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Independency of Central Bank: An Overview

Harihar Dev Pant*

INTRODUCTION

The belief that an independent central bank will be able to stabilise the value of currency and tame inflation better is now fairly well established in the literature on the subject. Because of this belief, most developed countries' governments have amended the laws making the central banks independent of the governments. Stimulated by the developments in the developed countries, many developing countries are increasingly liberalising their financial system, adopting market oriented techniques of monetary policy, and making the central bank independent. In Europe, the Mastricht Treaty requires national central banks, participating in the European system of central banks, to meet a prescribed standard of independence. Outside Europe, Federal Reserve in the United States of America has remained independent for fairly long time. Reserve Bank of New Zealand was given independence in 1989. In recent years large number of countries in Latin America, East Europe and CIS states have also given independence to their central banks.

RATIONALE OF A CENTRAL BANK INDEPENDENCEY

The notion of independence for a country's central bank is based on an understanding of the role of monetary policy. It starts from recognition of the fundamental truth that inflation is essentially a monetary phenomena, though other factors may play a role at times.

Gottfried Harberler (1959) wrote in the fifties that there is no record in the history of the whole world, anywhere, or at any time, of a serious and prolonged inflation which has not been accompanied and made possible, if not caused, by a large increase in the quantity of money. In every inflation money is a casual factor, either active or permissive.

The writings of Gottfried Harberler (1959) are corroborated by the inflationary experiences of the two decades, the late 1960s to the late of

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* *Dr. Panta is Executive Chairman, Nirdhan, Rupandehi, Nepal.*

1980s, when the world adopted, for the first time, fiat money, brought home the clear relationship between expansionary policy and inflation. The view developed that where central banks were less susceptible to government pressure they delivered lower inflation.

Alan Greenspan (1994) says that in recent decade it has become increasingly clear that inflation, even at moderate rates, is destructive of economic vitality. Evidence is beginning to mount of a strong negative relationship between the degree of inflation on the one hand and the rate of growth of the productivity on the other. Moreover, while evidence of a short run trade-off between inflation and employment seems to hold in periods of low inflation expectations, the trade-off rapidly deteriorates as inflation mounts, jobs are lost, not gained. Hence a longer term strategy of price stability is also a strategy to foster maximum gains in standards of livings and emplyment.

Besides the theoretical arguments, the case for it has been strengthened by the empirical evidence that, in recent decades, the more central banks have presided over lower inflation, but had largely similar growth employment outcomes compared with more dependent colleagues. Several authors, including Bade and Parkin (1982), Alesina (1988,1989), Grilli, Mascianandaro and Tabellini (1991), and Cukierman and Webb (1995), have found that more independent central banks are associated with lower levels of inflation. Alesina and Summer (1993) found near perfect correlation betwen inflation and central bank independence. Their empirical findings suggest monetay discipline associated with central bank independence reduces the level and variability of inflation but does not have either large benefits or costs in terms of real macroeconomic performances.

Besides, theoretical and empirical evidence, the success of the Bundesbank and the German economy over the past few years and the Reserve Bank of New Zealand's success in reducing inflation recently have provided support for central banking independence. The Latin American region's experiences over the last two decades, have also produced an emerging consensus that monetary stability can be achieved only with a central bank of established independence because government policies tend to be of too short a term. The misuse of central bank in most of Latin American countries, in absence of central banking independence, was largely the result of the ease with which political authorities were able to implement policies without subject to budget restrictions because of the central bank's power to issue currency and the lack of transparency in their operations. Monetary policy, more than any other economic policy, requires a public perception of the central bank as a credible institution for the

policy to be effective and thus the need for a central banking independence subject to strong legal accountability and monitoring mechanism.

Acceptance of the central bank's independence by Parliament will be tantamount to political recognition of the need for safeguards against the misuse of the potentially unlimited financing powers of the government through resort to the printing press. Limiting the state's recourse to the printing press by entrusting responsibility for monetary policy to an independent central bank with clearly defined powers, accountability and objectives can be seen in the public interest. It may even be in the interest of the government itself. For all these reasons, independence from the government would seem to be a necessary element for a central bank if it is to achieve its primary objecitve of maintaining price stability. This view has not always been accepted generally. Analysts have observed that the benefits of the central bank independence are less likely to be schieved in less developed countries with shallow financial market. But it has gained acceptance in developed countries as a result of high inflation during late 1960s. This has been also accepted in Latin American countries when inflation was running high until recently. The question of central banking independence is accepted where the inflation has been very high for quite some time, and the public in general have become inflation averse.

MEANING OF THE CENTRAL BANK INDEPENDENCY

Goodhart et al. (1994) define central banking independence as the right of a central bank to change the key operational instrument without consultation or challenge from the government. In their view, this instrument has, in practice, almost always been a central short term money market rate. They state that, if this definition of independence is applied, then there was surely a good measure of independence or freedom of action in the operation of monetary policy.

Bade and Parkin (1982) define cental banking independence as the ability of the central bank to select its policy objectives and use of monetary policy instruments without influence and restrictions from the government. The most common constraint imposed upon the conduct of monetary policy is the extent to which the central bank is required to finance government deficit.

Besides objective and instrument independence and prohibition or limit to the central bank finance to the government, central banking independence also depends on the institutional relationshop between the central bank and the executive, the procedure to nominate and dismiss the governor and the board of directors and the length of their tenure, the role

of government officials on the central bank board, and the frequency and nature of contacts between the executive and the bank officials. It is also based on whether *price stabilty* objective is explicitly and prominently part of the central bank statute.

In practice we find three variants of the central bank independence. The first is the traditional situation, where central banks are granted formal independence, defined as separate institution from the government department, but the governments retain enough power to make important decisions, including the right to remove the governor. This type of independence is still widely prevalent in most of the developing countries. Other type of independence is where statutes have tried to grant more independence to the monetary authority but the government reserves the right to dictate the final word on the exchange rate and monetary policies of the government formally, providing simultaneously for a mechanism to solve disputes in case of disagreements. Thirdly, recently enacted legislations have moved in the direction of granting full responsibility to the bank in monetary matters, under the well founded assumption that a strong and independent central bank would be in a better position to maintain price stability.

Among the three types of independence, in one extreme lies the statute of the European central bank adopted under the Mastricht Treaty, which provides effective independence to the central banks. The reason behind providing full independence to the central bank lies largely in the belief that, insulated from short term political pressures, it will be in a position to pursue its objective more effectively. Under this, the central bank's primary objective is fixed as price stability. The central bank is required to support the governnment's general economic policies only if it does not conflict with its main objective. The central banks under Mastricht are prohibited to provide overdraft or any other type of credit facility to the government or any other public authorities. Central banks are also prohibited to seek or take instruction from the government or from any other body. The term of office of the governor is fixed and it has also a provision on dismissal of the governor. To make the working of the central bank transparent and to check the misuse of resources and power, it has required the central bank authorities to be accountable, maintain professional secrecy and audit by independent external auditors. The above requirements, if implemented in letter and spirit, will make the central banks, within European Union, completely independent of the government and political authorities.

On the other hand there are many central banks, mostly in the developing countries, which are established under separate act but treated as a government department. In those central banks, the governor has to consult or get permission from the government authorities, it may or may not be necessary under the law, not only about policy matters but even about staffing and other functions to be conducted by the central bank. Appointment, dismissal and term of office of the governor and board of directors depend upon the pleasure of the government.

Then, there are some central banks in both developed and developing countries, whose statutes give them full autonomy in the functions and administration but reserve to the government the right to dictate, formally, the final word on the exchange rate and monetary policies of the country and providing simultaneously for a mechanism to solve disputes in case of disagreement.

ISSUES IN THE ROLE AND INDEPENDENCE OF CENTRAL BANKS

For the last one half decade, large number of countries have embarked on wide ranging structural reforms geared towards market based practices in general and financial sector in particular. Financial sector is an area that has received special attention and within the financial sector, reform of the central bank is considered essential. Strengthening of central bank independence has been seen as a necessary condition for sound central banking policies. But there are wide differences of opinion regarding the scope and extent of central bank independence. It must be recognised that independence will depend not only on legislation but also on the complex outcome of the interaction of a number of political, economic, cultural and institutional features, practices and central bank's own actions.

To provide full independence to the central bank, the government, politicians and the public in large have to strongly feel that inflation worsens economic welfare and prosperity of the people. They also have to be convinced that inflation is mainly a monetary phenomenon and can be controlled by monetary stability. It would also be helpful if the authorities are convinced in the necessity of monetary stability. It would also be helpful if the authorities are convinced in the necessity of monetary stability for efficient allocation of resources. Following are some of the important issues and consideration involved in the discussion of the role and degree of central banking independence.

Objective

Laws in most of the countries have assigned multiple objectives to central banks. Experience has shown that multiple objectives without prioritisation can at times lead to policy conflicts and create consistency problems between objectives. The advantage of having a clearly delimited objective is that central bnaks' policies can be geared to attain that objective and as a consequence, their policies can be more predictable and their outcome more easily evaluated. So the central bank should be assigned one single objective of maintaining the value of currecny. If a statutory objective with a relatively narrow focus is fixed, the central bank would find it convenient to achieve it, it can be easily monitored and the bank can be made accountable for not achieving the objective.

However, defining the maintenance of the value of currency as the central bank's main objective does not prevent it from exercising other supporting objectives. A major trend worldwide is to include promoting financial markets, fostering an efficient payment system, and maintaining a sound and properly functioning financial system as supporting objectives.

Instrument Independence

Independence to select and use any monetary policy instrument without consultation, influence and restraint from the government is another important issue to be considered in amendment of a central bank statue. Interest rate is one of the instruments which usually invites government intervention.

Financing of Government Deficit

Governments in most countries, specially in developing countries, like to spend beyond their means for creating employment and developing much needed social and economic infrastructure. Financing large government deficit has been main reason for monetary expansion and resultant inflation in most of the countries. The independence of central banks has often been associated with the powers to limit the credit that they can grant to the government. Governments have used the monopoly to issue money granted to central banks to obtain financing for their deficit. When the central bank is no longer allowed to finance the government, the possibility of creating money in excess of what is demanded because of political pressure is reduced. Main issue in this regard is whether to prohibit overdraft facilities or any other type of central bank credit to the government and other public authorities or restrict it to certain level.

However, there appears general unanimity in not providing unlimited central bank facilities to the government.

Foreign Exchange Policy

In a fixed rate system, if the exchange rate and interest rate policies are not coordinatedd, it may create difficulty to achieve the monetary target. If the government sets the exchange rate at a level inconsistent with the monetary target, the central bank is likely to loose control of the money supply since sterilised intervention will be ineffective. However, the conflict will disappear if the government opts for a free floating regime. There is no disagreement in the choice of the exchange rate regime to be determined by the government. The issue is whether the exchange rate should be determined by the government or by the central bank, if the monetary target is to be achieved.

Coordination with Government

Monetary policy is a very important element of economic policy. Therefore, central bank and the government's policy measures need to be closely coordinated. The central bank should cooperate with the government to make its economic policy successful if it does not jeopardise the attainment of the central bank's policy objective. So while providing independence to the central bank, such coordination mechanism should be developed which guarantees autonomy and effectiveness of the central bank but at the same time avert markets and economic agents from receiving conflicting signals about the direction of overall economic policy.

Rules Governing Appointment, Dismissal and Term of the Governor, Board and its Composition

The degree of independence of a central bank depends on how the governor and board members are appointed and removed from their post and also on the composition of its board. Governors with very short term of office generally find difficulty implementing long term policies, for example, the maintenance of price stability, for any political cycle. However, Cuckierman and Webb (1995) found that the threshold turnover of central bank governors between 0.2 and 0.25 for a governors tenure of four to five years. They also found that the estimated probability of a change of the governor is more than 2 times longer in periods within 6 months after a political transition than in periods that are more removed from political change. The study by Cuckierman, Webb and Neyapti (1992) also found that the legal term of office did not seem to have much effect on the turnover rate of the governor and board members in developing

countries, with political authorities frequently firing those who challenge them and choosing those loyal and sub-servient to them.

So to protect the central bank governor from being dismissed by the political authorities in the event of displeasure with the policies of the bank, the Mastricht Treaty Protocol (Effros 1994) has incorporated an express provision on the subject of dismissal as, 'A governor may be relieved from office only if he no longer fulfills the conditions required for the performance of his duties or if he has been guilty of serious misconduct." If the governor is removed on grounds other than mentioned above, the protocol provides for reference to the court of justice by the governor. But most of the central bank statutes do not provide such protection. However, the trend in new statutes is to give stability to the governor and boards and limit government intervention in appointment and dismissal, so that they can perform their duties without short term of pressure, and preserve them from political or sectoral influences.

So if the central bank actions are to be made effective, the governments should consider the following matters while enacting the central banking statues: (i) the government's appointment and dismissal powers, (ii) involve more than the executive branch of the government in appointment and dismissal, (iii) requiring individual board members to have techincal expertise on central banking matters and not represent interest groups, and (iv) setting long term of tenure.

Accountability of the Bank

Given independence, the central bank should be made accountable for the policies and operation to the parliament, government and the public. The bank should announce its policies in regular intervals. It should also be required to explain and justify its policies to the legislature and the public. Central banks' operations and accounting should be made transparent.

CONCLUSION

Recent changes in central bank legislations have sought to address the main concern that have affected central banks' working in the past. There appears consensus in some issues like objective, independence of instruments and financing to the governments. Most central banks within the European Union are prohibited to lend directly to the government. Some central banks even in other regions like Latin America, CIS countries, Eastern Europe are either prohibited to make loans and advances to the government or required not to exceed beyond certain percentage of GDP or

government expenditure. Recently enacted central bank legislations have also made efforts to make board of director more professional and independent of the goverment. They have devised ways in the appointment and dismissal of the governor and board of directors without political biaseness.

On the basis of the laws enacted in late 1980s and 1990s, it appears that central banks are moving towards relatively more independence. However, it must be recognised that independence of a central bank cannot be achieved in abstract by just passing a law. There could be sizable discrepancies between the level of independence legally conferred on a central and its degree of autonomy in practice. The degree of autonomy depends on economic, political and other informal aspects, traditions and unquantifiable factors wich are unlikely to be incorporated into legal provisions. It also depends on the personality of the central bank and government officials, their reputation, technical expertise and credibility and relations between central bank and other institutions.

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