Independence and responsibility of Central Bank

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A central banks have been created by a government to sub-serve goals of the government.

A central bank has governmental power behind it. ⇒ It is powerful.

A government may abuse a central bank to achieve its special-interests.

⇓

Pressure for central bank independence.

Question: Does formal independence of a Bank ensure its actual independence?
A central bank management is a bureaucracy—it has its own goals.

There is a great information asymmetry between a Bank management and both politicians and the public.

There are more special-interest groups than just a government there.

Hypothesis: *Information asymmetry opens a Bank to tacit pressure of a government, and perhaps to a push of other special-interests groups again—if they can threaten or “bribe” the Bank management.*
Structure of Presentation

- Bureaucratic nature of a central bank
- Incentives of central bankers
- Stakeholders, their incentives and potency
- Summary of the hypothesis
A central bank has been created by a government to serve a government. (Kane, 1980)
It could not have evolved spontaneously. (White, 1999)
It has privileges—it shares the governmental power.
It has no inherent goal—its goals are given by politicians.
Its goals cannot be derived from individual preferences of the public. (Rothbard, 1956)
Its personnel is appointed by a government.

A central bank is a special type of a bureau.
Papers on “Central Bank as Bureaucracy”

Original:
- Chant–Acheson (1972), Acheson–Chant (1973a, b)
- Kane (1980)
- Friedman (1982)

Partially also:
- Toma (1982)
- Goodfriend (1986)

Summary:
- White (1999, chapter 8)
Central Bank Strategies

In an uncertain world “optimal” strategies can be found only by the market process. “Optimal” is what is able to survive in competition. (Alchian, 1950)

A Bank has no competition—its strategy is not “proved”.

Bank’s environment is complex: A Bank changes it by its actions—it’s ability to learn from the past is limited. (Lucas, 1976)

There is no generally accepted central bank strategy.

It is hard to check Bank’s actions.
Managerial Discretion

Managers that are not “residual claimants” may act in their benefit at the expense of the “residual claimants”. (Jensen, Fama, Meckling)

The higher information asymmetry, the higher managerial discretion.

The lower bottom line, the higher managerial discretion.

Managerial discretion of central bankers is high because

- great information asymmetry
- very complex task
- no enforceable rules
- possibility to increase information asymmetry
- no real bottom line (esp. of an independent Bank)
Incentives of Central Bankers

Goal of central bankers: To maximize the prestige under the constraint of self-preservations.

Some results:

- secrecy, obfuscations (Friedman, 1982, Acheson–Chant, 1972, 1973a, b)
- resistance to rules (Friedman, 1982)
- struggle for independence (Friedman, 1982, Acheson–Chant, 1972, 1973a, b)
- effort to avoid a conflict with a group that can change their social status (Kane, 1980)
A Bank tries most eagerly to achieve those goals that are

- identified with the bank most
- most easily monitored
- most important for the group that may threaten the bank

The most potent group is the group that

- has superior understanding of Bank’s actions
- has a power over the bank
Application: Central Bank as a Scapegoat

Great information asymmetry and managerial discretion may be for a government beneficial. (Kane, 1980)

- a Bank may obey tacit commands of a government—even those aiming special-interests of the government
- a government may use a Bank as a scapegoat—to blame it in hard times
It is realistic to assume that central bankers consider their personal gains too.

It is possible to “bribe” them:

- offering of a future job
- offering prestige and popularity within a group
- patriotism
- “among us, bankers”
- ???
- . . .
Central Bank Policy

We can expect that the Bank’s policy would be influenced by interests of stakeholders that are able to threaten it or “bribe” it.

We have to analyze incentives and potency of these stakeholders.
Stakeholders

There are many potential stakeholders:

- a central government
- local governments
- the public
- banking and industrial pressure groups
- ???
Central Government

The government that is the nearest principal to a Bank.

It can influence the Bank most:

- it has power over the Bank
- it sets the formal goals for the Bank
- it appoints the Bank management
- it can change the social status of the Bank, its independence, ...
- it is able to monitor the Bank actions best
- it has the best opportunity to “bribe” the Bank management
Goals of Government

To maximize the probability of its reelection.

⇓

Three types of policies: Policy that

1. is preferred by majority of voters ⇒ formal goals for the Bank
2. bribes special interest groups (e.g. interest rates lowering in the benefit of an industry, or transfers financed by seigniorage) ⇒ informal goals for the Bank
3. cheats voters (e.g. political business cycle) ⇒ informal goals for the Bank

The policies are inconsistent—the government has to choose.
Abuse of Monetary Policy

The policy no. 2 and 3 can be called “abuse” of monetary policy.

They are more successful if they are not known.

Higher discretionary power of the Bank allows it to obey the government—secretly.

An attempt to abuse the policy can be more visible if the bank is not independent. The independence can be a veil.

The higher Bank independence, the lower direct control of the government (but still present), and the higher benefit of the abuse (it is worse seen). ⇒ The total effect is ambiguous.
Local Government

The government that has no direct power of the Bank.

Similar incentives and temptations as the central government.

Still ability to “bribe” central bankers—offering future jobs.

Higher temptations to “abuse”—it is not officially responsible for the monetary policy.

The case of European Central Bank.
Preferences of the majority change over time.

It can influence the Bank

- indirectly—through a government
- directly
  - offering prestige
  - offering safety

The Bank can seek the goals of the public and not of the government, if the public is able to protect it against the government—it would loose voters.
Banking and Industrial Pressure Groups

They may influence the Bank indirectly through a government.

Perhaps a banking industry may try to “bribe” central bankers—offering future jobs, prestige, . . .
Other Special-Interest Groups

(For the sake of completeness only.)

Sometimes there can be other powerful special-interest groups, e. g. inflationist movement in the US in the 19th century. (Friedman, 1994)
A central bank is a governmental bureaucracy. Its managers are governmental bureaucrats.

Their incentive is not to achieve “the optimal monetary policy” (which is an ambiguous term), but to maximize their prestige within the constraint of self-preservation.

As bureaucrats they are hired to follow the instructions of the actual government.

This link can be weakened by the central bank formal independence, but it cannot be totally removed.

Managerial discretion stemming information asymmetry cause that the governmental control of the Bank can never be complete.
Overall Effect of Increased Bank Independence

The higher Bank independence lowers the direct governmental control of monetary policy.

But it rises incentives to “abuse” it because it is more difficult to monitor the Bank’s actions and because they are less identified with the government.

There are other stakeholders too.

The outcome of their “game” is determined by their interests and their relative power—which change in the time.

The overall impact of raising the central bank independence is ambiguous.
Proposal for Future Research

We still have to find evidences supporting (or falsifying) our hypothesis.
Thank you for your kind attention. Any questions, comments, or hints?