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Central Bank: Independence, Governance and Accountability

Author: Fausto de Andrade Ribeiro
Advisor: Willian Handorf
Washington, DC
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1. Introduction

Recently, legislation brought intensive changes to the role of some central banks around the world, including those in Latin America. The main change for those central banks was the autonomy granted to them, in different degrees, in the design and execution of monetary policy.

This subject has frequently appeared internationally in both the political and economic agendas since 1989. Since then more than thirty countries have conferred a greater degree of independence, or autonomy, to their central banks. In such countries, both political and monetary authorities have shown an increasing interest in achieving monetary stability.

Central Bank Independence (henceforth CBI) has become one of the central concepts in monetary theory and policy. Most economists agree that CBI is desirable because it helps to reach the long-term goal of price stability. Although one might think about alternative mechanisms to reach low rates of inflation, CBI is clearly the one most often recommended.

In Europe, more and more countries belonging to the Organization for Economic Cooperation and Development (OECD) and countries outside of OECD as well have made their central banks independent. This includes important countries such as France, Italy, Spain, Portugal, Belgium, and Greece. In Latin America, this movement involved countries such as Argentina, Chile, Colombia, Ecuador, Mexico and Venezuela. In these countries, the legal reforms were aimed at ending a prolonged period of high inflation rates during which Latin American governments used monetary policy for short-term political purposes, either to finance fiscal deficits or to stimulate economic activity, and to reduce unemployment. In fact, one of the arguments used to justify the discussion about CBI revolves around the inflationary potential of such shortsighted policies, since governments really tend to use monetary policy to finance fiscal deficits. The capacity to issue currency is, besides the issuance of government bonds in the context of fiscal policy, a manner to finance the public machine. Thus, in theory, any dependent central banks, or those totally controlled by

government, tend to increase currency volume, under government pressure, and therefore, to produce more inflation than independent central banks.

In this research, I begin my discussion by reviewing the conditions of independence for central banks. First, I briefly summarize the fundamental issues underlying the case for CBI. Second, I give an overview about the United States experience. In this chapter I assess the structure of the Federal Reserve System, the type of mandate, accountability, formal meetings, targets, responsibilities, and I will also analyze the economic policy's process. From there, I quickly proceed to a discussion of the Latin American Experience. As a result of this survey, I analyze the recent progress achieved by granting autonomy to central banks. In addition, I compare situation in Brazil with other Latin American countries. Next step after this will be to compare and measure levels of independence and autonomy granted to different central banks.

The next chapter will assess the benefits of the CBI Model for an economy focusing on the benefits of the inflation control. I also will assess some constraints, risks, and concerns about the Central Bank Independence model.

The other important target of this research is to analyze the impact of transparency and accountability on the concept and practice of governance. This chapter will attempt to show the importance of transparency for CBI in a democratic society with its requirements of accountability. Finally, my final remarks will be dedicated to showing international market trends in order to answer to the following questions: Will the CBI model really decrease political interference in the process of establishing and executing monetary policy? Will it guarantee financial stability to the country involved?

2. Conditions for Independence

Independence Concept

The first point that has to be analyzed carefully is the independence level. The autonomy granted to central banks will determine the type of monetary institution they become. More specifically, it will classify them as dependent, independent, and autonomous institution.

Dependent central banks are commonly subordinated to the specialized agencies in charge of the country's overall financial activities namely Ministries, Departments or the like according to the country involved, and have the function to implement and to execute economic policies. Such institutions can not change or refuse the monetary policy in practice. In the same way, the Government will be responsible for the results of the targets, whether they succeed or fail. Executives will usually be designated from the outside.

On the other hand, independent central banks have total freedom to elaborate and conduct monetary policies. Thus these banks can choose freely the instruments to be used. Independence includes the power to define its own internal structure, as well as the way in which supervision and control of the financial system will take place. Here it is important to mention that the main criticism against the CBI is based on political arguments. The argument is that turning over decisions about interest rates, exchange rates, the efficiency of the financial system, and other monetary matters to a staff of unelected officials, is simply "undemocratic". In a democratic society, it is argued, all decisions should be subject to scrutiny by the elected members of the legislative and the concept of an independent central bank is, therefore, not acceptable.

Although there are plenty of other areas where decision making is delegated to independent unelected officials - the judiciary is a prime example - there is a fundamental confusion here between being independent and lacking accountability. No central bank can be totally independent in the sense that it does not have to answer to anyone. Even the most

autonomous central bank has to report in some form or another to the Legislative branch, which has the ultimate power to change the laws governing the central bank.

The last criterion refers to central banks that do not have total freedom to elaborate and conduct monetary policy, but are not totally dependent from the government. This type of institution can be called Autonomous Entities. This autonomy is the "relative freedom" to implement some strategies to achieve the objectives of the policies (monetary stability). The level of autonomy will influence others aspects such as supervision, control and internal structure.

“Independence signifies ignoring pressures, whatever its source. The independence of central banks goes, ... beyond independence from political, executive and legislative power. For me it also equates with independence from private or collective economic interest, autonomy versus the short term, frequently imposed by capital markets and, finally, freedom of action vis-à-vis the monetary policy of other central banks”.

Prime Minister Lionel Jospin. Paris, May 2000.

Preconditions for Autonomy

According to Mr. Mboweni, Governor of the South African Reserve Bank, during his speech at the Reuters Forum in October 2000, there are at least three preconditions for central bank autonomy. In the first approach, there should be a clear legal and operational framework in which monetary policy is conducted. In the legal framework, CBI should be defined to avoid any misconceptions of what the central bank is supposed to achieve. In the monetary policy framework, the central bank must indicate what it is attempting to achieve, what operational variables it will apply and what monetary instruments it will use to achieve its objective. Because credibility is usually not gained overnight, it is important that longer-term programs should be drawn up to show how the central bank will fulfil its mission.

In addition, the second condition for greater autonomy is transparency. The government and the public should continuously be informed of the monetary policy program followed by the central bank. Regular discussions between the central bank and the government will be necessary and some form of accountability to the Legislative branch will have to be established. It is also important to explain monetary policy decisions regularly to the public, along with an assessment of the progress made in achieving stated objectives.

The third condition for central bank autonomy is the creation of an efficient institutional framework in which decisions on monetary policy and its implementations can be made without undue interference by the political arena. This involves decisions regarding:

- I. Functional independence, which means the right to decide on all matters regarding monetary policy and price stability;
- II. Personnel independence, which covers the selection and appointment of Board members with a high professional competence and without an obligation to yield to political and other pressures;
- III. Instrumental independence, which means control over the instruments that affect the inflation process, including in particular the prevention of any direct financing of government deficits; and
- IV. Financial independence, which requires the central bank to have access to adequate financial resources of its own and full control over its own budget.

Finally, we can assume that the effectiveness of autonomy for the Central Bank will be determined by how deeply the country is going to implement this framework. How far is the country going to change the functions and goals of its central bank?

We have to keep in mind that to be independent a central bank must have a well defined area of action, as well as set goals to manage/implement monetary policy. The

extraordinary situation where the monetary policies must subordinate to the Executive branch, and also to the mechanisms of accountability must be clear.

Desirable Conditions for Implementation

Finally, is important to mention that some conditions are also desirable to achieve success on the implementation process, these are:

- I. Macroeconomic stability;
- II. Adequate fiscal policy to reduce the need of financing by the Treasury area;
- III. Recognition by politicians of the legitimacy of the central bank autonomy and the limitations to the role of the government; and
- IV. Recognition and understanding by the society at large of the importance and objectives of the autonomy granted to the central bank.

3. The Perspective from the United States of America

Historical

The Federal Reserve System (henceforth “the Fed”), which serves as the nation's central bank, was created by an Act of Congress on December 23, 1913. The System consists of a seven member Board of Governors with headquarters in Washington D.C., and twelve Reserve Banks located in major cities throughout the United States.

The Fed was established after a series of banking crisis. At first, the new agency received an extremely imprecise mandate: banking supervision, "furnish an elastic currency" and "other purposes". Price stability was not expressly defined as a primary objective for the central bank to pursue. With such a vague statement, the Federal Reserve Act had to be supplemented. Several laws were introduced especially those during the New Deal, which took power away from the Reserve Banks to Washington.

The Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 set three-tiered mandate for the Fed: price stability, economic growth in line with the potential of the economy and a high level of employment. Since no one objective has priority over the others, this arrangement can bring about conflicts on what policy should be adopted in time of economic distress. In spite of this, the Fed has been independent enough to target price stability as its primary goal. This autonomy of maneuver, however, can never be taken for granted because it does not come from statutes, but from tradition.

The United States is a very peculiar case regarding monetary policy and central bank independence. As a result of the Bretton Woods negotiations, the dollar was granted the status of international currency as it emerged from World War II, backed by three-fourths of the world gold reserves. By that time, no currency in the world could parallel the dollar in soundness. This situation changed dramatically until 1971 when President Nixon declared that the dollar was no longer freely convertible into gold at the thirty-five dollars an ounce parity. In spite of this, the dollar is still perceived as a safe haven by foreigners trying to

preserve their assets from inflation. Fed independence is perceived as the best way to make sure the US Government will not be able to give in to the natural temptation of inflating it anyway.

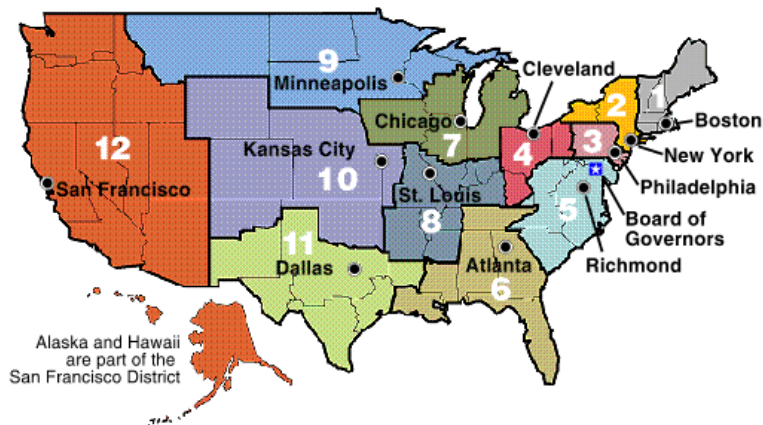
The Structure of the Federal Reserve System

The Fed has a three-level structure — Board of Governors, Federal Reserve Bank and its Branches — so that it is possible to have timely and accurate information on the economic activity all over the nation. The Board of Governors is placed on the top of the system. It is made up of seven members. They are nominated by the President of the United States and confirmed by the Senate for a non-renewable fourteen-year term. Members may serve only one full term, but a member who has been appointed to complete an unexpired term may be reappointed to a full term. The appointments are staggered in such a way that one term ends on January 31 of every even-numbered year. The Chairman and Vice-Chairman are chosen among the Governors by the President and confirmed by the U.S. Senate. They have a four-year term and can be reassigned as long as they remain Governors.

The Chairman is the official authority to speak for the Federal Reserve. This prevents speculative waves caused by leakage to the market of conflicts of opinions within the Federal Reserve. The Chairman also represents the agency internationally as well as domestically. Internally, he is the speaker before the Congress, the Executive branch, and the public. Abroad, he serves as the Alternate Governor for the United States at the IMF, World Bank, BIS and G-7 meetings. The Chairman works as a consensus-builder within the Board. Without consensus, his position is no longer sustainable.

The Federal Reserve System reaches all regions of the nation through the Federal Reserve Banks and their twenty-five branches. Each Federal Reserve Bank is located in a major city within a region over which it has jurisdiction. Each region is called a Federal Reserve District.

The Structure of the Federal Reserve



Responsibilities

The primary responsibility of the Board members is the formulation of monetary policy. The seven Board members constitute a majority of the 12-member Federal Open Market Committee (FOMC), the group that makes the key decisions affecting the cost and availability of money and credit in the economy. The other five members of the FOMC are Reserve Bank presidents, one of whom is the president of the Federal Reserve Bank of New York. The other Bank presidents serve one-year terms on a rotating basis. By statute the FOMC determines its own organization, and by tradition it elects the Chairman of the Board of Governors as its Chairman and the President of the New York Bank as its Vice-Chairman.

The Federal Reserve Board has regulatory and supervisory responsibilities over banks that are members of the System, bank holding companies, international banking facilities in the United States, Edge Act and agreement corporations, foreign activities of member banks, and the U.S. activities of foreign-owned banks. The Board also sets margin requirements, which limit the use of credit for purchasing or carrying securities. Moreover, the Board plays a key role in assuring the smooth functioning and continued development of the nation's vast payments.

Meetings

The Board usually meets several times a week. Meetings are conducted in compliance with the Government in the Sunshine Act, and many meetings are open to the public. If the Board has convened to consider confidential financial information, however, the sessions are closed to public observation.

Economic Policy's Process

As mentioned in Akhtar (1999), the Fed is responsible for formulating and implementing monetary policy. The formulation of monetary policy involves developing a plan aimed at achieving stable prices, full employment and, more generally, a stable financial environment for the economy. In implementing this plan, the Fed uses the tools of monetary policy to induce changes in interest rates, and the amount of money and credit in the economy. Through these financial variables, monetary policy actions influence, albeit with considerable time lags, the levels of spending, output, employment and prices.

Policy Formulation

The basic link between monetary policy and the economy is through the market for bank reserves, more commonly known as the federal funds market. In that market, banks and other depository institutions that are below their desired reserve positions borrow from others that are above their desired positions. The benchmark interest rate charged for the short-term use of these funds is called the federal funds rate. The Federal Reserve's monetary policy actions have an immediate effect on the supply or demand of reserves and the federal funds rate, initiating a chain of reactions that transmit the policy effects to the rest of the economy.

The Federal Reserve can change reserves market conditions by using three main instruments: reserve requirements, the discount rate and open market operations. The Board of Governors of the FED sets reserves requirements, under which depository institutions must hold a fraction of their deposits as reserves. These reserve requirements apply only to

checkable or transactions deposits, which include demand deposits and interest-bearing accounts that offer unlimited checking privileges. Directors of the Reserve Banks set the discount rate and initiate changes in it, subject to review and determination by the Board of Governors. The Reserve Banks administer discount window lending to depository institutions, making short-term loans.

The Federal Open Market Committee (FOMC) directs the primary and, by far, the most flexible and actively used instrument of monetary policy—open market operations—to effect changes in reserves. Under the Federal Reserve Act as amended by the Full Employment and Balanced Growth Act of 1978, the Fed and the FOMC are charged with the job of seeking “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” In fact, the act requires that, in the pursuit of these goals, the Fed and the FOMC establish annual objectives for growth in money and credit, taking account of past and prospective economic developments. This provision of the Act assumes that the economy and the growth of money and credit have a reasonably stable relationship that can be exploited toward achieving policy goals. The law recognizes, however, that changing economic conditions may necessitate revisions to, or deviations from, monetary growth plans.

Since about 1980, as mentioned by Akhtar, far-reaching changes in the financial system have caused considerable instability in the relationship of money and credit to the economy. In particular, monetary velocities—ratios of nominal GDP (gross domestic product) to various monetary aggregates have shown frequent and marked departures from their historical patterns, making the monetary aggregates unreliable as indicators of economic activity and as guides for stabilizing prices. Velocities of M1 (currency, checkable deposits and travelers checks of nonbank issuers) and M2 (M1 plus saving and small time deposits and retail-type money market mutual fund balances) have fluctuated widely in recent years, and their average values over the last five to ten years have been much different from their long-run averages. For example, until the late 1980s, M2 velocity had been relatively stable over longer periods, while its short-run movements were positively correlated to interest rate

changes. In the early 1990s, however, M2 velocity departed from its historical pattern and drifted upward even as interest rates were declining.

Some observers believe that ongoing, rapid financial changes will continue to cause instability in the financial linkages of the economy, undermining the usefulness of money and credit aggregates as guides for policy. Others expect the financial innovation process to settle down, leading to a restoration, at least to some extent, of the usefulness of money and credit as policy guides. Whatever the future outcome of these controversies, the Fed has been obliged for some time now to reduce its reliance on numerical targets for money and credit in formulating monetary policy. In recent years, the FOMC has used a wide range of financial and nonfinancial indicators in judging economic trends and the appropriateness of monetary and financial conditions, and in making monetary policy plans. In effect, under this eclectic approach, the FOMC's strategy for changing bank reserve levels aims at inducing broad financial conditions that it believes to be consistent with final policy goals.

In making monetary policy plans, the Fed and the FOMC are involved in a complex, dynamic process in which monetary policy is only one of many forces affecting employment, output and prices. The government's budgetary policies influence the economy through changes in tax and spending programs. Shifts in business and consumer confidence and a variety of other market forces also affect saving and spending plans of businesses and households. Changes in expectations about economic prospects and policies, through their effects on interest rates and financial conditions, can have significant influence on the outcomes for jobs, output and prices. Natural disasters and commodity price shocks can cause significant disruptions in output supply and the economy. Shifts in international trade rules and regulations and in economic policies abroad can lower or raise the contribution of the external sector to the U.S. economy.

Since the state of knowledge about the way the economy works is quite imperfect. Policymakers' understanding of the effects of various influences, including the effect of monetary policy, is far from certain. Moreover, the implementation of the economy changes

over time, leads to changes in its response to policy and nonpolicy factors. On top of all these difficulties, policymakers do not have up-to-the-minute, reliable information about the economy, because of lags in the collection and publication of data. Even preliminary published data are frequently subject to significant errors that become evident in subsequent revisions.

In all of this, there is no escape from forecasting and from using judgment to deal with the uncertainties of data and the policy process. Indeed, monetary policy formulation is not a simple technical matter. It is clearly an art in that greatly depends on experience, expertise, and judgment.

Critical Perception

Mr. Robert W. Worcester, Vice-President at the Federal Reserve Bank of Minneapolis, explains that out of long experience, the monetary system has evolved so that the supply of money and credit are "managed" at levels intended to be most conducive to stability, growth, and a high level of production and employment in United States economy. That responsibility requires not only a high degree of technical knowledge about the economy, and of the interaction of its different elements and forces but also requires objective, "independent" judgments about the best monetary adjustments to help achieve those national goals.

It is important to observe that coordination can be thought of as a non-conflict combination of Treasury and Fed policy toward common objectives. In that sense, the fiscal policy and its pattern of revenues/expenditures carried out by the Treasury should be reasonably compatible with Fed's target on money supply and interest rates to achieve the common goals.

Over the years the Fed has proved to be remarkably adaptable to changing needs. Both policies and procedures have been altered when the need for change became clear,

sometimes by statutes or amendment to the Federal Reserve Act, often by policy and administrative implementation within the authority of the Act.

Furthermore, this system makes it difficult to be used by politicians. In 1992, for instance, in the presidential campaign, the candidate to the re-election, the republican George Bush, desired that the Fed lowered the interest rates to help the country to leave the stagnation. The Fed's president, Allan Greenspan, however, that is also republican and he had been kept in the position by Bush, kept the interest rates in a considerable high level. As a result: the democrat Bill Clinton gained the election, and the Fed demonstrated, in the practical one, that it is really independent.

Moreover, studies have produced innumerable changes in responsibilities, authority and procedures. It is through such efforts that U.S. monetary mechanisms have kept pace with the changing needs of the times. While many problems persist, it is also true that over the past three decades — and despite some pretty difficult times — recessions have been moderate, and severe panics and disruptions have been largely avoided.

The Federal Reserve Independence and Accountability

The Fed's structure — functioning in an environment reasonably insulated from the day-to-day pressures of partisan politics and short-term expediency — was born out of decades of experience with boom/bust recessions, financial panics, and monetary instability. Over the years, the System and its vital monetary function have been under constant scrutiny and review by Congress, by professional economists, by banks and financial experts, and by the public as well. Hearings by Senate and House banking committees on Fed responsibilities and procedures have been exhaustive. Thus, the Fed can be considered with a high level of accountability in comparison with any other central bank.

4. The Latin American Experience

CBI and accountability was widespread established in Latin America during the 1990s with a few exceptions. On the basis of information drawn from central bank legislation and from national constitutions, Jácome in his an IMF Working Paper¹ discusses the main characteristics of the legal framework supporting monetary and exchange rate policies in Latin American countries.

The author explains that the reforms undertaken have embraced price stability as the single or the primary objective of the central bank in a number of countries. However, in some other countries central banks have still been assigned multiple objectives, including the stability of the financial system, which at times may have placed the central bank in a dilemma. In countries where the institutional reform has not been adopted, the central bank is still assigned multiple objectives, including the orderly development of the economy and the pursuits of economic and social progress (Brazil).

Political Independence

Central banks in Latin America have gained legal political independence through reforms that in most cases call for the board of directors to be independent from government and the private sector. The term of office for directors, when exceeds or overlaps the constitutional government period, also has contributed toward this goal.

In order to reduce linkages between central bank governance bodies and the Executive branch, the Legislative branch is involved in the appointment of central bank directors in most cases. In addition, only half of the countries have eliminated the tradition of giving the President of the Republic the power to remove central bank directors, and instead have adopted different procedures based on the Legislative and the Judicial branches that approves any kind of dismissal. Table 1 illustrates the level of turnover in Latin American central banks:

¹ Working Paper (Legal Central Bank Independence and Inflation in Latin America During the 1990s)

Table 1. Turnover of Central Bank Governors in Latin America
(Since the approval of the legal reform up to end-2000. Selected countries)

Country	Date of approval of legal reform	No. Of Central Bank Governors *	No. Of years *	Governors per year
Argentina	September 1992	3	9	0.33
Bolivia	October 1995	1	6	0.17
Brazil **	Law 64; Const. 1988	4	7	0.57
Chile	October 1989	3	12	0.25
Colombia ***	August 1991	2	10	0.20
Costa Rica	November 1995	2	6	0.33
Dominican Republic **	Law 1940; Const 1962	3	7	0.43
Guatemala **	Law 1945; Const 1985	3	7	0.43
Honduras	December 1996	3	5	0.60
Mexico	December 1993	2	8	0.25
Paraguay	June 1995	2	7	0.29
Peru	January 1993	2	9	0.22
Uruguay	March 1995	3	7	0.43
Venezuela	December 1992	3	9	0.33

Source: IMF

* form the following year after the approval of the law. If approved during the first quarter of the year, that year is considered the initial one;

** since the reform took place well before the period considered, governors' turnover is accounted only for the period 1995 onwards;

*** corresponds to the date when the new independent central bank board was appointed.

Jácomes also explains that another source of political autonomy weakness is observed in countries where central bank directors may be simultaneously private bank shareholders without limit on banks' capital. In Peru this limit is set at 5 percent of the private bank's capital – which is still a significant amount in nominal terms. In this case the structure of the central bank board may at some point give rise to potential conflicts of interest.

However, the authors agree that there has been widespread progress in terms of the economic independence of central banks, in particular, regarding, the prohibition or the adoption of severe limitations on central bank financing of the fiscal deficit.

Central Bank Reform

As mentioned in the IMF sponsored research, even countries that have not formally implemented central bank reform, like Brazil, carried out constitutional amendments during the 1980s preventing the monetization of fiscal deficits. Also, central bank freedom to conduct interest rate policy is a widespread practice. Although the Brazilian Constitution sets a limit for the maximum interest rate, this rule has never been placed in operation, since it has not formally been regulated.

Notwithstanding, directly financing budget liquidity shortfalls is permitted, although in limited amounts and over a short-run period, in a number of countries that have active state-owned commercial banks. The prohibition of granting credit to the government may be by-passed in the event that these banks provide credit to the public sector while they are simultaneously obtaining central bank resources.

On the other hand, Jácomes reminds us that some governments shares with the central bank responsibilities for the conduct of exchange rate policy, particularly in economies with high capital mobility such as Brazil and Argentina. Government participation in the conduct of exchange rate policy may restrict central bank's operational independence given the tight link between monetary and exchange rate policies.

Lender-of-last-resort (LOLR)

The economic autonomy granted to central banks may be diminished in cases where the role of the central bank as lender-of-last-resort (LOLR) to the financial system is highly discretionary and even permissive. This is particularly dangerous when price stability is not defined as the primary objective of the central bank, and specifically when the central bank has been legally assigned the responsibility of preserving the stability of the financial system. If there is no limit on the assistance that central banks can provide to troubled financial institutions, as in most Latin American countries, this could ultimately derail monetary policy and divert it from the objective of preserving price stability.

In addition, monetary discipline is more vulnerable when central banks become involved in handling financial crises and facilitating monetary resources for bank restructuring. From the sample of Latin American countries, Argentina and Peru appropriately regulate central banks' involvement in banking crises and resolution. This new regulatory setting was badly needed as a result of the legal prohibition in those countries of central bank becoming involved in the resolution of banking crises. In Argentina the central bank was severely limited in providing monetary assistance to financial intermediaries by the monetary rule associated with the currency board.

Progress Achieved

Despite the progress achieved in reforming central bank legislation, the record of financial autonomy of central banks is still poor. One important point to describe here is the fact that in most countries of Latin America the government is not obliged to maintain the value of central bank's capital. Moreover, there are situations where the central bank accumulates losses stemming from monetary operations, which typically are not appropriately reflected in the central bank's financial statements, as an artificial device aimed at preventing that an appropriate accounting wipe out central bank's capital. On the other hand, there are also countries where the central bank's budget is approved by Parliament (Bolivia, Honduras), or directly by the Executive branch (Argentina), which in the end may be just another way of limiting the central bank's financial autonomy, and to some extent its political autonomy.

According with Jácomes, accountability of central banks in Latin America has improved after the institutional reform, but transparency of policy formulation, and in relation to the disclosure of financial statements of central banks is still weak. Several countries, including Argentina, Bolivia, Brazil, Chile, Colombia, Honduras, Mexico, Uruguay, and Venezuela, have rigorous accountability requirements. The governor of the central bank must inform the Executive branch and Congress, or a specialized committee, of the results of the central bank's monetary policy and other activities, and the extent to which policy goals have been achieved. At the other end, in a few cases, legislation merely requires the publication of

an annual report, which ends up being only of academic interest given the delay with which such reports are generally disclosed and published.

On the other hand, central bank reform in several countries makes no provision for the transparency of financial statements, and hence, central bank transactions are not always properly recorded. As a result, balance sheets do not always reveal the insolvency resulting from operational losses – which may have been accumulated over the years – because of improper accounting procedures. Else they fail to make appropriate provisions on the basis of generally accepted accounting principles for poor quality assets, for example those acquired in the context of a banking crisis.

In short, today central banks in Latin America have greater autonomy in the design and conduct of monetary policy, which is focused on preserving price stability. The most notable features of the reforms that have been undertaken are the general restriction to the monetization of fiscal deficits, except in cases of national emergency or disasters, and the instrument independence granted to central banks, including the autonomy to conduct interest rates policy. On the other hand, the two aspects of greatest vulnerability appear to be the lack of financial independence of central banks with respect to the government, and the excessive discretion in the role of central banks as LOLR to the financial system. One the weaknesses observed in a number of countries is the limited transparency and disclosure of financial statements and, most importantly, the leeway that governments still enjoy in several countries in the region to remove central bank governors and members of the central bank's Board of Directors.

Brazilian Perspective

The Brazilian Central Bank is a special autarchy that also carries out activities of supervision and regulation for the financial system. The Constitution of 1988 defined some basic rules to be observed, which imply some options in favor of its autonomy. The Board of Directors of the central bank is nominated by the President of Brazil and confirmed by the Senate, as defined in the articles 52, 84, and 192, of the Federal Constitution. In addition, they usually follow the guidelines of the National Monetary Council, which is headed by the

Minister of Finance, and also includes the President of the Central Bank and the Minister of Planning. In fact, we can observe the first problem. In this case the structure of the central bank board may give rise to potential conflicts of interest.

One important point to mention is related to article 164², which determines that the Central Bank will have control over the process to issue currency, and to grant loans to the National Treasury Department, or to any agency or entity that are not financial. However, article 164 § 2° allows the Central Bank to purchase or sell bonds issued by the National Treasury in order to control the amount of money and credit in the economy, and also to induce changes in interest rates.

If the Central Bank can operate within a certain level of autonomy, on the other side it becomes extremely vulnerable to the pressures from the National Treasury, which could push the Central Bank to finance government expenditures. Moreover, the same article determines that "the cash in hand of the Union will be deposited in the central bank", attributing to the Brazilian's Central Bank a government bank's function. Consequently, it does not restrict as a whole the process to lend money to the National Treasury.

According to Saddi (1997), another important topic to analyze is the Board of Directors stability. He believes that this constitutional approach, which disciplines the Central Bank system and its framework, is not clear in terms of stability for the Central Bank's Directors

In addition, one of the important elements to be considered is: Should the Central Bank be responsible for some functions not related to monetary policy, such as banking

² **Article 164.** The competence of the Union to issue currency shall be exercised exclusively by the central bank.
Paragraph 1 - It is forbidden for the central bank to grant, either directly or indirectly, loans to the National Treasury and to any body or agency which is not a financial institution.
Paragraph 2 - The central bank may purchase and sell bonds issued by the National Treasury, for the purpose of regulating the money supply or the interest rate.
Paragraph 3 - The cash assets of the Union shall be deposited at the central bank; those of the states, of the Federal District, of the municipalities and of the bodies or agencies of the Government and of the companies controlled by the same, at official financial institutions, excepting the cases established in law.

supervision or financial system regulation? The proposal to create a Supervision and Regulator Agency related to the financial market activities has been discussed strongly since 1998 inside the Brazilian Government. The Central Bank would then concentrate its activities around the monetary targets.

In fact, the proposal is quite similar to the structure recently implemented in the United Kingdom, where some functions were transferred from the Bank of England (UK's central bank) to a new Agency back in 1997. This Agency was given the responsibility of supervising and regulating the financial system. It also assumed some functions that in Brazil are performed by CVM – Comissão de Valores Mobiliários (securities commission) and SPC – Secretaria de Previdência Complementar (regulator for pension plans). In addition, the Parliament gained more responsibility in setting targets and objectives for the Bank of England.

Although it is still in the realm of speculation, the implementation of such proposal could generate one extremely powerful institution. And such a powerful agency would certainly require control from a higher stance of power. In fact, it is important to have in mind that in no situation this entity could be totally immune to social control, or let to flourish without the oversight of Congress. By the way, this is an important element of the current debate. Even without such a degree of autonomy, the Central Bank of Brazil is actually considered by many critics to be a kind of “black box”, meaning an institution that is not subject to the supervision and scrutiny of Congress. It is a fact that most times the Central Bank does not provide information requested by the Legislative and Judiciary branches on the grounds that it would be an infringement of the banking secrecy law.

On the other hand, we have to answer to the following question in the context of monetary policy: How much autonomy should be granted to the Brazilian Central bank? The answer to this question will depend upon how much we want to relieve the Central Bank from political pressure so it can achieve monetary targets. Thus, some reasonable level of independence could be reached by adopting some basic principles such as:

- ? Clear definition of objectives and targets;
- ? To forbid treasure financing (economic autonomy);
- ? Preservation of the mandate of the Board (political autonomy);
- ? Possibility of establishing its own legal statute (political autonomy);
- ? Regulation of profits/losses transference from Central Bank to the Treasury (financial autonomy); and,
- ? Clear definition of some mechanisms for accountability;

In short, it should be said at this point that these issues are really important to relieve the institution from political pressure. The first challenge is related with clear objectives, establishing a primary objective in terms of preserving price stability.

Although some independent central banks usually buy bonds from their own governments, we can assume that this instrument is not properly used in Brazil. The recent approval of Complementary Law³ n° 101/2000 (Fiscal Responsibility Law) was not complete enough to forbid this possibility. According to its article 39 § 2°, the Brazilian Central Bank is still able to buy bonds directly, issued by the National Treasury, in order to refinance federal debt, replacing those bonds that will mature in its portfolio.

In addition, it should be stressed that the Brazilian government already has some experience in terms of establishing different mandates for some government agency staffs, such as ANATEL, ANEEL and the Oil National Agency. The directors are designated by the

³ “In Brazil, a Complementary Law is one that “complements” or disciplines/changes some issue that has already been treated by the Constitution; approval in Congress and Senate is subject to very high standards”.

President of Brazil for fixed renewable mandates, and they also have to be approved by the Senate. In most cases, the mandates will be about 5 years, and dismissal of directors will only be possible in the first four months of the mandates, or at any time in case of administrative improbity.

Finally, the Brazilian government still has to define clear rules to regulate the relationship between the Central Bank and the government in the treatment of Central Bank losses and profits. Over the last few years, we have seen the Brazilian Central Bank trying to control the exchange rate. Since 1994, this process has brought massive losses to the Bank, reaching recently the amount of R\$ 34,2 billions.

5. Measuring Independence and Autonomy

A number of studies have built different methodologies to quantify the degree of independence of central banks in the formulation and implementation of monetary policy after the adoption of the institutional reform during the first part of the 1990s. There is no doubt that in practice there are central banks that behave more independently than what is prescribed in the law. In general, the main discrepancies between central banks independence level emerge in relation to their political independence, accountability, and in policy and operational transparency.

Criteria and Assumptions (International Best Practices)

In this section, the criteria that we are going to present to measure the central banks autonomy is based on Jácome (2000). Political and economic autonomy of central banks should be based on the following features:

- I. In terms of political autonomy, in addition to government involvement, private sector participation (representatives of profit maximizing activities, such as agriculture, industrial or banker unions) on the central bank's Board of Directors is penalized in recognition of the fact that the involvement of such members in monetary, financial, and exchange rate decisions can produce conflicts of interest, which may lead to an outcome that differs from the central bank's fundamental long-term objective.
- II. The role of the central bank as LOLR is incorporated as a component of central bank economic autonomy and is an element of the CBI that is not commonly found in other studies. The relevance of incorporating this criterion is given, because central banks are assigned the role of LOLR and on occasions they also have the legal responsibility for overseeing the stability of the financial system. Second, given the high frequency of banking crises that have occurred in Latin America during the last years in which central banks were involved through different mechanisms that implied unexpected monetization. And third, and more important, because central bank support to troubled

institutions, when it is abundant and for a prolonged period of time, is equivalent to indirectly financing the fiscal deficit, given that bailing-out a banking crisis is more in the nature of the government role rather than a central bank responsibility.

- III. Still in relation to economic independence, the CBI penalizes government participation in exchange rate policy committees, where government powers go beyond the general scope of selecting and modifying the exchange regime, unless the law envisages a conflict resolution mechanism;
- IV. A criterion that recognizes the degree of financial autonomy of the central bank is also included in the proposed CBI, assigning optimal value to situations where the government assures the integrity of the central bank's capital, thereby contributing to monetary policy effectiveness; and,
- V. The CBI incorporates requirements for central bank accountability, including transparency in recording central bank operations and disclosing financial statements. Central bank independence may not survive in the long run if simultaneously central banks are not all held accountable. In turn, the lack of transparency provisions may weaken central bank autonomy and credibility.

Table 2. Index of Central Bank Independence and Accountability
(Criteria, values, and weights)

Criteria (weight)	1	0.5	0
1. Central Bank objective (2)	Preserving price stability is the single objective. If more than one conflicting objective, price stability has priority.	Multiple conflicting objectives without establishing that preventing price stability has priority.	Multiple objectives, including growth, an orderly development, or economic development, without priorities.
2. Appointment and term of office of the members of the Central Bank Board (2)	Nominated (appointed) by government and appointed (confirmed) by Congress. Term in office exceed or overlap government period.	Nominated and appointed in a two-step process for same term in office than government without overlap, or directly for longer term.	Appointed directly by the government for the same or shorter period than the government.
3. Structure of Central Bank Board (2)	No private sector and government representatives, except Min. Of Finance without vote.	Direct government representation, including Minister of Finance with vote.	Direct government plus private sector representatives (bankers, entrepreneurs, etc.)
4. Removal of Board members (2)	Two-step process, with qualified majority under strictly legal grounds. Final decision by Congress or Judicial court.	Directly by the Executive branch under strictly legal grounds, or in two-step process under non-legal basis.	Removal by the Executive branch for subjective or political – not legal – grounds, or by the private sector.
5. Central Bank credit to government (3)	No direct credit, except in clearly regulated emergency situations. Or Through the secondary market, with limitations.	Direct credit with limits, via secondary market without limits, through overdrafts, or indirectly via public banks.	Direct or indirect credit without limits.
6. Lender-of-last-resort (2)	Emergency loans legally regulated, including limits the amount to be granted.	Emergency loans legally regulated, without limits to the amount to be granted.	Discretionary policy for emergency loans and provisions for bank resolution.
7. Instruments independence in conduct of monetary policy (3)	Total independence in the use of monetary instruments.	Government involvement in formulation of monetary and exchange policy.	Limitations on the use of monetary instruments (reserve requirements, interest rates).
8. Financial independence (1)	Government assures central bank capital integrity. Central bank transfers profits to the government after proper provisioning.	Government not required to assure integrity of central bank capital. External approval of central bank budget.	Central bank conducts quasi-fiscal operations. No government capitalization required.
9. Accountability (1)	Central bank Governor appears before Congress and reports to government. Report disclosed on a timely basis.	Reports only to the government on a regular basis or when there are monetary disturbances, plus an annual report.	Central bank only publishes an annual report.
10. Transparency and disclosure of financial statements (1)	Publishes periodically financial statements certified by an external auditor.	Publishes financial statements with the approval of a public sector auditor.	Inappropriate accounting procedures. Publishes financial statements with the seal of internal auditor

Central bank independence and accountability was measured in Jácome (2000) under the structure of the CBI described above for a group of 14 Latin American economies. This is quantified based on the analysis of the countries' Constitutions, on their relevant issues, and central banks' charters, except for Brazil where relevant Executive Decrees aimed at strengthening central bank independence and accountability were also taken into account.

In Brazil, the alternative would have been to set aside these reforms given that they do not have a constitutional standing or are not part of the Central Bank's internal organizational rules. However, the paper values the decision of having articulated these reforms via Executive Decrees as a corner stone of the inflation targeting scheme adopted by the Central Bank of Brazil, which aims at establishing a firm public commitment with price stability based on instruments independence and accountability. Of course, we should be aware that such reforms might eventually be subject to backward revisions in the future if the institutional reform is not established on more solid legal basis. Based on this information indexes of central bank independence and accountability are calculated and ranked in table 1, which are fueled with the information provided in table 3, where each country is evaluated for the individual criteria included in the CBI.

According to Jacomes criteria, the results show the country with the most independent central bank according to legal grounds is Argentina, with a CBI of 18.5, followed by Peru and Chile with a score of 17 and 16.5 respectively. Among the countries that already have adopted the institutional reform, Paraguay and Venezuela show the lowest degree of central bank autonomy with scores at 10.5 and 9.5 respectively.

Table 3. Ranking of Legal Central Bank Independence and Accountability in Latin American Countries –

Country	Last Central Bank Organic Law or Constitution	Rank	Score
Argentina	September 1992	1	18.5
Peru	January 1993	2	17.0
Chile	October 1989	3	16.5
Mexico	December 1993	4	16.0
Colombia	August 1991	5	15.0
Bolivia	October 1995	6	13.5
Honduras	December 1996	7	13.0
Costa Rica	November 1995	8	12.5

Uruguay	March 1995	9	12.5
Brazil	Constitution 1988, law 4595/1964, and further executive decrees	10	12.0
Paraguay	June 1995	11	10.5
Venezuela	December 1992	12	9.5
Dom. Republic	Central Bank law 1940, Reform of 1962	13	7.0
Guatemala	Constitution 1985, Central Bank Law 1945	14	7.0

From: IMF Source

Table 4. Central Bank Independence and Accountability (Country evaluation)

Criteria (weight)	1	0.5	0
1. Central Bank objective	Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Honduras, Mexico and Peru.	Paraguay and Uruguay	Dominican Republic, Guatemala and Venezuela.
2. Appointment and term of office of the members of the Central Bank Board	Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Mexico Paraguay and Venezuela.	Peru and Uruguay	Dominican Republic and Guatemala.
3. Structure of Central Bank Board	Argentina, Chile, Colombia, Dominican Republic, Honduras, Mexico and Peru.	Brazil, Colombia, Costa Rica and Venezuela.	Brazil, Guatemala, Uruguay and Venezuela.
4. Removal of Board members	Argentina, Chile, Colombia, Dominican Republic, Honduras, Mexico and Peru	Bolivia, Costa Rica and Paraguay	Brazil, Guatemala, Uruguay and Venezuela.
5. Central Bank credit to government	Argentina, Chile, Guatemala, Mexico, Peru and Venezuela.	Bolivia, Brazil, Colombia, Costa Rica, Dominican Republic, Honduras, Paraguay and Uruguay	
6. Lender-of-last-resort	Argentina, Peru and Uruguay.	Costa Rica, Colombia, Honduras and Mexico	Bolivia, Brazil and Chile
7. Instruments independence in conduct of monetary policy	Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Guatemala, Honduras, Peru and Uruguay.	Mexico, Paraguay and Venezuela	
8. Financial independence	Colombia and Peru.	Argentina, Bolivia, Brazil, Chile, Costa Rica, Guatemala, Honduras, Mexico, Paraguay, Uruguay and Venezuela.	Dominican Republic
9. Accountability	Argentina, Bolivia, Brazil, Chile, Colombia, Honduras, Mexico, Uruguay, Venezuela.	Costa Rica, Dominican Republic, Guatemala, Paraguay and Peru.	
10. Transparency and disclosure of financial statements	Argentina, Brazil, Chile and Mexico.	Bolivia, Colombia, Paraguay, Peru, Uruguay and Venezuela.	Costa Rica, Dominican Republic, Guatemala and Honduras.

From: IMF sponsored research

Specifically, criterion 1 refers to the objective legally assigned to central banks. Criteria 2 to 4 are related to the political autonomy, whereas criteria 9 and 10 are linked to the accountability and transparency of central banks' policies and procedures.

The values assigned to each of the criteria are 0, 0,5 and 1, depending on how the legal provisions are related to such criteria conducive to central bank independence and accountability. A differentiated weight (1, 2 and 3) for the individual criteria is another particular characteristic of the CBI used in this analysis. This implies that some of the criteria included in the index are assigned more influence than others in terms of their contribution to central bank independence, and hence to the difficult endeavor of building and maintaining central bank credibility as a way of eliminating or reducing the inflationary bias.

Thus, the autonomy to design and conduct monetary policy, and the prohibition to finance the fiscal deficits are assigned the highest weight (3 points) since they are assumed to be the key factors contributing to the independence of monetary policy and to the reduction of inflation. The objective assigned to the central bank, the institutional procedures for the appointment, term of office, and the dismissal of members of the central bank Board of Directors, as well as the design of LOLR provisions are assigned a weight of 2 points. In turn, the criteria related to financial autonomy, accountability, and transparency are assigned a weight of 1, which does not imply that the latter are not relevant, but simply that their connection with the objective of preserving price stability may not be appropriately perceived by market participants.

As a result of these valuations, the maximum possible score for the CBI is 19. Needless to say, the structure, values and weights used in this IMF's research, as in similar papers, are discretionary and therefore subject to debate.

6. CBI and Inflation

Several experiences from the past two decades have shown that by allowing high inflation one cannot achieve lasting advantages in terms of sustainable growth, employment, and economic well-being. Inflation has come to be seen as the reason for severe problems and expenses to the economy. Those problems have been seen more clearly as the world has become evidently more transparent and international. This (often called monetarist) point of view that monetary policy should only help in maintaining inflation at a low level has paved the way for central bank independence.

From a Latin American perspective, inflation declined significantly during the 1990s. As the decade began, average inflation exceeded 600 percent, but at the end of the 1990s the average rate of inflation had plunged to less than 10 percent. This trend also holds true for the majority of individual countries in the region. In Brazil, for instance, the deceleration of inflation was achieved in spite of the adverse effects imposed by real and financial shocks and in some cases by a fiscal stance that was not consistent with the objective of preserving price stability.

Correlation between CBI and Inflation

A number of studies have built these indexes with the aim of determining whether there is any association between central bank independence and lower inflation rates. Most analyses have focused on industrial countries, although more recently interest has shifted to the developing economies. The general thrust of the results of these studies is that, when the sample includes only industrialized countries, there is an inverse relationship between central bank autonomy and inflation. However, Loungani and Sheets (1997) find an inverse relationship between central bank independence and inflation in the transition economies.

In a number of empirical studies, researchers found CBI is correlated with low inflation rates. A typical policy conclusion based on this finding is that the creation of an independent central bank will bring price stability.

Although there is no strong evidence supporting any form of causation from central bank independence to lower inflation during the 1990s in Latin America, it is possible to assume that some correlation may exist, given that inflation is indeed a monetary phenomenon. It could be better observed in the next table, where every time that we saw an increase in the level of currency (M1), we also saw a huge effect on inflation. Furthermore, we can also observe the monetary policy in practice and its effects on interest rates in order to minimize the inflation growth.

Table 5. Macroeconomics Indexes. Selected Latin American countries

Year	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
	MI		Growth %				
1980	95.4	69.7	51.3	28.0	32.6	58.4	17.1
1985	584.3	334.3	24.2	10.7	49.6	281.7	8.8
1990	1,022.9	2,333.6	23.3	7.1	63.1	6,724.8	58.4
1995	1.6	25.7	22.2	20.2	3.5	34.2	39.4
1999	-3.6	-7.0	32.8	25.1	9.8	16.1	25.0
	Inflation %		Interest Rates %				
1980	100.8	82.8	35.1	26.4	26.4	59.1	21.5
1985	672.2	226.0	29.5	24.0	57.7	163.4	11.4
1990	2,314.0	2,947.7	26.0	29.1	26.7	7,481.7	40.7
1995	3.4	66.0	8.2	21.1	35.0	11.1	59.9
1999	-1.2	4.9	3.3	11.2	16.6	3.5	23.6
	Interest Rates %		Fiscal Deficit %				
1980	79.6	115.0	37.7	n.a	25.2	n.a	n.a
1985	630.0	295.4	32.0	36.3	55.2	n.a	10.5
1990	1,517.9	9,394.3	40.3	36.4	27.9	2,439.6	27.8
1995	11.9	52.2	13.7	32.3	38.1	15.7	24.7
1999	8.0	26.0	8.5	21.3	9.6	16.3	21.3
	Fiscal Deficit %		GDP				
1980	-3%	-2%	5%	-1%	-3%	-2%	0%
1985	-5%	-11%	-2%	-3%	-8%	-2%	5%
1990	0%	-6%	1%	-1%	-3%	-7%	0%
1995	-1%	n.a	3%	-2%	-1%	-1%	4%
1997	n.a	n.a	2%	-4%	-1%	1%	2%
1998	n.a	n.a	0%	-5%	-1%	0%	-3%
1999	n.a	n.a	n.a	-6%	n.a	n.a	n.a

Source: Salomon Kalmanovitz – La independencia del Banco Central y la democracia en America Latina.

In critical perception, although the average inflation rate and the degree of central bank independence are negatively correlated, this relationship does not reflect any causal link running from central bank independence to low inflation. The critics argue that countries where the electorate is particularly averse to inflation, are more willing to keep inflation down. These countries are also more likely to have made their monetary authorities functionally independent so as to help preserve low inflation. Conversely, countries where the electorate is more tolerant of inflation, are also less inclined to see monetary policy turned over to an autonomous central bank.

These critics claim that average inflation is determined by history and the preferences of a country's inhabitants with causality running from inflation to the institutional structure. According to this view, attempts to impose an independent central bank and with it a more purposeful anti-inflationary stance in a country tolerant of inflation, are doomed to failure. The outcry against restrictive policies would simply be too great for the central bank to withstand.

Inflation targets

A practical solution is assigning an inflation target to the central bank. This solution, adopted by countries such as the UK, New Zealand, Sweden, Switzerland, Australia, Israel, and Canada, often found in connection with a nominally independent central bank, can be understood as dependence. Here the government either assigns a target for the inflation rate, say 2 percent, over the short to medium run to the central bank, or the government and the central bank “negotiate” such a target. If the central bank fails to meet this target it not only has to justify its failure, but in some cases it is then foreseen that the central bank president loses his job as a penalty (such as in New Zealand). In this way, one hopes to achieve a low and stable rate of inflation by holding the central bank, like in the contract solution, which is responsible for too high a rate of inflation.

7. Constraints, Risks and Concerns

CBI is not a sufficient condition for price stability

Even assuming that we are right in terms of strong evidence for a relationship between CBI and inflation, there is no reason to expect that this policy will be robust. In other words, this correlation does not tell us anything about causality. Instead, at least two decisions determine the choice of CBI by a society. There needs to be a decision on whether price stability should become a major economic policy objective. If this decision is being made in the affirmative, then comes the question about the appropriate choice of a monetary policy design instrument. So the “probable” cause underlying the empirical relationship between CBI and low inflation rates is the social choice in favor of a stability-oriented monetary system.

Taking these aspects into account, we lay out existing theories and empirical evidence regarding the decision to make price stability an important aim for economic policy. The two main explanations rest on either the idea of an ‘inflation culture’ in societies that opt for a stable monetary regime or, alternatively, that specific interest groups are able to influence the government so that such a monetary policy objective is implemented

In the first stage, societies have to decide on their policy priorities. One of the questions is whether price stability should be regarded as an important policy objective. In the literature, two explanations have been given. The first one emphasizes that societies differ with regard to their inflation aversion; they have different “inflation cultures”. Consequently, the nature of the inflation culture will, directly or indirectly, determine the choice of the monetary policy objective.

The second approach focuses on the political decision process and looks at the interests of economic actors and their ability to influence monetary policy objectives. Here the financial sector is attributed with having a specific interest in avoiding high inflation rates. If a society has decided to pursue price stability then in the second stage a decision has

to be made about the monetary policy arrangements that can help to bring about such an outcome.

National Inflation Cultures

The first approach to answer the question of why countries differ in their inflation record is related to the idea that societies differ with respect to the importance of pursuing a monetary policy directed towards low inflation. A simple view, called “preference-instrument view” in Hayo (1998), argues societies, for whatever reason, have differing preferences for inflation rates and this is reflected in the setup of monetary institutions and in the conduct of monetary policy.

This view is somewhat naive though, in the sense it presumes preferences for inflation are fixed over time. But it is not obvious why this should be the case. More realistically, we would expect the actual performance of the CB influences people’s attitudes towards price stability. If an independent CB does not bring about price stability, people’s trust in this organization will be undermined and its ability to perform a tough monetary stance against conflicting interests may be severely damaged. On the other hand, if people believe the CBI handles monetary policy competently, they will support it in a power struggle against, for instance, the government. One might call this the “historical-feedback interpretation”.

Politics Interests

According to Posen (1998), economic policy reflects the struggle of interest groups attempting to influence policy in a way they consider favorable. It is inappropriate to concentrate only on questions of design of organizations, such as central banks, and to ignore the self-interest of political interest groups. In particular, the monetary policy is affected by the lobbying effort of the financial sector, which is assumed to be highly inflation averse.

Conflicting Objectives

Another argument against the autonomy of central banks is that they form part of overall economic policy and that there can be no meaningful separation between fiscal policy,

monetary policy, labor policy, trade policy or for that matter any other policy measures. If such a separation is attempted and if policies run at cross-purposes, then conflicting objectives will have to be solved one way or another. In the process, a conflict between the policies may inflict considerable damage on the economy. There is clearly substance in the argument that a tightly coordinated package of policies has a better chance of success than a set of conflicting ones. It can nevertheless be argued that such conflicts may be inevitable over the short term, as long as central banks have the primary responsibility for controlling inflation. However, over the long term, stable financial conditions promote sustainable higher economic growth rates, increased welfare and more employment opportunities.

8. Transparency and Accountability

Transparency of monetary policy

Central banks have also to fulfill one of the most important conditions for independence, namely transparency. Government and the public are provided with a stream of information on the monetary policy stance. This means to publish comprehensive statements following each meeting of the Bank's area in charge of monetary issues or policies, to provide annual economic reports and quarterly bulletins to the shareholders and the society at large.

Some observers have suggested that these elaborate accountability provisions are onerous and constrain the Bank's independence. I take the contrary view, that they are essential to the legitimacy of the arrangements as a whole and so actually reinforce our independence – provided of course we are able to prove convincing explanations of our conduct! And the likely public and financial market reaction is, in my view, the most effective protection against abuse of the treasury's emergency powers.

Speech by Mr. Edward George, Governor of the Bank of England – GBE, to the SEANZA Governors' Symposium in Colombo, Sri Lanka, on 26 August 2000.

A system that provides responsible policy must serve the broad public interest, remaining objective and removed from special interest, yet ultimately accountable to and in dialogue with the realities of changing times, human values, and economic conditions.

Accountability

In the case of the European Central Bank – ECB, one of the aims of publishing the monetary policy strategy is to make ECB's policy decisions transparent. Second, the ECB has

to publish an annual report in which, inter alia, the monetary policy of the previous and current year are discussed. The President of the ECB presents the ECB's Annual Report to the European Council meeting in the composition of the Ministers of Finance and Economy (the ECOFIN Council) and to the European Parliament, which may hold a general debate on the basis of the Report. The President and other members of the ECB's Executive Board may be heard by the competent committees of the European Parliament.

The ECB's President has agreed to appear before the European Parliament **at least four times a year**. Third, the ECB has to report on its activities at least quarterly. It has been decided to go beyond this requirement and to publish a monthly bulletin.

“It is my view that the main way to achieve accountability is through being transparent and open. In passing, I note that transparency also enhances the effectiveness of the central bank”

“What we do not do is publish individual arguments and voting records, for several good reasons. The ECB conducts a single monetary policy for 11 countries and the governors of the national central banks do not represent their individual countries on the Governing Council, but are obliged to base their arguments on euro area-wide considerations. To publish voting records and arguments put forward by individuals would be to risk. I do not believe that maximum transparency is the same as maximum information.

It would, for example, be rather confusing and not at all transparent to publish a full transcript of the meetings. This would also diminish the frankness and quality of the exchange of views which takes place. I should like to emphasise that our concept of accountability is a collective one. We are accountable for the decisions taken by the ECB's Governing Council as a body. Therefore, our external communication focuses on these decisions and the underlying reasons for them, including arguments for and against.”

Speech by Mr. Christian Noyer Vice-President of the European Central Bank, on the relationship between politics and central banks to the Estonian Central Bank at Tallinn, Estonia on 3 May 1999.

Finally, we can summarize that Transparency is a measure of the ways decision making procedures can be evaluated from outside, which bodies are able to research the state of affairs and if anybody has the right to veto decisions. Accountability is also an important form of democratic oversight. Who is responsible for what and for whom. It also serves as an incentive for executives to meet desired goals. It is critical to survey the responsibility of the decision makers for poorly implemented policy decisions. Therefore, we can assume that accountability for policies is the logical complement to independence in any democratic society.

9. Final Remarks

The traditional argument in favor of a strong and independent central bank is that the power to spend money should in some way be separated from the power to create money. Numerous episodes in the world's economic history testify to a government's potential tendency to abuse of its power to create money. During elections periods, many governments have given in to the temptation to improve its expenses or to reduce interest rates. This may boost spending and employment in the short term, but ultimately it usually also causes higher inflation over the long term, unless the capacity of the economy can meet this higher level of demand.

Politicians, the elected representatives who make laws and determine public policy, are themselves subject to pressures inherent in the structure of government. They are expected to respond to the desires and needs of their constituents. And constituent expectations tend not to be tempered by such realities as cost and resource limits. In short, politicians are under pressure to accomplish more than available resources permit. This can mean attempting more than we can afford or are willing to pay for. Such pressures probably give our national policies and goals an inflationary tilt.

This is especially true in a democracy where the powers delegated to elected officials must be affirmed by "back home" constituents every two, four, or six years. The need for elected representatives to be responsive and "tuned in" to their constituents is a vital function in political process. It provides important guarantees to citizens. But it may also limit the extent to which elected representatives can afford to consider the long-term merits of policies.

Balanced policy therefore requires an institutional structure that insulates monetary policymakers from such short-term pressures, which is to say one that also insulates elected officials from the negative electoral consequences of policy decisions that may be essential but unpopular.

Obviously, not all policy decisions pose this type of conflict. Not all elected officials yield to short-term pressures or would need to. In any case, the merits of a given policy are seldom unambiguous. But the consequences of persistently expansive monetary policy are too severe to risk procedures that compound a bias in favor of short-run options and produce short-sighted results.

Central banks normally operate on a longer-term time scale than politicians and therefore do not face the same temptation to relax policy to achieve short-term objectives. By delegating decisions about interest rates and other monetary matters to such an independent institution, with a clearly defined mandate, society can hope to achieve a better inflation outcome over the longer term.

On the other side, many criticism against making central banks autonomous entities is based on the following arguments, as we already mentioned before:

- ? Although the average inflation rate and the degree of central bank independence are negatively correlated, this relationship does not reflect any causal link running from central bank independence to low inflation.
- ? Central bank is part of overall economic policy and independence could bring a risk of conflicting objectives with the others policies (fiscal policy, monetary policy, labour policy, and trade policy).
- ? Any decisions about interest rates, exchange rates, the efficiency of the financial system and other monetary matters to a staff of unelected officials, is simply "undemocratic".

In short, society faced with a trade-off: On the one side a totally independent central bank, and on the other an entirely controlled institution. Although there may be many arguments against CBI, such as: Who is politically responsible for the economy status, the legitimacy of the central bank Directors, and misunderstands between the Government and Central bank as to the coordination of the economy. Considering the advantages observed in

this research, we can conclude that some degree of independence to the Central Bank is really important.

Finally, I would recommend the adoption of CBI in Brazil. Among other things that we have been discussing in this paper it helps to establish a good reputation, something that can not be acquired overnight. In addition, by pursuing financial stability, the central banks become relatively well aligned with international best practices. They can then operate autonomously within a legal framework that affords them a substantial degree of independence, while remaining accountable to the Legislative branch. Moreover, they could help the country to achieve a certain level of financial stability that provides a sound basis for sustainable strong economic growth and development.

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