A BOTTOM-UP APPROACH TO RIGHTING FINANCIAL REGULATION

Central Banks: Do They Have Human Rights Obligations? - Issue No. 2

What are central banks?

Central banks issue currency, influence the money supply, regulate banks and, through their monetary policy decisions, affect key prices in the economy, such as interest rates and exchange rates. Central banks also operate as “lenders of last resort”, providing credit in times of crisis. Although central banks are generally statutory institutions - created by the state and operating under government mandates - most central banks enjoy a very significant amount of independence from government decision-making.

What do they do and how do they do it?

Central banks influence the money supply by stipulating broad rules for the banking sector. For example, central banks require commercial banks to keep back a fraction of the money supplied to them by depositors as “reserves.” These reserve requirements limit the amount of loans that commercial banks can extend. By changing reserve requirements, central banks affect the amount of credit in the economy and, hence, the money supply.

A central bank also sets the interest rates that it charges other banks. By raising and lowering this interest rate, the central bank influences interest rates throughout the economy. Why might other banks need to borrow? In normal times, banks may make loans that bring their reserves below the legal requirement. Under these conditions, they borrow from the central bank to make up the difference. When the central bank raises interest rates, commercial banks are less likely to borrow and this limits the credit they provide - another way of influencing the money supply.

Commercial banks also rely on the central bank for credit in times of crisis. During a financial collapse, banks may not be able to meet their obligations and need to borrow from the central banks to keep themselves afloat.

Central banks often take steps to influence exchange rates by buying and selling foreign currency. Suppose a central bank wants to strengthen the value of its currency. To do this, the central bank sells foreign currencies and buys the domestic currency. The central bank can only do this if it has a stock of foreign currency on hand. In other words, it needs “foreign exchange reserves.”

What do central banks have to do with human rights?

The policies which central banks adopt affect the realization of economic and social rights along a number of dimensions, from the right to work to the right to food and housing. For example, if the central bank restricts the money supply and raises interest rates, this slows down the economy. A slower economy generates fewer jobs. Slower growth can reduce tax revenues that governments rely on for social and economic policies. Higher interest rates affect the sustainability of debt - both public and private - and may cause government to cut expenditures when interest payments on the debt rise. Exchange rate policies can affect the prices of food and other essential goods. During an economic crisis, the actions of the central bank can also help stabilize the economy and prevent backsliding in the realization of rights more generally.

Although central banks affect the economic environment under which rights are realized, real world monetary policies are often very narrow in scope. Around the world, central banks primarily focus on reducing inflation and stabilizing prices. While these are important goals, they are often pursued without considering trade-offs. Central banks try to keep inflation extremely low by reducing the growth of the money supply and slowing the economy. As pointed out, this frequently has adverse consequences for human rights, especially the right to work. Controlling inflation, incidentally, often generates concrete benefits for financial interests, by protecting the value of financial investments and keeping interest rates high.

How can central banks support human rights obligations?

Although most central banks are independent, they are in the end government bodies. As such, central banks are subject to the human rights obligations of their state. Unfortunately, central banks rarely if ever take into account these obligations when formulating policies. Some of the core challenges are institutional. The official mandates of most central banks are excessively narrow, leading to conservative monetary policies and an inability to address extreme economic crises. These mandates could be changed in a way that includes a consideration of human rights. Such changes can be made without necessarily sacrificing the independence of central banks - the central bank would pursue policies that would take into account basic human rights, independent of the executive, legislative or judicial branch. Too often, however, independence is used to justify a lack of transparency and accountability. The governance of central banking is a political choice and democratic central banks, as opposed to purely independent institutions, could be easier to hold to account to their human rights obligations. Participation is also a problem, since the governance structures of central banks are typically dominated by the banking sector and financial interests. Therefore, there is a need to alter central banks' mandates to include human rights obligations. Changes are also needed to provide significantly more space for participation of civil society in central bank governance, to make information freely available regarding actions taken and the consequences of policy choices, and to provide channels of accountability whereby central bank decision-makers can be replaced if they fail to take into account their human rights obligations.

A case in point: The European Central Bank and the economic crisis

The failure of a central bank to take strong steps during an economic crisis jeopardizes economic and social rights. The current economic crisis in Europe and the actions of the European Central Bank (ECB) provide an example of these dangers. The ECB is the central bank for the Euro and the Euro Zone countries - including Greece, Portugal, and Ireland among others which currently face severe economic problems linked to their debts and debt payments. The problems are not limited to these countries, but threaten the entire Euro Zone, the European Union, and the global economy.

During the crisis, the ECB could have embraced its role as "lender of last resort" and stabilized the situation in Europe early on by buying sovereign debt (i.e. the bonds of the debt crisis countries), increasing the money supply, and lowering interest rates. The ECB has been loath to do this, arguing that such actions may lead to inflation and they violate a principle not to finance government borrowing. In many respects, the ECB's position reflects its conservative mandate which focuses narrowly on inflation and reduces its flexibility in times of crisis. Other central banks, such as the U.S. Federal Reserve, have a broader mandate that includes protecting employment, although the extent to which the Federal Reserve has been responsive to unemployment remains debatable. Recently, the problems in Europe have gotten so severe that the ECB has begun to relax its stance, providing emergency loans to financial institutions to try to prevent a collapse and by beginning to act as a lender of last resort. But by the time the ECB began to take these steps, enormous damage had been done.

Countries like Greece and Portugal have been bailed out through a process in which the ECB played a minimal role. They now face extreme austerity measures that will fundamentally undermine economic and social rights. This situation could have been ameliorated with more significant and timely actions by the ECB.

This issue was written by James Heintz, Research Professor, Political Economy Research Institute, University of Massachusetts, Amherst.

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...catalyst for economic and social justice

202.635.2757 PHONE | 202.832.9494 FAX
1225 Otis St. NE | Washington, DC 20017
www.rightingfinance.org