The Importance of the Independence of Central Banks

By {Student Name}

Course Number

Date

Professor

Word Count: 1937

The Importance of the Independence of Central Banks

Introduction

One of the most effective and efficient institutions in the management, regulation and reinforcement of a country's economic stability is the central banks (European Central Bank, 2017). To be able to execute their mandate without unnecessary influence from the government, their independence is imperative. Most of the policy instruments used by central banks focus on different functions which include but not limited to ensuring the stability of prices in a nation, maintaining a desirable value of national currency relative to other countries, regulating the supply and demand of money in the economy and ensuring the financial market stability among others notwithstanding (Vianelli, 2017). It is therefore quite important that any undue political turbulences be evaded in a bid to ensure that such important roles are executed without any fear of contradiction. This paper, therefore, seeks to explore the need to have the central banks independent in the execution of their mandates and functions in a particular country.

Explicating the Benefits of Independence of the Central Banks

In an article by Plender J. (2012): *The aims of Central Bank Independence*, institutional independence defines the ability of an institution to operate in a free environment without the influence of third parties in aspects such as the functioning, decision-making as well as in the exercising of its powers. The central bank is one such institution whose independence, when explored from a critical perspective, stems from four central characteristics- institutional independence, instrumental independence, personal independence, and financial independence. It is therefore imperative to explore these forms of independence in a broader scope in terms of the specific tasks carried by the bank and then relate them to the functional roles and how beneficial they are based on the applicable law of institutional independence.

First, institutional independence of the central bank is important because it helps in prohibiting the third party influence that can affect the structure, functioning as well as decision-making initiatives by the bank (European Central Bank, 2017.). In its broader discretion, this is indispensable because it gives the bank an ample opportunity to make decisions in a free and relaxed atmosphere which is not only important in enhancing the efficiency and effectiveness of the institution but also valuable in promoting the effectiveness and reduction of errors that can be caused by such interference. Through such institutional independence of the central banks, they can define constructive and rational monetary policies as well as quantify the primary long-term and short-term objectives of the price stability and price actions in a given country.

Instrumental independence of the central bank refers to the ability of the bank to determine various policy actions and tools to pursue the stability of prices in a country without undue influence from third parties such as the government and other financial institutions. This is important in many ways. By exercising this type of independence, it is obvious that the central banks can have the discretion to explain, use and clarify different monetary and fiscal policies that it implements and makes and how they are applicable in the context of law with regards to making outright purchases and even in understanding the aggregate collateral frameworks and those of the other counterparties which the banks work in close association with.

Personal independence of the central bank, on the other hand, defines the ability of the bank to safeguard its members and those of the European Central Bank to make independent decisions without the fear of contradiction or influence. Some of these decisions relate to those of making appointments as well as conducting dismissals from within and without its structure and framework. It also stipulates the length of the mandate going any longer than the expected electoral cycle within the institution. Under any circumstance based on the applicable principle of the personal independence of the bank, it is a requirement that any member of the executive board of the central bank is spelled out in the particular bank's treaty. This should precisely indicate their eight-year tenure as well as the circumstances which can lead to their dismissal or termination of contracts (Plender, 2012). Accordingly, the requirements for the appointment of the governors of central banks should always coincide with those of the national laws as well as the Governing Council and the provisions of the statute of ESCB. This type of independence, however, provides the same platform for dismissal of the members of the executive board and all are subjects to scrutiny by the CJEU. This type of central bank's independence is also one of the best in terms of protection of the employees of the bank against external influence such as those resulting from the political corridors.

The last type of independence of the central bank is the financial independence. This is one of the greatest provisions of independence provided by Article 282(3) of the Treaty of the European Central Bank. Ideally, this provides for the independence of the banks with regard to issues such as the management of the finances and making of autonomous budgets for the country. This is essentially important because it ensures that the bank has enough reserves for capital, staff as well as income which it can use to execute its core mandate and functions. According to the provisions of article 14.4 of the Statute of the ESCB, financial independence of the central banks empowers the Governing Council of the bank to object to different national functions of the countries in which they operate. This makes them execute their expected roles in line with their objectives without any influence from outside and thereby enhancing their sense of autonomy.

The entire concept of the independence of the central banks is an important venture for understanding how the banks plan, execute and implement their duties without influence from the external environments such as the governments and other financial institutions.

According to Peter Bihari (2018), there are additional benefits attached to the independence of central banks which stem from the fact that the banks do not operate under the influence of the political business cycles. The influence of the businesses of the central banks from the government of the day in various countries is so much to an extent that it plays a significant role with regards to the economic business cycles and the role it plays in the elections of these countries. Based on this fact, it is verifiable evidence that the central banks control the government's decision to conduct re-election among different countries (Pettinger, 2017). This happens especially at a time when the central banks decide to reduce the rates of interests significantly in a nation. When this happens, there is usually a lot of money supply into the economy leading to its substantial growth and expansion. At such times, it is possible for such governments to organize successful re-election because there are enough funds for the exercise. In this sense, the independence of the bank plays a key role because it influences the government's decision to conduct such activities in a nation. The implication is that if the central banks are not strong enough to stand firm by their decisions, then they can be influenced by the government and this can be detrimental to the nation in many ways. Usually, such a large supply of money into the economy leads to the creation of unemployment. Therefore, the independence of the central bank in influencing government decisions cannot be underscored.

Another imperative benefit that arises from the independence of the central banks is the insulation of a country's monetary policy from the influence of the politics and the pressure of the election. In the short-term perspective, this leads to the expansion of the economy of the country through a reduction in the cost of inflation. A country whose central bank is independent is has a lot of benefits when it comes to the protection of its monetized debt. This makes the governments remain committed in its efforts to reduce the cost of inflation at the expense of raising the interest on borrowed capital and loans by its citizens. This is usually achieved under two important models; the goal and the operational model. Precisely, the goal model enables an independent central bank to clearly set its objectives relating to the country's monetary policy such as the stability of the prices and the appropriate targets of inflation. The operational model seeks to stabilize a country's fiscal policy by the implementation of measures such as quantitative easing and tracking of fiscal conservatives. These aggregately lead to better performance of the central banks compared to when they would have been dependent or controlled by the governments of the respective countries.

The independence of the central bank reduces the rates of inflation in a country. Rationally, it is the mandate of the central banks to keep and track records of inflation in different countries. These statistics are then used to make decisions such regarding fiscal and monetary policies in a country. If such a noble role would be given to the respective governments, there would be a significant failure in the governments tracking the records and eventually allowing the growth of inflation in a country. This would lead to the growth of inflation beyond expected levels. It is therefore important that the autonomy of independence be accorded to the central banks especially regarding the making of such monetary and fiscal policies. In this sense, the independence of the central banks is unavoidable.

Vianelli (2017) argues that the independence of the central banks also increases a sense of accountability, credibility, and transparency among the citizens of a given state. When the citizens become confident in the operations of the central bank, it is certain that the levels of the inflationary expectations will decline compared to when such confidence does not exist. This can only occur when the central banks are independent in the making of decisions and implementation of their policies. It also gives the banks the ability to earn transparency and conduct credible operations because the environment is conducive and provides for that.

Conclusion

Arguments for and against the benefits of the independence of central banks can best be explicated from the perspective of the need to control the monetary and fiscal policies. Arguably, if such a mandate would be left in the hands of the government, then a number of issues would arise such as increased inflation rates and poor decision-making on monetary and fiscal policies. It is quite evident that through the independence of the central banks, such decisions can be made without any fear of contradiction from the political and business cycles (Pettinger, 2017). Precisely, this sense of independence is what leads to the establishment of stable economic policies in a country such as a price stability and favorable monetary policies. Eventually, the citizens' expectation of inflation declines and their confidence is increased about the operations of their country's central banks. In this sense, the independence of the central bank is such an indispensable concept and cannot be underscored.

References

European Central Bank. (2017.). Central bank independence revisited. Retrieved from https://www.ecb.europa.eu/press/key/date/2017/html/sp170330.en.html

Koziuk, V. (2016). Independence of Central Banks in Commodity Economies. *Visnyk of the National Bank of Ukraine*, *2016*(235), 6-25.

Peter Bihari. (2018). Independence and Accountability of Central Banks With a Special Focus on India. *Economics World*, *6*(2).

Plender J. (2012). The aims of central bank independence. Retrieved from https://www.ft.com/content/f2676caa-2779-11e2-8c4f-00144feabdc0

Tejvan Pettinger. (2017). Benefits of Central Bank Independence. Retrieved from https://www.economicshelp.org/blog/165/finance/benefits-of-central-bank-independence/

Vianelli, A. (2017). The Changing Nature of Central Banks Independence: A Critic Perspective. *SSRN Electronic Journal*.