SPEECH

The mission of Gerard Vissering: why we need independent central banks

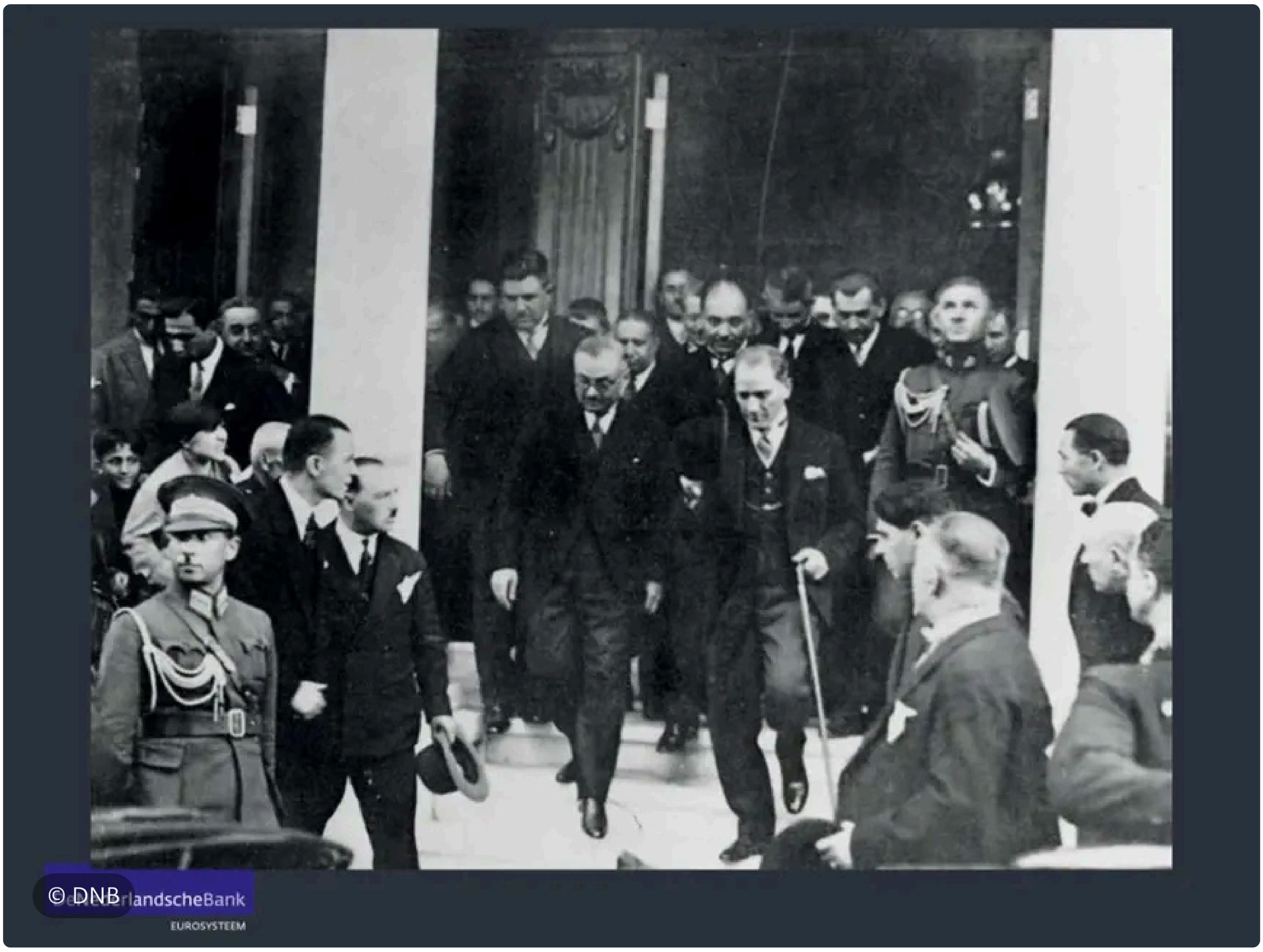
Read aloud

'Monetary policy credibility does not come overnight. It has to be earned. Again and again.' , said Klaas Knot in his speech at Koç University, Istanbul. He spoke about the need for independent central banks to face the challenges of our times.

Published: 19 September 2024

Good morning everyone. It is a great honour to speak to you here today at Koç University, one of the top universities in Türkiye, and one with an outstanding international reputation. And I am delighted to be here in your country to celebrate the longstanding relationship between the Turkish central bank and the Dutch central bank. A relationship that is practically as old as the Turkish republic itself. A relationship that started with a secret mission by a Dutchman, on the invitation of the Turkish government. You will understand that I cannot stand here today and talk about our two central banks without referring to this wonderful story.

It is 1928. The new Turkish republic is experiencing financial difficulties. The country is struggling to obtain much-needed loans on the international capital market. Türkiye does not have a well-developed domestic banking system and still depends on the old Ottoman Bank. But the Ottoman Bank is almost entirely in the hands of the UK and France: countries with which Türkiye had been at war. So the government of President Atatürk is looking for independent advice. They approach the governor of the Dutch central bank, Mr Gerard Vissering, to investigate how the Turkish Pound can be stabilised and how a solid state bank can be established. Vissering is chosen because of his outstanding international reputation as an economist. He has been advising China on currency reform in 1912. It also helps that he is from a country that was neutral in the First World War and that has had strong commercial and political ties with Türkiye over several centuries. Vissering takes up residence in the building of the Iș Bank and gets to work. Here he also meets with Kemal Atatürk. There is a picture of the Turkish president leaving the building after his meeting with Vissering.



After two weeks, he presents his report. He puts forward the idea to convert the Iș Bank – the investment bank that is in Turkish hands – into a central bank. It has experienced staff and sufficient knowledge and resources. The government in Ankara is very enthusiastic about the report. His advice offers a step-by-step plan for an independent and stable monetary system without interference from the British and the French.

The rest is monetary history. A law for the establishment of the Central Bank of the Republic of Türkiye was enacted in June 1930, and the central bank started operations on the 3rd of October 1931.

Key in Vissering's advice was that the new central bank should be robust, with a strong reputation for stability and expertise. This would require the central bank to be independent of the government. Almost 100 years later, his advice has lost none of its value. Also today, low inflation and a stable currency still depend on public trust in the central bank. Trust that the central bank will do everything in its power to pursue monetary stability. To do this, it must be independent of the government. This involves statutory independence, providing a sound legal basis for its mandate and powers. It involves the personal ability and the will at the board level to make difficult decisions and to resist outside pressure. And it involves financial independence, ensuring that the central bank has sufficient resources to fulfil its mandate.

Of course, central bankers are unelected officials. So it is essential for their legitimacy that they operate within their legal mandates, listen to the concerns of the public, and are accountable for their decisions to its democratically elected representatives. That's one of the reasons why, over time, central banks have become more transparent about their policies to the public and the financial markets. And it certainly helps if the central bank has a good working relationship with the government and the financial sector, without becoming vulnerable to excessive influence.

Strong central banks are needed to meet the challenges our economies are facing today. Surprisingly, these challenges are not that different from 100 years ago, when our story started.

Like today, the big wave of globalisation in the period from 1880 to 1913 was characterised by the emergence of new markets and increasing capital flows. Together with innovation and financial deepening, they boosted economic growth. These trends ended abruptly with World War I. In the late 1920s, geopolitical tensions, disruptions in cross-border payments, and weaker balance sheets in the financial sector led to greater uncertainty.

These developments culminated in the collapse of the global financial system in 1929 and the Great Depression. Governments reacted by closing off their economies from the outside world, which deepened the economic crisis. What did not help either was the lack of coordination between countries in the way they reacted to the worsening crisis. An example of this is the widely diverging monetary strategies across the major economies – most evident in the different timing with which countries left the Gold Standard. This led to strong exchange rate fluctuations and major losses on central bank balance sheets.

It also meant the demise of Gerard Vissering as governor of the Dutch central bank. In 1931, the central bank incurred enormous losses as a consequence of the devaluation of the pound after the Bank of England left the gold standard. Vissering had been a stubborn supporter of the Gold Standard, against growing opposition, and now he stood with empty hands and a gaping hole in the balance sheet. Later that year he resigned from his post as central bank chief.

The challenges central banks have been facing over the past two decades, are to some extent comparable. The period of macroeconomic stability and financial boom that marked the first years of this century was followed by the Global Financial Crisis, a deep recession and a serious risk of deflation. In recent years, we have witnessed major supply side shocks, such as the Covid pandemic and the war in Ukraine, which triggered an energy crisis. This drove up global inflation to double-digit levels. Like in the 1920s, we are also witnessing heightened uncertainty and geopolitical tensions, an increasing backlash against globalisation and a growing support for inward-looking policies in many parts of the world. As a result, globalisation has come to a halt, as you can see in the graphs. Very expansionary monetary policies in the decade after the Global Financial Crisis led to ballooning central bank balance sheets. When inflation and interest rates rose sharply in recent years, central banks made significant losses, as they did in the 1930s.

But in some respects the current period is different from the interwar years. In particular, the fiscal, monetary and regulatory responses to the Great Financial Crisis have avoided a repeat of the Great Depression. Fiscal policy has been used to absorb the costs of the near collapse of the banking system and to respond to the sharp fall in output. Monetary authorities have used conventional and unconventional tools to support macroeconomic stability.

After the double shock of the Covid pandemic and Russia's invasion of Ukraine, major central banks managed to tame inflation by responding forcefully. Key to this success is that – unlike in the 1970s and 1980s – inflation expectations remained well-anchored. This reflects the credibility of monetary authorities in their pursuit of price stability. I will come back to this later in my talk.

And, following a period of financial liberalisation between the 1980s and the global financial crisis, prudential policy has been used to strengthen the resilience of the financial sector and to mitigate excessive swings in the financial cycle.

Looking forward, new developments have emerged, notably structural changes in the economy as a result of ageing populations, the climate transition, and the digital revolution. These pose challenges to central banks in their pursuit of price stability. And, as I mentioned, central banks need to be independent to meet these challenges effectively, as well as for other good reasons.

So let me now delve a bit deeper into the arguments for central bank independence. Central bank independence did not come about overnight. In fact, with his advice that the new Turkish central bank should be independent, Gerard Vissering was ahead of his time. In the early 1900s, there were just 18 central banks in the world. They often lacked a clear legal or autonomous status to set monetary and financial policies. They functioned primarily as the executive arm of the government.

The concept of central bank independence only truly matured in the final two decades of the 20th century. The main macroeconomic challenge of the 1980s was to deal with the so-called Great Inflation that marked the 1970s and early 1980s. Questions arose such as why inflation was so tenacious and how monetary policy contributed to its endurance.

A new macroeconomic paradigm emerged during this period, which emphasised the importance of time-consistent policies and credibility for macroeconomic stability. Proponents of this view highlighted the government's inclination to inflate the economy, particularly prior to elections, thus creating an inflationary bias. To counteract this tendency towards excessive inflation, an institutional mechanism was needed to limit government interference in monetary policy. Seminal work by Kenneth Rogoff (1985) proposed a solution through which monetary policy would be entrusted to a conservative central bank with a strong mandate against inflation, and free from government influence. As a result, central bank independence emerged as a safeguard against a recurrence of the high inflation of the 1970s.

The advantages of this approach extend further. If inflation expectations were stable, monetary policy could be used effectively to stabilise economic output. Consequently, central bank independence appeared to offer dual benefits: a reduction in inflation without an increase in output variability. As the 1980s and 1990s unfolded, with more central banks gaining operational autonomy, empirical studies increasingly confirmed that central bank independence played a significant role in diminishing inflation rates. This body of evidence then supported the momentum toward greater central bank independence in the later years of the 20th century.

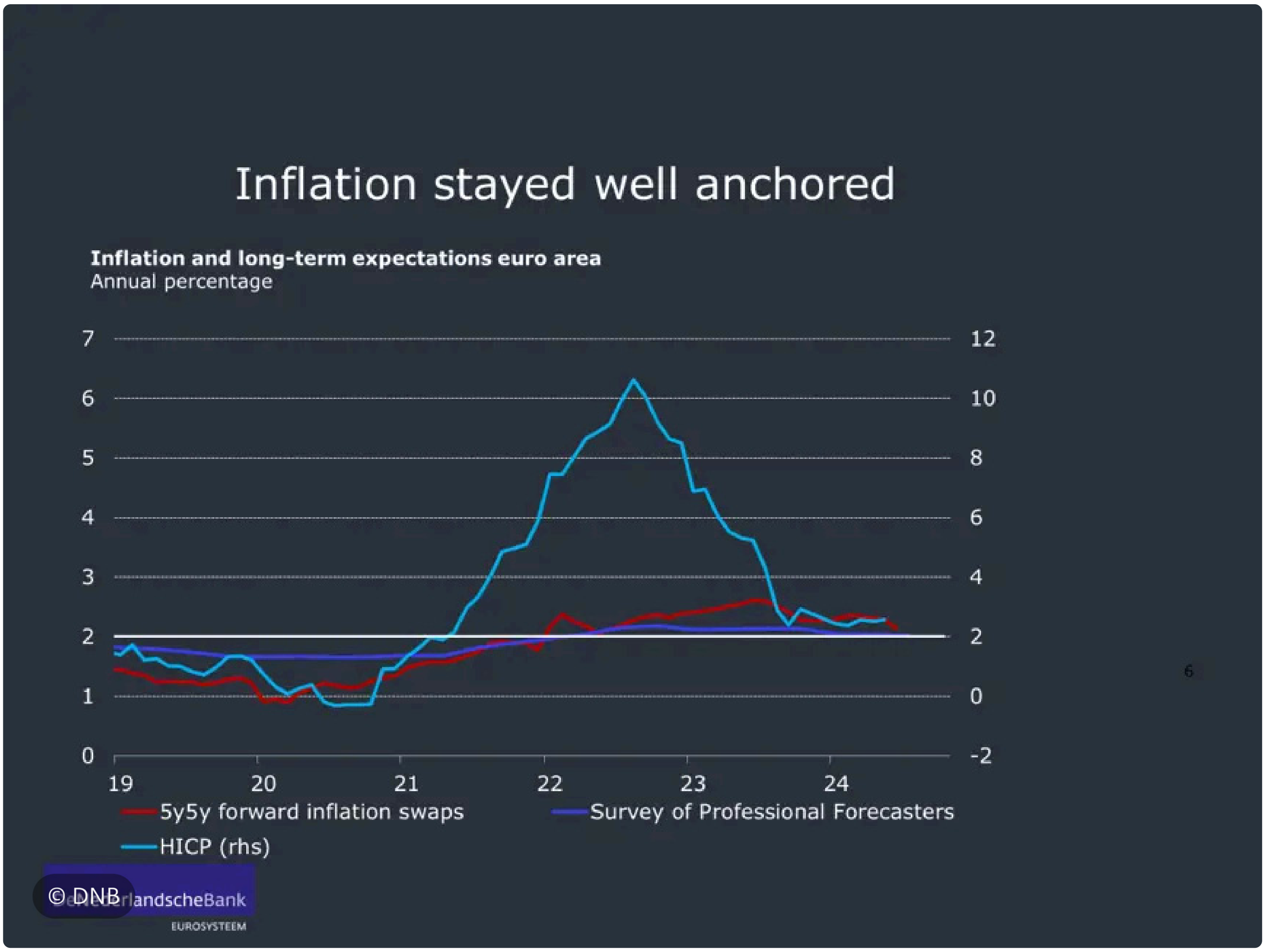
But still, it took time and effort in many countries to wrest the mighty instrument of money from the clutches of government. In the UK, famously, the Bank of England only gained policy independence in 1998. Also in my country, the process did not go smoothly. Let me tell you what happened in 1983, for example. Back then, the Netherlands was participating in the European Exchange Rate Mechanism, and the Minister of Finance was responsible for setting the parity of the domestic currency. For years, DNB's monetary strategy had been based on firmly pegging the Dutch guilder to the German mark. By doing so, we had successfully imported the credibility of the Bundesbank, which was at that time the champion of monetary orthodoxy. When, in 1983, the Deutschmark revalued against the other western-European currencies, the Dutch government, for reasons of competitiveness, and against the advice of the Dutch central bank, did not fully follow the German move. That proved to be a costly decision, particularly for the highly indebted Dutch government. As a result of this breach of a long standing policy commitment, Dutch interest rates rose vis-à-vis German interest rates, reflecting a visible risk premium. It took about 10 years for this interest rate differential to come down.

The arrival of the Economic and Monetary Union was an important step for central bank independence in Western Europe. Germany, with my country's support, insisted that the Bundesbank model of firm central bank independence would be copied to the newly established European Central Bank. The Treaty on the Functioning of the European Union provides that the ECB "shall be independent in the exercise of its powers". Importantly, this independence also applies to the EU's national central banks. This ensures that no single EU Member State can change or revoke the ECB's independence alone.

Standing on this firm legal footing, I think that overall the ECB has been successful in establishing its reputation as an independent and firmly committed inflation fighter. As you know, this has not come without challenges. The Great Financial Crisis, followed by the euro sovereign debt crisis and the Covid pandemic, spurred the ECB, together with other central banks, to resort to unconventional policies. This involved purchasing huge amounts of government bonds, which for some critics blurred the distinction between monetary and fiscal policy and raised questions about central bank independence.

Without going into that discussion at length, I think this episode did not tarnish the ECB's reputation for being tough on inflation. Examining the behaviour of inflation expectations can be quite insightful here. They serve as a critical measure of how credible a monetary regime remains over time. When the regime is trusted, these expectations should remain stable around the target and not be significantly influenced by short-term economic changes.

A real test of the ECB's credibility came when the two shocks of the Covid pandemic and Russia's invasion of Ukraine sent inflation rates soaring to levels not seen since the 1970s. When inflation pressures started to mount in the course of 2021 following a prolonged period of below-target inflation, my colleagues and I on the Governing Council decided to wait with tightening our policy until sufficient evidence was available to suggest that the large inflation shocks were not just temporary. Once a second inflation shock hit in the spring of 2022, with Russia's invasion of Ukraine, it became evident that inflation pressures were becoming persistent. Although that meant we started tightening policy a little bit later than we could have, our forceful response prevented high inflation from causing a de-anchoring of inflation expectations.



As you can see in this graph, long-term inflation expectations for the euro area, measuring the ECB's credibility, have remained broadly in line with our target. This has enabled us to bring back inflation levels to close to target without a significant cost to the real economy. So I think we can safely say that the ECB's policy credibility, enshrined in the Treaty and built up carefully over the past 25 years, has paid off well.

Similarly, the central bank of Türkiye has set on a course to strengthen its reputation as a tough inflation fighter. It has brought inflation down significantly in recent years and it is strongly committed to stabilising prices further. I think this is an accomplishment whose significance should not be underestimated. As the central bank's credibility grows, inflation expectations will decline over time. In the long run, this will reduce the economic cost of future disinflation policies. For the people of Türkiye this means: a more stable economy, more jobs and more prosperity.

As for Vissering, judging from his travel diary, Türkiye really stole his heart. He was mesmerised by the city of Istanbul, he even bought two traditional Turkish carpets and had them shipped to Amsterdam. And he admired the work ethics of his Turkish hosts. As he wrote in one of his letters: 'I cannot give enough praise to the cooperation by the Turks. They are friendly without being pushy, businesslike but still very attentive.'

Even after he resigned as president of the Dutch central bank, Gerard Vissering always maintained friendly ties with Türkiye. The later Turkish President Mustafa İsmet İnönü in particular continued to seek his advice. And every New Year, Celâl Bayar, the director of the Iş Bank, who would later also become president of Türkiye, sent Vissering 2,000 cigarettes as a token of friendship.

Vissering's mission was of great historic and economic significance. Not only to Türkiye. I believe that his groundwork for establishing a modern central bank, and his focus on expertise, stability and independence, in essence can serve as a role model for central banks around the world up to this day.

Monetary policy credibility does not come overnight. It has to be earned. Again and again. This requires central banks to have a clear and unambiguous mandate, independence coupled with accountability, and a constructive but at-arm's-length relationship with the financial sector and government. This is not something that central banks can deliver all by themselves. For this to happen, society must stand with their central bankers as they fulfil their role as guardians of stability. This is not only essential, but it is also the rational thing to do, because in the end, a stable and healthy economy is in the interest of everyone.

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