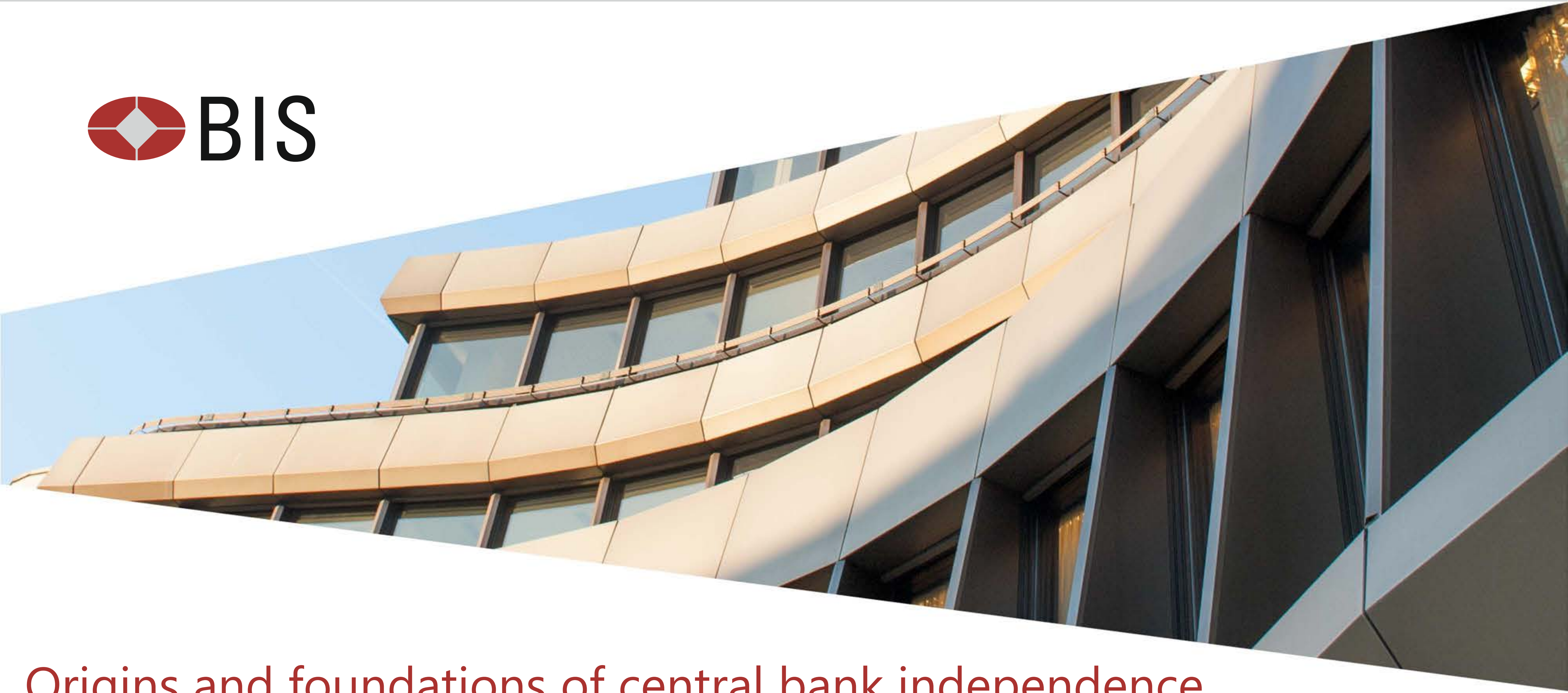

Origins and foundations of central bank independence

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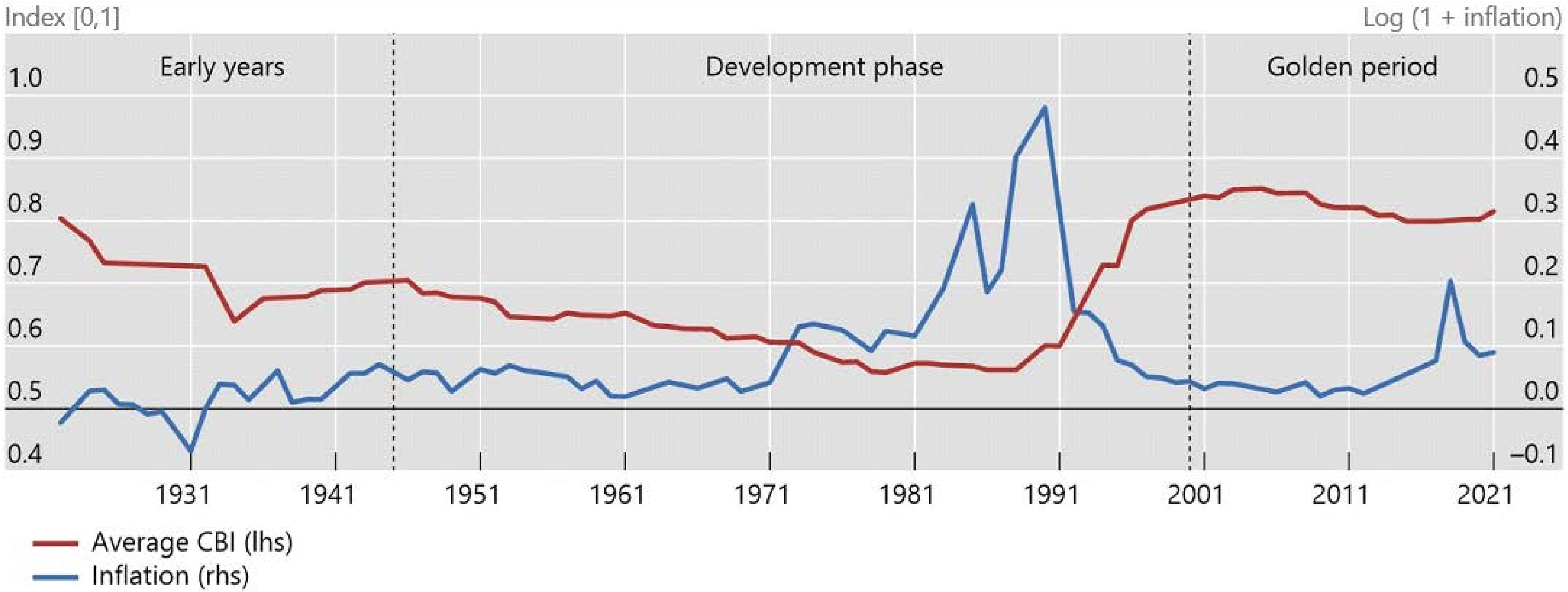
Central bank independence in the face of present and future challenges

Bank of Spain, Madrid, 17 January 2025

Widespread acceptance of central bank independence

- Broad adoption of central bank independence

One hundred years of central bank independence and inflation in Latin America | Graph 1



Notes: the central bank independence index takes values between 0 (minimum) and 1 (maximum).

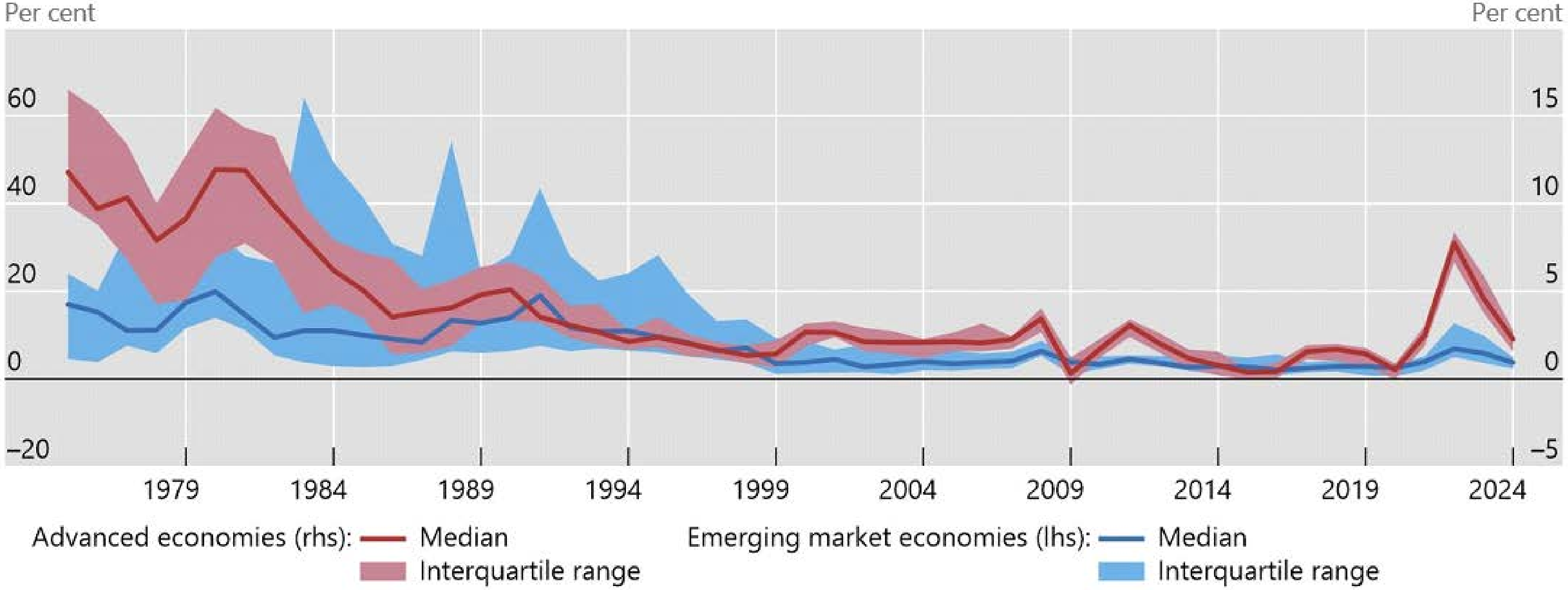
Source: Jácome and Pienknagura (2022).

Widespread acceptance of central bank independence

- Main reason: independence helps to keep inflation in check

The decline of inflation over the past decades

Graph 2



Source: BIS.

Widespread acceptance of central bank independence

- Despite consensus on its importance, there is no single formula for its adoption
- National characteristics
  - Inflation record, financial stability
  - Political regime
  - Temporal / conjunctural / structural factors
  - Economic and financial development over time

Conclusion: independence can be perfected over time

Objective of the presentation

- Certainly <u>not</u> to specifically assess the arrangements in a particular country or central bank, but to...
- Dissect in detail generic independence schemes, highlighting their:
  - Origins, which are:
    - Social
    - Political
    - Legal
    - Economic/financial/technical
  - Practical implementation
- From the analysis, identify those aspects that would appear to be most subject to revision/refining

Reasons for the preponderance of central bank independence

- Fundamental issue for central banks: *the nature of money*
- Fiduciary money has no intrinsic value. Its value derives from the social convention that underlies it, and from the institution that enables it to function: the central bank.
- Money has value if the public trusts that others will recognise its value, today and in the future
  → the value of money derives from *trust*
- Abuse of issuance erodes trust in money and the issuer, leading to inflation, depreciation of the national currency and financial instability
  - At the extreme: hyperinflation, financial instability, recession and mass unemployment
- History shows that governments can succumb to the temptation to abuse the power of issuance

The dire consequences of the loss of trust in money are the rationale for central bank independence

Nature of the granting of independence

- Essential: delegation of the state's own powers to an institution created specifically to exercise such powers.
- Four relevant dimensions:
  - Social: consensus in the population on the desirability of having an entity within the state dedicated primarily to protecting the value of money
  - Political: delegation of powers
  - Legal: formalisation of the delegation of powers
  - Economic: economic and financial underpinning of the law of independence, technical solution to the challenge of "guaranteeing" the value of money
- Social consensus represents the political support for legislating independence
- The law of independence specifies the scope of the delegation of powers and the manner in which these powers may be exercised

Independence: social arrangement to preserve the value of money

Independence is designed to inspire trust

- Trust: society's expectation that authorities will act in a predictable manner in pursuit of predefined objectives and that they will be successful in their mission
- With trust
  - The public incorporates central bank action in determining their behaviour
  - Central bank is more likely to achieve its objectives
  - Enhanced legitimacy of policies
- Trust is acquired by linking together the achievement of objectives
- Important to establish clear policy goals, subject to evaluation
  - Authorities must continuously take decisive action in a visible way in pursuit of their objectives, particularly when deviations occur
- Feedback in the trust dynamic

This logic must underlie the structure of the law of independence

Main principles in statutes of independence

- Mandate(s) assigned to the central bank
- Policy instruments/powers
- Anticipated accountability
- Provision of budgetary resources to carry out its functions
- Governance of the institution
- Relationship with the government

Mandate(s)

- The fundamental purpose of central banks is to provide legal tender (primary money) to the economy
- The central bank does this by using its balance sheet and the terms under which it changes it, which represents monetary policy as a whole
- Monetary policy is very powerful
  - With varying degrees of effectiveness it can affect various margins:
    - Value of the currency
    - Inflation
    - Economic growth, employment
    - Stability of the financial system
- The historical evidence is compelling: monetary policy is most effective in ensuring the stability of the value of the national currency and in ensuring low and stable inflation

Keeping inflation under control is generally the primary mandate of most central banks, but not the only one

Mandate(s) - 2

- Keeping inflation low and stable is an end in itself, and a means to achieve broader objectives in terms of the welfare of the population

- The promotion of economic growth and employment is frequently mentioned as a central bank objective

- There is not much evidence that monetary policy can affect potential growth, although it can have an impact by smoothing business cycles

Central banks do not always have a priority mandate to promote economic growth and job creation

This is often a subordinate objective to the primary objective of pursuing price stability

Mandate(s) - 3

- Bank money, the result of intermediation by commercial banks, is central to the monetary system
- For society, primary and bank money are indistinguishable: this is no coincidence!
- The central bank is part of the institutional arrangements for extending trust in primary money to bank money
  - Key element: irrevocable reconciliation of interbank payments on the central bank's balance sheet
  - This guarantees the finality of payments and the singleness of money
  - At the extreme, the central bank provides liquidity as lender of last resort

Inescapable mandate: ensuring the smooth functioning of the payment system

Mandate(s) - 4

- The banking system must also remain solvent
- Regulation and supervision are essential
- Financial crises (not just banking crises) are extremely costly for society
- The health of the non-bank financial system needs to be monitored
- Under normal conditions, the health of the financial system should not impede the central bank from using monetary policy to meet its primary objective

It is essential that the central bank have a mandate to ensure the stability of the financial system

- Mandates may conflict with each other
  - Prioritisation is key
  - The more mandates, the greater the likelihood of dilemmas and controversy

It is advisable not to overburden the central bank with mandates

Central bank tools

- Functional independence: in general, statutes provide for central bank independence in the use of its tools
- In many cases: explicit prohibition on extending direct funding to the government
- Tools derive from the use of the balance sheet and the terms on which the central bank performs operations
- Types of tools:
  - Credit to the financial system (direct or repurchase agreements)
  - Deposits of the banking system with the central bank
  - Open market operations (public and private securities)
  - Remuneration of bank liabilities (reserves)
  - Reference interest rates
  - Use of international assets
  - Exchange regime
  - Ability to regulate financial operations/entities
  - Supervision of banks and other financial intermediaries
  - Communication

Monetary policy

Foreign exchange policy

Financial policy

Tools - 2

- The central bank tends to establish monetary policy strategies, whereby it may use more than one monetary policy tool
  - Example: Inflation targeting regime
    - Commitment to use tools to achieve inflation target, high degree of discretion
    - If the target is credible, the inflation target becomes a fundamental reference that society incorporates in its price and wage decisions
      - Expectations are anchored
    - Communication is essential in this strategy

- Strategies for acting as a lender of last resort

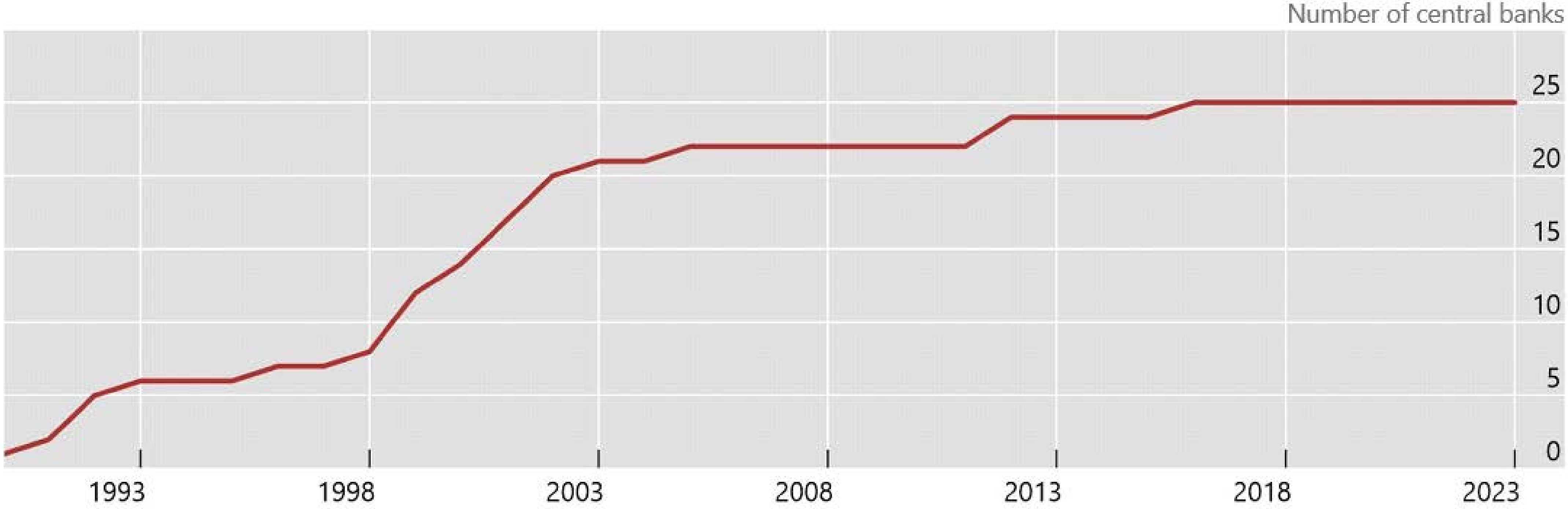
- Strategies for acting as a market-maker of last resort

Financial stability

Inflation targeting on the rise over the last 35 years

Growing adoption of inflation targeting regimes

Graph 3



Notes: euro area countries count a single jurisdiction.

Source: Borio and Chavaz (2025).

Tools - 3

- In terms of foreign exchange and financial system regulation and supervision, the central bank does not always have all the necessary tools
  - Shared responsibilities requiring collaboration with other levels of government

- In general, central banks have limited tools: argument for limiting objectives

It is essential that tools correspond with objectives

Accountability

- The key point is to answer the following question:
  - Has the delegation of powers been well used?
- Helpful to have clear, measurable and limited objectives
  - Inflation targeting
  - If there are too many targets, trade-offs arise and accountability becomes very difficult
  - Prioritising is essential
- Operational transparency
- In-depth explanations of:
  - Determinants of inflation, economic growth
  - Monetary policy transmission mechanisms
  - Evaluation of adopted policies
- Motivation for the policies adopted, clearly distinguishing the objective pursued
- Vehicles: marketplace, reports, speeches, appearances before the legislature, press conferences

Budget sufficiency

- The central bank must have the financial resources needed to carry out its functions
- It must be able to obtain and invest in excellent human capital
- Easy access to new technologies
- Transparency in the use of resources
- As far as possible, replicate the spirit of austerity of governments

Budget shortfalls should not be a conduit for limiting or imposing conditions on independence

Governance

- The central bank's governance should reinforce its independence

- Preferably delegation of powers:
  - A group of individuals (board of directors)
  - Technical, diverse, multidisciplinary profile
  - Appointment for relatively long, staggered periods, limited renewal
  - Proposed by the executive branch, approved by the legislative branch
  - Differential powers for the Governor (board member and CEO)
  - Dismissal process foreseen in the law

- Strict code of conduct, to avoid conflicts of interest

No single formula – depends on national characteristics

Relationship with the government

- Highly complex, largely by design; multidimensional

- Delegation of powers is <u>sure</u> to create friction

- Operational independence must be asserted
  - <u>No one</u> can instruct the central bank how to use its credit and interest rates
  - Explicit ban on funding of the government
  - <u>Fiscal dominance</u> should be avoided

- Independence does not imply isolation: daily interaction desirable

- To the extent that the achievement of its objective(s) is not jeopardised, the central bank should support the government

Relationship with the government - 2

- Inflation does not depend solely on monetary policy. Public policies, in particular fiscal policy, can have an impact on inflation.
  - <u>Argument for continued dialogue between authorities</u>

- Shared responsibilities: financial stability and exchange rate policy
  - <u>Essential coordination and cooperation</u>

- The central bank as financial agent of the government: non-controversial

- The central bank as adviser to the government: positive but in some cases controversial

- Profit-sharing / central bank capitalisation: can be very controversial
  - Some profit-sharing could represent primary issuance / direct financing to the government

Relationship with the government - 3

- Central bank operating losses
  - Potential friction with the government
  - Can generate political and social unrest
  - Justifiable as they derive from efforts to comply with mandate(s)
  - Law must provide legal support
  - Communication effort by the central bank

In general, it should be in the government's interest to support central bank independence

Conclusions

- The statutes of independence of the vast majority of central banks share a logical structure that has proven to be successful

- Core issues are generally well addressed

- In some cases, certain aspects can be improved upon, for example:
  - Composition of governing bodies
  - Appointment processes of Governors / board members
  - Clarification of financial stability mandates, in the light of the financial system's increasing complexity
  - Providing for periodic reviews of monetary policy frameworks

In any case, if any amendment to the statutes is contemplated, it should be in the direction of strengthening independence and increasing its legitimacy