



Central Bank Independence: A major victim of the 2007 crisis

Amol Agrawal
amol@stcipd.com
+91-22-66202234

Till recently, central bank independence was a well accepted norm in monetary economics but has come under serious scrutiny post this crisis. The first steps taken by central banks to mitigate the financial crisis to their current role of keeping rates low has been questioned by economists/policymakers. Further, some recent decisions by Governments to influence central bank decisions have been seen as major signs of concern amidst economists.

This paper attempts to track these recent developments in central banking. We begin with discussing the economics of central bank independence and then look at specific case studies which have come to light in this crisis.

Need for Central Bank Independence

Though central bank independence has become a vogue since 1990s, its importance has been known for a long time. David Ricardo a noted British economist had expressed the need to have Central Bank Independence as early as 1824. Ricardo raised concerns that there should be no money transactions between Government and the Commissioners (central bankers) it has appointed to handle the money related matters.

Dr. Y.V. Reddy, former RBI Governor in a speech (2001) said central bank independence is based on three theories:

- **Time Inconsistency:** If policymakers follow policies as per their promises made in past, such policies are called time consistent. However, there are chances that future policies are not adhered to or policies followed in short-term make policies in future sub-optimal. Such policies are then called as time-inconsistent. This theory was first espoused by Finn Kydland and Edward Prescott in 1977 and the duo was given the Nobel Prize in 2004.

In monetary policy, this theory is highly relevant because of the possible trade-off between inflation and unemployment in short-term. This is based on the original idea emphasized by Alban Philips in 1960s. He showed that there is a trade-off between inflation and unemployment and policies can be adjusted accordingly. If government wants low inflation, it will have to tolerate high unemployment will be high and vice-versa. This finding was questioned in 1970s when the economies suffered from stagflation where both unemployment and inflation were high and there was no trade-off. Milton Friedman then showed that so called trade-off might be true in short-term but over a long term it will only lead to inflation. Hence, even if a central bank is committed to price stability it could be tempted or asked by the government to lower



these rates for a short-term period to boost economic growth further. This then undermines the overall central bank objective to maintain inflation and price levels.

- **Political Business Cycle:** Research in 1970s and 80s showed that governments time the business cycle in order to win elections. Hence, they will follow expansionary fiscal policies before the elections leading to lower unemployment and allowing high inflation. Once elected, they again start looking at inflation control. This is nothing but time inconsistency of fiscal policies. Few US presidents have blamed the Federal Reserve for losing elections. Hence, an independent central bank is important which does not ascribe to the interests of the government.
- **Public Choice Theory:** This branch of economics looks at economics of government. One part of this branch of economics is government deficits. In the past, governments have used central banks to help manage these deficits. To prevent this, economists said there should be a constitutional amendment which specifies that central bank credit to government would be limited. However, despite this amendment it was abused in many countries. The next solution was to have an independent central bank which does not allow deficit financing beyond the constitution limit.

These three broad theories form the basis for central bank independence. In true form, a central bank is never fully independent. Most central banks are capitalized by their respective government/finance ministries. Central bank independence also does not imply that it is not accountable for its actions. Either central banks are mandated to present monetary policy and economic outlook to the Government or central banks have themselves taken measures to improve their transparency in communications.

Over the years, central banks have developed variety of tools using internet and information technology to explain their decisions to the public. This has led to vigorous interest amidst economists and central bankers evaluating best practices of central bank communications and transparency (For a review see our report - RBI Communications and Monetary Policy: A review of recent measures, Nov-10). Instead of independence, autonomous is a better term but former has picked up in usage.

The next question is how governments grant independence to their central banks. There are a number of ways:

- **Appointing head of central bank:** The government can send signals to the economic agents by appointing the head of the central bank who is conservative and is well-known as an inflation averse (referred as inflation hawks in market parlance). Here, the reputation of the central bank plays a key role. Another approach is that government enters into a contract with the central bank head under which if the latter not able to achieve price stability the contract will be repudiated.

Most central bank heads are appointed in the first category of a conservative central



banker. The best example of this is appointment of Paul Volcker whose aggressive policies helped Fed control inflation in 1980s. This image of Fed has been carried over since. There is always a lot of excitement in media over the appointment of the central bank head. New Zealand follows the optimal contract approach but so far contract has never been repudiated.

- **Goal vs. Instrument independence:** Economists have started classifying independence in these two categories. In goal independence, the central bank can itself choose which goals it would follow. So, it could set priorities of stabilizing inflation or output and how much weight is to be given to each variable. As stated above, such cases are rare. As most central banks are set up the government, the goals are accorded by the government itself. ECB is one bank which has goal independence as well as it has been set by a special treaty. In instrument independence, the central bank can choose the tool-kit by which it will meet the goals set by government. These goals are mentioned in the Central bank act. Most central banks are given instrument independence.

To sum up, central bank independence usually means to appoint a conservative central bank chief and give instrument independence to the central bank to achieve the goals set by the Government. Accountability and Transparency is another aspect of independence in which central banks are responsible for their actions and explain their policies to the public.

Research on Central Bank Independence

A number of papers have been written on central banks independence and its impact on monetary policy and then overall economy. The results have been favorable with central bank independence showing lower inflation (See Central Bank Independence and Transparency: Evolution and Effectiveness by Crowe and Meade for an overview). Though again central bank independence alone does not help achieve economic outcomes. Central Bank Independence in most cases has been accorded after a crisis resulting in overall macroeconomic reforms. It is always difficult to separate various factors of growth and then evaluate which factor was had a higher contribution compared to others. Overall, central bank independence is seen as an important institutional reform.

Other form of research has focused on measuring central banks independence and ranking different central banks based on these measures. This is always a difficult exercise as much of independence related activities are qualitative and quantifying them are difficult. Then there is difference between de jure (as per the law) and de facto (as per reality) independence. Seeing these limitations, studies have looked at de jure independence. Barry Eichengreen and N. Nergiz Dincer in a study (Central Bank Transparency: Where, Why, and with What Effects? 2007) compare the central banks and show Reserve Bank of New Zealand and Riksbank (of Sweden) as the most independent and transparent central banks.



Some economists have questioned this focus on Central Bank Independence. They argue that making the central bank independent causes frictions between fiscal and monetary policy which is costly for the overall economy. There could be times when the two agencies do not agree on the policies leading to status-quo. Others argue that a strong independent central bank can take actions which are sub-optimal for the society at large. It could be possible that central bank moves in line with international best practices but economy is still under-developed to understand the practices.

The role of central banks becomes very interesting in zero interest rate policy (ZIRP). There are number of papers which have looked at the several options central banks have under ZIRP (for a review refer to our research - US in Liquidity Trap - What are the Options? October 2010). But very few have looked at how central bank independence will be affected when central banks start intervening to mitigate financial crisis. This has been a major deficiency which has come to light now.

Under ZIRP, one major tool for central banks is balance sheet expansion where central banks buy government bonds and if necessary, assets from private sector balance sheets. As a central bank conducts these operations, it takes risks on its balance sheet and these are actions more suited for fiscal authority. These are called as fiscal actions of the central bank. This questions the overall independence of central banks which are then seen as agents of the government working closely with the same.

The 2007 crisis has opened a number of case studies questioning central bank independence in variety of ways. Let us discuss these cases.

Case studies of central bank independence in 2007 crisis

Advanced Economies Case Studies:

- **Federal Reserve:** Federal Reserve has been criticized severely in this crisis for its role in managing the financial crisis.

First, Federal Reserve intervened aggressively in this crisis leading to build up of moral hazard. Hence, by intervening Fed has given a signal to financial firms that they will not be allowed to fail. Moral hazard in finance had already risen because of Federal Reserve support in previous crisis as well. In this crisis, this has increased significantly.

Second, the intervention was selective as it saved Bear Stearns, let Lehman fail and then saved AIG the next day. Till date, there is no clarity on why this was done. Fed chief Ben Bernanke has explained in numerous testimonies to US Congress that



Lehman could not be saved as the firm did not have adequate collateral but has not been seen as a sufficient reason.

Third, the early association between Fed and Treasury was seen as dangerous. Some economists say the tasks of Treasury were done by Fed as it would have taken longer to get these tasks done by Treasury as latter requires Congress approval. John Taylor, a noted economist termed Fed policies as Monindustrial Policy where monetary policy was used selectively to save certain financial markets and firms.

Fourth, as Fed was intervening and buying risky assets from the private sector, the risks were being shifted to the central bank's balance sheet. Ideally, these risks should be on Treasury's balance sheet. Even if Fed took these risks, there should have been a clear accord that either these risks would be transferred to Treasury eventually or in case of losses, they would be borne by Treasury. In other words, the program should have been funded and guaranteed by Treasury. There was no such accord in the beginning leading to further uncertainty. The accord was signed much later.

Fifth, the aggressive government bond buying program of Federal Reserve generated criticism. Central banks usually conduct monetary operations buying and selling government bonds but it is a much smaller operation. In this crisis, Fed bought US Treasury bonds in much larger amounts US Government ran high deficits and issued bonds and its central bank was a major buyer of these bonds. This is nothing but debt monetization, a development abhorred by monetary economists. We have stated above that preventing debt monetization or debt financing is seen as one of the primary reasons for having independent central banks.

Sixth, the crisis pointed to deficiencies in the organization structure of Fed. There are 12 Regional Federal Reserves to so that there is adequate representation of US economy in the monetary policy. Each regional Federal Reserve president explains in the FOMC about the economic developments in his/her region. This structure was developed at time of establishing the Federal Reserve in 1913 for the same reason. The board of directors of regional Feds especially New York Fed are chiefs of major banks and financial firms. This was seen as a conflict of interest as NY Fed was saving its own board-members! Since then, it has been suggested that regional Fed Presidents also become a political appointee like in the case of main Federal Reserve.

Seventh, few Congressmen were unhappy with Federal Reserve handling of the crisis. Ron Paul, a congressman from Texas a leading critic of Federal Reserve proposed to audit all the monetary policy operations of the central bank. Bernanke and other Fed members vehemently opposed this move as it would undermine Fed independence.

- **European Central Bank:** ECB is seen as the most independent central bank because of its unique structure. It has both goal and instrument independence. It is not formed by any one government but has been formed by a special treaty with capital coming



from erstwhile central banks of European Monetary Union countries. Hence, ECB decided the goal it would pursue (which is price stability with inflation below 2%) and the instruments it would use to achieve the goal.

In order to keep the bank independent, ECB decided not to buy any government bonds apart from accepting bonds as collateral for liquidity purposes. Buying the bonds to address deficit financing or balance sheet expansion was strictly not allowed.

As the crisis shaped, ECB resisted from buying government bonds. This was criticized by some economists saying ECB was not doing enough to stimulate its economies. It was an opposite concern compared to Federal Reserve. ECB finally could not resist the market pressures and started buying government bonds following Greece bailout in May-10. Though, the overall program was muted and ECB sterilized the flows, leading to no real increase in money supply in the Eurozone. Overall, in term of independence, there is no major damage to ECB's reputation but its management of the crisis has been criticized severely by both economists and market participants.

- **Bank of England:** Bank of England also has a unique approach of independence and accountability. If the target is missed by more than 1 percentage point on either side of its inflation target of 2% (i.e. CPI inflation is more than 3% or less than 1%) the Governor of the Bank must write an open letter to the Chancellor explaining the reasons why the Bank missed the target. He must also explain what the Bank proposes to do to ensure that inflation will come back to the target. BoE got its independence in 1997 and no letter was written in the first ten years of getting independence. However, since April 2007 open letters have been written on nine occasions.

Bank of England also started an asset purchase program like Federal Reserve and other central banks. But unlike the case of US, there was more clear segregation of responsibilities between Government and central bank. In January 2009, the Chancellor of the Exchequer authorised the Bank to set up an Asset Purchase Facility (APF) to buy high-quality assets financed by the issuance of Treasury Bills. Purchases of assets will be undertaken by a subsidiary of the Bank - the Bank of England Asset Purchase Facility Fund. An indemnity is provided by HM Government to cover any losses arising from the facility. Hence, in this case Bank of England was merely conducting operations on behalf of the UK government. This is unlike the case of Federal Reserve where the asset buying activity was seen as an independent activity.

However, the independence of Bank of England was questioned in an interesting set of events. Recent media reports show how Bank of England chief Mervyn King had compromised his position by acting as an adviser to the current government. He even



openly praised the government's efforts to consolidate its public finances, a fact criticized by Bank of England MPC members. This has led to huge criticism of King and experts have asked him to resign from his position.

- **Bank of Japan:** Bank of Japan got its independence in 1998 and thus was reluctant to engage in aggressive bond buying in Japanese crisis in 1990s. The central bank was worried that such buying would question the newly received independence. Economists including current Fed chief, Ben Bernanke who said independence should not be an issue only to learn that it is a major issue when Fed reached zero interest rates.

In this crisis, there were media reports that Japan's new administration has put increasing pressure on the Bank of Japan to increase lending. The finance minister said he was looking for even more cooperation from Japan's central bank.

Emerging economies case studies:

- **Bank of Korea:** Earlier in the year, South Korea's president had urged the Bank of Korea to go slow on its exit strategy from accommodative monetary policy. In a surprise move, the president sent the vice finance minister to attend a Monetary Policy Committee meeting for the first time in a decade. The vice minister has voting rights in the monetary policy committee and can influence decision making. After criticism the government said the move came as a need for coordination emerged amid the global financial crisis and is expected to help improve risk management of the local economy.
- **Central Bank of Argentina:** Argentina's president fired the governor of the central bank when he refused to transfer \$6.6 billion in foreign-exchange reserves to the government's coffers to meet fiscal expenses ahead of next year's election. The Central Bank President was even blocked from entering his office. The new central bank governor was seen as very close to the President. Argentina has had 56 central bank presidents (including the new one) in their 80 year old history! That is roughly 1.4 yrs per President with first president having served for 10 years. This has been seen as one of the main reasons for Argentina being under crisis since 1980s and struggling to grow thereafter.

Just like Argentina, Mexico's president appointed a new governor for the Bank of Mexico. The President wanted the central bank to lower interest rates but the former governor was reluctant.

- **Hungary's Central Bank:** This is the latest case where the independence of the central bank came under a question mark. The current government was unhappy with the central bank and wanted it to cut policy rates. As the central bank refused to do so, it was decided to make amendments in the Central Bank Act. The new Act will



allow the Prime Minister to nominate four members of the seven member monetary policy committee compared to two members earlier. By putting more members from the government, Prime Minister was hoping he could press the government's agenda.

Final Thoughts

Milton Friedman once said money is too important a function to be left to Central bankers. These were surprise remarks coming from an economist who showed the usefulness and importance of monetary economics. His idea held strong till 1980s as most central banks failed to deliver price stability barring few exceptions like Bundesbank (Germany). However, his thought was vindicated as Paul Volcker and institutional changes in central banks showed money could be left to central banks.

All these developments have come full circle with the 2007 crisis. The above case studies show what once looked a given i.e. central bank independence has been compromised in many countries. In some cases governments have intervened in central bank operations. In other cases the actions by central banks have led to questions over their self acclaimed independent stance. Earlier we would see these cases in developing economies but here we have cases of four largest advanced economies.

The government granting independence is one thing but to become respectable comes after many years of dedicated application of principles of monetary economics. However once the principles are not adhered to, the independence is lost quickly and takes many more years to recover. This has been the painful lessons of many countries. Some central bankers in Latin America knowing their economic history resisted but to no avail.

Having said this, a severe financial crisis like the one seen in 2007 opens a Pandora's Box for the central bankers. If it sticks to principles the economy is likely to suffer and if it intervenes aggressively, its principles are compromised. More research and thinking is needed to work on these very important issues.



STCI Primary Dealer Ltd.

A/B1- 801, A Wing, 8th floor, Marathon Innova, Marathon Next Gen Compound,
Off. Ganpatrao Kadam Marg, Lower Parel (w), Mumbai 400013.

Dealing Room: (022) 66202217-20 • Settlements: (022)66202262-64, Fax (022) 66202288

Delhi Office: (011) 47676555-570 • Bangalore Office: (080) 22208891

Please mail your feedback to stcipd@stcipd.com • Website: <http://www.stcipd.com>

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