An Examination of Central Bank Independence and Power

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The argument which stresses the role of an independent central bank in preserving the soundness of money by ensuring a low rate of inflation tends to be both narrow and inconsistent. However, much of the debate for independent central banks derives from empirical evidence rather than from theoretical propositions, and if low rates of inflation could be clearly demonstrated to lead to higher rates of economic growth and/or more stable rates of growth, it would provide an argument with which it would be difficult to disagree with the proposition that the market economy operates more efficiently at low rates of inflation. As macroeconomic policy has been developing at a fast pace in recent years, governments have increasingly moved in the direction of restricting themselves to the use of one instrument of policy. It is in this context that the role of the central bank has been accorded so much focus along with its governance. At the same time, there has been a significant move to increase the independence and power of central banks. This would appear to be placing macroeconomic policy almost entirely in the hands of central banks. Yet, monetary policy seems only likely to be effective when central banks behave in the way that financial markets expect and wish them to do so. Moreover, governments seem to have little control over the operation of financial markets. This appears to remove macroeconomic policy entirely not just from short-sighted politicians but from any institutions which might be expected to have the best interests of the entire economy at heart.

I. INTRODUCTION

Attitudes towards the central bank and its roles have changed regularly over time and has been different among countries. The world has experienced a major change across many economies as politicians and economists have shifted their stance in the direction of the 'independence' of central banks, moving strongly towards the adoption of the arrangements and procedures of the ideal central bank model. The basis was proposed looking at the arrangement of the Bundesbank. Other examples of a move towards 'independence' was the Bank of France at the beginning of 1994. In the United Kingdom, there have been some small moves in that direction as well as much discussion of the issue.

It must be first noted that the usual discussion of the role of the central bank in this context concentrates on one aspect only of the full set of responsibilities borne by central banks in many countries—that of the operation of monetary policy.

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Specifically, it omits consideration of the supervisory role of many central banks[1] – the role of ensuring the financial probity and soundness of individual banks as well as the banking sector as a whole and hence the role of guarantor of the degree of public confidence in the system which is essential for the operation of an advanced market economy. The separation of monetary policy from bank supervision is easy enough to accept at one level particularly both because it is practised in several advanced economies (notably in Germany where the responsibility for bank supervision rests with the *Aufsichtsamt*, the Federal Banking Supervisory Office) and because there are some clear arguments for it based principally upon moral hazard. Nonetheless, this separation leads to a compartmentalization of the elements of the idea of the 'soundness of money' which is central to the needs of the market system. It also raises questions about the nature of the credibility of the central bank.

Against the above backdrop, the general meaning of 'independence' and what central bank independence implies for monetary policy are discussed.

II. THE MEANING OF AND STANDARD JUSTIFICATION FOR 'INDEPENDENCE'

In the modern debate over the independence of central banks, 'independence' has taken on the simple meaning of independence from the political institutions and processes of the country. This is nothing new. Politicians were always under suspicion of having a bias towards 'easy money' and 'inflation' (Sylla, 1998). As such, some of the elements of the requirements of independence when the US Federal Reserve System was set up in 1913 were independence from a) duly constituted government authorities (executive and legislature); and b) partisan political interests.

Modern political and economic theory has, however, gone well beyond a generalized suspicion of politicians and has formalized the arguments in favor of this form of independence in a number of ways. Thus, there is the theory of political cycles as a criticism of the short-run motivation of politicians; public choice theory as a criticism of the self-interest of both politicians and bureaucrats; arguments for the irrelevance of demand-management policy based upon rational expectations; and the notion of time inconsistency developed by Kydland and Prescott (1977) and Barro and Gordon (1983) to adore this viewpoint. This is all supported by empirical evidence implying the absence of a long-run trade-off between inflation and unemployment and the apparent relative success in the

[1] In 26 countries investigated by Goodhart and Schoenmaker (1993), the central bank was fully responsible for bank supervision in 13, including Australia, Italy, the Netherlands, Spain and the United Kingdom. In another four, including Japan and the United States, supervisory duties were shared between the central bank and one or more other agencies. In the remaining nine, including Germany, Switzerland and Austria, there was a complete separation between monetary policy and supervision of the banking system.

control of inflation of countries with relatively independent (in the above sense) central banks.

Yet, several issues are fudged in the way in which these various propositions are put together. To begin with, the assumption is that if countries with politically independent central banks are successful at maintaining low rates of inflation, the central bank must in some sense have control over monetary policy and the monetary system. But, this may not be so always. The goal of monetary policy has come to be defined solely in terms of the rate of inflation. This derives from the absence of a long-run trade-off between inflation and unemployment, allowing the possibility that welfare may be improved through a reduction in inflation at no long-run cost in terms of loss of output and higher unemployment. More broadly, the low (or zero) inflation target can be seen as a more technical definition of the old idea of 'sound money' for which the money-issuing authority could reasonably be held to be responsible. The problem is that it represents an extremely limited view of 'sound money'.

There can be no doubt that rapid inflation, by reducing the real value of money, undermines public confidence in money as an asset and strikes at the basis of a modern monetary economy and hence an efficient market economy. However, international distrust of the currencies of high-inflation countries either undermines the international value of the currency (damaging the country's terms of trade) or requires risk premia to be built into national interest rates (in turn keeping interest rates high with potentially damaging impacts on investment). In this sense, continued high inflation rates damage the 'soundness' of money.

But the notion of the soundness of money may be hard hit in other ways, too. Vitally, since a high proportion of the money stock consists of the liabilities of banks, the willingness of the public to hold money may be undermined by the possibility of bank failure. This may also arise dramatically in the case of a too-tight monetary policy which forces banks into cash-flow problems and generates doubts in the public which may lead to runs on banks. Alternatively, it may arise as a result of the failure of individual banks due to unfortunate investment policies. If these are large banks, the great amount of interbank activity may cause problems for the system as a whole. Again, if the failure leads to a public suspicion that banks in general are not to be trusted and are inadequately supervised, problems may spread.

Thus, the difficulties in which international banks found themselves at the beginning of the 'debt crisis' of the developing countries in the early 1980s were in part due to the behavior of the banks themselves and in part due to the monetary policies of the developed countries. These difficulties raised serious doubts about the soundness of the international monetary system as a whole and hence about the soundness of the 'product' of that system. It must also be noted that the failure of the British merchant bank, Barings, raises doubts about the effectiveness of bank supervision and the potential risks associated with speculation in complex derivative products. This, too, calls into question the soundness of money.

At an international level, the soundness of different currencies may only partially (and then only in the very long run) have anything to do with relative rates of inflation as has been witnessed recently in relation to the weakness of the US dollar. In a world of such complexity, it is surely simplistic to judge the soundness of money by the single measure of domestic inflation rates.

Even with domestic systems, inflation represents only one half of the problem since one should ask why the soundness of money is so vital for a market economy. For economists, the first answer must be in terms of resource allocation – the ability of the market system to combine the scarce resources of a country to produce high levels of economic welfare. Logically then, if the exchange mechanism is hampered by lack of confidence in money, the market system will not perform its economic task satisfactorily. But the market system also fails to carry out its resource allocation role effectively if there is a lack of co-ordination in the system and a distribution of income which does not ensure that those who need and/or wish to spend have access to the income required to carry out their plans. In other words, the 'soundness' of money is irrelevant to people who do not have wealth and for whom the decision as to how to allocate their portfolios consists entirely of dreaming what they will do, for instance, if they win a lottery. The soundness of money may be a necessary condition for the efficient operation of a market economy, but it is certainly not a sufficient case.

Indeed, it is arguable that the growth of domestic central banks in industrial countries was associated with bankers exercising control over monetary policy in an attempt to reduce the number and severity of slumps in the economy. That is, central banks arose out of a perceived need on the part of manufacturing and finance for greater stability and a fear of falling prices (Hicks, 1967).

The modern concentration on inflation, on the other hand, assumes that in all matters other than the issue of money itself, the market economy works effectively to co-ordinate decisions within the economy and to ensure that demand always matches supply in the long-run. Attempts to match demand more closely with supply in the short-run only interfere with incentives and cause problems for long-run supply. Free banking models assume that the market economy can also be trusted with the task of providing the economy's money. This has the virtue of both simplicity and logic.[2] There seems to be no *a priori argument* for suggesting that an uncontrolled market system can cope with the co-ordination of the vast number and range of complex decisions required to convert scarce resources into output desired by consumers but cannot cope with the relatively simple task of providing the economy with a medium of exchange (something which has been achieved even within primitive societies with no productive capacity).

Thus, the argument which emphasizes the role of an independent central bank in preserving the soundness of money by ensuring a low rate of inflation seems both narrow and inconsistent. However, much of the argument for independent central banks is based upon empirical evidence rather than from theoretical

[2] For a short outline of a free banking model, see Selgin (1994)

propositions; certainly, if low rates of inflation could be clearly demonstrated to cause higher rates of economic growth and/or more stable rates of growth, it would provide an argument with which it would be difficult to disagree with the proposition that the market economy operates more efficiently at low rates of inflation.

III. THE QUESTION OF CONTROL OVER MONETARY POLICY

The assumption underlying the case for independent central banks that the central bank must in some sense have control over monetary policy and the monetary system needs further elaboration. Clearly, if this is not true the correlation between measures of central bank independence and inflation rates[3] must then: (1) indicate that there must be reverse causality; (2) indicate that some other factor must be causing both the degree of independence and the inflation rate, or (3) be merely accidental. Thus, it needs to be explored in what sense this could be held to be true.

According to the basic monetarist theory, the central bank's power must come from control of the rate of growth of the money supply through control of the monetary base of the economy. Not only that, but this is meant to operate through the establishment of medium– or long-term monetary rules. It is known, however, that monetary base control is not usually practised by monetary authorities. Goodhart (1994), arguing from the perspective of central bankers, suggests indeed that monetary base control is impossible, although he notes that most economists go on believing mistakenly that the monetary base is controllable within a narrow margin. In practice, all central banks operate monetary policy through control of short-term interest rates. This is meant to influence the full spectrum of interest rates and through this aggregate demand, the demand for credit, bank deposits and hence the rate of growth of the money supply. The first question relates to the sense in which an .independent central bank is actually in control of short-term interest rates.

The bank will, in the terms of Fischer (1994), have operational independence but not goal independence. This is, it will have been given a broad objective which stresses control of the rate of inflation. This emphasis on control of inflation is both desired by financial markets and is used to generate expectations as to what the central bank is likely to do. The few attempts at the establishment of long-term monetary rules have had little apparent success. Nonetheless, economists continue to debate at some length whether interest rate policy should be decided on the basis of some measure of the money stock (despite the problems with definitions in several countries caused by financial innovation) or a final target such as nominal

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[3] For the most detailed statistical analysis of this link, as well as the fullest statement of the case for independent central banks, see Cukierman (1992). Cukierman (1994) summarizes much of the argument.

GDP, the level of prices or the rate of inflation. In practice, central banks are likely to make their decisions about interest rate policy on the basis of changes in a number of indicators chief among which are likely to be the rate of growth of the money supply, the rate of growth of demand (in relation to what is perceived to be a 'sustainable' medium-term real rate of growth for the economy), unemployment figures and other evidences concerning pressure within labor markets, the rate of inflation shown by a variety of price indices, and exchange rates. Interest rate changes occur quite regularly in all the industrial countries and policy accords much more with the 'discretionary' level which used to be attached to Keynesian policies than with the idea of a monetary rule. All of this is true even for 'independent' central banks, the Bundesbank or the European Central Bank.

Many of the changes in interest rate are small, often 0.25 or 0.5%. Why are such changes believed to work in the way that the central bank wishes ? We have moved a long way in recent years from belief in Keynesian interest – inelastic investment demand curves, but it remains that very few people are likely to think that a change of 0.25% in short-term interest rates would, of and by itself, produce a significant change in the investment decisions of firms or the consumption decisions of households. But, the mechanism which is generally held to operate is that of credibility and reputation.

It is generally viewed that the central bank would have the power to control demand through the interest rate if it chose to exercise it. But it does not need to do this as long as financial markets believe that it could and would do so if required. Thus, the central bank operates through a series of signals to the financial markets. The catch is that these signals only have power as long as the financial markets believe that the policy of the central bank is 'credible', by which is implied that the central bank follows the path that the markets think it should do in order to achieve the target which the markets accept as desirable.

Worse than this, if the central bank's policy is not held to be credible, and it does wish to achieve a low rate of inflation, it will need to push interest rates up much faster and much further than would otherwise be necessary in order to overcome the scepticism of the markets. This, almost inevitably, will produce a much deeper recession than would otherwise have been needed.

Under these circumstances, does it actually matter who makes the interest rate decisions ? If politicians make them, the markets will not believe in the authorities' determination to control inflation, the policy will not be credible and the economy will not respond to small interest rate changes. But what would happen if an 'independent' central bank chose, against market expectations, to follow an expansionary path? Surely, the outcome would be exactly the same as if the decisions had been undertaken by the politicians. Thus, it is significant that even an 'independent' central bank either has to have an anti-inflation reputation built up over many years, as with the Bundesbank or the Swiss National Bank, or it must have its hands tied in a very specific way, as in the case of New Zealand where achievement of a narrow target rate of inflation is linked to the possibility of reappointment for the central bank governor. It is not irrelevant either that the

evidence seems to suggest, even to strong supporters of the case for independence, that central bank independence 'appears to be efficient mostly as a safeguard against the onset of high inflation rather than as a remedial device' (Cukierman, 1994, p.1441). In the language of the debate, authorities who do not have a strong anti-inflation reputation must pre-commit monetary policy to a pre-announced (low inflation) course.

Further, consider a government which decided to make the country's central bank independent of it and drew up a constitution for the bank but included in this an objective function for the bank which stressed the importance of the rate of growth and the level of employment ahead of any concern with the rate of inflation. Is there any reason to believe that the financial markets would regard the policy of such an independent central bank as credible ? Again, in a country where the control of inflation wins votes, politicians are likely to choose policies which will keep inflation in check. Would there be any difference in such a case between the central bank policy followed by a government and that followed by an 'independent' central bank which was required to maintain a low rate of inflation as a priority ?

It has been argued that gains arise from political independent central banks because they can build a reputation for precommitment (to a low inflation policy) which is not, by definition, available to politicians. The central bank can then exploit this reputation to allow it to use monetary policy for short-run purposes (expanding the money supply, for instance, to counter deflationary shocks) without raising long-run inflationary expectations. Thus, a politically independent central bank could, so long as it allowed itself or was allowed then freedom to move away in the short run from its inflation target, achieve a combination of low inflation in the long-run and stable short-run output.

But isn't there something missing here ? If the argument against politicians is that they adopt short-run policies in order to win elections, why does that generate long-run inflationary expectations ? The answer obviously must be that politicians do not have a reputation for achieving low inflation in the long-run. But there is no theoretical support of political behavior to justify this. Indeed, the standard theory of the political cycle does not necessarily suggest that there is any long-term bias towards over-expansionary policy since, between elections, governments may be forced (often by the balance of payments constraint) to operate restrictive policies. In any case, if people understand that the economy is best-served in the long-run by low inflation, they surely will not vote for politicians who have a long-run bias towards inflation. Hence, it is not the distinction between politicians and a politically independent central bank which is important but the nature of the target and whether or not that target is accepted by financial markets.

As such an 'independent' central bank is in fact not independent of the preferences and expectations of financial markets. Interestingly enough, the third independence requirement for the Federal Reserve System created by an act of Congress in 1913 was that it should be independent of 'private financial business interests' and this may be interpreted as relating to individual business interests

rather than to the financial or business sectors as a whole. Thus, the intention may have been to ensure that the central bank did not pursue policies which favored one set of business interests at the expense of others. In any case this makes it imperative to consider the undergoing questions.

Is it necessarily the case that the preferences of the financial sector reflect the preferences of the market economy in general? The answer might only be yes, if there were conclusive evidence that low rates of inflation led to higher and more stable rates of economic growth (although changes in income distribution may mean that higher rates of growth are not Pareto-improving[4]). However, as is indicated above, such an evidence does not exist. Studies such as that by Alesina and Summers (1993) suggest that although central bank independence, however measured, is accompanied by lower inflation, it is not associated with lower unemployment, a more stable economy, higher economic growth, or less volatile rates of economic growth[5]. If this is so, it must be true that monetary policy which only becomes effective when it is credible to financial markets must from time to time be against the interests of other business interests.

And again, even if the interests of different elements of the business sector were always in accord, does the view that, with regard to monetary policy, the preferences of that sector should dominate those generated by the political system? It has been illustrated above that the argument against the political system is that politicians are governed by short-term concerns while in this area of policy there is a conflict between the short-term interests of the voters and the long-term interests of the economy. The implication appears to be that voters do not know the long-term interests of the economy and are thus duped by politicians. The problem here is that, as agents in the market economy, people are assumed to have rational expectations and to be able to understand both how governments are likely to respond to economic circumstances and what the impact of government policy will be. It is indeed known that the Kydland and Prescott/Barro and Gordon time inconsistency construct assumes that people know very well exactly what politicians are up to. Yet, as actors in the political system, people are assumed to be

[4] There is also the seigniorage argument which suggests that differential rates of inflation may be justified among countries and that higher rates of inflation may be desirable in countries with inefficient public finance structures.

[5] Cukierman (1994) suggests that central bank independence may be related to higher rates of economic growth in developing countries – but, in countries in which the average term of office of the central bank governor was about one year, as compared with a legal term of office of four years (as was the case in Argentina between 1950 and 1989) is clearly subject to so much political turbulence that simple correlations between central bank independence and rates of growth seem hardly likely to provide an adequate representation of the motive forces of the economies. With industrial countries, the evidence appears to be neutral – that is, that average real growth is unrelated to central bank independence. Thus, one has the argument that there is a costless gain available through the reduction of inflation at no cost. However, this assumes that reduced inflation has no other cost for an economy and that the direction of causation is from central bank independence to the real economy, neither of which seem justifiable.

short-sighted and easily fooled. It is difficult to justify this inconsistency. If the political system generates a long-run inflationary bias which voters do not want, politicians will surely appear to win votes by promising what voters want. And to be re-elected, governments will ensure that low inflation is delivered. If, on the other hand, voters have a long-run inflationary bias, in what sense is lower inflation best for the economy ?

This is, naturally, all part of a deeper problem which derives from the assumption that there is such a thing as the long-term interests of the 'economy' as distinct from the separate and conflicting long-term interests of different groups within the economy. If this latter view is considered, an alternative interpretation of the independent central bank agenda can easily be provided—that it is a justification for the deliberate substitution of the preferences of the market system (in which voting power is replaced by market power) for those generated by the democratic system in circumstances in which it is not possible to see one set of preferences as being objectively 'superior' to the other. After all, if voters are short-sighted but market agents are 'forward-looking', it must surely be the case either that:

(a) market agents are only a subset of voters – that is, that substituting the judgement of the market for the judgement of the political system is allowing some minority to dominate;

(b) voters consist of a mixture of short-sighted and long-sighted people but there is a strong correlation between long-sightedness and wealth/market power, causing the long-sighted to dominate in the market—the outcome is the same as in (a); or

(c) that the same group of people make one set of judgements in one context and a different set in another.

If (c) is chosen, some clear justifications are warranted. It can be hardly assumed that they are irrational in one context and rational in another since this would be extremely dangerous for the majority of the economies these days. If it is assumed that both sets of decisions are rational, then is there a ground to believe that the decisions generated by the market should dominate, other than to approve of what is implied by (a) or (b) ?

An extreme version of this argument is that of Greider (1987) who says that the US Federal Reserve as a non-elected body with an anti-inflationary bias restrains economic growth in order to preserve the value of financial assets, most of which are owned by wealthy people. That is, the short-term versus long-term distinction is merely a cover for a conflict of interests. Historically, it may be said that people with market and/or military power resisted the growth of political democracy. When that battle is lost, the aim becomes to remove as much decision-making power as possible from the political system. Independent central banks determining monetary policy may be seen as one very small part of this big agenda.

IV. THE QUESTION OF CONTROL OVER THE FINANCIAL SYSTEM

Turning to the question of supervision of the financial system, the 'soundness' of money is dependent not only on the maintenance of the purchasing power of money but also on confidence in individual banks and in the banking and financial sector as a whole, and hence on the adequacy of supervision of that sector. It is this idea which leads to the proposition that the central bank should also have a supervisory role. It is possible to argue that there is no short-term gain available to politicians from the supervisory function in the same way that there is from generating inflation through a relaxed monetary policy. Thus, the supervisory role may be placed in the hands of a non-independent government agency while the independent central bank is left to deal only with monetary policy. It has been argued, indeed, that the separation of the monetary policy and supervisory roles has positive advantages for the control of inflation since where central banks are not involved in bank supervision, financial sector representatives will be less inclined to lobby central banks for easier monetary policy to reduce the regulatory burden on banks and financial companies. Whether this is true or not, under present circumstances, the separation of the two roles does not matter; however, if an attempt is made to recapture monetary policy for the political system they would need to be brought together. Even if they are kept separate, it should be conceded that the two roles are complementary and that the supervisory role is at least as important.

Whoever carries out the supervisory role, severe problems emerge with respect to the power of the supervisor to control the banking and financial sector. Here, two difficulties stand out immediately. The first one relates to competitive deregulation. No single authority is in a position to exercise firm control over the sector, for fear that the market will simply move to other financial centres. The other difficulty is the lack of information held by supervising authorities. Financial markets continue to evolve so rapidly and capital moves with such ease that there is only a slight possibility that the authorities can know precisely what is happening. The role of the central bank, is therefore, not so much as one of controlling the market as it is one of limiting the damage to the reputation of the market and containing the fallout, when things go wrong.

Putting together what is happening to monetary policy and the way in which financial markets are developing produces a paradox. At a time when more and more attention is being drawn to central banks and the demand for their independence from the government is growing, implying that central banks have considerable power which cannot be trusted to politicians, they are being shown to be virtually impotent. The debate over the form of control of central banks seems then to be barely relevant to the question of control of economic policy and of economies.

The question of why politicians everywhere, and also bureaucrats in our context, seem to be adopting central bank independence with such enthusiasm in most cases can be addressed here. One possible answer is that they are aware that,

in allowing central bank independence, they are merely giving up a nominal power—a power which has, in effect, already been lost to the markets. Thus, they lose nothing but gain by publicly shifting responsibility for the control of inflation on to a non-elected body.

V. Central Bank Independence and Nepal Rastra Bank Act, 2002

From what has been argued in the previous sections, it can now be comprehended that increasing the independence of the central bank may help to contain inflation to a certain degree if containing inflation is the main objective, but this is in itself not a full readymade capsule to swallow. It is rather a smaller part of a set of institutions and reforms that can support the objective of price stability.
The Nepal Rastra Bank Act 2002 has levied independence to some extended degree: Section (2) subsection (3) of the Act reads "The Bank shall be an autonomous and corporate body with perpetual succession." Similarly the Act has fully empowered the Nepal Rastra Bank (NRB) to enact independently among others on the formulation as well as execution of the foreign exchange as well as monetary policies.

The appointment of the Governor, the Deputy Governors as well as the Board of Directors are somewhat levied as independence. The appointment of the Governor is made on the basis of a recommendation of the Recommendation Committee formed for the very purpose and the appointment of the Deputy Governor is made on the recommendation of the Governor. However the appointment of the Board of Directors of NRB is made representing different sectors from amongst the persons renowned in economic, monetary, banking, financial, commercial, management and law sectors (Sections 15,16, and 17 of the NRB Act). Further, all the appointments are made by the council of ministers of His Majesty's Government.

Other features that extend towards the independency of the NRB include the following:

- Section 22 of the Act has imposed strong grounds in case the Governor, Deputy Governor or any Director of the Bank is to be removed. However, HMG shall not deprive the concerned person from a reasonable opportunity to defend himself prior to removing him from his office. This in any case has tied up the hands of those trying to act upon any kind of biasness.
- Section 23 has made a provision of an Inquiry Committee in case the Governor is required to be dismissed.

Several studies in the Nepalese context have also revealed that government expenditure has had a significant role in impinging on domestic prices. This, however, implies that expansionary fiscal policy, which the government has been pursuing for several years in the past, does not suit the Nepalese context. As such, the government's efforts to meet the fiscal deficit should be directed towards other sectors like increasing production, as well as widening of the tax base rather than

heavily relying on the Bank's credit and/or overdraft whatsoever the nature of it may hence be. It is here that the arguments regarding the independence of the NRB stands as relevant in order for it be apt to withstand all sorts of unwanted pressures to successfully meet the goal that it has set forth to ultimately obtain a sustainable economic growth.

Moreover, one may see through speculative eyes and be tempted to be content because the NRB Act, 2002 has given ample means thus providing the opportunity to the NRB to act independently: However, independence does not occur merely on papers. It is based on how much of the power that NRB can really bring into existence.

VI. THE CONTROL OF ECONOMIC POLICY – A SUMMARY

As macroeconomic policy has been developing at a fast pace in recent years, governments have increasingly moved in the direction of restricting themselves to the use of one instrument of policy – the rate of interest – and to one policy target – control of the rate of inflation. It has been in this context that the role of the central bank has been given so much attention along with its governance. At the same time, there has been a considerable move to increase the independence and power of central banks. This would appear to be placing macroeconomic policy almost entirely in the hands of the central banks. Yet monetary policy seems only likely to be effective when central banks behave in the way that financial markets expect and wish them to do. Moreover, governments seem to have little control over the operation of financial markets. This appears to remove macroeconomic policy entirely not just from short-sighted politicians but from any institutions which might be expected to have the best interests of the entire economy at heart.

Is there any way out of this trap? One major solution has been proposed—that of James Tobin to place a tax on capital movements in order to make speculative capital movements less profitable and hence to reduce the flow, restoring some degree of control to national governments. But, as Tobin accepts, this would only work if the tax was applied by all the governments. The possibility of reaching this degree of agreement and trust among countries may not seem very great. Yet, an increasing realization of the powerlessness of national economies in a world of mobile capital may concentrate minds wonderfully. In this broader context, the issue of central bank independence seems of minor importance. And still, it is important in the sense that it may be another example of economists attempting, even if with the purest of motives, to conceal a conflict of interests behind an apparently objective argument based upon some simple correlations.

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