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By:

Marko Škreb[1]

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Mr. Chairman, distinguished ladies and gentlemen,

It is my great pleasure to participate in your Symposium with the topic of the Session: "Fiscal -Dominance and Independence of Central Banks." I would like to start with a caveat. I have no ambition for this speech to be an academic contribution or give some firm policy recommendations. I have good reasons to be humble about the goals. First, you are central bankers, experts in your field and I am sure that no one knows the functioning of your economies, central banks and relations with finance ministries better than you do. Second, the African continent is so vast, economies are very different and so are monetary regimes (from inflation targeting to monetary unions with pegs to the euro). In spite of an overall improvement in inflation and macro stability in general, the fiscal situation ranges from double-digit fiscal deficits to fiscal surpluses and the inflation record is equally diverse.[2] Some countries (or monetary unions) have modern laws with a high degree of *de iure* independence; some laws are not so modern[3]. Third, I admit, my knowledge about African economies is limited.

This presentation consists of two parts. First, I will discuss independence and fiscal dominance as well as their relation. In the second part, I would like to share some of my own views and experiences on this topic, the lessons that I have learned, first during my term as governor in my home country, Croatia (1996-2000), and afterwards while following central banking developments. As they say, once a central banker, always a central banker.

1. What do central bank independence and fiscal dominance mean?

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[1] Marko Škreb, Advisor at the AFRITAC West 2, contact mskreb@imf.org. I would like to thank Ashraf Khan and Tonny Lybek for their very useful comments on an earlier draft. The usual disclaimer applies so they bear no responsibility and the opinions expressed here are my own and should not be linked with any other institution.

[2] Regional Economic Outlook, Sub-Saharan Africa, IMF, April, 2014.

[3] IMF MCM database on Central Bank Laws.

Initially the concept of independence[4] of central banks was focused on the central bank's monetary policy objective. Since the early 1990s was a broad consensus that for a central bank inflation or price stability[5] was an overarching goal. The idea behind promoting independence for central banks was to protect them from government and parliament influence on monetary policy decision making.

Governments are considered to have: a short-term time horizon (myopia) and both "optimism" and "inflation" biases in their decision-making. Governments' time horizon usually does not go beyond the next elections (i.e. the political cycle). Furthermore, governments often believe that expansionary budgetary policy before the elections will "buy" additional votes. So, if they can exert enough power over the central bank to finance increased deficits by "printing money" or lower (or not increase) interest rates (even if inflation is on the rise and tightening would be warranted), this leads to an inflation bias and medium-term negative consequences for the economy. Welfare losses due to high inflation are well-known and documented. Governments often underestimate the risk of increasing inflation caused by additional borrowing from central banks (an optimism bias) and count on the short-term memory of economic agents. The time lag of monetary policy decisions may be several quarters, so inflation might pick up only after the elections. In a nutshell, that is why independence for central banks in pursuing price stability is needed.

It is useful to distinguish between different types of independence[6]. Lybek, 2004, distinguishes between: a) goal independence, under which the central bank can determine its primary objective among several ones mentioned in the act on the central bank b) target independence, where the goal is clearly defined outside the central bank (in law etc.) and the rest is left to the central bank; c) instrument independence, where the government defines the target and the central bank has the liberty to decide how to achieve it; and d) limited independence, which means that the central bank is subordinate to the government.

While there are discussions in the profession about the optimal level of independence, as a general rule, more is considered better. However, recent trends in assigning multiple mandates to central banks have somewhat complicated the discussion on independence. After the 2008 events—which are still felt today—it has become clear that central banks should not only focus on the narrow goal of price stability. Many central banks now combine this goal with a focus on financial stability, micro and macro prudential supervision and possibly even banking resolution mandates. Bank bailouts are common in financial crises. Bailouts are often conducted using taxpayers' money. Should the finance minister have his say in this?

[4] Some authors (Lybek, 2004) distinguish between the terms autonomy and independence of central banks. In this context, autonomy refers more to the substance like conduct of monetary operations in a way that central banks consider appropriate. Independence refers more to the form, meaning lack of institutional constraints in decision making. For simplicity in this presentation, I will use only the term independence, meaning both the substance and form.

[5] Price stability is often interpreted as inflation stability, meaning looking at changes rather than at the level of prices.

[6] There are different classifications of independence. Some refer to legal independence, others to management independence, etc. This will not be elaborated in more detail here.

I will finish my brief discussion on central bank independence by pointing to a relatively less mentioned, but increasingly more important, dimension of independence. Having adequate laws and regulations in place, the ones that ensure the independence of central banks from external (government and/or parliament) influences is a necessary but not a sufficient condition to ensure optimal central bank decisions What is also needed are appropriate governance structures within the central bank. A good central bank needs to think of having appropriate checks and balances. For example, one could have non-executive independent Board members. Time does not permit me to go into details, so let me just point out that having independence does not automatically guarantee optimal decision making for central banks so it should not be considered a panacea. I will refer you to the authoritative BIS report on "Issues in the Governance of Central Banks" (2009), which was a joint effort of a number of central bank presidents, including Tito Mboweni of the South African Reserve Bank.

Let me start the discussion on fiscal dominance with a quote from the former Bank of England Governor, Mervyn King (2005): "Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy."[7] And I would add, rightly so. If fiscal dominance is present central banks are restricted in their decision making and, consequently, less independent.

It might be helpful to start with explaining the two extremes: complete monetary dominance on the one hand and complete fiscal dominance on the other. Complete monetary dominance means a total absence of fiscal dominance and total independence for monetary policy. In such a situation, if the government wants to increase its future payments of principal and interest on the debt, they need an excess of future revenues over future expenditures. On the other hand, we have a situation of complete fiscal dominance. This implies that monetary authorities are totally subordinated to the government. The existing public debt is fully financed by the central bank. Alternatively, fiscal dominance can be defined as a situation where monetary policy acts in such a way as to ensure the solvency of the government[8].

Most countries fall between the two extremes. In the times of crisis, like this one, there is usually more fiscal dominance[9], while in good times one should expect less of it. The issue of fiscal dominance can be simplified to central bank financing the government. So, the question boils down to: Should central banks finance governments? If yes, what should be the rules? Jacome et al., 2012, offer recommendations on the topic:

- Ideally, central banks should not finance government expenditures at all. What central banks can do is buy government papers on the secondary market and only for monetary policy reasons (Open Market Operations – OMO).

[7] It is interesting to note that some central banks, such as the Bank of England (1694) or Banque de France (1800), were created to finance the wars their countries were fighting.

[8] Weidmann, 2013.

[9] More on a recent threat of fiscal dominance can be found in Moessner et al., 2012.

- If this is not possible, then financing the government is allowed only temporarily. The reason behind this is that fiscal revenues often exhibit strong seasonality, while expenditures are more uniform, so gaps emerge. In developing economies, domestic financial markets are often not developed enough to fill in the gap and financial shallowness cannot be easily overcome. International markets may be prohibitively expensive for this purpose. So, to smooth revenues governments have only central banks to rely on.

- Such lending should be very clearly defined within the law. It should be only a small proportion of government revenues, charged at market interest rates and paid back by the end of the same fiscal year.

Those recommendations are of course economically sound and well-founded. But sometimes real life does not allow us to act according to written rules, academic papers, best practices or even common wisdom. We often refer to central banking as being an art, not a science. Just think how easy your professional life would be if all central bank decisions were made based on rules (for example the Taylor rule), laws or as a result of an economic model. "In theory there is no difference between theory and practice. But in practice there is." This brings me to the second part of my speech.

2. Central banking lessons on independence and fiscal dominance from my own experience.

The first lesson that I learned in my 20+ years in central banking was that central banking is an ever evolving subject. During the 1990s the main central banking mantra was price stability. I remember being told at one of the Governor's Meetings at the Bank of International Settlements (BIS) in Basel: "To be a good central banker you have to remember only four things: Inflation is always too high, interest rates are always too low, if the economy is growing healthily it is because of the central bank, and if it has problems, blame it on the finance ministry." Nowadays central bankers do not have such simple guidelines on what to do. Specifically, in less advanced economies they have to take decisions in a more complex and uncertain world than ever. This is well expressed in a quote from one of the leading experts on central banking history, Charles Goodhart (2010). He defined three historical periods in the development of central banking: the Victorian era (1840s to1914), government control (1930s to 1960s) and the triumph of the markets (1980s to 2007). He pointed out that interregnums between those periods are often confused without a clear consensus. Speaking about recent developments he added: "… central banks are now….on the verge of a fourth epoch, though the achievement of a new consensus may well be as messy and confused …".

Even defining an appropriate target for a central bank has lately been questioned. Some (Frankel, 2012) claim that the goal of price stability (and inflation targeting as a tool to achieve it) is too narrow and that central banks should target nominal GDP. This sheds a new light on who should define the target, which has major implications for the governance structure of the central bank (Lybek and Morris, 2004). In 2013, Mark Carney, the Bank of England Governor, implemented a new central banking tool: forward guidance policies[10]. He mentioned the unemployment rate as a trigger for changing interest rates.

Central banks today in their communications usually announce their moves far in advance. I still remember that at grad school in the 1980s I was told that only an unexpected economic policy measure was efficient as otherwise economic agents would anticipate it. Central banking was very secretive at that time. In the present day, governors consider central bank communication to be:"… at the heart of monetary policy. It is actually a monetary policy tool in itself." (Draghi, 2014). While transparent communication is today seen as an important tool to anchor expectations, one should not forget that accountability and, in turn, transparency is the flipside of more independence; the point being to reduce the so called democratic deficit of delegating monetary policy to unelected central bankers.

A couple of years ago (before the crisis), when discussing independence, who would have thought of a need for insulation from "financial dominance" (the pressure from financial markets on central banks to act) or "expectations dominance"[11] (unrealistic expectations of what central banks can do)? If in the mid-1990s one had spoken at the BIS about: quantitative easing in the amounts that quadrupled central bank balance sheets, negative interest rates (real and even nominal), unemployment as a trigger for interest rates policy[12], one would have been considered insane or plain ignorant. I could go on with such examples for a long time. The lesson for me is that what we do know about central banking today may and probably will change in the future. So the very concept and definition of independence as well as relations to finance ministries need to be re-examined regularly.

The second relevant lesson that I learned about fiscal dominance and independence was that as a central banker one needed to be firm, yet flexible. In the late 1990s, in my home country Croatia, the central bank act allowed short-term financing of the government (up to 5% of the revenues). In 1998-1999 our economy was in crisis (partly as a consequence of the 1997 Asian crisis and its negative spillover). Inflationary pressures were increasing and the depreciation of the domestic currency was small but persistent. GDP was falling and so were fiscal revenues. The Government was asking for more and more loans. I remember getting weekly calls from the finance minister, which reminds me of an old joke:

"An economist was visiting his friend, the central bank governor. While they were having coffee, the governor received an important phone call. The conversation the visitor heard was going like this: No, no, no, no, (pause), yes, no. And the conversation ended. His friend asked: Who was on the phone? The governor replied: It was the finance minister asking for a loan.

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[10] Forward guidance is in different forms used by all big four central banks i.e. the Federal Reserve, the Bank of Japan, the European Central Bank and the Bank of England.

[11] Both terms borrowed from Caruana, 2013.

[12] In 2014, a very prestigious Jackson Hole Central Banking Summit is devoted to unemployment, i.e. the role of labor markets in monetary policy.

The friend nodded in understanding to the "no-s", but then asked: What was the "yes" for? The governor replied: Oh, he asked if I could hear him."

So, with an economic history of extremely high inflation and permanent devaluations and depreciations from the 1950s to 1994 it was very tricky to allow more government financing. At the central bank (with a lot of diplomacy) we managed to keep this amount at a reasonable level. But just before end-1999, our then President passed away, the country was in a state of increased social and political tension and anxiety and economic crisis was still felt. At that moment, a big international bank that had been rolling over its loans for eight straight years to the Government in the amount of USD 150+ million[13] decided not to prolong them. As a consequence, the Government was in danger of not being able to pay public sector wages and pensions in full. They needed a loan and inflation was on the rise. Another international bank was willing to extend a bridging loan, but only with central bank's international reserves under firm pledge. Needless to say this was against internal regulations and best practices. After a sleepless night and knowing well that pledging central bank's reserves is a blasphemy (but seemed like a lesser evil than a loan in domestic currency) I decided to sign the pledge. The story has a happy ending. The loan was repaid soon afterwards.
If I had said no at that moment, as a resolute central banker should have done, would political unrest and demonstrations have erupted in my country? I do not know. Sometimes you will not find answers to real life situations in textbooks. Only your own experience, knowledge of your own country and jour judgment can tell if at times some flexibility is warranted or not.

The third lesson on relations between the central bank and the finance ministry concerning debt financing (fiscal dominance) can be summarized in: *Always take good news as temporary and bad news as permanent*. The point here is not to be a *permabear*, permanently in a bearish mood. If we have learned anything in this and previous crises it is that tail events can happen. I can think of a country on this continent that is now struggling with a double-digit fiscal deficit. Part of it is due to the fact that public sector wages and public sector employment were increased (before the elections) based on an expected increase in revenues. But revenues did not grow as planned. Because of the asymmetry in the payoff matrix, it is relevant to have contingencies and be ready for the materialization of downside risks. One should remember the old central banking wisdom: *Central bankers are paid to worry*.

This brings me to my next lesson, the importance of credibility. In the 1998-1999 period in my country we had not only an economic crisis, but a serious banking crisis as well. We, the central bank, had to close down 22 (admittedly small) banks out of 60+ that were functioning in the system. As you might imagine, this created a lot of heated debate in the public, on top of huge fiscal and economic costs (due to deposit insurance and bank closure). It was the first time since the World War II that a bank had been closed down. In the past, during socialism, banks with losses (meaning most of them) would be bailed out every couple of years and costs would be socialized via inflation tax. So, after the closure the press was all over the central bank. In early 2000 we had the parliamentary elections and the opposition political party came to power. Following this, the attacks on the bank and me personally escalated. The

[13] All foreign loans were and are in foreign exchange due to the "original sin".

Government wanted to sack the Governor, but they could not legally do that. Finally the Parliament rejected our Annual Report. At that point I realized that I, as the Governor, had lost credibility in the public eye. In spite of keeping inflation low and the fact that decisions on closing down the commercial banks were both legally and professionally well founded, it was me who was on the front pages daily, not the crooked bankers that had made their banks insolvent by their decisions. This situation was not sustainable for the central bank or for the country. Finally, together with the whole Board, I resigned. My lesson is that one has to build up credibility daily, but can lose it very quickly. And without credibility, even a good central bank act is not of much use for a central bank to be effective.

The final lesson is: “Trust yourself and your team”. Nobody understands your economy better than you do, or at least not if you are a professional. In other words, read and follow modern trends in central banking, be up to speed, but be aware that groupthink and intellectual capture can be dangerous (Škreb, 2012). Second, your own country and situation might need a different perspective than the one in advanced economies or in textbooks. So, think of your own solutions to your problems. If this means going against the conventional wisdom (the IMF or academics) and you can honestly make your case (and not because the minister of finance “persuades” you to do so), then do it. For example, the Croatian central bank introduced capital controls around 2005 against the IMF advice. I left the bank five years earlier so I take no credit for this. At that time, this generated a lot of criticism from the academic and commercial banking communities. However, today the bank is vindicated for its foresight. Capital controls are again palatable. But at some times, standing against dominant professional views requires a lot of work and self-confidence. Central banks are being confronted with new challenges that vary from country to country. For example, the spread of the deadly Ebola Virus Disease (EVD) in the West Africa means not only a human tragedy but challenges central banks. How to cope with depreciation pressures or inflation given the travel and production restrictions in those countries? A lot of African economies were or are confronted with wars or terrorist threats. Furthermore, how will the future increase in world interest rates affect government borrowing in Africa, both domestic and international (especially bond sales)? One needs answers to those questions, and they cannot be found in a “cookbook” like recipes can. So, my lesson here is that one has to build up a strong and professional institution with the best economic team in the country and a governor that discourages group think[14].

Let me end by paraphrasing the famous Tomas A. Edison’s saying: “There is no substitute for hard work.” My version is: “There is no substitute for building a strong professional capacity at the central bank to face future challenges.” Only then can you be truly independent and find the optimal solutions within the existing constraints.

Thank you very much for your attention.

[14] As I have elaborated this topic elsewhere, I will not pursue it here (Škreb, 2005).

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