

Central bank independence

Speech by Athanasios Orphanides, Governor of the Central Bank of Cyprus, at the Oxford University Society Cyprus branch meeting

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"It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it; and that, on any occasion when it was pressed for money to carry on a war, it would cease to pay coin, on demand, for its notes; and from that moment the currency would become a forced Government paper. There would, I confess, be great dangers of this, if Government—that is to say, the Ministers—were themselves to be entrusted with the power of issuing paper money" (Ricardo, 1824).

With this statement, written in London shortly before his death in 1823 and published the following year, the brilliant British economist and member of the British Parliament David Ricardo explained the main concern that led him to the conclusion that a central bank responsible for the issuance of paper money should be independent. He thought it critical for the bank to be governed by individuals "entirely independent" of the government's Ministers and stressed that the individuals governing the bank "should never, on any pretence, lend money to Government, nor be in the slightest degree under its control or influence". His proposal was a radical departure from his view of the Bank of England at the time. Referring to the Bank of England's Directors, he continued: "Experience shows how little this latter body have been able to withstand the cajolings of Ministers; and how frequently they have been induced to increase their advances on exchequer bills and treasury bills, at the very moment they were themselves declaring that it would be attended with the greatest risk to the stability of their establishment, and to the public interest".

Today it is widely recognised that independence may be the most critical element for the successful design of central banking institutions entrusted with the issuance of paper currency and the objective of securing stability in the value of this currency. But this was not well understood during Ricardo's time, and it took several decades of instability and numerous crises for this fundamental lesson to be comprehended. I have argued previously, on the occasion of the 50th anniversary of the Bundesbank, that this is perhaps the most important lesson regarding central banking over the past 50 years, and a lesson we can draw by comparing the success of policy at the independent

Bundesbank with the not so successful experiences of less independent central banks (Orphanides, 2009, forthcoming). Over the past two decades, in particular, a number of central banks in industrialized as well as less developed nations have been granted independence. We have witnessed in the founding of the ECB the creation of a supranational central bank created to serve the citizens of the European Union, that serves as a model of the independence David Ricardo had envisioned for the money-issuing central bank in Britain. In 1998, the Bank of England also gained its independence.

I will take the opportunity presented to me by your kind invitation for this evening to make some remarks on the meaning and the rationale of central bank independence: that is, what is and why do we need an independent central bank. I will also discuss specific issues that come up in the broader context of central bank independence, such as the importance and scope of central bank independence in the EU and particularly in the euro area, the connection between central bank independence and prudential supervision, and finally the link between central bank independence, accountability and transparency. But before I proceed I should note that the views I express are my own and do not necessarily reflect those of my colleagues on the Governing Council of the European Central Bank.

As I already alluded to, central bank independence is needed to help a paper-money-issuing central bank deliver price stability over time, and thus achieve the well-known benefits we associate with price stability for the economy. But why should the independence of the central bank be a concern, especially in a democratic society where an elected government is entrusted by the electorate with the power to conduct other economic policies? Why should monetary policy and the pursuit of price stability be different? Indeed, why have politicians in so many democracies over the past two decades come to the conclusion that the welfare of the citizenry is enhanced over time if the political authorities permanently relinquish control of the central banks and grant them independence?

In one word, the answer is "temptation"—specifically the temptation of future political leaders and governments to allow corrosive inflation to develop in the economy, that is the temptation to debase the currency by issuing too much of it and more than would be compatible with price stability over time.

During his tenure as President of the Federal Reserve Bank of San Francisco, Robert Parry compared the temptation that can be faced by politicians and government

ministers to the temptation Eve faced in the Garden of Eden (Parry, 1995). Parry went on to remind us that the punishment for succumbing to the temptation of debasing the currency could be as harsh as Eve's punishment. According to Dante's *The Inferno*, the punishment for the corrupting influence of those who debase the currency, like other forms of fraud, is to be condemned to the 8th circle of Hell, one of the worst possible spots, just one short of the 9th and final circle.

Indeed, both the possibility and the tremendous damage that can be caused by the power to debase the currency have been recognised since ancient times. For modern capitalist societies closer to ours than the 14th century Florence that Dante had known, particularly interesting was the remark John Maynard Keynes attributed to Vladimir Ilyich Lenin, shortly after the end of World War I: "Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency". Keynes continued: "Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose" (Keynes, 1919, pp. 148-149).

There are two reasons why political authorities in democratic societies face a temptation to tolerate, if not seek inflation. The first is the short-term pressure to risk pushing the economy to run beyond its productive capacity. This is the potentially irresistible draw to the short-term trade-off between more employment and higher economic activity at present versus higher inflation that may build more slowly and only be recognised somewhat later on. It is well understood that any gains to employment that may be seen from running overly expansionary policy are bound to be ephemeral and are likely to lead to a worsening of economic welfare over time. That said, running overly expansionary monetary policy for a time may be particularly tempting to the political authorities when elections are looming on the horizon and policies could potentially become more short-sighted than usual.

The second reason is budgetary. The temptation governments may have to incur budget deficits and finance the accumulated debt at a low cost for a time, perhaps disregarding much higher costs to be faced by future governments down the road. The real cost of servicing debt that has already been issued, for example, can be reduced if part of it is inflated away. Other things being equal, a government can create room for additional short-term spending by debasing the currency. This may be quite expensive to future governments, but the Minister of today may not have a strong incentive to put the

appropriate weight on the difficulty a future Minister might face as a result of his or her actions.

Both of the suggested reasons why political authorities may face a temptation to risk inflation can be seen as resulting from the political pressures that prompt governments facing an election to have shorter horizons than would be ideal from society's perspective. But neither of these reasons could yield any benefits, even in the short run, if the public recognises that the government would be tempted to create inflation in an attempt to secure a short-sighted benefit. Rather, the existence of the temptation would only lead to higher inflation--resulting in higher costs for society with no countervailing benefit⁽¹⁾.

Concerns that the government would try to monetise its debt, for example, would only drive nominal interest on government debt higher because of higher inflation expectations. The government would be left with higher inflation but no benefit in terms of debt finance. Similarly, concerns that the government would systematically attempt to push the economy beyond its productive capacity would lead to permanently higher inflation expectations. In the end, in their attempt to inflate the economy to generate additional short-term output gains, the political authorities would only manage to achieve higher inflation with no overall gain in output or employment.

If the public could trust the political authorities not to attempt to inflate the economy for short-term gain, then inflation expectations and inflation would remain low. But if opportunistic political authorities subsequently exploit the public's trust, the realisation of inflation may come too late for the public to recognise that its trust has been compromised. In the meantime, the opportunistic behaviour may be incorrectly rewarded at the polls. Recognition of this time inconsistency, suggests that the mere possibility that a government may face the temptation to act opportunistically is costly to society.

The only way for the political authorities to avoid this cost to society is to forever relinquish the control of the money-issuing banks in their economies and grant independence to a central bank along with a mandate to pursue price stability over time. Thus, by delegating the task of running monetary policy to an independent central bank that is insulated from short-term political influences and a mandate to pursue price stability, the political authorities can protect themselves against the destructive temptation to seek policies that would prove to be systematically too short-sighted for the common good.

A large number of empirical studies suggest benefits from central bank independence⁽²⁾. Apart from purely legal indicators, a number of other indicators have been compiled to capture the degree of independence across central banks. These relate to, among others, the freedom of the bank to select its policy rate, its ability to use monetary instruments without restrictions and the turnover of central bank governors. Overall, these studies provide suggestive evidence that, especially for advanced economies, central bank independence is associated with a lower level and lower variability of inflation.

An interesting case which clearly indicates the association of central bank independence and lower inflation is Cyprus. The fact that the decisions of the Central Bank of Cyprus (CBC) have been taken independently from political interference for more than 40 years, has helped to deliver price stability and financial stability amid high growth rates and low unemployment. More specifically, the average inflation rate in Cyprus in the 40 year period of 1968-2007 was 4,8% compared with 6,3% in the UK. This impressive inflation performance was partly due to the fact that although the CBC was only officially granted its independence in 2002, and although the government had a representative on the CBC's Board of Directors, this representative very rarely, if ever, questioned the Board's monetary policy decisions (see Syrichas, 2008).

It is already evident that, while central bank independence entails the freedom to determine the policy instrument for achieving the bank's primary objective, there are different institutional and functional attributes which differentiate the approaches followed by independent central banks. For instance, in terms of functional independence, some central banks pursue a single goal of price stability while others may attempt to pursue multiple goals, including price stability. Some have the freedom to determine on their own a quantitative definition of their primary objective, while other central banks pursue an objective, e.g. an inflation target, set by the government. All of these approaches however share the same feature, a clear and precise mandate with regard to their primary objective and the capacity to independently set the policy instrument in the pursuit of this objective. Which approach is preferable is a debatable issue which I will not dwell on now. Instead, I will focus on the EU arrangements and scope for central bank independence.

The design of the European System of Central Banks (ESCB) and the European Central Bank (ECB) exemplifies the deliberate efforts to endow the ECB with the best practices of the most successful precursors, notably the Bundesbank, and also to ensure that these practices are adopted by the national central banks (NCBs), which together form

the ESCB. The fact that European politicians understood and agreed on the need to delegate the conduct of a single monetary policy to a supranational institution, independent of political influence, is in my view the most important achievement in the run-up to the design of the monetary framework of the EMU. In order to rule out the possibility that they succumb to the temptation to influence the single monetary policy, politicians reinforced central bank independence at the highest level. Central bank independence is enshrined in the Treaty establishing the European Community, and in particular article 108 which asserts: "...neither the ECB, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body". Moreover, article 108 states that "Community institutions and bodies and the governments of the Member States undertake to respect this principle [of central bank independence] and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks". Article 108 of the Treaty is reproduced in article 7 of the Statute of the ESCB and of the ECB, which is annexed to the Treaty. Furthermore, article 109 of the Treaty requires that: "Each Member State shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation including the statutes of its national central bank is compatible with this Treaty and the Statute of the ESCB". Therefore, new Member States are obliged to establish central bank independence by the time of their accession to the EU.

Since 1998, the ECB describes in detail in its convergence report a list of features of central bank independence. Four aspects of central bank independence can be considered: functional, institutional, personal and financial independence. I would like to elaborate on two of these aspects, namely personal and financial independence, as they may not appear as straightforward and uncontroversial as functional and institutional independence.

Personal independence is enshrined in article 14.2 of the Statute of the ESCB and of the ECB, according to which the NCB statutes must provide for a minimum term of office of five years for the Governor. Moreover, the same article provides that a Governor may be relieved from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct. The purpose of article 14.2 of the Statute of the ESCB is to ensure that the Governor is not dependent on the political authorities in office. The government should not attempt, by means of legislative amendments, to circumvent this. Even when the NCB statute is amended to introduce a change in the Governor's term of office, the incumbent Governor should

remain in office for the tenure he has been appointed for. This point was clarified, for example, in an ECB opinion on an Italian draft law which reduced the Governor's term of office to six years.

Furthermore, article 14.2 of the Statute is also applicable to members of NCB decision making bodies, other than Governors, who are involved in the performance of ESCB-related tasks. If different degrees of independence co-existed among the members of the decision making bodies within a NCB this would severely endanger the personal independence aspect of the central bank as a whole. For instance, the government may have an incentive to appoint a member of the Board of Directors for less than the minimum five years required by the Statute, with the possibility of reappointment after the conclusion of a shortened term. However, it cannot be precluded that this member is more prone to being pressured by the government than members whose tenures are longer. Indeed, the Central Bank of Cyprus Law, 2002, was amended last year to make it compatible with article 14.2 of the ECB Statute, because the original law gave the Council of Ministers the right to appoint a Board member for a term of less than five years.

In light of these restrictions against shortening the term of an appointment, it is imperative that the appointment process of Governors and Directors ensures that the professional qualifications of the persons that are nominated are well beyond question regarding the fulfilment of their responsibilities.

Personal independence also implies that there should be "...no conflict of interest between the duties of members of the NCB decision making bodies in relation to their respective NCBs (and also of Governors in relation to the ECB) and any other functions which such members of decision making bodies involved in the performance of ESCB-related tasks may have and which may jeopardise their personal independence" (European Central Bank, 2008, p. 20). It goes without saying that the avoidance of any actual or potential conflicts of interest should not stop at the appointment process of any members of the decision making bodies of an NCB. Continuous confirmation of avoidance of any actual or potential conflicts of interest is particularly important for non-executive Directors of an NCB. Non-executive Directors are not employed by the NCB on a full-time basis and their evolving outside business or other activities may inadvertently create conflicts that may not have been present at the time of the appointment. Consider, for example, a situation where following the appointment of a Director to an NCB that also has supervisory responsibilities for financial institutions, a company in which this particular Director has a controlling interest is found to engage in substantial

business activities with the financial institutions that are being supervised. Situations such as this might raise legitimate questions about actual or potential conflicts of interest that may not have existed when the Director was appointed.

Another problem relating to personal independence may arise if the Governor or Directors of an NCB are known to have a political affiliation and have either played an active political role prior to their appointment or are expected to have such a role after their term is over. The issue was recently highlighted by Lorenzo Bini Smaghi (2007), the ECB Executive Board Member who is responsible for the oversight of the legal aspects of the convergence process of non-euro area Member States. Such political affiliations, he points out, may be interpreted as political interference with the NCB which would not be compatible with the spirit of the Treaty and the Statute.

With regard to financial independence, as the ECB stipulates in its latest Convergence Report, "even if an NCB is fully independent from a functional, institutional and personal point of view, its overall independence would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate (i.e. to perform the ESCB-related tasks required of it under the Treaty and the Statute)" (European Central Bank, 2008, p. 20). Therefore, the NCBs should not be financially dependent on the political authorities in office or any other third party in order to exercise their ESCB-related tasks. For example, the government cannot force the NCB to sell part of its foreign reserve assets with a corresponding reduction in its capital and reserves position, as this may impair its overall financial soundness. The principle of financial independence also holds for non-ESCB related tasks, since the ability of an NCB to perform smoothly its ESCB-related tasks could be undermined when, for example, the NCB does not have sufficient control over its budgeting process for administrative and operating issues. Thus, financial independence takes into account a multitude of factors such as the ability of the NCB to determine its own budget, to prepare its accounts in accordance with general accounting principles, and to enjoy the requisite autonomy in staff matters.

The next issue I would like to discuss is that of the connection between central bank independence and prudential supervision. In Cyprus, in addition to monetary policy, the central bank is also responsible for bank supervision, with an important exception being the supervision of the individual cooperative societies. Bank supervision is not a eurosystem task and is not the responsibility of all NCBs in the euro area. I will not elaborate on the advantages of the exercise of prudential supervision within a central bank except to point out that, especially in light of the recent financial turbulences worldwide, there can no longer be any doubt that the supervisory function should be

coordinated with other NCB functions since the NCB would need to act as a lender of last resort in the case of an unforeseen circumstance that warrants doing so. Rather, I wish to focus on the issue of independence, that is the necessity to keep all supervisory matters as far from the influence of political forces and special interests as monetary policy has been recognised needs to be. In the context of the eurosystem, an important advantage of combining the supervisory function with the other functions of the central bank is that it ensures that this necessary degree of independence in supervision is granted to the supervisory authority simply because the independence of the NCBs is already enshrined in the Treaty. Simply put, the decision making process for supervisory issues should not endanger the independence of the NCB.

More generally, lack of independence and the risk of political interference with the supervisory framework should be avoided in any other related field in the financial system. In an interrelated financial system a financial crisis is most likely to arise as a result of a flaw in the weakest link of the system. Weak supervision in one area of the financial system could potentially cause unanticipated strains even in parts of the financial system which on their own may appear to be well-supervised by independent authorities and are deemed to be well-prepared to weather a storm.

An example of such interactions that relates to the current financial turbulence is that of Fannie Mae and Freddie Mac, the two housing-related government sponsored enterprises (GSEs) in the United States that have been linked with the subprime crisis and that, following their recent collapse, have been taken over by the US Government. In brief, these two GSEs represented systemically important institutions not under the supervision of the Federal Reserve, which is the primary supervisory agency for the banking sector in the United States. These GSEs were allowed to expand their portfolios of assets virtually without limit and with an implicit government guarantee, despite warnings by the Federal Reserve.

In testimony before the US Senate in April 2005, Chairman Greenspan noted that "in the Federal Reserve's judgment, a GSE regulator must have as free a hand as a bank regulator in determining the minimum and risk-based capital standards for these institutions". He then stressed: "We at the Federal Reserve remain concerned about the growth and magnitude of the mortgage portfolios of the GSEs, which concentrate interest rate risk and prepayment risk at these two institutions and makes our financial system dependent on their ability to manage these risks. ... To fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later" (Greenspan, 2005, p. 3).

Unfortunately, warnings of the problem were not heeded, and the systemic failure that had been a source of concern at the Federal Reserve materialized. The expansion of these two GSEs was in part made possible by facilitating the extension of credit to households with rather poor credit ratings. As Calomiris (2008) points out, "political pressures on those institutions to increase their 'affordable housing' programs" (p.12), was one of the ways the US government subsidised residential real estate but also promoted financial fragility in the real estate market. Unfortunately, and regardless of how well-intentioned the role of politicians may have been in influencing the residential real-estate market through the GSEs in this case, the results proved catastrophic. The increasing number of foreclosures in the United States over the past year serves as a demonstration that even the households that were supposed to be helped by the lax provision of credit likely ended up being worse off.

In retrospect, I would argue that if the Federal Reserve had broader supervisory authorities, it could have better internalised the systemic risks associated with the GSEs and, in light of its independence, would have been better positioned to insulate this aspect of mortgage lending from political pressures, possibly averting what eventually became the proximate cause of this crisis.

Finally, I turn to the link between central bank independence, communication and transparency. It goes without saying that in a democratic society a high degree of independence goes hand in hand with a responsibility for accountability. The public has a right to know what independent decision makers are doing and why. And this is why communication and transparency become an integral part of the decision making process of an independent central bank. Independent decision makers have an obligation to explain to the public how the decisions they take contribute to the attainment of their objectives and, in case the mandated objectives are not satisfactorily met, the reasons for any deviations from their objectives. Thus, precisely because accountability goes hand in hand with independence, communication and transparency acquire an elevated role in modern central banking.

With respect to monetary policy decisions, clarity in communicating and explaining the rationale behind policy actions provides a direct way the public can assess and hold accountable policymakers for their actions. This is what lies behind the communication strategy of the ECB and was also the rationale behind the communication strategy of the Central Bank of Cyprus prior to our entry into the euro area this year.

In the case of the CBC, you may recall that following every meeting of the monetary policy committee, the committee would issue a statement that announced its policy decision and explained the macroeconomic developments and other factors influencing the outlook for the economy that were pertinent to the decision. This was followed by a press conference where the Governor, in his capacity as president of the monetary policy committee, would provide further explanations and clarifications that were needed. With our joining the euro area, this process has now been integrated into the common monetary policy process for the 15 euro area members but is otherwise fundamentally similar. Following every regularly scheduled monetary policy meeting of the Governing Council of the ECB (which typically takes place during the first week of every month in Frankfurt), a Statement explaining our decision is released to the public. The President of the Council, Jean Claude Trichet, also gives a press conference that provides an opportunity to reporters from all Member States of the euro area to obtain further clarification and explanation of our policy action. As is well known, financial analysts follow these communications very closely and detailed reporting of the decision and its rationale appears in euro area media and elsewhere virtually in real time.

To be sure, all other channels of communication that were practiced by the CBC prior to our joining the euro area remain. These include a series of publications, such as the Annual Report and the Economic Bulletin, that provide information regarding the CBC's operations as well as comprehensive analysis of our economy. It also includes frequent appearances by the Governor and CBC staff before Parliamentary Committees and at other fora.

I should add that independence from government does not preclude frequent contact and dialogue with the political authorities and government officials. Indeed, an ongoing dialogue on all issues pertinent to the competence of the central bank is most helpful not only to the central bank but also to the fiscal authorities. Such communication is needed for ensuring that the government's fiscal policy choices are compatible with the policy framework of the Monetary Union and for serving the public's needs in the best possible fashion over time.

In closing, I return to Ricardo to note that after centuries of recognizing that there would be great dangers if "the Ministers" were themselves to be entrusted with the power of issuing paper money, we have finally come to accept his conclusion that central bank independence is the key to avoiding the temptation to debase the currency. After all, by safeguarding central bank independence and thereby facilitating the maintenance of

price stability, "the Ministers" can contribute towards achieving and maintaining economic prosperity over time.

ENDNOTES:

- (1) Theoretical demonstrations of this result draw on the dynamic inconsistency literature as developed by Kydland and Prescott (1977) and Barro and Gordon (1983). See also McCallum (1995) for a related alternative view.
- (2) See for example, Alesina and Summers (1993), Cukierman (1994), and Loungani and Sheets (1997).

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