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# The Role of Central Bank Independence in Improved Macroeconomic Management

**Central bank actions directly affect the cost and availability of credit and indirectly affect output, employment, the price level, the exchange rate, and the balance of payments. These actions have an impact on the welfare of almost everyone, often with significant political repercussions. For their part, governments frequently adopt policies that are financially disruptive. They require banks to lend at below-market interest rates to designated sectors. They also spend more than can be adequately funded by tax receipts and borrowing from the domestic non-bank public. Moreover, governments are often slow to reverse counterproductive policies such as food subsidies, tax holidays, and chronically overvalued exchange rates.**

These conflicting pressures generate friction between the central bank and the government. Supporters of one side can always find fault with the other. Politicians deflect blame if they can. Central bank officials suggest that their policies would improve if only the government would not interfere. Many observers believe that the solution is to make the central bank "independent" of government. This policy brief examines some of the issues involved.

**Government and the Financial System:** It has been common for African governments to intervene in the financial system. Sometimes the intervention is ad hoc in response to pressing policy concerns. For example, interest rate ceilings might be imposed to reduce the cost of borrowing for particular groups. More often, however, intervention is prompted by attempts to promote economic growth.

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Experience from the last three decades provides a number of lessons about the efficacy of such intervention to foster growth and development. First, bureaucrats (whether party appointees, central bank officials, or ministry of finance staff) have made poor commercial and/or development bankers. Second, politicians typically fail to distinguish between real and financial resources leading them to encourage the over-expansion of finance and credit. Third, delaying financial reform has invariably undermined growth. Fourth, the financial system is an inefficient means of redistributing wealth. And fifth, efforts to promote financial development by re-engaging the private sector do not succeed until entrepreneurs are convinced the government will not re-intervene.

While these outcomes have been widely noted, less attention has been devoted to the central bank's influence on the economy. One reason is that there are numerous arrangements through which the central bank exercises its influence. At one extreme, some central banks are part of the government and merely carry out government policy. At the other extreme, some central banks enjoy administrative and financial autonomy.

Yet, formal arrangements are only part of the story. The ability of the central bank to pursue any policy ultimately depends on public support. The scope for independent action by the German Bundesbank rests on strong popular support for its anti-inflation policy. The Federal Reserve System in the United States has been aptly described as "independent within, but not, of the government."

**Form vs. Substance:** The formal relationship of the central bank to the government is important primarily because it determines the difficulties encountered when governments seek to override central bank policy.

In practice, the independence of a central bank is a matter of degree. How far the bank can raise interest rates or restrict the growth of money and credit, how long restraint can be maintained, how often it can be applied, and how often it can be re-applied (if need be) largely depend upon the context. Legislative support for the bank and secure tenure for its managers provide the central bank with more room to maneuver. The bank's reputation for competence and objectivity also helps in this regard.

The leeway available to a central bank for changing policy hinges on the political balance between those who benefit and those who bear the costs of that change. Responses to central bank policy are not symmetrical. Popular complaint is more vocal when actions are restrictive than when they are expansive. And, even if the long-term consequences of expansive actions are adverse, the immediate effects usually benefit far more people than they hurt.

**Testing the Limits of Independence:** The independence of a central bank is most likely to be tested when its policy objectives prove inconvenient to the government. An example is when the bank's price and exchange rate objectives require credit restraint because of increasing budget deficits, or reduced export earnings, or a decline in official transfers, or local price pressure from rising import prices and poor food crops.

Central bank managers may believe that increasing nominal demand associated with higher government spending will start a spiral of rising prices and wages and exchange rate depreciation that will be difficult to reverse. If the bank maintains a monetary program consistent with price and exchange rate stability, the government will find that it must either accept the interest rate increases that crowd out private expenditure, or give up its effort to increase expenditure.

When faced with supply side pressures on prices, central bank managers may believe that early and vigorous action will limit price increases thereby preventing a wage-price spiral. They also see such actions as helping maintain confidence in the country's commitment to a stable exchange rate. Nonetheless, credit restraint in the form of rising interest rates or rationing is always painful.

The central bank will have to proceed cautiously if it has little support as an institution and the public is unwilling to bear the costs of keeping inflation low. In practice, this means that central bank managers take the political implications of their proposed policies into account. They will limit their restrictive actions when there is too much opposition and often seek a compromise before they act.

**Inflation Contracts, Currency Boards and Dollarization:** Faced with persistent inflation, several governments have sought to "tie their hands" by limiting the mandate of their central banks. Perhaps the most dramatic change was in New Zealand where the Reserve Bank has been given one objective — low inflation — and the governor's tenure has been made dependent upon keeping inflation below a specified rate. After some dramatic success in reducing inflation, problems have arisen recently due to the need for fiscal loosening to stimulate the economy. That action, however, is precluded by the tight monetary conditions the Reserve Bank must sustain to keep inflation low.

Currency boards have also been revived. Argentina is the best known example although several of the Newly Independent States (notably Latvia and Estonia) have created them as well. The objective has been to adopt a mechanism through which the balance of payments determines the local money supply and not vice versa.

With its history of rapid monetary growth, budget deficits, chronic external debt problems, and bouts of hyperinflation, Argentina seemed to be an "ideal" candidate for using this mechanism to impose monetary self-restraint on the government. Yet, Argentina has now been saddled with an increasingly unrealistic exchange rate as its major trading partners (especially Brazil) have devalued. Argentina faces the prospect of sustained deflation or the credibility-destroying choice of abandoning its fixed exchange rate. The basic lesson from both New Zealand and Argentina is that, in a dynamic world, mechanisms for "tying the government's hands" are useful but they can be overdone.

A third possibility is "dollarization" through the adoption of some other country's currency. This does not eliminate the need for a central monetary authority. The financial system still needs supervision, the government requires banking services, and payment mechanisms potentially require lender-of-last-resort facilities. However, dollarization rules out the adoption of an independent monetary policy and severely limits government scope for discretionary action with respect to fiscal policy and public debt management.

The debate on these mechanisms will continue. All arrangements have their merits and demerits. None of them relieves the government of the need for fiscal prudence and strict limits on access to debt financing. Indeed, recent experience with these various arrangements has shown that the basic issue is not whether the central bank is independent, there is a currency board, or the country dollarizes. The key issue is the behavior of government. Any government exercising fiscal self-restraint will not generate the conditions-chronic deficits, high inflation, exaggerated levels of debt-that typically undermine the central bank's ability to stabilize the economy.

**This policy brief is based on EAGER Research, *Restarting and Sustaining Growth and Development in Africa*, 2000, by James S. Duesenberry [duesenb@fas.harvard.edu], and Malcolm McPherson [mmcphers@hiid.harvard.edu], Harvard Institute for International Development, Cambridge, Massachusetts.**