately owned and operated then it is a private holding company controlled by the financial interests of the City, it was then nationalized in 1946. Its independence was further strengthened in **1997** through a parliamentary vote. The Financial Services Act 2012 which came into force in **2013** and established a new macro-prudential regulator, the Financial Policy Committee (FPC). Since that date, it is in theory an independent public organization.

Established in 1998, the ECB is owned by the central banks of EU member states

In **Europe**, the European Central Bank is a particularly interesting case. The Central Bank of the European Union, was established in **1998** and is headquartered in Frankfurt. It succeeded to the European Monetary Institute (EMI), which was created to develop the central bank for the euro zone and modelled on the German Bundesbank. The German central banking model, somehow imposed after the Second World War, was at its very origin influenced by the negative experience of the 1930s brought about by the creation of money in order to finance government spending, thus generating hyperinflation. The fight for full independence of the Bundesbank is the proof of the distrust in the political power, which is tempted into printing too much money at the risk of causing inflation and social instability.

The ECB has been originally established as an independent body of members of the EU or any supranational European institution. Its independence is guaranteed by the Statute of the European System of Central Banks, which establishes that a governor may only be revoked in cases of gross misconduct or incapacity.

The Bank of Japan only has a relative degree of independence since the revision in 1998

In **Japan**, the Bank of Japan issues money on behalf of the government since 1882, but has gained its independence only through the Bank of Japan Act in April 1998. A certain degree of dependence is enshrined within the law but is very difficult to prove compared to other cases. Since the appointment of Prime Minister Abe in 2012, the monetary policy of the Bank of Japan and its governor Haruhiko Kuroda, has clearly been driven by government policy.

Who appoints central bankers?

Since the breakout of the financial crisis in 2007 and its media epitome with the collapse of Lehman Brothers in 2008, central banks are back in the forefront and are subject to the worldwide attention of the media and investors around the world. There is no longer a single word, sentence, Freudian slip or grimace of a central banker which is not husked and instantly analysed to extort new information and to accurately decode the future economic and financial policies. The future of the world economy is now in their hands. The names of the most influential central bankers are, now more than ever, recognizable by investors and citizens, even if the latter have a limited interest in the world economy and finance. Janet Yellen (Federal Reserve), Mario Draghi (ECB), Thomas Jordan (SNB), Marc Carney (BoE) or Haruhiko Kuroda (BoJ) are regularly in the media and their economic assessments and decisions are relayed with fervour as their role has become crucial for the health of the global economy and its development. The election of central bankers is public business, as is the case of the five abovementioned leaders and of others which will be mentioned in the following lines: **the choice of the president or governor of a central bank has become a political fray.**

In **Switzerland**, it is the **Federal Council, on proposal of the Bank Council** (which oversees and controls the conduct of the SNB) which elects the president (Thomas Jordan) and two members of the Governing Board. The SNBs policy is conducted by a board of three members.

In the **United States**, the Board of Governors is the governing body of the Federal Reserve (Fed). It is a seven-member federal agency **appointed by the President of the United States and confirmed by the Senate.** The chairman (Yanet Yellen) is appointed for four years, the mandate is renewable without limitation, while other officers are appointed for a period of fourteen years.

In **Europe**, the Executive Board is composed of six members, including its president Mario Draghi, **elected by mutual agreement of the governments of the Member States at the level of Heads of State or Government of the euro area upon recommendation of the Council** after consulting the European Parliament and the Governing Council of the ECB. The latter comprises the members of the Executive Board and the governors of the National Central Banks of the euro area countries.

In **the United Kingdom** the British Finance Minister appoints the future governor of the Bank of England. In **Canada**, Stephen S. Poloz was appointed new Governor of the Central Bank of Canada by the Canadian Minister of Finance. In **Japan**, the governor was appointed by the Senate upon recommendation of the government. In **China**, the president of the People's Bank of China is nominated by the Premier of the State Council and approved by the National People's Congress (NPC).

The appointment of central bankers is just government business.

Who are the central banks' shareholders?

In **Switzerland the central bank is owned by cantons**, cantonal banks and by individuals and institutions. **The bank's independence is, hence, theoretically not guaranteed** since the political influence is present in the share capital and the Governing Board is elected by the Confederation. The Bank Council oversees and controls the conduct of business which is composed of six members appointed by the Federal Council and five other elected by the General Assembly. The independence is not ultimately preserved on an institutional level.

In **Europe**, **the ECB is held by the national central banks of the EU member states**, **the only entities which are authorized of being its shareholders.** Its capital is 10.76 billion euros and the initial capital allocation was determined on the basis of the share of each member country population and GDP. The Bundesbank holds 18% of the capital, Bank of France and the Bank of England hold 14%. In theory, the ECB is independent from any governmental authority, but the central banks of the three previously mentioned member's states are themselves government-owned entities. **Thus, independence is not guaranteed from this aspect.**

The **U.S.** institution is less evident. The Federal Reserve System Structure is composed by **twelve regional Federal Reserve Banks**, which tend to confer to it an independent governmental status since the Federal government is not a Fed's shareholder. However, **nationally chartered commercial banks are required to hold shares in the Federal Reserve Bank of their region;** this entitles them to elect some of the members of the board of the regional Federal Reserve Bank. The Federal Reserve Bank of New York is largest and represents approximately 40% of assets of the twelve regional banks' assets. The New York Fed is also responsible for conducting open market operations on behalf of the Fed. The Federal Reserve System has thus both private and public aspects: the Board of Governors chaired by Janet Yellen, the Federal Open Market Committee, the twelve central banks, member banks of regional central banks and various advisory councils. The FOMC is the principal organ in charge of the monetary policy; it consists of twelve members, seven from the Board of Governors and five from the regional Federal Reserves. The peculiarity of the system is that money creation is the prerogative of the Treasury Department and not that of the Fed. In this case, Congress exercises its right of control and supervision.

Who benefits from central banks' profits?

In the United States the Fed generates a guaranteed 6% profits for its shareholders, while the Federal government receives the remaining profits. In 2014, the Federal Reserve paid the U.S. Treasury a record $**96 billion** of its profits.

In Switzerland, the National Bank Act (NBA) sets out specific provisions on the allocation of the SNBs' distributable profits (**38 billion Swiss francs** in 2014). No more than 6% of the profits are distributed as dividend to shareholders, while the remaining goes for one-third to the Confederation and two-thirds to the cantons.

Global financial crisis tests the boundaries of central banks' independence

Since the break out of the financial crisis, the central banks' independence has constantly been questioned. In most countries, central banks' independence has clearly been undermined by political and financial instability and growing government interventionism. Political power has actually interfered in central banks' conduct of monetary policy within perfectly democratic countries, aligned with the notion of independence, as otherwise required by the same governments. **The risk of social unrest, which should have been the direct consequence of uncontrolled inflation have in fact taken an unexpected path, but are just as dangerous to the stability of the financial system and social order as justifying the interference between governments and central bankers.** These events however, could simply shade some light on a pre-existing situation: the independence of central banks is quite relative. On a prior occasion, the Fed had already pursued a tight monetary policy on the public debt market to allow the government to refinance after World War II. In Germany, during reunification, the government imposed parity between the Deutsche Mark and the OstMark against the opinion of the president of the Bundesbank.

At present, the most independent central bank may not be the one we had in mind. The ECB may have the advantage of not having to report to a greater, unified and organized political authority which could probably influence its action more directly. Furthermore, the ECB's implementation of an EU QE programme reflects its independence from any political intervention. German authorities are obviously against this stimulus programme.

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