CENTRAL BANK INDEPENDENCE:
RECENT SUCCESSES IN EMERGING ECONOMIES AND FUTURE CHALLENGES

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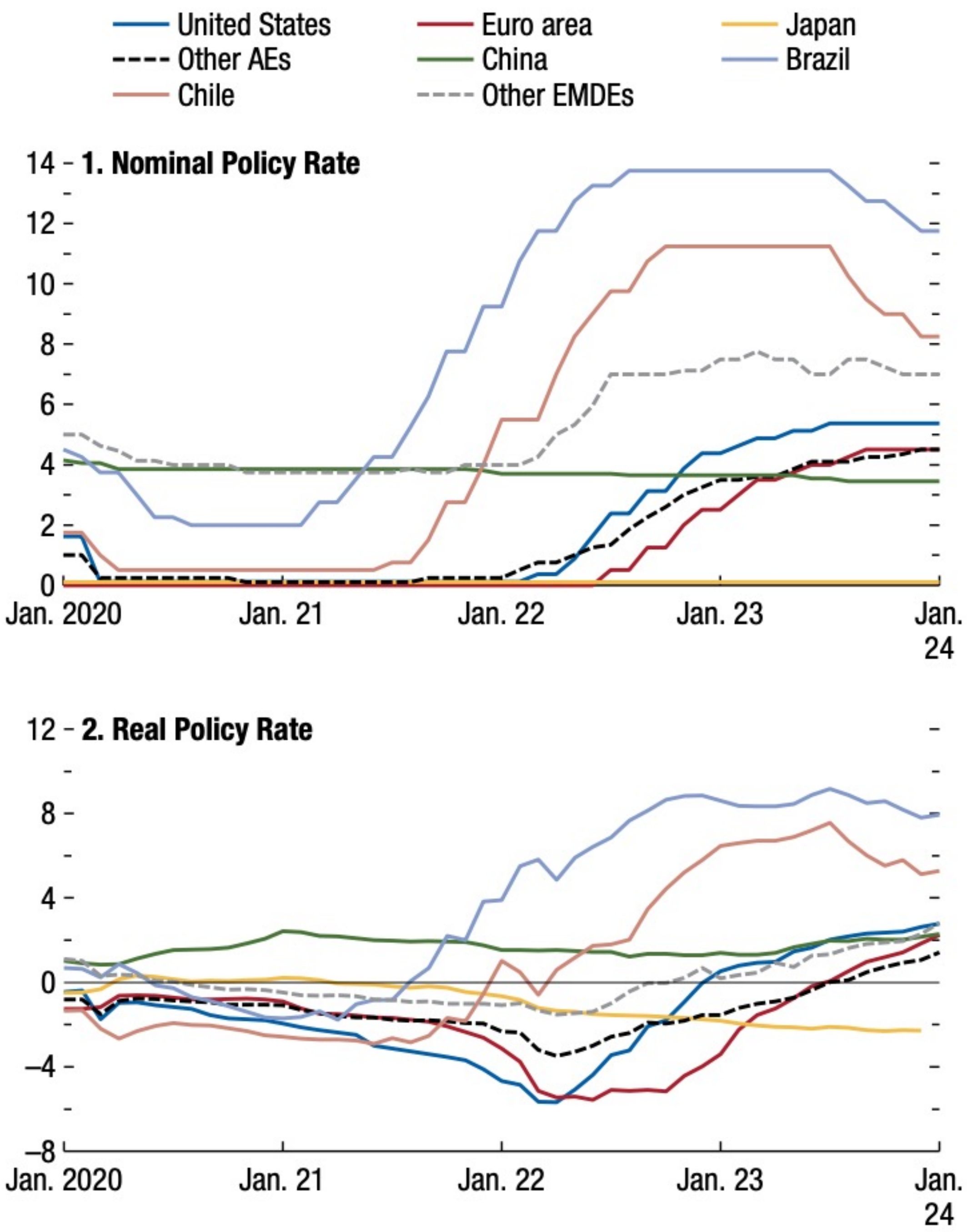
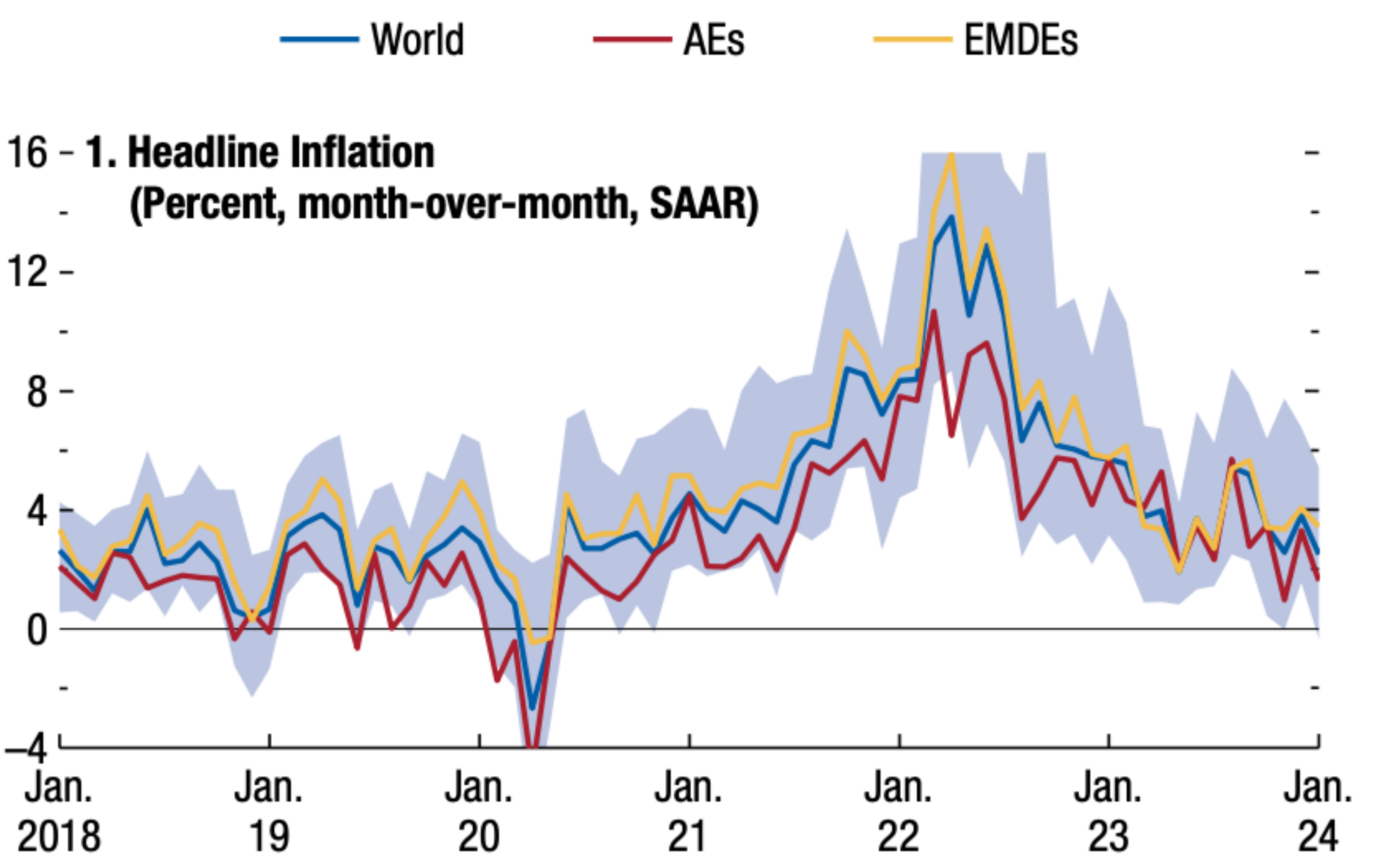
THE BIG PICTURE

- Many central banks (including EMDE) reduced interest rates in response to COVID-19.
- Inflation rose in 2021-2022.
- In response, many central banks (including EMDE) increased nominal (and ultimately real) interest rates.
- Inflation fell 2022-2024.



Many central banks, including emerging market and developing economies (EMDCs): Ease and then tighten monetary policy following COVID

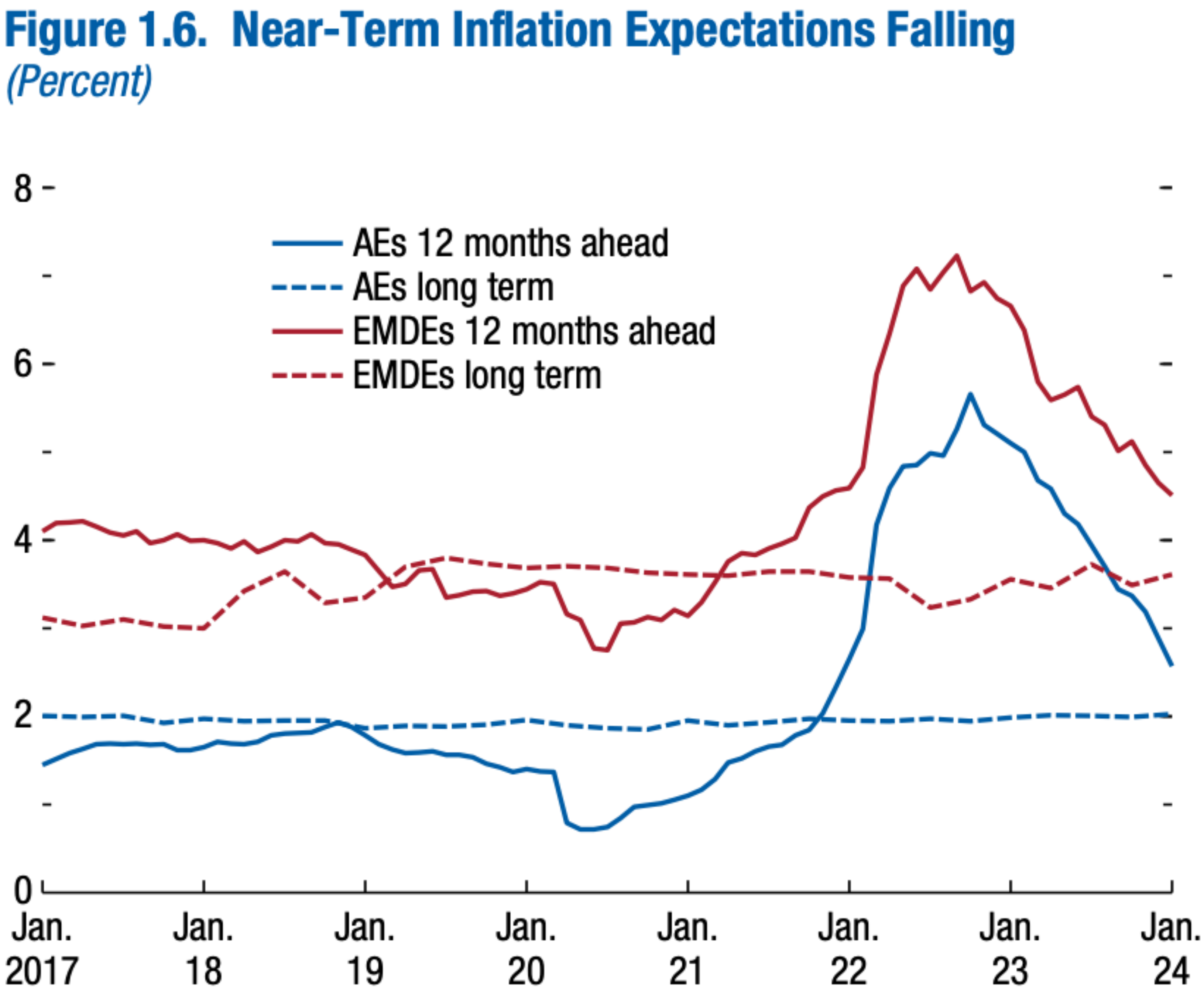
CENTRAL BANK RATES



Inflation rises around the world following COVID and central bank easing.

It then starts to decline steadily in 2022.

INFLATION RATES



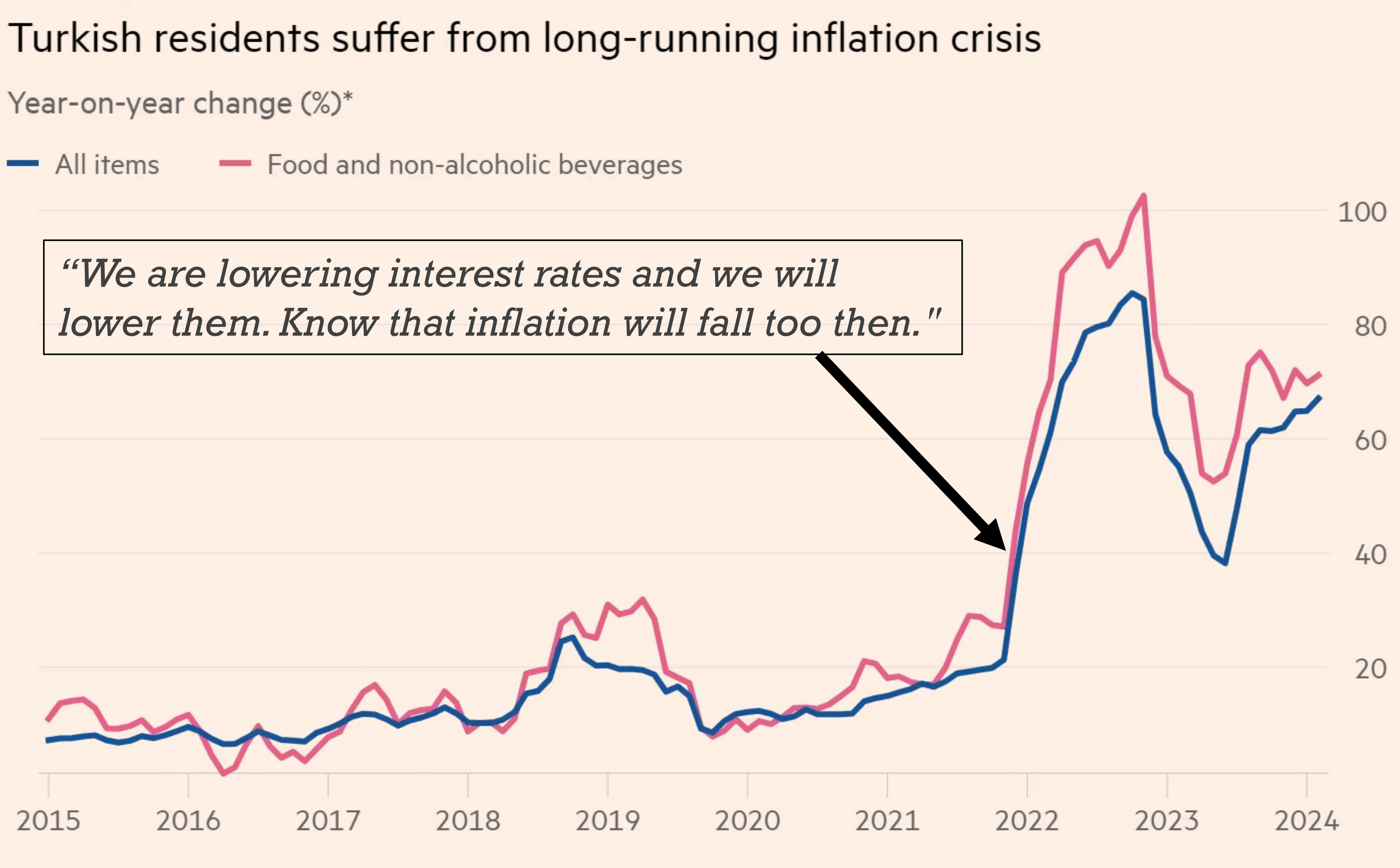
Markets view the surge in inflation as temporary.

Suggests that central banks had gained considerable credibility prior to the COVID shock.

INFLATION EXPECTATIONS

THERE WERE EXCEPTIONS TO THIS PATTERN

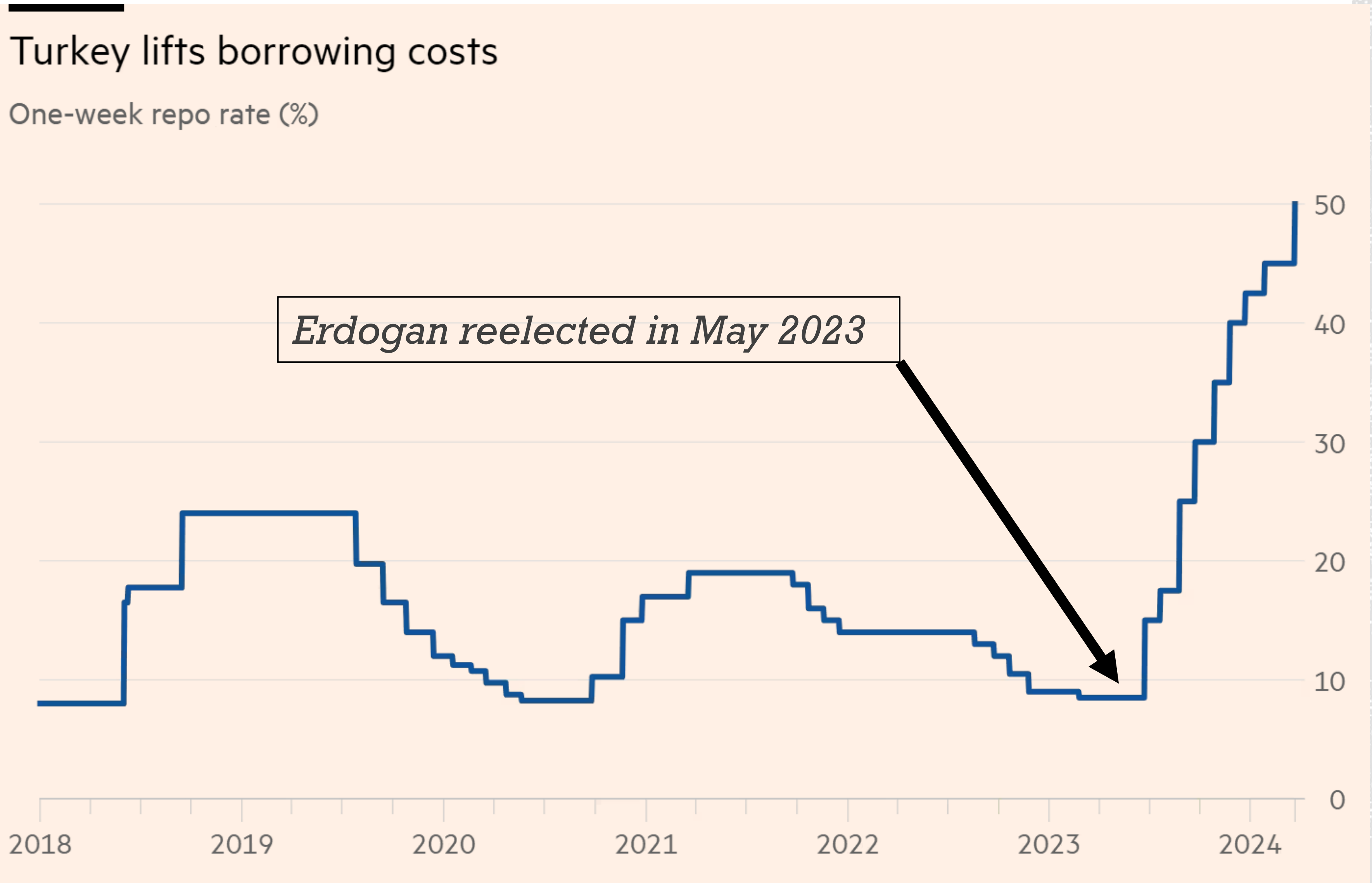
Turkey



Erdogan announced that expansionary monetary policy would lower inflation in January 2022, when it was close to 40%.

Inflation response exacerbated by the Russian invasion.

TURKISH INFLATION



Policy rate falls in nominal and real terms through 2022 into 2023.

Then, central bank increases rate substantially, but it is still negative.

CENTRAL BANK RATE

DESPITE EXCEPTIONS, THERE WAS A BASIC PATTERN AFTER COVID

- Many central banks reduced interest rates due to the pandemic
- Inflation rose in 2021-2022, though long-term inflation expectations remained anchored at pre-COVID levels.
- Many central banks increased interest rates.
- Inflation fell 2022-2024.

IMF'S EXPLANATION:
CENTRAL BANK INDEPENDENCE+

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March 2024

CENTRAL BANK INDEPENDENCE+

- "[Central banks'] success thus far has largely been because of the independence and credibility that many central banks have built up in recent decades."
- "+" Essential inputs into central bank achieving its monetary policy objectives:
  - **Prudent fiscal policies** that "keep debt sustainable helps to reduce the risks … of pressure on the central bank to provide low-cost financing to the government."
  - **Sound bank regulation** "reduces the risk that the central bank becomes reluctant to raise interest rates for fear of causing a financial meltdown."

Cynical question: If prudent fiscal and financial policies eliminate demands for excessively expansionary monetary policy, does central bank independence add much to attaining sound monetary policy?

DEFINING CENTRAL BANK INDEPENDENCE:

1) Clear delegation and designation of responsibility.
2) Clear goals, numerical targets, and tools to achieve targets.
3) Transparent communication and assessment.

It should be easy for the public to observe whether the central bank is achieving its objectives.

IMF RESEARCH FINDINGS

- Strong association between these three features and moderate inflation.

MY CONCERN

- Most central banks also conduct bank regulation.
- Sound bank regulation is essential for effective monetary policy.
- Can central banks deliver sound bank regulation?

LET'S TAKE A STEP BACK AND REVIEW CENTRAL BANK INDEPENDENCE

- Remove one policy (monetary policy) from normal governmental processes and put it into an entity run by unelected officials (central bank).
- How do we get the central bank to operate in the public interest?
- IMF identifies three crucial features:
  1) Clear delegation and designation of responsibility.
  2) Clear goals, numerical targets, and tools to achieve targets.
  3) Transparent communication and assessment.

BUT: 2/3 OF THESE CRUCIAL FEATURES DO NOT APPLY TO BANK REGULATION AND SUPERVISION

1) Clear delegation and designation of responsibility.
2) Clear goals, numerical targets, and tools to achieve targets.
   - Concerning bank regulation, I have never seen a clear articulation of how specific tools link to specific numerical targets and well-specified goals.
3) Transparent communication and assessment.
   - The bank regulation and supervisory activities of central banks are largely confidential, making them unmonitorable and essentially unaccountable.

The public cannot easily observe whether the central bank is achieving its bank regulatory and supervisory objectives.

CONCERN

- Besides being important for long-run economic growth and economic stability, well-functioning banks are essential for effective monetary policy.
- Central banks are not well structured to deliver sound bank regulation and supervision.
- Instead, we have given control over the policies that shape the allocation of capital and, hence, economic opportunities to unelected, unaccountable, and unmonitorable individuals. What could go wrong?