Comité Latinoamericano de Asuntos Financieros
Comitê Latino Americano de Assuntos Financeiros
Latin-American Shadow Financial Regulatory Committee

Statement N°4

October 18th, 2001
Montevideo, Uruguay

CENTRAL BANK INDEPENDENCE: THE RIGHT CHOICE FOR LATIN AMERICA

The Latin American Shadow Financial Regulatory Committee (LASFRC) met at a time of increased volatility in international financial markets. Capital flows to all emerging markets have dwindled and net private debt flows have been negative for their third straight year. Latin America has not escaped this trend, and some countries are undergoing exceptional stress. This adverse international financial environment has caused a marked decline in economic growth in the region, has made it harder for countries to adjust to declines in the terms of trade, and has amplified internal fiscal weaknesses.

While recognizing the need for countries to adopt prudent and consistent macro policies to face up to this situation, the LASFRC believes that the international financial community should strive to adequately address the important systemic problems present in capital markets. In part, these have been exacerbated by uncertainty over the policies of the international financial community towards countries under stress. In addition, contagion remains a key characteristic of financing flows to emerging markets, and efforts should continue in understanding its causes and limit its effects.

Notwithstanding the importance of international systemic issues, the Committee considers that institutional reform at the national level is an essential ingredient in the quest for financial stability. This meeting was dedicated to discussing one of these reforms: central bank independence in Latin America, its trend and conditions fostering it.

1. Why Central Bank Independence?

There has been increasing recognition of the economic and social benefits from low and stable inflation. Attaining low and stable inflation, however, is fostered by shielding the central bank from pressures to utilize monetary policy for conflicting economic objectives.

Especially after the experience of the seventies and eighties, the political community in Latin America increasingly gained understanding about the negative consequences of inflation in terms of its adverse impact on economic growth and employment. This process implied recognizing that it has generally been lax fiscal and wage policies, “financed” by expansionary monetary policies, that caused the region’s chronic experience with external disequilibria and high and erratic inflation, which in some countries evolved into hyperinflation. From this perspective, the creation of independent central banks can be seen as a reaction to these experiences and as an attempt to institutionalise the achievement and preservation of economic stability in the region.

Over the last decade Latin America has made significant progress in adopting central bank independence, starting with Chile in December 1989, and followed by Colombia in 1991, Venezuela and Argentina in 1992 and Mexico in 1994. More recently, Peru and Brazil have initiated legislative actions towards adoption of central bank independence.

Notwithstanding this encouraging trend, there have been setbacks to the process, notably in Argentina and Venezuela. In the former case, the President of the Central Bank was removed from office over disagreements with the government, and the charter of the central bank was changed by executive decrees without due intervention by Congress. In the latter case, the mandate of the central bank was widened in a way that potentially weakens the achievement of price stability.

2. "Fundamentals" of Central Bank Independence

There are seven key aspects that, in the view of the Committee, constitute the core of central bank independence[1]:

i) Clarity of the mandate to be pursued by monetary policy;

ii) Freedom for the central bank to set the stance of monetary policy;

iii) The central bank should have complete command over its own credit and, in particular, should be under no obligation to extend credit to the government;

iv) Sufficient financial and administrative autonomy;

v) Security of tenure and well defined appointment and removal procedures for central bank board members;

vi) Central bank accountability; and

vii) Transparency of its decision making process and its operations in order to foster confidence.

Clarity of the mandate to be pursued by monetary policy

The mandate of monetary policy should be focused, well defined, and technically feasible. Until the early nineties Latin American central banks had to pursue simultaneously many and potentially contradictory goals. In contrast, the recent move towards independent central banks has involved a legal requirement to concentrate mainly on achieving price stability[2].

[1] The institutional location of the bank supervisory and regulatory activity is, as is well known, quite a debatable issue. This topic will be addressed by the Committee in a future statement.

[2] In some cases, price stability has been accompanied by other objectives, such as regulating and safeguarding the payment system, and regulating and supervising banks.

Clarity of objectives facilitates the evaluation of central bank performance and better defines its accountability. Hence, it enhances independence as it reduces the scope for political interference.

Freedom to set the stance of monetary policy

Monetary policy formulation and implementation should be placed under the exclusive responsibility of the independent central bank. Achieving price stability may require that central banks act forcefully and on a timely basis so as, for instance, to counterbalance inadequate fiscal policies. Often, they need to point out in an outspoken manner the risks to price stability implicit in fiscal and/or wage policies which are not coherent with overall macroeconomic equilibrium.

Given the close interrelationship between monetary and exchange rate policies, if the latter is under the responsibility of the Ministry of Finance, it should be appropriately coordinated with the central bank.

Independent central bank charters often state that, when pursuing primarily the objective of price stability, shall also "take into consideration the general economic policy of the government". The latter should be understood as requiring proper consultation and two-way communication between the central bank and the government rather than as a government's attempt to influence central bank decisions.

The benefits obtained from independence are strengthened by fluid coordination and collaboration between the central bank and the government. Such a relationship should be built by developing frequent and open exchanges of information, diagnosis and projections so as to develop an overall coherent macroeconomic policy framework.

The central bank should have complete command over its own credit and, in particular, should be subject to no obligation to extend credit to the government

An important reason to justify central bank independence is the need to establish institutional checks on fiscal deficits. At a minimum, the central bank should be subject to no obligation—and should be free to refuse—to extend credit to the government. If such an obligation existed, the central bank would effectively lose its control over domestic liquidity, and hence over inflation. Therefore, the central bank should be free to deny financing to public banks as well as to all non-bank financial entities. In addition, when providing credit to financial entities, it should do it only under well defined conditions and in a way that is fully consistent with the objective of maintaining price stability.

Sufficient financial and administrative autonomy

In order for the central bank to be effectively independent it is necessary for it to be empowered to autonomously elaborate its internal budget, albeit not in a capricious manner but in accordance with criteria defined in the law so as to ensure that the bank's expenditures be reasonable. Compliance with the above-mentioned provisions should be subjected to regular auditing performed by an external auditor not appointed by the bank, whose report should be sent to both the Executive Power and Congress.

When considering central bank expenditures, however, it is important to distinguish between operational expenditures and those related to the special nature of its policy functions. Thus, for instance, sterilization of the effects of foreign exchange intervention on domestic liquidity following the attempt to reduce an exchange rate appreciation may lead to losses for the central bank. Unlike operational ones, this type of expenditures should not be subject to the above-mentioned provisions.

Security of tenure and well defined appointment and removal procedures for central bank board members

The tenure as well as the appointment process and removal procedures of board members is essential to ensure transmission of experience from older to newer members and that their decisions be protected from pressures, threat or inducement, be it from government, Congress and/or private interests.

In the view of the LASFRC central bank independence requires that:

a) The process to appoint board members should involve both the Executive Power and Congress.

b) Board members' terms of appointment should generally exceed, in length, those of most political office-holders. If board members' appointment period is too short, then difficult and politically costly policy decisions may be avoided or postponed.

c) Board members should be appointed in a staggered fashion, so that no new government can change the entire body at once. In this way, representation at the board will be broad, allowing for change while at the same time maintaining institutional tradition and experience.

d) Once appointed, board members should not be dismissed at the discretion neither of government nor Congress. Removal of board members should only occur for specified reasons, such as criminal conviction, conflict of interests or serious misconduct, and following procedures clearly established in the law.
e) Board members should hold no other position (except of an academic nature) in the private or public sector.

Central bank accountability

It has been alleged that in some cases legislation has given central bank board members an excessive degree of immunity from the normal process of accountability applicable to other public institutions in democratic societies. Obviously, in conferring independence to central banks, government and Congress have every right to expect the central bank to be accountable.

Accountability should mean no loss of independence to set the stance of monetary policy. Rather, it means holding the central bank responsible for attaining its policy target and for appropriately managing public resources. It is usually exercised by requiring, by law, that central banks provide all the relevant information to the government, Congress and/or the public at large at least twice a year. While these reports are widely disseminated, Latin American Congresses often do not analyse them with sufficient attention. The Committee believes that in a democracy there is a strong case for requiring that the central bank's board be subjected to regular hearings with specialized congressional committees.

Transparency of its decision making process and its operations in order to foster confidence

Transparency and disclosure to the public of relevant information regarding central bank operations and decision making process is an essential component of the process of building institutional reputation and credibility. The Committee believes that a policy of transparency and disclosure, through market discipline, is also a crucial element that supports central bank independence, as the likelihood of undue political interference is greatly diminished when monetary policy is subject to informed public debate.

Transparency and disclosure also reinforce central bank accountability facilitating the verification of the compliance of central bank policy with its mandate.

3. Constraints to Central Bank Independence

The effectiveness of the central bank, and thereby its credibility, may be weakened by a number of factors. For instance, the presence of a large stock of short-term public debt or of debt indexed to the short-term interest rate creates an extraneous link between monetary and fiscal policy. In such a context, monetary tightening designed to bring inflation down may not be as effective since it will worsen the fiscal accounts and cause market concerns over the sustainability of the public debt, thus increasing expectations that the system will need to resort to inflation in the future. A similar problem may occur when monetary tightening can lead to banking problems that would cause future quasi-fiscal losses.

Under these conditions, the effectiveness of the central bank may be hampered by its inability to convince markets of its capacity to achieve its policy goals. The implication is that central bank effectiveness is enhanced by an appropriate public debt level and structure and by a strong banking system.

4. What Kind of Central Bank Independence?

There are two principal models of central bank independence. One involves the central bank being empowered both to decide on the specific target of monetary policy, within a fairly general objective specified in legislation, and to choose the appropriate monetary policy instrument to achieve that objective. This is often referred to as "goal and instrument independence", and is epitomised by the relationship which the Bundesbank had with the German government prior to the establishment of the European Central Bank. This is currently the most common form of central bank independence, and is adopted by such central banks as the Federal Reserve System in the United States, the European Central Bank, the Bank of Japan, the Swiss National Bank and the central banks of Chile and Mexico.

The second model empowers the central bank with the independence of choosing the monetary policy instrument, but the objective which must be achieved is defined by, or in agreement with, the government. The central bank is accountable for delivering that objective. This is referred to as “instrument independence”, and was first formally adopted in New Zealand in 1989. Australia, Canada and the United Kingdom have since adopted it.

Whichever model is chosen, the Committee believes that there should be a close coordination between central banks and their respective governments in setting the targets, as it is difficult to attain them without such coordination.

The Latin American Shadow Financial Regulatory Committee (LASFRC) gratefully acknowledges financial support by CAF for funding its meeting in Montevideo. The Committee is fully independent and autonomous in drafting its statements.