Independence and Accountability of Central Banks

With a Special Focus on India

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According to the consensus view, central banks reached a high level of independence by the end of last century. This paper argues that as a result short-term political considerations applied during the appointment process of central bank decision-makers, their actual independence was at a lower level already that time. The global financial crisis created new tasks for central banks and forced a review of the meaning of independence. The paper argues that central banks should be responsible for safeguarding financial stability and their macro-prudential activity can only be executed in cooperation with governments. However, interest rate policy decisions must remain free of political influence. The novelty of this paper lies in showing the conflictual relationship of the various roles of central banks. The paper concludes that the duality of independence and cooperation represents a major uncertainty in the operation of central banks. As a result of the greater degree of politicisation of the activities of central banks, their *de facto* independence in interest rate policy making may further shrink in the future. The paper also shows that India represents a unique case of central bank independence. In most countries, *de jure* independence is higher than *de facto*. India is one of the very rare countries where the reverse is the case.

Keywords: central bank, independence, macroprudential policies, financial stability, government policies

Introduction

There are very few technical-scientific debates which end with the full and complete victory of one side. The debate on the independence of central banks is certainly not one of this kind. The debates in connection with the institutional setup began in the 1980s, at the time of the deviation from the fixed exchange rate system and the search for a new path related to monetary policy regime and came to rest by the early 2000s. Conflicting opinions remained but according to the most broadly accepted views the operation of the central bank free of political influence has been a necessary condition of meeting monetary policy objectives. After the global crisis, the old arguments for independence were put into a new light under changed macroeconomic circumstances, new criteria arose, urging the re-thinking of the content boundaries of independence. The earlier consensus was upset and the theoretical debate on principles started anew. This writing reviews the traditional set of arguments for independence in relation to this debate and makes an attempt at their reformulation, taking into account the changed circumstances, putting the final conclusion of the article forward: *de jure* the central

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banks of the advanced countries reached a high level of independence by the turn of the millennium, yet actual central bank independence was of a lesser degree than that shown by various measurement indices. In the post-crisis era, freedom from the influence of short-term political interest continues to be necessary in interest rate policy, while financial stability can be preserved only with the close cooperation of the central bank and the government, as will be shown subsequently. There is a high probability that this duality will lead to some de facto infringement of central bank independence in monetary policy and it will come to staying at a lower level than in the pre-crisis period.

The next part of this article reviews the theoretical aspects laying the foundations for independence, the way as they arose in the period before the global crisis. The following part summarises the empirical experience related to central bank independence. Subsequently, it will be examined whether the original arguments for independence are still relevant under today's conditions and what extent of cooperation is required by the expanded scope of responsibility of central banks. A discussion of central bank independence in India is provided in the next part. The article ends with drawing the conclusions.

Arguments for Central Bank Independence Before the Global Financial Crisis—A Literature Review

One of the most fundamental macroeconomic problems of the last quarter of the 20th century was the rise in inflation coupled with a low growth rate in several countries. Both practical economic policy and economic research sought for the possibilities of reaching low inflation over the long term and as part of this, the best institutional solution. By the early 2000s, a practical consensus evolved about the fact that monetary policy can best contribute to economic growth by maintaining price stability while the operation of the central bank free of political influence can best guarantee to reach price stability. It was primarily the works of Rogoff (1985), Debelle and Fischer (1994), Sargent and Wallace (1981), and Kydland and Prescott (1977) that constituted the theoretical point of departure of this consensus. The clean final result was, however, the joint work of so many people that they simply cannot be listed¹. The three most important arguments for central bank independence are brought up below.

1. With a view to reinforcing public trust in them and to increasing the chances of retaining power, politicians have a propensity to reduce taxes, introduce new welfare expenditures and new public investments, even if the welfare surplus generated through these measures is coupled with surplus inflation. They hope that the impact on growth will appear first and prices rise only with a delay preferably following the next elections and only for a transitory period². Economic agents, however, tend to react to higher prices with demands for higher wages. Rising wages transform the initial demand price increase into lasting cost inflation, while the higher cost level channels the growth rate back to the level prior to the demand shock.

Government politicians act against their self-interest—their re-election—if they introduce measures concomitant with real economic costs with a view to curbing inflation. As long-term interests linked to price stability are not aligned with the short-term interest of politicians, there are good reasons to make the cause of price stability into a responsibility of an institution outside the government structure. This institution is the

¹ In view of the fact that the next three points summarise the arguments more or less generally accepted in international literature, references to authors will be omitted.

² The theory of political business cycles places the empirical correlation between political cycles and economic cycles into a wider macroeconomic framework (Nordhaus, 1975).

central bank. But even a central bank is able to achieve price stability only when it is outside the government structure not only in a formal sense, but its actual activity is free of the influence of short-term political interests³. A number of empirical studies showed a correlation between the independence of the central bank and the low rate of inflation, and the lack of independence and the high rate of inflation (Alesina, 1988; Cukierman, 1992; Grilli, Masciandaro, & Tabellini, 1991; Arnone & Romelli, 2013). There were also studies, which demonstrated the causal relationship between the two (Masciandaro & Romelli, 2017). Moreover, Cukierman, Web, and Neyapti (1992) showed that a successful anti-inflationary monetary policy may contribute to the reinforcement of independence through strengthening public trust in the central bank⁴.

The central bank's independence, however, does not guarantee the implementation of price stability. If there is no supportive social environment, if economic policy itself fuels inflation, if the budget is too lax, if there is an external demand price shock, the low inflationary environment adequate to price stability cannot evolve despite a central bank's independence. "No monetary policy regime including inflation targeting will succeed in reducing inflation permanently in the face of unsustainable fiscal policies" (Bernanke, 2005). Yet, there is a better chance of achieving price stability if it is safeguarded by an institution in whose operation short-term political interests linked to re-election are not present and which cannot be forced to implement instructions driven by such interests.

2. Governments have a propensity to spend more than they take in. If it is easy to find cheap sources of funding for expenditure in excess of revenue, then the motivation to make for a greater deficit is higher. If a government can borrow from the central bank (or can sell government papers to it), then the deficit can certainly be financed up to the amount of such credits. If, however, it is not possible to have the central bank finance the budget deficit⁵, then the possible extent of the deficit is limited by the possibilities of financing from the market. If these funds peter out, then this pressure creates budgetary equilibrium.

With an institutional structure keeping the central bank subordinated to the government, the central bank can be easily instructed to issue credit for creating the sources of financing of a demand shock. Such lending (government paper purchases) is limited only by the self-restraint of the government. But why would a government refrain from borrowing, if it can hope for greater electoral support from additional expenditure?

If the central bank operates outside the government structure and it cannot be instructed to finance the government, there is a better chance for the evolution of a disciplined fiscal policy. A chance, however, is not a guarantee⁶. The claim is no more than stating that a high deficit may come into being with more difficulty when the central bank is independent and more easily when the central bank is not independent. As high deficit in the budget fuels inflation, the central bank responsible for price stability will refrain from central bank financing

³ Lastingly low inflation may occur even in the absence of independence. Prior to monetary integration, the Bundesbank did not enjoy a high degree of independence, yet there was price stability in Germany as a result of a social consensus against inflation. Government policy fuelling inflation would not have resulted in political gain but losses owing to the inflation sensitivity of the public. In most countries, however, there is no such anti-inflationary constraint of cultural origin.

⁴ Many disputed the grounds of the calculations and the final conclusion. Several authors questioned the grounds of the data (fundamentally, the assessment of independence). Others criticised the merging of experiences of the advanced and the emerging countries. See, for instance, Cargill (1995), Eijffinger and Van Keulen (1995), Hayo (1998), and Posen (1993).

⁵ Fiscal financing, fiscal dominance, or the monetisation of debt are notions with content similar to the central bank financing of the deficit.

⁶ Market investors may be willing to finance unsustainable budgets, even for longer periods of time, because of being short-sighted and driven by the possibility of momentary profits.

enabling the high deficit based on its own set of objectives. In most countries, central bank laws exclude the possibility of financing the budget, which also includes a paradox. Independence means a higher degree of freedom, while the prohibition takes precisely that freedom from the central bank to make the decision on whether or not to finance the state with its own instruments.

3. Public trust in a central bank means that economic agents regard the declared objectives of monetary policy as stable and accept them, and they believe that the central bank is committed to and able to meet its mandate. If the public has no trust in achieving the price stability objective, and shaping its expectations on the basis of this perception, inflation is very likely to be higher. The higher the credibility of a central bank, the lower the real economic cost of the fight against inflation. If the central bank is part of the government structure, people will have reason to believe that the central bank will not be able to consistently act to achieve its declared objectives. Low inflation is not a primary objective for economic policy as a whole (see point 1 above), hence it cannot be a primary objective for the central bank either. The public will have reason to fear that the objective will be changed or that the objective is no more than an empty declaration. The operation of the central bank free of political influence is a necessary precondition to central bank credibility. An automatically higher level of credibility does not, however, follow from an independent status. If a central bank makes professional errors, if it gives in to political pressure, if it fails to meet its objectives serially as a result of exogenous factors, its credibility will be damaged.

Authors in political economy fundamentally approach the issue of central bank independence from the side of political fragmentation and interest relations. According to Bernhard (1998), in the event of a coalition government, the different political preferences of the partners, any eventual tensions between the government and its own legislators can be more easily managed, if the central bank is independent, because at least the debates concerning exchange rate, inflation and anti-inflationary measures do not burden the relationship of the parties. They can blame the central bank for unpopular measures instead of one another. Central bank independence is one of the instruments of reinforcing government stability. When there is a high degree of identity of views between coalition partners, political monochromaticity and a non-democratic establishment, there is less chance of central bank independence. Crowe and Meade (2007) showed a positive correlation between central bank independence and the democratic political setup. According to Hallerberg (2002), in the event of a federal structure the holders of local power may support central bank independence in order to mitigate the weight of the central power. According to De Haan and Eijffinger (2016), the greater the political fragmentation in a country (e.g. coalition government, disputes between coalition partners, a strong system of checks and balances, a federal state organisation), the higher the chance of a central bank becoming independent.

Several authors explain the fact that central banks have become independent through the lobbying activities of economic interest groups. Had price stability been of the same significance for every social group, none of the social groups would have any special interest in central bank independence. Inflation and monetary policy decisions impact individual social groups differently. Responses appear to depend on the size of the group concerned, the extent of being aware of belonging to the group, the interest enforcement capabilities, etc., in different forms (changed inflationary expectations, changing wage demands, newspaper articles, protest movements, etc.). According to Posen (1995), the greatest losers of high and sudden inflation are the companies of the financial sector, hence the establishment of institutional conditions best facilitating the implementation of

price stability is largely in their interest⁷. In Posen's interpretation, the entire society wins with the implementation of price stability, since the companies of the financial sector facilitate the enforcement of the public good by supporting central bank independence while they are pursuing their own interests. Interpreting Posen, Hayo and Hefeker (2001, p. 17) state:

...it is not really central bank independence that causes monetary policy to strive for low inflation rates. Rather, central bankers simply reflect the interests of a specific group, namely the private financial sector, which is ultimately the source of low inflation.

Stiglitz also believes that the central bank enforces the interest of the financial sector. In contrast to Posen, however, in his view, private interests are enforced to the detriment of the public good in the meantime. Financial interest groups exercise pressure on the central bank through their personal relationships and the public with a view to having monetary policy decisions made, which suits them. "America's central bank was captured by Wall Street: [Fed] came to reflect the ideology and interests of the financial sector, which it was supposed to regulate." "...delegating the conduct of monetary policy and regulations to those who come from and reflect the interests of the financial market is going to result in policies that are not (and were not) necessarily in society's broader interests" (Stiglitz, 2013, p. 31). Stiglitz's assessment—if understood to refer to modern central banks in general—is excessive, yet his proposed solution is remarkable. As early as 10 years before the outbreak of the global crisis, he didn't advocate the subordination of the central bank to the government, but a combination of central bank independence and a broader social representation, i.e., stronger social control over the central bank than at present. He regarded the central bank representation of consumers, traders, and employees as desirable considering it not as a constraint on central bank independence, but as better compliance with a democratic setup (Stiglitz, 1998). In 1998, he still regarded this as an appropriate solution for enforcing social interests. Since then Stiglitz's assessment has changed radically (see later).

Discussion of Measurement Issues and Interpretation of Measurement Results

There are many known procedures for expressing a quantified extent of independence. The original sources of measuring independence are the Cukierman-Webb-Neyapti (CWN) and the Grilli-Masciandaro-Tabellini indices. Both procedures are based on the combined assessment of the sub-constituents of independence⁸. Individual central banks can be placed on a scale of independence based on the indices, and time comparisons can also be made. The subsequent refining of the measurement procedures taking into account new variables, omitting certain variables and the modification in the data sources used resulted in new and newer independence indices (For instance, Crowe & Meade, 2007; Dincer & Eichengreen, 2014; Arnone, Laurens, Segalotto, & Sommer, 2007; Masciandaro & Romelli, 2017). A detailed presentation of the measurement procedures is not the subject of this article. The CWN index is presented in the Appendix only to illustrate the technology of the procedure. The number of the criticisms of the calculating procedures is almost proportionate

⁷ Banks tend to finance their longer term credits from short-term funds. The interest rate on short-term funds follows changes in inflation. If banks were to raise the lending rates on longer maturities in line with the rise in inflation regarded to be transitory, then the rise in real rates following the curbing of inflation would give rise to a deteriorating return on credits. If expecting a reduction in inflation, banks raise their lending rates ab ovo at a rate lower than the rise in inflation (and of deposit rate), then with the shrinkage of the margin, their net interest revenues decline. The plausible banking response to a rise in inflation is largely a reduction in lending activity.

⁸ For a more detailed comparison of the two procedures, see for instance Masciandaro and Romelli (2017) or Mangano (1998).

to the expansion of the independence indices. Most of the criticisms relate to the variables used or not used, and the subjective elements of assessments and the weighing system.

The concurrent conclusion of the measurements applying different procedures is that central bank independence has reached a very high level by the early 2000s, starting from the low level of the early 1990s. Crowe and Meade calculated the value of the CWN index using 2003 data projected to a range of countries broader than originally. The results show a significant increase in central bank independence. In particular, the independence of the central banks of the emerging countries and within them the Central East European EU Member States rose spectacularly (2007)⁹. The distinction of *de jure* and *de facto* independence, however, adds hue to the picture. Independence indices measure the kind of autonomy guaranteed by the formal rules applicable to a central bank and “*de jure* institutional rules are not good indicators of actual independence” (Vuletin & Zhu, 2011, p. 1209)¹⁰. The figures for legal independence tend to overestimate the extent of the actual independence of central banks. *De facto* independence is hard to measure, yet public opinion tends to recognise sooner or later if a central bank is independent only on paper and this may be the source of serious problems of credibility/expectation. Below, certain manifestations of the difference between *de jure* and *de facto* independence are discussed.

The various indices regard a central bank all the more independent, the greater the influence of parliament or the head of state standing above political parties on the appointment of the central bank governor (central bank decision-makers)¹¹. In reality, however, the government (the prime minister) has a decisive role, even if its formal authorisation is restricted merely to initiation, the parliament (or parliamentary committee) has the right of approval and the head of state effects formal appointment. The rejection of the prime minister’s proposal is not much more than a formal possibility for the head of state or the parliament. In particular, that is the case when the parliament and the head of state do not have a controlling function over power. Governments are able to achieve that a person who meets the political preferences of the government the most and who means a personal guarantee that the central bank will function in accordance with these preferences be appointed to head the central bank at the end of the appointment process¹². The importance of selection is underlined by the fact that after the appointment, the possibilities to influence monetary policy are substantially constrained and there is no legal possibility to remove an inadequate person¹³. If the decision-makers of a central bank are not sovereign thinkers, the central bank will function in subordination to the government even if the rules of appointment, removal and conflicts of interest are the most independent even without instruction and the direct exertion of pressure. In contrast to Stiglitz, one may say that there is a greater risk of the central bank being captured by the short-term political interests of the government, then of the economic private interests of various economic interest groups.

⁹ Balls, Howat, and Stansbury (2016), and Dincer and Eichengreen (2014) and Arnone (2007) arrive at a similar result.

¹⁰ According to Cargill (2016) *de jure* independence is suitable for signalling major shifts in the relationship between the central bank and the government even under the best scenario. Owing to the lack of clarity of the notion and the difficulties of measurement, he recommends the rejection of the use of the notion of independence and instead proposes the application of accountability and transparency.

¹¹ The CWN index gives a score of 0 (does not regard it independent), if the governor of the central bank is appointed by the government and a higher score, if the role of the government in the appointment process is restricted.

¹² “To be sure, the acquisition of control over monetary policy is the primary driver of the appointment process.” (Ennsner-Jedenastik, 2013, p. 6)

¹³ “Politicians have an interest in appointing persons with government-aligned preferences to monetary councils and to remove those who go against the government’s political actions.” (Ennsner-Jedenastik, 2013, p. 5)

Central bank governors (and central bank decision-makers) are always political appointees.

The replacement of the departing central bank governor with an allied central bank governor shows relatively low frequency overall the sample amounting to 5.4% of the total of governor changes. It is interesting, although not surprising, that there is a substantial difference between developing and advanced countries in this field. While central bank governors in advanced countries do not tend to give up the highest positions of ministries or government institutions for their new mandate, in developing economies 8.5% of the total central bank governor changes were central bank governor positions following government posts held till then. This practice occurred in the case of 11 of the 21 developing countries in the sample¹⁴. (Vuletin & Zhu, 2011, p. 1192)

...it cannot be disputed that the appointment of a person who at the time of his appointment was the highest ranking leader of a ministry or some kind of a government institution represents the clearest case of the capture of the central bank by the government. (Vuletin & Zhu, 2011, p. 1191)

Governments, however, do not necessarily use the possibilities available to them in the selection process to make puppets head central banks. A politician's self-restraint and sensitivity to longer term criteria dictates that they do not expect the service of their short-term power and political interests even from a "friendly" central bank governor. Manifestation of this would be to seek multi-party support in initiating the appointment or the invitation of external experts for the parliamentary hearing of the selected persons. Largely, it was the government politicians of leading market economies that showed evidence of their foresight, their respect for longer term criteria, their insight and liberality. In addition to the quality of the persons, the condition of political culture and political power relations also play an important role in the selection process. On the other hand, it depends also on the selected governor to what extent the independence of the central bank is violated in the event of a "friendly" appointment. Compliance with the provisions of the Central Bank Act, the pursuit of the central banking ethos, the demand for professional credibility may clash with the political expectations of the appointer. It is the personal choice of the central bank governor (and the central bank decision-makers) that will decide what they (he) give(s) priority to in the case of such a conflict.

While independence indices frequently show a substantial independence of the central bank based on the rules pertaining to appointment, in reality the appointment process provides substantial opportunities for enforcing political influence. There are, however, other instruments as well for enforcing the government's intentions. The various dimensions of the personal independence of the central bank governor (and the decision-makers) constitute parts of every independence index. It is, however, surprising that the rules pertaining to the determination and the mode of changing personal income are not included among the variables of the indices. It follows that these indices are insensitive to income changes applied as political retaliation or political reward during the period of the mandate. Changing the income is an obvious attempt at changing monetary policy or reinforcing the existing direction. It is also a message to future central bank governors (decision-makers) that their personal incomes depend on how the government assesses monetary policy. If the fundamental mandate of a central bank and the personal income relations of the higher central bank decision-makers are not harmonised with one another, it constitutes a severe structural problem and may be a source of operational disturbances¹⁵. Because of this, an income rule fixed in advance for the period extending

¹⁴ Vuletin and Zhu analysed the data of the governor replacements of 42 countries (21 advanced and 21 developing countries) between 1972 and 2006. They studied altogether 257 cases. They regarded a central bank governor as an ally of the government, who held a high-level government position within a year preceding his appointment.

¹⁵ Giving financial incentives to central bank managers to implement central bank objectives, such as the inflationary target, may have detrimental consequences. A central bank governor may press for the achievement of the inflationary target because of personal material advantage, even if it goes with excessive real economic sacrifice.

from the moment of appointment to the end of the mandate is an indispensable precondition to central bank independence and a successful implementation of the central bank mandate.

Beyond all this, professional debates between the central bank and the government led to forcing the central bank governor to leave before his time on several occasions. Enforcing the resignation is an obvious violation of central bank independence; the objective of such a step is to change monetary policy in a direction deemed to be right by the government. Such precedents may motivate the next central bank governors to undertake as little conflict with the government as possible having learned from the experiences of their predecessors. Most frequently, what stands in the background to such debates is the difference in views about the contribution of monetary policy to economic growth and the expansion of the elbowroom of the budget. As the rules of recall generally do not provide for an opportunity for political consideration and leave only a minimal possibility for the government to recall the central bank governor, the primary instrument of removal has been the exercise of political pressure. The methods of enforcing resignation extend from persuasion behind closed doors to open attacks questioning the professional qualifications, human dignity, and loyalty as citizen of the central bank governor. In their study already referred to, Vuletin and Zhu (2011) established that 28 of the 93 bank governor changes in the advanced economies and 105 of the 164 cases in the developing economies took place prior to the expiry of the governor's mandate. They do not give quantitative estimates, but they explain some of the changes before their time with political attacks against the "disobedient" central bankers. Ennser-Jedenastik (2013) studied the interrelations between the party affiliations of central bank governors and the governments and heads of states in 30 European countries in the cases of 196 central bank governors between 1945 and 2012. He established that central bank governors having the same party affiliation as the parties in executive power had a much longer period in office than nonpartisan central bank governors. The period in office of central bank governors having affiliations with opposition parties was shorter than that of nonpartisan central bank governors (Ennser-Jedenastik, 2013).

Legal independence includes the decision-making freedom of monetary policy. Independence indices reward the fact when the government cannot give and the central bank cannot accept instructions in the course of using monetary policy instruments with a high score. In reality, however, the exercise of political pressure is frequent¹⁶. The instruments of influencing range widely from personal meetings and phone calls through covert hints dropped in statements made to the press, through undisguised demands and threats¹⁷. Some decision-makers adjust to the political expectations even upon the slightest signals while others do not give in even to the most forceful pressure. The handling of the expectations of public opinion constitutes perhaps an even greater challenge for central banks. The intentional contrasting of public opinion with the central bank is one form of exerting political pressure. A weakening of the acceptance of the central bank by society may also weaken the success of monetary policy because in such a situation it is less to be expected that market expectations change in the manner hoped for by the central bank. The trade-off between independence and social insulation may motivate the central bank to make compromises.

¹⁶ Representatives of the financial sector, employers, trade unions, academic circles, and international organisations frequently give vent to their opinions in relation to the monetary policy to be pursued. These give useful feedback to monetary policy. The exertion of political pressure is to be distinguished from this, as it means a government intervention to make the central bank deviate from the fulfilment of its mandate.

¹⁷ Havrilesky (1993) uses an indicator to measure political pressure. He gives a value of +1 to every occurrence of government demand for tightening in the press, while -1 for loosening it. He draws conclusions as to the strengths and direction of political influence based on the sign and magnitude of the end result.

It may happen that de facto independence exceeds the extent of de jure independence. A central bank that is de jure less independent may be able to efficiently enforce the criteria of monetary policy, if the head of the central bank has a substantial ability to enforce interests by virtue of his professional qualifications, personal strength of conviction, or the relationship of trust with the prime minister. As this ability is linked to specific persons, the de facto independence arising from this exceeds independence determined by legal regulations so long as the key actors are in office.

Overall, it can be established that the independence of central banks definitely increased over the two to three decades prior to the global crisis, but actual independence has characteristically been lower than that shown by the formal rules and the quantified values of independence indices.

Analysis of the Changes in the Content and Boundaries of Independence

According to the traditional argumentation, central bank independence is a necessary precondition to a successful fight against high inflation. In the case of low inflation, however, the central bank need not protect the case of price stability against the government because both the central bank and the government have their interest tied to avoid inflationary undershooting. In the case of rising inflation that jeopardises price stability, boosting by the government is harmful, but in the case of too low inflation, it is useful even if the reason behind it is the consideration of politicians being re-elected. According to Summers (2016), central bank independence “can be traced back to a macroeconomic problem, which no longer has relevance today”. Today the primary macroeconomic problems are secular stagnation, chronic shortage of demand, and low inflation. According to Lynn (2012), “the model of the independent technocratic central bank is on the decline and is being replaced by direct government control over monetary policy”.

If Summers is right and inflation remains below the level of price stability over the longer term, there will be no need for an independent central bank. If, however, one regards reduced growth and price increase rates as the transitory consequences of a lasting crisis and looking forward to a longer period of time, one expects an acceleration of growth and price increases, then there will be a need for central bank independence. Longer term inflationary expectations will remain anchored even in the low inflation environment attributable (also) to credible central bank policy. Giving up or substantially restricting independence would lead to a rapid termination of expectations being anchored with a high probability, which would render the tasks of central banks substantially more difficult when inflation begins to rise later. Because of this, the operation of a central bank free of political influence (instrument independence) is equally warranted with high and low inflation (Fischer, 2016; Balls, Howat, & Stansbury, 2016).

The earlier consensus behind the categorical rejection of fiscal financing (the second major pillar of the theoretical basis of central bank independence) has ceased. There still are theoretical debates, but this taboo has been toppled by economic policy practice, launching the quantitative easing programmes. Extensive government paper purchases by central banks are irrespective of whether this takes place in the primary or the secondary market clashes with the ban on fiscal financing. The development of a higher deficit is rendered more difficult by the ban on fiscal financing while government paper purchases by the central bank make it easier. Central bank purchases do not constitute a problem so long as there is a place for fiscal invigoration with a view to macroeconomic stabilisation and raising inflation. The yield decrease invoked by the central bank’s security purchases reduces the burden of repaying the outstanding government debt, releases funds for the state, which can be put towards increasing current expenditure. The possibility of cheaper financing also encourages

additional government spending. However, there is more to it than this. The interest paid on government papers in the central bank's portfolio increases the profit of the central bank. In the vast majority of countries, the profits of the central bank add to the revenues of general government, which means that so long as they are in the central bank's portfolio, government papers held by the central bank pay a zero interest rate. Whatever the government pays to the central bank as interest is returned in the form of central bank profits¹⁸. Some authors go further than this, and recommend the open financing of the state by the central bank (the application of Friedman's helicopter money)¹⁹. If the central bank credits an amount to the account of the government, it enables tax reductions or increases in expenditure so that in the meantime government debt does not increase. In the absence of a debt increase there is no need to fear a necessary tax increase following a tax reduction whereby the tax saving turning into consumer (or investment) demand it exerts a stimulating effect on both economic activity and prices²⁰. The same argument, which earlier was the main argument against fiscal financing, is today the argument for it: it opens a free way to increase government expenditure. Earlier fiscal financing had to be banned in order to forestall the rise in fiscal expenditure (and thereby the rise in inflation). What argues for it at the time of the real economic ebb and threat of deflation following the crisis is that it enables the budget to reinvigorate the economy. Tolerance related to fiscal financing is, however, no more than a transitory historical episode. Maintaining central bank government paper purchases after the extraordinary circumstances no longer obtain would land in a contradiction with the criteria of fiscal sustainability and price stability. There is no experience as to how quickly low inflation can change into high inflation and as a result at what speed central banks concerned will have to transit from government paper purchases to selling them.

According to the earlier argumentation, central bank independence was necessary in order to prevent fiscal financing. The transitory suspension of this ban does not weaken the importance of central bank independence. If the quantity of securities purchased by the central bank or the volume of open central bank financing (if there is any) was determined in a political bargaining process, there would be a major threat of an "uncurbed" increase in the quantity of money²¹. In addition, the principle of the democratic control of the executive will also be violated if the government were to meet its revenue requirements through operating the central bank press subject to its influence rather than levying taxes requiring authorisation by parliament.

The most important lesson of the global financial crisis is that monetary policy is responsible for safeguarding financial stability (and it was responsible for shaking financial stability). This responsibility is dual: it is manifested firstly in the management of the damage that has already been incurred and secondly in

¹⁸ In the case of government papers held until maturity, the prepayment of capital paid to the central bank makes the debt fully free of cost for the state depending on whether or not capital repayment is regarded as a revenue increasing profits. This depends on the interpretation of seignorage related to new central bank money spent on government paper purchases by the central bank. Central bank government paper purchases carried out within the framework of traditional open market operations typically aimed at a short period. This is what makes it distinct from fiscal financing, which means the final purchase of the debt. The time horizon of open market operation is short, that of quantitative easing is longer and that of the monetisation of the debt is infinite.

¹⁹ For instance, Turner (2015) or Bossone (2015).

²⁰ "Overt money financing is the most efficient instrument of solving deflation, particularly in countries burdened by high indebtedness and depressed performance, which have no or only restricted fiscal elbowroom." "...enables the creation of new purchasing power, giving it to those who are the most in need and who are most likely to spend it." (Bossone, 2015)

²¹ "The cost of influencing the central bank's decision by the government in connection with quantitative easing may be extremely high, since this influencing is equivalent to giving an opportunity to the government to require monetisation of the debt which should be avoided at all cost." (Bernanke, 2010)

avoiding future damage. Cooperation in warding off corporate bankruptcies threatening systemic risk has traditionally been a task of the central bank (lender of last resort). The central bank has the information and the specialised knowledge on the basis of which it is possible to evaluate whether the failure of a company would launch a chain reaction jeopardising financial stability as a whole. The central bank is able to create the financial coverage of rescue actions. Rescue actions, however, also have substantial political consequences²². Political responsibility related to rescue actions and their political legitimacy can be guaranteed if a company rescuing intervention is based on the joint decision of the central bank and the government. The central bank may not rescue a private company without the agreement of the government and the government may not instruct the central bank to rescue a company.

Macro-prudential policy makes sure of preventing future damage. Prior to the global financial crisis, central banks and governments implicitly assumed that markets functioning in an increasingly liberalised manner would establish financial stability, the government and central bank policy would not have much to do in this area. The central bank's lender of last resort function would provide an adequate solution to individual company problems constituting systemic risk. This was an error. Since the global crisis, it is known that systemic risks can be built up even though the most significant corporate actors are all successful and monetary policy also seems to be successful. Macro-prudential policy has appreciated upon the impact of the crisis and it gives tasks equally to central banks, financial regulatory authorities, and a number of institutions of the government's economic policy. Accordingly, it has become necessary to expand the scope of responsibility of central banks with tasks related to financial stability. At the same time these tasks cannot be left fully in the hands of technocratic experts because performing them is concomitant with a wide range of distributive effects and political consequences. Hence the central bank cannot solely be in charge of financial stability.

Accordingly, the legislators of several countries supplemented the mandates of central banks, while maintaining the primary goal. At first sight, the new goal is not in contradiction with the old ones because financial stability is a condition of enabling the central bank to carry out its primary task. That is, maintenance of financial stability can be deducted also from the fundamental mandate of the central bank as a monetary policy goal. Conflicts, however, are possible. Hence with the appearance of the new task, it is necessary to clarify the relationship of monetary policy goals and objectives to one another and the relationship of the central bank with other institutional actors with a role in financial stability. This situation is made even more difficult through the fact that financial stability cannot be characterised by any single easy-to-observe indicator²³.

This writing does not intend to discuss the relationship between the price stability objective and the financial stability objective in detail. It is, however, worth noting that in a substantial part of the cases, macro-prudential instruments are suitable for the management of financial stability tensions even without being supported by interest rate policy, while interest rate decisions brought on the basis of price stability criteria may assist in safeguarding financial stability (interest policy is also a macro-prudential instrument). Monetary tightening can be an effective weapon against the evolution of bubbles in the case of accelerating inflation. The

²² Unavoidably, all central banking actions designed to finance corporate rescue programs find themselves at the heart of strongly over-politicized debates. Criticism may refer to government gift given for private interests (Stiglitz, 1998), the role of rescue missions is encouraging to take even greater risks (moral hazard), macro-crisis due to an omitted or mis-timed central bank intervention (Lehmann Brothers) as well as giving in to political expectations.

²³ It follows that the set of criteria for the accountability of the central bank related to financial stability stands on relatively uncertain feet, and this may easily become a source of political battles.

central bank would lend in a schizophrenic situation in the hypothetical case when a tightening of monetary conditions would be warranted for reasons of financial stability, while their loosening would be called for reasons of price stability. Choice is obvious, if the decision-making alternatives are financial collapse or missing the inflationary target. For stability risks building up slowly, decisions weakening price stability rather than strengthening stability constitute the good answer. In this case, the central bank may support the use of other elements of the macro-prudential instruments, take actions to protect stability that is not consistent with the logic of interest policy, if the possibilities of using macro-prudential instruments have been exhausted and the continuation of the processes would inevitably lead to the loss of financial stability within the foreseeable future. In this ultimate case, financial stability must enjoy priority vis-à-vis price stability. So long as financial stability can be maintained with other instruments, the primary goal of the central bank must be price stability. Currently, there is no conflict of merit in between the tasks of the central bank in most places: expectations of inflation call for an interest rate increase in an increasing number of countries, there are, however, no signs that a higher interest rate level would weaken financial stability.

The central bank has to perform macro-prudential activities, but these activities cannot be independent of the government²⁴. On the one hand, macro-prudential policy is not a privilege of the central bank, this policy is also shaped by the government, thus these decisions can only be made in cooperation with the government. State interest support to curb excessive lending dynamics, the modification of state interest subsidies, state guarantee assumption rules, the amendment of the rules related to required coverage, the bank's capital requirements and interest policy decisions could equally be considered. Finding the most reasonable decision presumes the joint consideration of the concerns of the Ministry of Finance, the Bank Supervisory Authority, and the central bank. On the other hand, macro-prudential decisions frequently affect specific industries, specific groups of income holders and thereby have larger and more direct distributive impact than classical monetary policy decisions (De Haan & Eijffinger, 2016). Obviously, it would not be desirable if the central bank could independently modify the rules related to housing policy including provisions concerning evictions without the influence of the government with reference to the criteria of financial stability. Macro-prudential activity has the best chance of being exempted from serving day-to-day politics, if the institution in charge of this policy is one that is not driven by political cycles. Politicians stand to take action against a housing lending boom supported by government preferences less vehemently if they hope for the votes of the many satisfied house owners. And this calls for a leading role for the central bank. The analytical knowledge available to the central bank and the information originating from the areas of monetary policy and eventually banking supervision also warrant this. Tensions between monetary policy and macro-prudential policy can be reduced to the minimum if the central bank plays the leading role in the latter.

While maintaining central bank independence continues to be necessary in the field of interest policy, macro-prudential tasks (the new central banking tasks) require close cooperation with the government. These roles are separately well supported, their joint exercise, however, may be a source of disturbances. The dividing line between interest policy and macro-prudential policy has become merged as a result of interactions. And it

²⁴ This is the majority opinion in international literature. See for instance Kohn (2014), Cecchetti (2013), Balls, Howat, and Stansbury (2016). According to Ueda and Valencia (2012), the social optimum cannot be reached if the central bank performs monetary policy and macro-prudential tasks at the same time. In their view an independent central bank and the non-independent macro-prudential regulator would not suffice for an optimum. The condition of reaching the optimum is the simultaneous political independence of the central bank and the institution in charge of macro-prudential regulation.

is particularly difficult for public opinion and politicians to see a cooperating partner in the central bank in one aspect and an institution meticulously defending its independence in another aspect. Partially, the same persons shape interest policy and macro-prudential policy. In one of their capacities they are independent decision-makers, in their other capacity they are cooperating partners. As the government shapes macro-prudential policy together with the central bank, its representatives may easily feel the urge to influence monetary policy also. Macro-prudential policy decisions affect interest relations, they activate lobbying groups, the groups get political representation and through this, the central bank as one of the shapers of macro-prudential policy finds itself in the area of political fights. Political pressure on the other hand hardly stops at the boundary of macro-prudential affairs; it is likely that it will ripple over to monetary policy as well.

Beside the duality of independence and cooperation, the distinction between *de jure* and *de facto* is more warranted than before. From the viewpoint of price stability, the instrument independence of the central bank is the optimal institutional form. As a result of the greater degree of politicisation of the activities of the central bank than before and consequently, its greater exposure to political pressure, the independence of central banks may shrink in the area of monetary policy. There are attempts at restricting independence *de jure* mostly, however, *de facto* without changing the formal framework, but the independence of central banks is becoming tighter relative to the period prior to the crisis. This does not give rise to direct damage in the present low inflationary environment. Negative consequences for society will arise when a more stringent monetary policy will become necessary in the interest of price stability, but the central bank may not have sufficient power to bring the decision which might differ from the short-term interests of politicians.

Issues of Independence in the Case of the Reserve Bank of India

A new governor was appointed as head of RBI in August 2016. The previous governor completed his three-year tenure but decided not to run for the two-year extension of the term which is normally allowed and has been a common practice for long time. Actually, Dr. Raghuram Rajan was the second Reserve Bank Governor who left RBI without getting a five-year term since 1991 when India started liberalizing its economy. The decision to quit is generally considered as a reaction to the lack of support from the Finance Minister and the Prime Minister. Influential politicians accused the outgoing governor of being “mentally not fully Indian”. According to the newspaper sources, a selection panel was set up to consider candidates rather than directly offer the governor in office an extension to his three-year term, effectively forcing him to reapply for his own job. He may have felt limited chances to be reappointed and decided not to run for the position.

The government of India has been repeatedly asserting that RBI should be content with “full” autonomy. A statement of the Finance Ministry made clear in January, 2017, “It is categorically stated that the government fully respects the independence and autonomy of the Reserve Bank of India”. However, the *de jure* independence of RBI is rather limited. According to Dincer-Eichengreen (2014) India has the lowest independence score in a group of 89 countries investigated.

Source: Dincer-Eichengreen (2014).

This low score of India is mainly attributable to two formal rules.

First, The RBI Act (Section 7 on Management) states: “The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest” (p. 18). This point gives a great deal of power to the government as it is the government itself who determines what the public interest is. Subjectivity and political considerations may play an outstanding role in this. One also has to admit that this instruction power has never been used in the history of the RBI, yet. Most of the time formal instructions are unnecessary. The very existence of the instruction power may give rise to an ex ante adjustment of the policy makers. The government has many other ways to enforce its interests. A large part of the banking system is state-owned in India and functions under the directions of the finance ministry. If RBI is in conflict with the ministry, it is possible to frustrate the efforts of RBI through directives issued by the banking division of the finance ministry.

There is no widespread discussion to change status of RBI. There are only isolated suggestions to give constitutional protection to RBI’s autonomy (see Chandavarkar, 2005). But at a time when support for central bank independence seems to be waning globally, it may not be easy for RBI to demand and gain greater autonomy. Nor will legislators be keen of RBI’s greater autonomy.

The Dincer-Eichengreen’s (2014) ranking reflects 2010 data. To be sure, there would also have been some improvement in the RBI’s independence ranking after adoption of the inflation targeting framework. However, one can also argue that in the pre-IT times too much power concentrated in one’s hand. In India, until inflation targeting was introduced, the RBI Governor had complete control over monetary policy goals and decisions. That was vesting too much independence in an unelected official. This paper has argued that the proper way to conduct monetary policy is when goals are laid out by the government and are executed freely by the expert group of Monetary Policy Committee.

Beside the formal rules, there have been numerous attempts to curtail RBI’s autonomy. The most widely discussed issue was the withdrawal of the 500 INR and 1,000 INR bills in the fall of 2016, replacing 86% of the currency in circulation. The supply of money is normally a central bank responsibility. Therefore, the decision

of the government to withdraw those notes had to be made on the recommendation of the central board of directors of the RBI. Many entertained doubts whether this recommendation to the government happened after due deliberations. It was not clear if there was a special meeting for discussing the demonetization issue. Many come to the conclusion that this was a decision of the prime minister, the RBI had an executive role only. If that was the case then the autonomy of the RBI has been severely compromised.

The second rule which formally curtails the independence of RBI is the government right to remove the governor. Section 11 of Chapter II of RBI Act states: (1) “The Central Government may remove from office the Governor, or a Deputy Governor or any other Director or any member of a Local Board” (p. 22). Freedom of action by central banks clearly requires fixed tenures for those who head these institutions. Their removability represents a clear counter-incentive to drive monetary policy by the sole goal of price stability.

However, new governments rarely called for new central bank governors quickly. There have been only two instances in the central bank’s history of India in which the governor was changed right after a new government came to power.

“So, you have to distinguish what is *de jure* (by law) and what is *de facto* (in reality) and I think *de facto*, the RBI is independent,” Raghuram Rajan made this comment at a press conference in 2015. That is to say, that India represents a unique case in regards of central bank independence. In most countries, *de jure* independence is higher than *de facto*. India is one of the very rare countries where the reverse is the case.

Conclusions

In the period prior to the global financial crisis, there was an almost general agreement in that the independence of a central bank is a necessary condition of achieving price stability. Independence meant the use of instruments free from the influence of short-term political interests rather than the fundamental goals of the central bank’s mandate and monetary policy. Society’s control over central banks was ensured by the fora of rendering central banks accountable, and the specification of central bank goals by the legislature. By the early 2000s, central banks enjoy a high level of *de jure* independence in most countries. The *de facto* independence of central banks was, however, substantially less than indicated by formal independence indices because of the political criteria enforced in the course of the appointment (and recall) of central bank decision-makers and the political pressure exerted on monetary policy decision-making. It may be a case of pseudo-independence, when a former politician earlier serving in the government or a servile official serving the political interests of the government is placed to head the central bank. After the global financial crisis, the validity of the theoretical considerations laying the foundations for central bank independence transitorily weakened. Neither increasing inflation in the interest of achieving price stability, nor the fiscal financing becoming necessary to enhance the elbowroom of the budget required central bank independence. With the future normalisation of the macro-economic situation, however, these considerations do not lose their validity. Monetary policy goals can be achieved with the highest degree of security with the independence of the central bank also in the post-crisis period. In the wake of the global crisis, the scope of authority of central banks was expanded with the protection of financial stability. Macro-prudential activity can, however, be carried out only in cooperation with the government. Central bank independence is not possible in this area. The two goals and the two forms of operation can be aligned only with grave difficulty. It is difficult to safeguard the independence of monetary policy, simultaneously with the macro-prudential activities carried out in cooperation with the government. The negative social consequences of central bank independence shrinking de

facto will become visible when a tightening monetary policy will become necessary in the interest of achieving price stability in the future, but the central bank may not have sufficient power to bring decisions that might be different from the short-term interests of politicians.

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