SAFEGUARDING CENTRAL BANK INDEPENDENCE[1]

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The broad turn towards central bank independence can be traced back to the 1970s and 1980s. Many countries were experiencing high inflation. Therefore, attention focused on overcoming 'time inconsistency', a problem inherent to monetary policy. This is the risk that policymakers, for political reasons, will aim for short-term gains through expansionary policies, since their costs will not be visible immediately. Proposals to enhance central bank independence emerged as a viable device to face these challenges.

The case for independence has strong underpinnings, but there has been growing doubt over its merits. This was initially a consequence of the monetary policy response to the 2008 financial crisis, particularly in the largest advanced economies. First, amid low inflation, some argued central bank independence was no longer justified. Second, as major central banks implemented quantitative easing measures, there were concerns these institutions would end up shaping fiscal policy, which is beyond their remit. Third, greater central bank involvement in financial stability raised doubts about entrusting them with too many endeavors, and on the consistency of these tasks with independence. Fourth, detractors of independence identified it as an obstacle to coordinate monetary and fiscal policies, while also worrying about the distributional implications of quantitative easing.

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These arguments are paradoxical. In the absence of an adequate and timely reaction by fiscal and structural policies in the aftermath of the financial crisis, monetary policy became the only tool to bolster the world economy. There are also strong indications that, without independence, central banks would probably not have been able to undertake the measures needed to face the crisis.

Furthermore, the above-noted question marks about the merits of central bank independence can be easily refuted:

- Independence is still needed in a low-inflation environment. Inflation declined partly as the result of the recessionary effect of the financial crisis. There are other factors helping to contain inflation, but their future potential impact is uncertain.
- Trade-offs with financial stability goals have always existed, as well as incentives to consider them.
- Consistency of public finances with central banks' goals is the key issue for proper coordination between fiscal and monetary policies. This does not imply, though, that central banks should be stripped of their independence.
- Over the long run, the distribution of resources owes mostly to fiscal, structural and institutional factors.

Fresh criticisms against central bank independence have come to the fore recently. These are politically motivated and their dissemination across both advanced and emerging market economies is alarming. They are again the result of developments following the financial crisis and have found widespread support among those disenchanted with globalization. This is

particularly worrying in emerging markets, since their institutional frameworks are more vulnerable to tensions.

Failing to protect central bank independence would cost the economy dearly, especially in emerging markets. Their central banks' primary mandate—price stability—would be jeopardized. It could entail a return to time-inconsistent monetary policies, with potentially severe macroeconomic and financial implications.

Many arguments support central bank independence. To deal effectively with price pressures, institutions need a long-term perspective, insulated from political considerations. They should be able to respond quickly to changing conditions, and have the technical competence and credibility to do so. Central bank independence has been key to stabilizing long-term inflation expectations and overcoming episodes of distress in many countries. Destroying the institutional framework that has made these achievements possible would be irrational.

Granted, central bank independence must be accompanied by checks and balances. Clear and transparent goals must be in place, and central banks must be held accountable. Existing concerns cannot be ignored. This is a time to reflect on what actions are needed to improve public understanding of the role of these institutions and the importance of their independence. Elected officials usually define central banks' mandates and the mechanisms to ensure accountability. However, central banks should guarantee that policies implemented are fully consistent with their mandates, and continuously evaluate means to enhance their transparency and accountability.