FRBSF WEEKLY LETTER

Number 91-43, December 13, 1991

The Independence of Central Banks

What explains the difference in inflation rates among countries? According to widely cited studies by Bade and Parkin (1987) and Alesina (1988), countries with central banks that have greater *legal* independence in setting monetary policy tend to have relatively lower average inflation rates. For example, Switzerland and Germany are said to have the most legally independent central banks and also the lowest annual inflation rates among industrialized countries, each averaging about 3.5 percent between 1974 and 1990. Japan and the U.S. rank next in terms of central bank independence, with average inflation rates for the period of 5.1 and 6.3 percent, respectively. At the opposite end of the spectrum are the central banks of Italy and the U.K., with relatively little formal independence. Average annual inflation rates in Italy and the U.K. were 12.1 and 9.8 percent, respectively, during the same period.

These findings are consistent with the theory that inflation and the credibility of monetary policy are linked. According to this theory, governments are sometimes tempted to attain short-term political objectives by compromising long-term economic goals. For example, a government may try to win an election by printing money to increase output and reduce unemployment in the short-run. Repeated use of this approach, however, erodes the credibility of monetary policy and drives up the public's inflationary expectations, and hence prices, without any long-run effect on unemployment. Placing monetary policy under an independent authority that the public perceives as less prone to pursue such myopic policies provides an institutional mechanism to mitigate this credibility problem.

These findings have not gone unnoticed by policymakers. A growing number of countries plagued by high inflation rates in the past have sought to give their central banks more formal independence from the government in conducting monetary policy. Chile and New Zealand enacted new legislation to this effect in 1989 (see *Weekly Letter* November 23, 1990), and similar proposals currently are being considered in Argentina and in a number of Eastern European countries, including Czechoslovakia and Poland. As the European Community (EC) moves closer to forming a monetary union, some member countries have been calling for greater national central bank independence within the Community, as a step to ultimately establishing an independent supranational central banking system.

This *Letter* discusses the three principal legal determinants of central bank independence—formal central bank objectives, appointment procedure for its policy board, and financial relations with the Treasury—by drawing on the experience of three countries: Germany, the U.K., and Japan. Germany and the U.K. represent the opposite ends of the spectrum of independence. Japan provides an interesting example where formal legal arrangements understate the actual degree of central bank independence. This suggests that the establishment of a legally independent central bank is not a necessary condition for credibility of monetary policy; a well-established reputation for controlling inflation can be an effective substitute.

Formal objectives of central banks

In Germany, the Bundesbank Act of 1957 explicitly states that the Bank "shall be independent of instructions from the federal government." The Bundesbank is legally obliged to support the general economic policy of the German government "only insofar as this support does not undermine its assigned task of preserving monetary stability." This latter provision is fundamental to safeguarding the Bank's independent position.

At the other end of the spectrum, the Bank of England is subordinated by law to the Treasury. The Bank of England Act (1946) stipulates that the Treasury may issue directives to the Bank after consultation with the Governor. This legal provision ensures that, in the event of a disagreement, the government's position on monetary policy will prevail over that of the Bank of England (BOE). In practice, the Treasury has never actually issued directives, because monetary policy is formulated through close coordination between the Bank and the Treasury, with the latter having the upper hand.

Japan falls somewhere between these two examples. Legally, the Bank of Japan (BOJ) can independently determine discount rate policy and open market operations. In other respects, however, the BOJ's independence is significantly curtailed. For instance, any change in commercial banks' reserve ratios requires approval of the Ministry of Finance (MOF). In fact, the Bank of Japan Law (1942) empowers the Finance Minister to direct the BOJ to change its bylaws or to undertake any actions it deems necessary. This power, however, has never been exercised, and in practice, major monetary policy issues are determined through close cooperation between the BOJ and the MOF, which is facilitated by having a (non-voting) MOF representative on the Bank's Policy Board.

Appointment of central bank policy boards
Governments may exercise leverage over central banks by controlling the appointment and dismissal of members of the monetary policy board. The degree of a central bank's independence can thus be enhanced by limiting these powers, for example, by making the terms of board members longer than the electoral cycle, or by limiting the proportion of policy board members that can be directly nominated or appointed by the government.

When the government is responsible for formulating monetary policy, it typically controls directly all appointments to the policy board of the central bank. In the U.K., the Governor, Deputy Governor, and directors of the BOE are all appointed by the Crown, which in practice means by the Prime Minister acting on the advice of the Chancellor of Exchequer (Treasury). The Governor and Deputy Governor are appointed for renewable terms of five years; the directors have staggered four-year terms which are also renewable.

Although the Bank of Japan is considered to be a relatively independent central bank, all positions on its Policy Board are direct government appointments. The Board consists of seven members: the Governor, appointed by the Prime Minister's Cabinet for a five-year renewable term, two nonvoting members serving ex *officio* as representatives of the Ministry of Finance and of the Economic Planning Agency, and four voting members appointed for four years by the Cabinet with the consent of both Houses.

In Germany, the Central Bank Council determines the monetary and credit policies of the Bundesbank. It consists of the ten-member Directorate and the eleven Land (district) Central Bank Presidents. The Directorate, which includes the President and the Vice President, are nominated by the federal government and appointed by the President of the Federal Republic for a period of eight years. The President of the Federal Republic also appoints the eleven Land Bank Presidents for eight-year (renewable) terms. Their nomination, however, must come from the Bundesrat, the upper house of the parliament, which represents the various regions of the country. In making a nomination, the Bundesrat must follow the recommendation of the political authority in the Land concerned. This ensures that the federal government is not able to nominate directly a majority of the Central Bank Council. As a further check on the government's direct input in the appointment process, the Central Bank Council has the right to comment on the nomination of any Directorate member or Land Bank President.

Financial relations between central banks and governments
Budgetary autonomy would seem to be a natural feature of central bank independence. But, in fact, many central banks along the entire spectrum of independence have complete budget autonomy. The Bank of Japan, along with the Bank of France and the Reserve Bank of New Zealand, are notable exceptions; all must obtain prior approval from the government for their budget expenditures. One possible reason why budgetary autonomy is not linked to monetary policy independence is that, unlike other government agencies, virtually all central banks generate revenue from seignorage or assets purchased by creating non-interest bearing (or low interest-bearing) liabilities against themselves.

A significant determinant of central bank independence is the extent to which the government can obtain financing directly from the central bank. The more power the Treasury has to demand direct financing from the central bank, the less latitude the central bank has in pursuing monetary policies aimed at maintaining long-term price stability. In Germany, direct central bank credit to the government is strictly limited, but the Bundesbank is allowed to acquire government paper in open market operations. The law explicitly states, however, that such secondary market purchases can be used only for monetary control purposes. In the U.K., the Treasury can cover current budget spending requirements with direct short-term loans from the BOE. Moreover, the law does not limit BOE purchases of government securities. In Japan, the BOJ is prohibited from direct purchases of new issues of long-term government securities, but there is no barrier to BOJ advances to the government or secondary market purchases of government debt.

Law versus reputation

Formal legal arrangements of central banking in Germany and the U.K. give a fairly clear indication of the degree of their independence. And, the relative inflationary performance both countries is consistent with the notion that independent central banks tend to generate lower inflation rates. In Japan, less formal arrangements and practices (which are more difficult to measure) also have been important; monetary policy generally has been more independent in practice than central bank legislation suggests. In other words, achieving low inflation has been possible in Japan without the benefit of a particularly *legally* independent central bank.

This achievement may be explained by the BOJ's trustworthy record of keeping inflation in check. Such a reputation may have provided an effective substitute for legal independence in establishing policy credibility. Of course, the two are not mutually exclusive, as the German case illustrates, where the Bundesbank's track record in controlling inflation has been even more impressive. No doubt, the collective memory of hyperinflation contributed to Germany's decision to buttress high central bank reputation with legal safeguards for its independence.

Establishing formal independence will be particularly important for a country attempting to build monetary policy credibility against an historical background of variable and insufficient monetary restraint. Perhaps it is not a coincidence that countries with particularly poor inflation records in the past, such as Argentina, Chile, New Zealand, and some of the Eastern European countries, are the very ones that have recently formalized, or are contemplating formalizing, the independence of their central banks. Formal central bank independence may offer the potential to provide a disciplinary check on monetary policy and thereby improve long-run inflation performance.

Sun Bae Kim
Economist

References

Alesina, Alberto. 1988. "Macroeconomics and Politics." In *NBER Macroeonomic Annual, 1988*, Cambridge Mass., MIT Press.

Bade, Robin and Michael Parkin. 1987. "Central Bank Laws and Monetary Policy." Unpublished mimeograph. Department of Economics, University of Western Ontario.

Research Department
Federal Reserve
Bank of
San Francisco
P.O. Box 7702
San Francisco, CA 94120

Index to Recent Issues of *FRBSF Weekly Letter*

The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.