Principles of Central Bank Law

15 January 2024

Model Answer

Question 1 (25%)

Discuss how central bank mandates/objectives have changed over time and whether you feel they are fit for purpose in today's economy?

A – Traditionally, central banks were banking corporations that performed banking operations for economies – borrowing and lending – to other banks and individuals/firms.

In 19^{th}/20^{th} centuries central banks came under governmental control and influence to support government economic policies.

Governments enacted statutory mandates (and in some cases constitutional mandates) that set forth their powers, functions and objectives. This provided the legal basis for their mandates. Mandates consisted of institutional authority in which they were given independence to achieve their objectives.

Different countries had different mandates/objectives. Price stability was a prominent objective in the 20^{th} century – to control inflation and protect value of currency. Other countries had objectives including supporting economic growth and development, and others had financial stability as an objective.

Central bank mandates vary from country to country. For example, Swiss central bank pursues price stability and financial stability and has a strong form of independence. Bank of England used to have only price stability but now has financial stability objective.

As monetary policy became important for government economic policy. Governments began to influence central bank operations – for example purchase government debt. Like the Bank of England did with the UK government when it was established in 1689.

Today new challenges confront central banks/govts, such climate change, social sustainability, inequality. Can/should central bank mandates be interpreted more broadly.

Discuss evolution of central bank mandates in terms in of their functions, powers and objectives. Some mention of legal framework – statutory and/or constitutional or EU treaties framework.

Question 2 (25%)

Discuss what tools central banks can use to address financial stability risks? In your view, which ones are most effective?

1) Monetary policy tools – interest rates – may be used, but may not be most effective, because they concern mainly inflation and price stability, not necessarily financial stability. Some tools like quantitative easing (changing supply of money) might provide liquidity to banking system.
2) Macroprudential tools are most important for financial stability risks.
   - Countercyclical capital requirements, capital conservation buffer, SIFI surcharge for capital, and liquidity requirements, Liquidity coverage ratio and Net stable funding ratio
   - Monitoring payment system – RTGS is most modern but multilateral netting still used.
   - New financial risks, such as climate change and environmental stability risks.
   - Should discuss which tools/instruments are more effective. Each one is effective in own way and so no absolute correct answer. Expect to spot issues.

Question 3

Hypothetical question

a. Discuss what principles of European Union law discussed in class would be applicable to the above facts. (10%)

   Principle of independence of central banks. EU law requires four types of independence: Financial independence, functional, institutional and operational independence,

   The Maastricht Treaty (or EU Treaty), can cite articles 382 and other articles, but not necessary to cite articles. ESCB/ECB has strong gorm of independence that applies for all EU central banks. Discuss how central banks should operator without being politically influenced. ESU State for Central banks requires that central banks only take price stability into account. Not take into account political events, such as elections.

b. Do you think the central bank president acted in conformity with the applicable EU legal principles? Why or why not? (10%)

   Inflation was over the ESCB target of 2%, so probably not advisable to reduce interest rates in inflationary environment. It appears that CB president took upcoming elections into account in deciding whether to reduce interest rates. But could argue that there were other factoers justifying the interest rate reduction that were not political and were related to price stability. Generally, central bank should only adjust monetary policy – interest rates – if it is necessary to support price stability, specifically 2% inflation target.

c. Do you think the parliamentary investigation of the central bank president is lawful under the applicable EU legal principles? Why or why not? (10%)

   One the on hand, it could infringe on central bank independence to make decisions as CB deems fit or necessary. On other hand, accountability is important principle that CBs should be held to account for decisions and if decisions are allegedly unlawful then perhaps legislative investigations are necessary. Students should have balanced argument supporting both views.

Question 4
What are Central Bank Digital Currencies? In your view, should central banks issue them? What are some of the pros and cons?

Discuss electronic nature of CB currencies – digital currencies. Should CBs allow individuals and firms to hold CB digital currency accounts. What are the implications for the banki9ng system? Will banks lose a lot of business and possibly become unsound as CBs move into the provision of digital currencies. It could create financial stability problems, such as bank runs and undermine depositor confidence in private banks.

Social implications – might increase financial inclusion, more access of low income people and non-traditional firms to bank accounts if central banks are allowed to issue CB digital currencies and allows accounts for such electronic digital accounts.

Looking for balanced discussion of pros and cons.