Economics of Banking and Finance Markets
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Lecture - 50
Independence of Central Banks

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Hi everyone, welcome to this session. The objective of this session is to discuss the Independence of Central Banks, and more specifically we will discuss what are the case for independence and what are the case against independence. And after that we will review the independence of some of the well-known banks across the globe.

About the independence of Central Bank there are various dimensions of independence of Central Bank.

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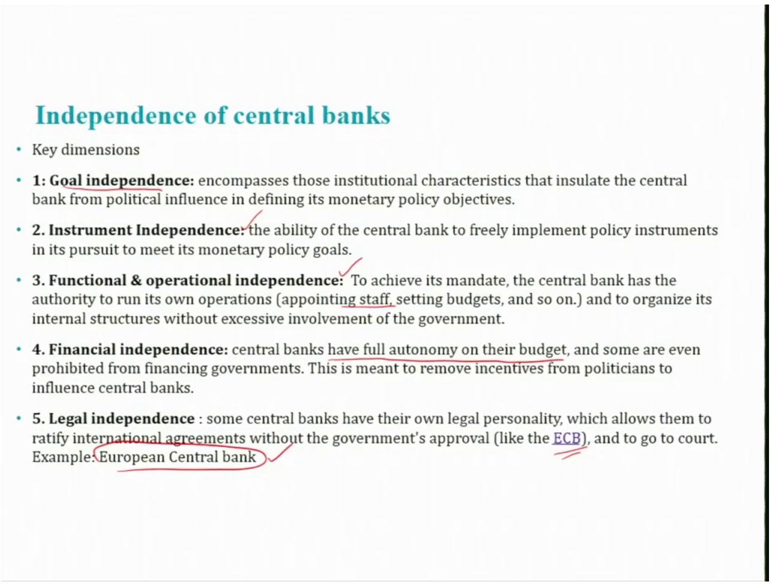

One is goal independence. So, the goal independence encompasses those institutional characteristics that insulate the Central Bank from political influence in defining its monetary policy objectives, that is one. The goals, for example, price stability, interest rate stability, growth in GDP, employment level, foreign exchange stability etcetera.

In setting these goals, in prioritizing, for example inflation over economic growth or economic growth over inflation, whether the Central Banks having this goal independence, that is one dimension.

Another dimension is selecting the instrument, the instrument independence; it refers to the ability of the Central Bank to freely implement policy instruments in its pursuit to meet its monetary policy goals. So, among the monetary policy tools for example, between open market operations and the discount window, whether the central bank can apply the tools as per their wish or not.

For example, about discount window, if they reduce the discount rate you know that the banks can borrow more, and the liquidity of the banking system will increase and at the same time it also increases the liquidity in the economy money supply in the economy will increase. So, similarly another tool for example, a cash reserve ratio, increasing the reserve requirement or reducing the reserve requirement is not only affect the liquidity in the bank it also affects the profitability or the investment opportunities of the banking system.

For example, increasing the reserve requirement, you know that the money with the banking system will come down that; that means, the assets or funds that is available out of the total deposits with the banking system will come down.

If the required reserve ratio has been increased, then, of the total liabilities demand and time liabilities, the fund available with the banking system to make investment, for example, giving loans or investing in securities will come down and then that will affect the profitability of the banking system, which has further implication about the entire financial system and overall economic growth as well. So that means, choosing between these goals for example, open market operations and discount rate and cash reserve requirement plus many other qualitative tools, do the Central Bank have the freedom to choose the tools to use, that is another dimension.

In addition, there are other dimensions of independence of Central Banks, that is one is called functional and operational independence. It refers to whether the Central Bank has the authority to run its own operation. That means, without depending on the government whether it can appoint its own staff, setting budgets and so on by its own, without relying on the government. And to organize it internal structures without excessive involvement of government.

And the fourth one is called the financial independence. So, here Central Bank enjoying financial independence will have full autonomy on their budget and some are even prohibited from financing governments. So, this meant to remove incentive from politicians to influence Central Bank; that means, Central Bank is having complete full financial independence, that means, full autonomy on their budget.

The fifth one is called the legal independence; that means, some Central Banks have their own legal personality, which allows them to ratify international agreements without government's approval. Example, European Central Bank.

If a central bank enjoy independence in all these dimensions, then we can say that the Central Bank is fully independent, and the monetary policy that they are designing and implementing will be independent from the government.

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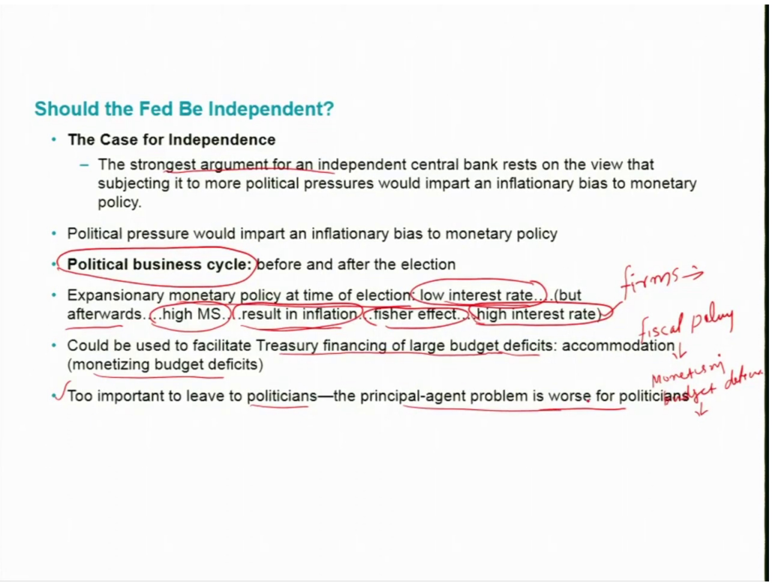

So, these are the dimensions and there are some arguments for independence and case against independence. So, the strongest case for independence, the strongest argument for an independent Central Bank rest from the view that subjecting it to more political pressures would impart an inflationary bias to monetary policy. So, that means, political pressure would impart an inflationary bias to monetary policy.

You know there is the concept called business cycle. Especially during the election time, you know that if the Central Bank is not independent, that means, the Central Bank is under the control of the government, then you can see that especially during the election time there will be political business cycle. What is the objective function of the politician especially, you know they want to score more votes.

So, to win the election they will be following more populist policies. Maybe they will be especially at the time of election, they prefer to have an expansionary monetary policy; that means, expansionary monetary policy means low interest rate, low interest rate means for the firms, you know that the firms will be happy with a low interest rate because the cost of borrowing will come down.

And they will engage in more economic activity; that means, production of goods and services which would lead to high employment and high GDP. So, similarly low interest rates for consumers, who is taking mortgage loan or taking other durable consumer loans will benefit, all these will send a positive signal in the economy; that means, the economic activity will increase.

Another thing is that during election times governments will be interested in following an expansionary fiscal policy; that means, more government expenditure, and more government expenditure especially in the social sector; more populist fiscal policy they will be following at that time increasing government expenditure, at that same time cutting government taxes. To finance this fiscal expenditure, government will be monetizing the budget deficit.

Suppose if the Central Bank is under the control of the government, you can see that during election time there will be expansionary fiscal policy. The required finance for this fiscal policy will be raised through printing more currencies, injecting more money in the economy. That means, monetizing the budget deficit, monetizing the budget deficit by printing more currency or borrowing more from the market. So, that means, there will be monetizing this budget deficit, then leading to low rate of interest.

So, at the time of election what you can see that it will lead to low interest rate, but afterwards you know that when the liquidity in the economy increases when the liquidity increase; that means, high money supply in the economy eventually would lead to inflation.

So, then you see when there will inflation in the economy; that means, it also just adds the fisher effect; that means, when inflation is increasing, the nominal rate of interest also will increase. Because those who lend their money in the finance market are looking at the real interest rate. So, when the inflation increases, then the nominal rate of interest will be increased.

It has been observed that there has been political business cycle; that means, during election time the economic activity due to expansionary fiscal and monetary policies will increase. But thereafter, adverse effect for example, increase in inflation will take place, which would eventually lead to hyperinflation and leading to high interest rate, this would happen due to the political business cycle.

And the case for independence: those who argue for independence of the Central Bank state that if we reduce the independence of the Central Bank, there is high probability for political business cycle. So, because of that it is better to give more independence to the Central Bank to avoid political business cycle.

So, here again the point I just mentioned here I am just showing here in the slide; that means, treasury financing through a large budget deficit, that the accommodative monetary policy, also would lead to political business cycle. So, another relative point is the principal-agent problem is worse for politicians.

The advocates of independence for Central Bank, they believe that politicians are short sighted, their time span is nearly 5 years or maximum 10 years. Then, all their policy that the fiscal policy and accordingly using monetary policy in their advantage will be looking at a short time, which would not be at the best interest of the economy. So, the principal agent problem is worse for politicians.

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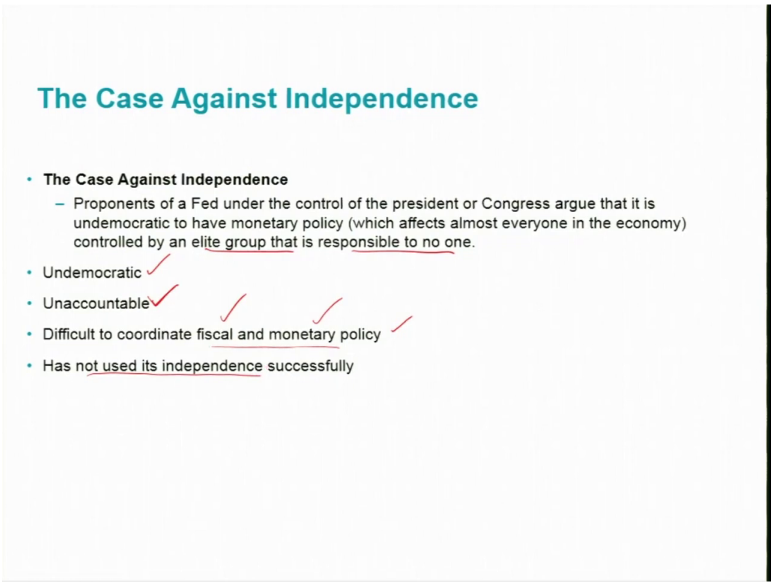

So, that is the case for independence.

Case against independence: The proponents of fed under the control of the president or Congress argue that it is undemocratic to have monetary policy, controlled by an allied group that is responsible to no one.

Here the main argument is that, against independence of the Central Bank, is that macroeconomic stability can be best achieved if monetary policy is properly coordinated with the fiscal policy. Because the two major forms of economic policy in a domestic economy; one is monetary policy, the other one is fiscal policy. So, the those who argue against independence states that macroeconomic stability can be best achieved if monetary policy is properly coordinated with fiscal policy.

Since government is responsible for the macro economic performance of the country, the opponents of independence argue that it must have some degree of control over the monetary policy. The opponents also argue that Central Banks are not necessarily immune from political pressure. The main points are that itis undemocratic, and another point is that the elite group, especially the monetary authority are not democratically elected people, they are not accountable to the public. Moreover, to attain the long-term goals of the economy, that is, the economic growth, money, inflation price stability, employment, foreign exchange rate stability etcetera both fiscal and monetary policy should go together. However, if central bank is independent, it is difficult to coordinate fiscal and monetary policy.

So, here let us see the theory of bureaucratic behavior.

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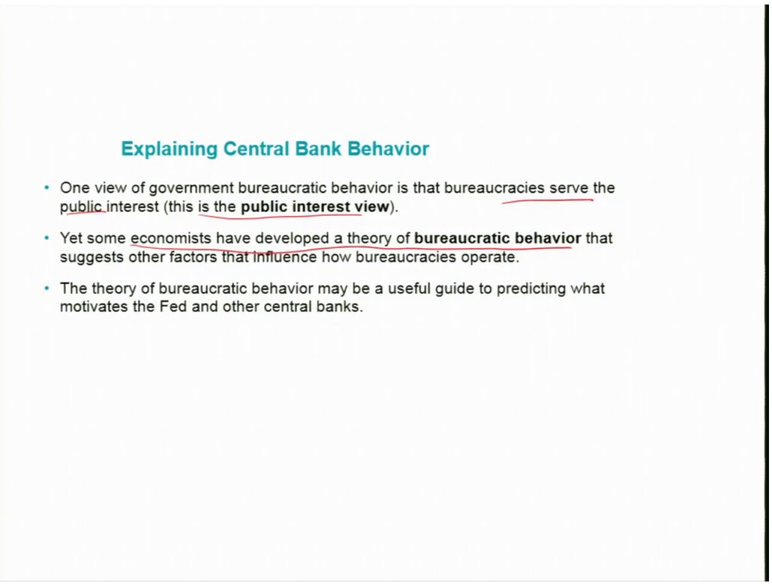

One of the theories explaining the behavior of the Central Bank is the bureaucratic behavior; that means, the bureaucrats serve the public interest that is the public interest view.

So, one view they say that they serve the interest of the public interest; however, some economists have developed a theory of bureaucratic behavior that suggests that other factors influence how bureaucracies operate. So, the theory of bureaucracy behavior may be a useful to predicting what motivates the fed and other Central Banks in its operation.

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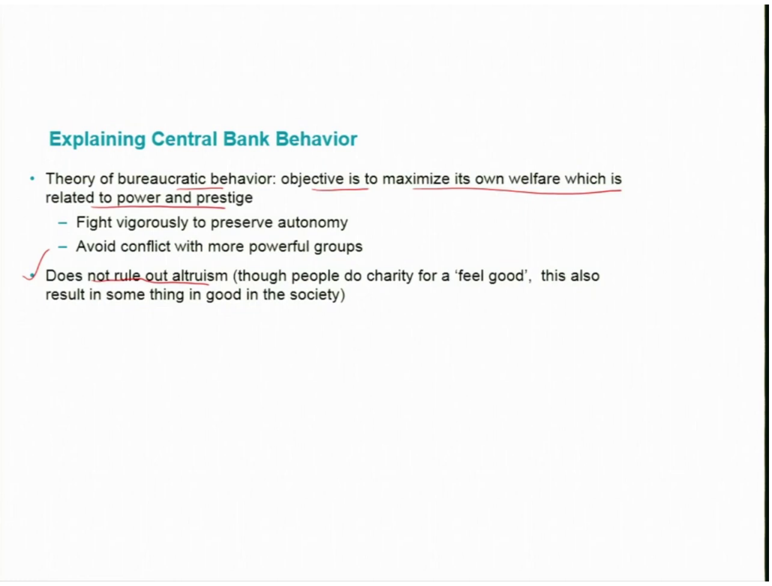

So, the theory of bureaucratic behavior states that the objective of the bureaucrats is to maximize its own welfare, which is related to power and prestige; that means, officials of the Central Bank who can be as the bureaucratic as per this framework, their objective according to this theory is that they will maximize their own welfare, which is related to power and prestige.

So, they fight vigorously to preserve their autonomy, they also avoid conflict with more powerful groups in the economy. So, in this case what is happening is that this theory suggests that the objective of the bureaucracy is to maximize welfare akin to consumer behavior that aims at maximizing personal welfare.

The Central Bank can pursue a course of narrow self interest to increase its power and prestige at the expense of public interest. So, looking at this, clearly, based on this theory, it is argued that it is better not to give more independence for the Central Bank because bureaucrats will try to maximize their own welfare.

However, some do not rule out altruism though people do charity for feel good, this also result in some good in society.

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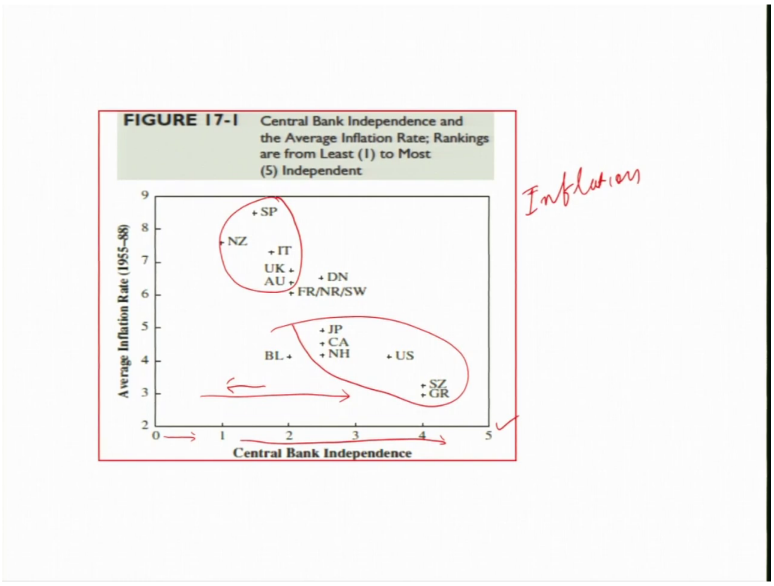

When it comes to the degree independence of Central Banks, whether it is good for the economy or not, lots of research has been happening on this area. One research shows that especially with related to the goal of price stability or inflation, look at this diagram that is the level of degree of independence is measured on the X-axis here. That means, our rankings from least independent from that 0 from here to here more independent. So, you can see that those countries with high degree of independence are having less inflation. So, you can see that when we are moving to the rightward axis you can see that these countries are having less inflation.

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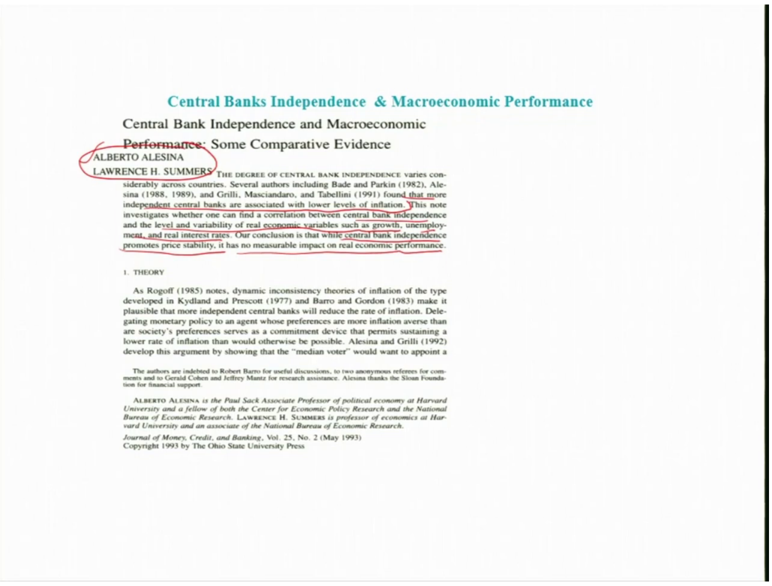

There are several studies; one study in looking at the Central Banks independence and macroeconomic performance by Alesina and Summers; they examined the degree of Central Bank degree of Central Bank independence, which varies considerably across countries according to their study as per their estimates.

They reviewed several studies and found that more independent Central Banks are associated with the lower levels of inflation. Because from a consumer perspective and policy perspective, a mild inflation is better for the country better for the economy. So that means, more independent the Central Bank, there is a low level of inflation. However, the relationship between Central Bank independence and the level of variability in real economic variables such as growth, unemployment and real interest that is less investigated and this study found that while Central Bank independence promotes price stability, however, it has no measurable impact on real economic performance; that means, real economic variables such as economic growth unemployment rate and real interest rate; this study could not find a clear-cut impact. However, they agree that Central Bank independence has a very clear-cut predictable impact on price stability.

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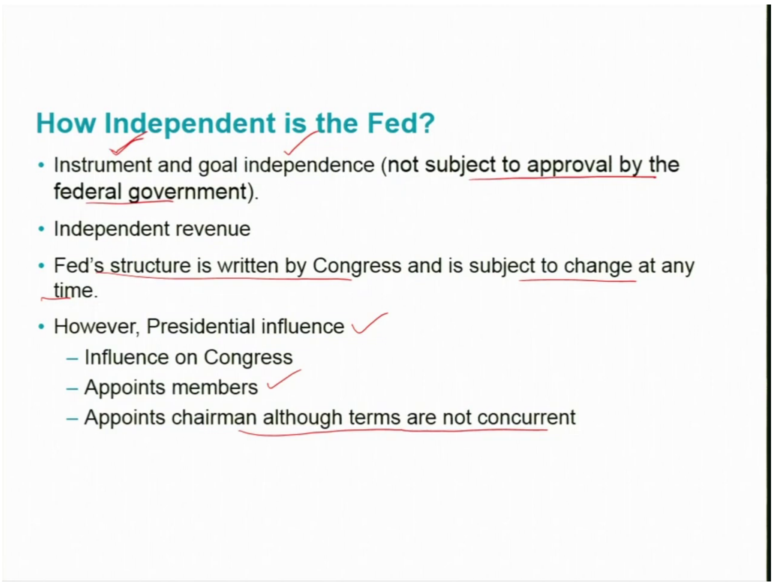

Let us now review the independence of some select Central Bank across the globe, first about the Fed, how independent is fed? When it comes to monetary policy instruments such as selecting open market operations, discount rate and reserve requirements as well as the interest rate on reserve requirements, the Fed reserve system enjoy full autonomy.

Similarly, goal independence, looking at whether the goal is inflation, price stability or economic growth, there also the Fed enjoys full autonomy; that means, it is not subject to approval by federal government. So, overall, in addition to that, you can also see that the Fed is having independent revenue as well; however, you can see that the Fed structure is written by the congress and is subject to change at any time.

You can see that there is congress influence in appointing members and presidential influence in appointing chairman, although the terms are not concurrent with the president's term. So, important point here is that the key bodies within the Federal reserve system are the board of governors and the FOMC that the Federal Open Market Committee. And that we have discussed in the previous classes that the board of governors is composed of seven governors appointed by the president of the United States.

So, in that way, we can say that there is government intervention; however, an important feature of the Federal reserve system is that, of the FOMC, the considerable degree of independence given to the monetary policy making authority. The 14-year term for which governors are appointed and the fact that they cannot be reappointed provide insulation from the political process.

So, one more thing; the chairman of the board of governor is appointed for a 4-year term, but this term is not concurrent with that of the president of the United States.

So, therefore, an incoming president does not immediately get to appoint his choice of chairman, nor can he dismiss the chairman if he disagrees with his/her policy actions. So, similarly the other members of the FOMC, the regional bank presidents are appointed by the directors of the regional banks with the approval of the board of governance.

Overall, we can see that there is a trend towards greater independence across the globe for many Central Banks. The high correlation between macroeconomic stability and independent Central Banks has led to remarkable trend to further enhance the independence of Central Banks across the world. Many of the drawbacks that we have discussed have been tackled overtime.

And to ensure that Central Banks do not deviate from the overall socio-economic goals of nation, most Central Banks have been made accountable to their parliaments and are required to become more transparent about their operations by publishing minutes of their meetings and communicating their policies to the public.

So, you can see India’s monetary policy, whenever Indian monetary policy committee meets, they are also mandated to publish the minutes of the meeting as well and asked to state the reason for why they vote for or against the final decisions.

So, the Federal Reserve has historically been more independent than almost all the other Central Bank.

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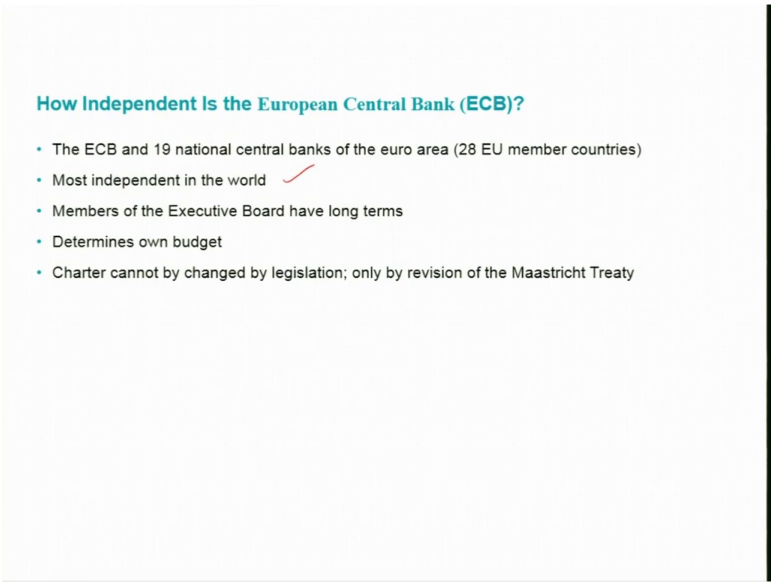

So, we can see that other Central Banks for example, European Central Bank is one of the most independent Central Banking. About the European Central Bank, there are 19 National Central Banks of the euro area. The European Central Bank is also considered as one of the most independent in the world.

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So, about Central Bank of Canada, they essentially control the monetary policy, they have control over the tools as well as the goals of monetary policy. In addition, the Bank of

England, they also have more independence, they enjoy high level of independence, Bank of Japan also recently gained more independence.

Recently more Central Banks have gained more independence that have been traditionally subject to intervention of finance ministries. For example, Bank of England and Bank of Japan have been granted more independence since the 90s. So, about people's bank of China, though they enjoyed some degree of independence; however, it comes directly under the government.

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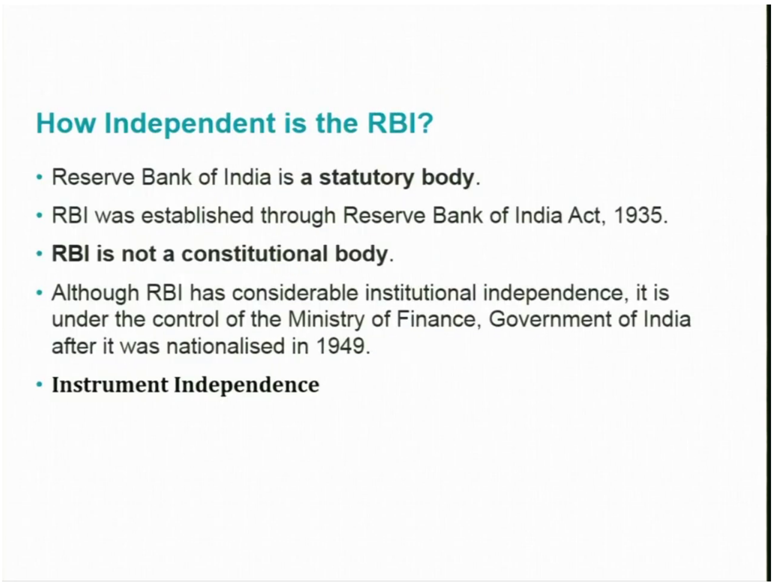

And coming to India, you know that Reserve Bank of India is not a constitutional body, is only a statutory body. It was established to the reserve bank of India at 1935, although RBI has considerable institutional independence it is under the control of ministry of finance of the government of India.

So, we can see that when it comes to the selection of the monetary policy instrument, the Reserve Bank of India enjoys independence.

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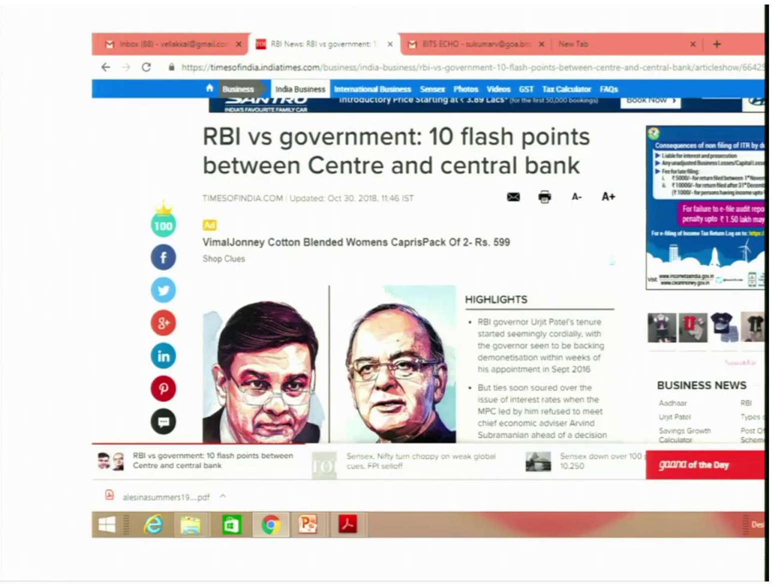

But when it comes to the goals, there have been some clashing points between the central government and the Reserve Bank of India. These are some newspaper cuttings clippings I am showing you, just to show there are some clash points between government and the Reserve Bank of India.

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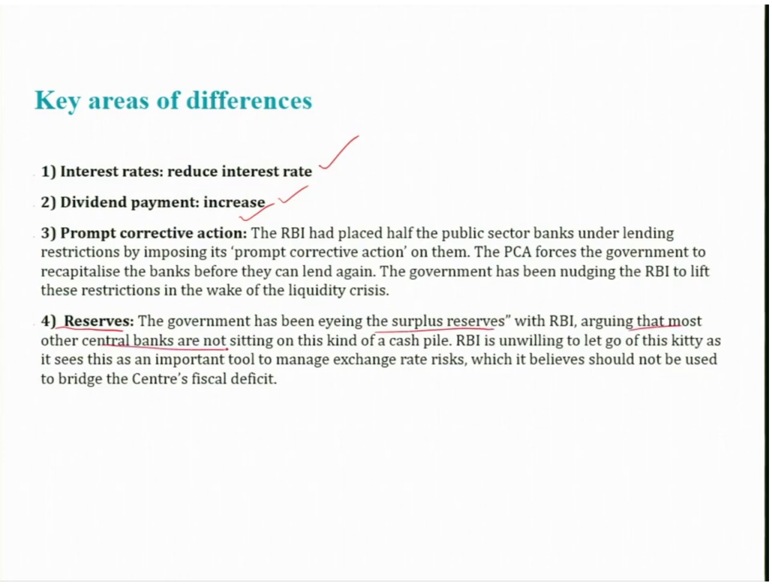

One of the things is the interest rate, especially government at the central over time we have seen that especially during election time or crisis time, they have been asking for reducing the rate of interest. However, Reserve Bank of India often resist because they anticipate that reducing the rate of interest, that is injecting more money in the economy, will lead to inflationary pressure in the economy.

Another area of disagreement is the dividend payments from the RBI to the government, where the government has been asking for more dividends, but RBI is resistant. Similarly in the case of prompt corrective action, RBI has recently increased the scope of prompt corrective actions, many public sector banks are under the radar of the RBI, and sometimes government has been objecting to it.

Similarly, in the reserve, especially the cash reserve with the Central Bank, sometime the government has been eyeing the surplus reserve with RBI, arguing that most other Central Banks are not sitting on this kind of cash pile. However, RBI is unwilling to let go this kitty as is this is an important tool to manage exchange rate risk as well as to ensure that the RBI can use this fund to save the banking system to rescue the banking system in case there is banking crisis.

So, in this session overall we have discussed the independence of central banks, what are the case for and against independence and we have reviewed the independence of some of the Central Banks across the globe.

Thank you for watching this video and we will see in the next session.

Thank you.

Keywords: independence of central banks, goal independence, tool independence, functional and operational independence, theory of bureaucratic behavior, fiscal and monetary policy, price stability, FED, European central bank, RBI