On the Meaning of Central Bank Independence

G M Wessels

Department of Money and Banking, Free State University

ABSTRACT

This article aims to clarify the meaning of the multifaceted term central bank independence. Such independence cannot be understood in an absolute sense, because the elected government in a democratic society remains the highest authority in respect of economic policy-making too. Nevertheless, central banks globally are currently endowed with strong relative independence. This may be separated into two broad categories, namely formal and informal independence. Political and economic independence are identified as elements of the former, and their various subcategories are expounded below. Informal independence is then highlighted as the more important component of independence, of which personalities, professionalism and public support are crucial. However, an ideal combination of the determinants of independence is hard to find.

INTRODUCTION

The field of central bank independence has received much attention during the past two decades and attracted a considerable amount of research. This is in step with practical developments in the European Monetary Union, the former East Bloc states, Chile, the UK, France, New Zealand and a number of other countries where central bank statutes have been amended or completely revised in order to strengthen their independence. Independence for its central bank also received attention in South Africa during the constitution-making phase, in that independence was debated and eventually included in the constitution.

Although theoretical and practical deliberations have extensively considered the motivations for strong independence and ways to institute it, the important prior question of what independence means has been dealt with scantily. This question merits attention in its own right and represents the focus of this article. The article does therefore not debate the necessity for independence but stresses the meaning of the concept. The fact that independence is a multifaceted notion which cannot be compressed into a simple and straightforward definition, and an elusive topic which takes on different meanings in different contexts, forms the scope of the paper. After describing what independence is *not*, an attempt is made to provide some perspectives on the meaning of independence, as well as a distinction between formal (*de jure*) and informal (*de facto*) independence, their nuances and significance. The clarification of these matters should provide the necessary point of departure for further discussion of the many other dimensions of central bank independence.

THE MEANING OF INDEPENDENCE

What independence is not

The meaning of "independence" may be pursued, maybe paradoxically, by starting not with an exposition of the maximum freedom and power for implementing central bank policy decisions, but by focussing on the *restrictions* and *limitations* on central bank actions. It should be stressed that an independent central bank is not an omnipotent institution devoid of supervision and accountability, but part of a democratic society. As such, there are limits to its powers and restrictions on the scope of its discretion and policy. Viewed broadly, the elected government in a democratic society has the ultimate power to formulate and implement the macroeconomic policy of the country and is also responsible for it. Independence for a central bank does therefore not mean that the bank occupies the position of a state within a state; it is impossible to have two sovereign authorities in a single state. In the final analysis, the economic policy of a country cannot be anything but the policy of the elected government. Independence, therefore, does *not* and *cannot* imply policy decisions and actions without accountability (Mittra, 1978 : 38). No country has ever granted complete or absolute independence to its central bank and none is likely to do so. This is neither practical nor – in a democratic framework – feasible.

Independence, furthermore, does *not* imply that central bank policy should be devoid of critical discussion and shielded from scrutiny. A supreme central bank above discussion and criticism, not accessible to public scrutiny in its public functions, is out of the question. Independence cannot, therefore, be equated with complete isolation of the central bank from any supervision and public accountability (Greenspan, 1993: 1101). In fact, a central bank exempt from all authority and responsibility, would be the strongest argument against central bank independence.

In a *relational* context, it is important to stress that a central bánk cannot operate in a constitutional vacuum without a relationship with, or responsibility to, a higher political or economic authority (Zijlstra 1979: 148). These authorities and their constitutional powers place limits on the sphere of central banking and its scope of decision-making. Tietmayer (current president of the *Bundesbank*) correctly states that "an independent central bank should, and must, accept the limits of its responsibility and power" (*Banking World,* 1994: 26). It is always within a limited area and range of responsibilities that a central bank is independent.

Although government has the final say and none has granted absolute independence to its central bank, governments do grant or delegate monetary powers to central banks. Mandated independence means that the bank is insulated from day-to-day political interference and short-term affinity. It provides the bank with the means to resist political expediency and subserviency, and to withstand populist pressure for trade-offs that lead tó inconsistency and inefficiency in policy. The emphasis on such independence is greater in *federal* states (e.g. Germany, Switzerland and U.S.A.) whose constitutions were drafted with the specific aim of curbing government's financial powers (Fair, 1979: 31).

Relative independence: The central bank/government relation

If independence is not to be taken literally, as argued above, it should be viewed in a *relative* context, emphasising the *degree* of independence. In line with recent tendencies and discussions of central bank independence, "independence", though not absolute, is to be understood as *strong* independence. This implies that the control of money in the economy should be separated from the uncertainties of political life. It also means that, although the central bank may be established and some of its officers even appointed by the state, the bank should nevertheless enjoy a position of strong independence. The expertise and professionalism of the central bank as a technocratic institution with specialised knowledge, is thereby acknowledged. This realisation requires the insight by government that in a democracy it is often not the *exercise* of power, but the *restraint* on its use that matters (Mittra, 1978: 200). Legal provisions that put the bank in the position of the main executor of monetary policy, will also provide it with the required formal independence. The bank will then possess a mandate giving it the necessary authority to implement its policies, e.g. to fight inflation and maintain purchasing power stability of the currency unit. Although acting in a generally non-interfering manner in such a framework, the government will, no doubt, intervene directly and determinedly in the event of an emergency or crisis that threatens the national interest.

The aforesaid independence may, or should, entail that government be obliged to consult with the bank when considering policies of a financial and economic nature (Woolley, 1977: 171). Such a position of independence does not preclude any contact and consultation with Treasury officials on the initiative of the bank itself. On the contrary, it is imperative that close and professional relations be maintained between the two entities. However independent a central bank was on establishment, it needs the support of government (Treasury) not only to avoid policy clashes, but to make its monetary policy effective (Bockelman, 1991: 135). The credibility of the policy of an independent central bank will therefore also depend to a large extent on a close co-ordination with fiscal policy (Blackburn and Christensen, 1989: 27; Walshe, 1991:113).

In order to further illuminate the meaning of "independence", a more structured description is needed. It should be stressed, however, that the term is difficult to encapsulate and that no unique measure or criterion exists with which it can be sufficiently identified. With this qualification, a more precise description of independence requires a distinction between formal (*de jure*) and informal (*de facto*) independence. In addition, formal independence should be further divided into *political* and *economic* independence to elucidate their different meanings and contents.

FORMAL INDEPENDENCE

Formal independence is conferred by statutory provisions which enshrine independence in a legal framework. It entails establishing an institutional framework which provides the central bank with independence. This framework should include as many informal aspects of independence as possible. The higher the degree of legal independence granted to the central bank in this way, the firmer should be its commitment to adhere to its long-term objective. Structuring the various relationships between the bank and the government, should also enhance the credibility and accountability of the bank's policy by making the exact locus of responsibility more transparent.

Political independence

Political independence refers to the ability of the central bank to choose its economic policy without constraints or influence by government. The following features of a central bank may be used to assess its *political* independence:

The tenure, appointment and replacement of the bank's chief executive officers

To protect the independence of the bank, the governor and the board of directors should be guaranteed a sufficiently long term of office. Short terms of office could make them vulnerable to dim-sighted political pressures because of the uncertainty around the possible extension of their appointment. Independence will therefore be enhanced if the officers have long, staggered terms of service. Their terms should be longer than that of parliamentarians, and staggered to avoid the simultaneous replacement of all officers by a new government, which would create uncertainty as to the consistency of monetary policy. Furthermore, independence will be strengthened if the governor of the bank is not appointed by the government, or if government has to consult with the board of the bank before appointment (Goodman 1991: 330). The same principle of independence applies to other executive officers: the less government authority there is with regard to their appointments, the stronger will the central bank's independence be. Independence will also be strengthened if replacement of the governor of the bank by the government (save for personal reasons) is excluded in the bank's statute, or if legal procedures are envisaged to deal with possible confrontations regarding such replacement. These procedures promote the transparency of deliberations and prevent any arbitrary removal of officers. Summarising, the independence of the central bank will be enhanced if:

* the governor is not appointed by government.
* the governor is appointed for more than 5 years.
* the board is not appointed by government, or
* if more than half of the board members are appointed independently of government.
* the board is appointed for more than 5 years.

Government's role and dictates in policy matters

Independence is also stronger where government has no explicit statutory participation through an appointed government official in the deliberations of the board of the central bank, or has no representative with veto powers on the board.

Government officials, if any, who may attend board meetings should be observers or discussants only, without a say in the final policy decisions of the central bank. The statutory enforcement of a policy directive by government which may overrule the policy decisions of the central bank, is logically untenable for maintaining the independence of the bank. Such an enforcement must be avoided, if it does not at least contain an arbitration clause that prescribes a public debate on the matters at issue between government and central bank.

Main formulator of policy

If the central bank is legally appointed the main executor of monetary policy in the country and does not need any prior consent from government to implement its policy, then its independence will be strengthened. In addition, if the government is required by law to seek policy advice from the central bank on economic affairs, the same end will be served. Legally assigned roles and responsibilities of monetary management, and the absence of instructions subjecting the central bank to government, obviously promote the independence of the bank (As mentioned above, this does, however, not exclude the need for consultation with other authorities.)

A single and clear policy objective

Independence requires an explicit, clearly defined single objective which is statutorily determined (Grilli a.o. 1991: 368). To avoid political pressure and interference that lead to sub-optimal policy trade-offs — thereby creating uncertain and inconsistent policies — the statute of the central bank should state a single uncompromised policy objective, and give the bank a mandate to follow it. Such an objective supports the status of the bank as a distinctly non-partisan organisation whose functions are removed from political intervention (Burns, 1976: 22).

There is, however, considerable debate on who should determine the single policy objective of the central bank. If the central bank alone chooses the objective and the government does not necessarily concur, it is more than likely that conflict will arise and detract from the bank's consistent pursuit of its goals. If, on the other hand, the bank together with government set a common policy goal which the bank then has a mandate to pursue steadfastly, it may be taken to mean that the bank has less than "total" *goal* independence. However, given *instrumental* independence to apply whatever policy measures it deems necessary, the bank actually ends up with more than "total" independence. In other words, having instrumental independence but not goal independence, can provide the bank with more independence than having both types of independence.

Economic independence

Economic independence refers to the ability of the central bank to use without restriction the monetary policy instruments it deems necessary to pursue its task. The following criteria can be used to measure economic independence:

Budgetary independence

Although subject to external auditing and accountable to parliament or another such body, a central bank must nevertheless have budgetary independence. Apart from the obligation to transfer its financial surplus to government, it must have internal control of its own financial affairs in order to exclude any political influence on its operations *via* manipulation of its budgetary or financial resources.

Restrictions on the financing of government by the bank

Because excessive government financing by central banks has been a primary cause of many previous inflations world-wide, a curb should be placed on this practice. Such a curb is especially important in countries with high public debt levels. The less automatic and the more market related the central bank finance is, the more independent the bank will be. Limits on finance should not only entail advances and direct loans, but also the issue of government securities to the central bank. The bank must have a voice in determining the value and tenure of loans and the relevant interest rates (Cukierman, 1992: 273). The more stringent these limits and prescriptions, the stronger is the resistance the bank can offer to debt monetisation and the fiscal imprudence stemming from this kind of finance, and the sharper the focus of the bank on the pursuit of monetary stability. In summary, the central bank will be more independent if:

* a credit facility to government is prohibited, or if it exists,
* the credit facility must not be automatic,
* the facility must be based on market interest rates,
* the facility must be temporary, and
* the facility must be of a limited amount.
* the bank must not participate in the primary market for government debt.

Control over policy instruments

The independence of a central bank is strengthened if it has full command of its monetary policy measures. Changes in short-term interest rates are the most important variable under the control of the central bank, and it is crucial that the bank, and not the Treasury, has unfettered control over them. If the bank's discount rate is determined without the prior consent of government, and if the bank has access to sufficient government securities (or can issue its own securities) to pursue open market operations, its independence will be enhanced (Grilli a.o., 1991: 369). This will be even more the case if the instruments are indirect and market related in their operation. Direct and selective instruments are susceptible to political and pressure group manipulation, which may compromise the bank and seriously endanger its independence.

The monetary policy of the bank should also be separated from the public debt management of the government. Conflicts between the goals and instruments of the two policies can easily arise when the central bank must attend to both. This is especially true of the management of interest rates and the amount of liquidity in the economy, where clashing ends are often experienced. Such conflicts compromise the central bank and bring its dedication and credibility into question.

Ownership of capital

Although the capital of most central banks is state-owned, a few cases of privately owned capital do occur. Private ownership may be interpreted as reflecting greater independence, since government not does seem to "own" the bank. However, the stock of a central bank has a different meaning and function than usual, and does not endow stockholders with the normal rights associated with company stock. The ownership of central bank capital, therefore, is of a more symbolical nature and not regarded significant for the behaviour or independence of central banks (Woolley, 1977: 160).

The incompleteness and fragility of formal independence

The foregoing features of an independent central bank can be arranged, and do occur, in various combinations in practice, leading to different models of central bank independence. The formal criteria used for the definition of independence, although illuminating, do not fully reveal the meaning, background and scope of independence. The criteria are also not equally important and must be complemented with various background factors and country-specific details, in order to give a fuller picture of the meaning of independence. They do, however, convey a structured idea of what independence means and what some of the essential characteristics of an independent central bank are.

Furthermore, as already mentioned, the independence conferred by these legal attributes is of a fragile nature. The central bank statute through which independence is accorded, can be easily changed by a majority vote in parliament, which, in case of one party having a substantial majority, can be done without much resistance. However, criticism of the bank and its independence based on economically trivial grounds or because of political expediency — and which may endanger its fragile legal independence — can be countered by entrenching central bank independence in the *constitution* of the country. Such independence that cannot be as easily amended as an ordinary law, seems prudent and will render independence less vulnerable to political or other forms of pressure.

INFORMAL INDEPENDENCE

Although legal arrangements and statutes may provide a striking picture of bank/government relations, they cannot account for all the various nuances of independence amongst central banks, and fail to do justice to the meaning of *real* independence. However elegantly worded and drafted, the legal stipulations may be dead letters if the government's attitude or the general socio-political climate do not support it. The (officially required) objective recommendations and advice of the central bank will have no practical relevance if, in practice, they are not accepted by government. Such independence will be as fragile as it is, if the policy and irrelevant leadership of the bank are under suspicion. What is more important than formal criteria and statutes, is a deeply rooted respect and a reputation for objectivity and technical competence on the part of the central bank, to resist the pressure of political expedience (Woolley, 1977: 161).

Another reason why informal independence needs to be emphasised, stems from the fact that formal independence covers only part of all the contingencies of practical monetary policy, and *de facto* independence can, therefore, deviate substantially from the letter of the law (Cukierman, 1992: 360). The less complete, or the more vague the statute that governs the formal independence of the bank, the more scope is there for other — especially political — forces to influence monetary policy. These forces are fluid and not always easily detectable, but remain of the utmost importance in the determination of the degree of central bank independence. By granting the central bank *de facto* independence, the government limits the influence of these forces and reduces the number of instances when price stability might be sacrificed for other (short-term) goals. *Informal* independence, therefore, implies a practical *acceptance* of the central bank by government and the public. The following aspects underlying *de facto* independence may be discerned:

Public support

The public's support of the central bank and its policies is a major consideration . The greater the voting public's dislike of inflation and its consequences, the greater will be the cost to government of neglecting conservative economic policies, and the more it will be willing to delegate power to an independent central bank (Goodhart, 1988: 3). The strength of central bank independence therefore also depends on the political constituency and public support, whatever else the formal position of the bank may be with regard to independence.

Public support for conservative economic policies would also benefit an independent monetary policy *indirectly*,through fiscal discipline and an appropriate monetary/fiscal mix, which will result in a healthier overall macroeconomic policy. The establishment of a tradition of public support for anti-inflationary policies, apart from well-articulated formal stipulations about independence in a central bank charter, forms the basis of informal independence in countries like Germany and Switzerland. Such a tradition may have its roots in historical experiences of high inflation, but also depends on the moral character, work ethic, integrity and far-sightedness of the rulers and population of a country. The quality of government, the degree of law abidance and respect for authority, public awareness and information, and the general level of education in a country, together with the maintenance of political stability, all play an important role in the establishment of such a tradition or culture. They are all joint determinants of the willingness by government and the public to grant independence to the central bank. Here, then, lies the very substance of independence, namely whether the central bank is given the authority to pursue its basic responsibilities concerning monetary stability, and whether it has the public's support in doing so (Cargill, 1989: 32).

Pursuing the discussion further, it may be said that *formal* independence is neither necessary nor sufficient for the central bank to achieve financial and monetary stability. Independence really exists when a central bank, regardless of its formal relations with government, is *permitted* to fulfil its basic responsibilities. However, the bank will only enjoy such permission if it performs its task effectively. In other words, the bank will have to *deserve* its independence. Prestige and confidence cannot be taken for granted by the bank. The bank must make itself indispensable through a committed policy, based on sound principles which, through good results and goal achievement, will earn the bank a positive track record. Once credibility and respect have been earned, the public and the government will not only be inclined towards strong independence for the bank, but government itself will benefit from the policy success of the central bank. This is because the success also reflects favourably on the government (Mancera, 1991: 73).

Professional competence

As an important informal determinant of independence, professionalism involves the quality of personnel and management, and indicates that the bank is well managed and performs its functions and policies competently. Staff selection, training and promotion should promote professionalism, expertise and continuity. It is necessary to provide a solid empirical data base for outstanding research, and to survive passing political and ideological fads and fallacies (Erb, 1989: 12). Outstanding economic knowledge and in-depth knowledge of the institutional structure of the country, supported by good public relations, will enhance the respect for — and therefore also the independence of — the bank even further. Good liaison work will not only garner support for the bank, but explain the reasons for a particular policy stance, making the bank's operations more transparent and accountable.

In addition to employing professional and career-orientated officers, the bank deals with money and monetary functions, and must therefore have a corruption-free record and incorruptible staff. Bank statements must be non-partisan in nature and convey the image of freedom of speech within the organisation. The statements should also be an integral part of the bank's communication function by means of which it explains its policies. Reports, articles, speeches, panel discussions, submissions to parliamentary committees etc., should all be part of the bank's mode of communication and accountability, which enhances its stature and independence and explains what its policy can and cannot do.

Personalities

Because policies are drawn up and implemented by people, their personalities play a major role in determining their acceptance and success, especially in the case of monetary policy. The extent to which various viewpoints are sought and the degree to which consultation and policy co-ordination of economic policies are conducted — and therefore the likelihood of policy success — depend crucially on the personalities engaged in the exercise. The major driving force behind monetary policy is in most cases the governor of the central bank; chairmanship is the key to both accountability and effective performance (Reagan, 1961: 75). The extent to which he or she enjoys the support and confidence of the country's head of state, a good working relationship and open communication with the Treasury as well as sound relations with the financial community, is decisive for the independence, support and respect accorded to the central bank. Not only should he/she be able to speak out convincingly on behalf of the bank and sound monetary policy, but this should be done objectively and tactically. Aware of the importance of the bank's contribution to economic policy, yet mindful of the limitations on the bank and the scope of its responsibilities, the bank governor should pursue the general welfare and public interest, not yielding to political or sectoral pressure. To be efficient and purposive, rather than popular, should be the bank's guiding principle. It remains a classic function of the central bank to swim against the current.

However, too much concentration of power in the chair should be avoided, since overbearing behaviour is not reconcilable with informal independence and the need for consultation. (It may be necessary to establish decisions about policy not with the chairman alone, but with a broader committee in the manner of collective responsibility.) Nevertheless, the policy stance of the bank and its governor should be expounded with vigour, for as Volcker (1991: 65) has said, "the status and prestige of the central bank lie with the public attitudes, with the *strength of the people running the bank and how independent they are and how much they are willing to fight for what they think is important in terms of stability, or whatever"* (italics added).

The above exposition once again testifies to the fact that it is *informal* rather than *formal* autonomy which matters, albeit a complex mix as difficult to maintain as it is to define and study. It also shows that this kind of independence is closely related to the intellectual and moral status of those who run the government and the bank, while heavily relying on the support and views of the general public too.

CONCLUSION

Central bank independence is a complex, multifaceted concept that is difficult to encapsulate precisely. It should be seen within a context of limitations and restrictions, not of unlimited power or unrestricted scope. The different criteria of measuring independence occur in various combinations, leading to various kinds of central bank independence. Independence has both a formal and an informal dimension. The former consists of political and economic elements. There is, however, no specific blueprint for the ideally independent central bank in a formal sense. Different countries may construct different types of formal independence models along a spectrum of possibilities. In the final analysis, informal independence is what forms the actual substance of central bank independence. Informal determinants of independence range from institutional, cultural, and social to personal, moral and intellectual factors. The importance of these variables shows that the independence of a central bank cannot be fully safeguarded by laws and statutes alone. It also needs wisdom and statesmanship by the government and the directors of the central bank, together with the support of the general public. Furthermore, independence should not be pursued purely for its own sake; its presence must make a difference to policy-making. In addition, it must be earned rather than given, even though this has become a popular tendency in recent times. To live up to the meaning of independence, a central bank should realise that this requires a continuous educational programme to explain what central bank policy can and cannot do.

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