

## 10. DE FACTO AND DE JURE CENTRAL BANK INDEPENDENCE

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In a recent op-ed, Kenneth Rogoff (2019) comments on central bank independence and the rise of populism:

“With the global rise of populism and autocracy, central-bank independence is under threat, even in advanced economies. Since the 2008 financial crisis, the public has come to expect central banks to shoulder responsibilities far beyond their power and remit. At the same time, populist leaders have been pressing for more direct oversight and control over monetary policy...

Not too long ago, central-bank independence was celebrated as one of the most effective policy innovations of the past four decades, owing to the dramatic fall in inflation worldwide. Recently, however, an increasing number of politicians believe that it is high time to subordinate central banks to the prerogatives of elected officials...”<sup>2</sup>

Walsh (2005) points out that “legal measures of Central Bank independence may not reflect the relationship between the Central Bank and the government that actually exists in practice.” In other words, *de jure* and *de facto* central bank independence (CBI) may be quite distinct. In recent years, this distinction has become especially apparent. Politicians have been interfering with central banks, even without formally or legally restricting their independence.

What are the effects of these *de facto* violations of central bank independence? When and where do they arise? Data limitations have made these questions difficult to answer. While there are several datasets measuring legal CBI, such as Garriga’s (2016) impressive dataset based on the charters and legislation of a large number of central banks, *de facto* CBI is less easily observed.

### 10.1. MEASURING PRESSURE ON CENTRAL BANKS

In recent research (Binder 2019), I use a narrative approach to construct a dataset on political pressure on central banks around the world. I use country reports from the Economist Intelligence Unit (EIU) and Business Monitor International (BMI), which report at a consistent frequency on monetary policy-related devel-

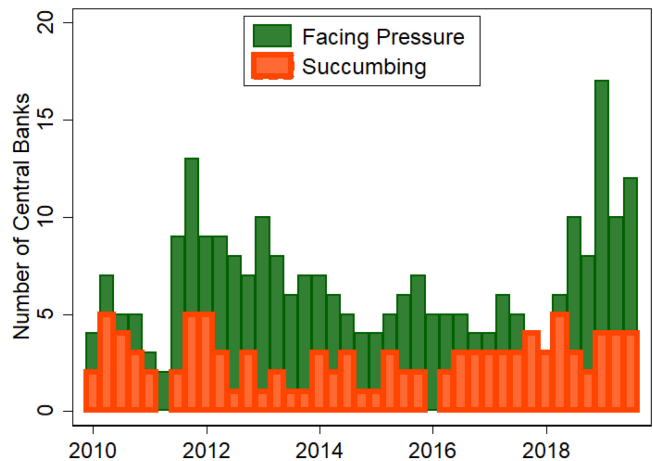
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<sup>2</sup> <https://www.project-syndicate.org/onpoint/how-central-bank-independence-dies-by-kenneth-rogoft-2019-05>.

opments in a large number of countries. I search the reports for discussions of political pressure on or government interference with the central bank, and code several features of the pressure. For instance, I record whether the pressure is for easier or tighter policy, and whether the central bank is reportedly resisting or succumbing to the pressure. My dataset is a balanced panel of 118 central banks quarterly since 2010.

I find that political pressure on central banks is widespread. About 39% of the central banks in my sample reportedly face political pressure at least once since 2010. As you might expect, the vast majority of this pressure is for easier monetary policy. In an average quarter, 6% of central banks face reported political pressure. Actual numbers may be even higher, as some instances of political pressure may go unreported, for instance if they are too subtle for the country report writers to observe. I have updated the dataset through the third quarter of 2019, and find that political pressure on central banks is especially prevalent in 2019. In the first quarter of 2019, 14% of the central banks in my sample face reported political pressure, which is the maximum recorded in my sample (see Figure 1).

Figure 1. Political pressure on central banks over time.



Source: Binder (2019), updated for this article

10.2. WHERE AND WHEN DOES PRESSURE OCCUR?

Political pressure on central banks appears to be similarly prevalent across geographic regions, though somewhat more common in Africa and Asia. In an average quarter, 5.2% of central banks in the Americas, 4.5% in Europe, 6.9% in Africa, and 4.5% in Asia and the Pacific. The top seven countries in terms of frequency of political pressure are Angola, Turkey, Argentina, Myanmar,

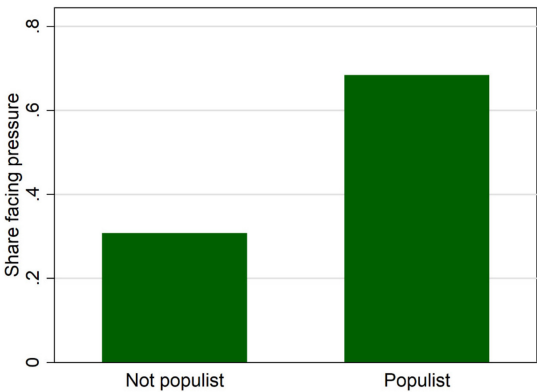
Venezuela, Syria, and Japan. The top seven in terms of frequency of succumbing to political pressure are Turkey, Myanmar, Venezuela, Angola, Argentina, Vietnam, and the BEAC.

I use data from the Polity IV Project from the Center for Systemic Peace and the Database of Political Institutions (DPI) to study the association of political pressure on central banks with political characteristics. Political pressure is less likely to come from an executive from a centrist party than from an executive from a right-leaning or left-leaning party. Pressure is also less frequent in highly democratic countries compared to less democratic or autocratic countries, and less frequent in countries with strong checks and balances.

The strongest and perhaps most interesting predictor of political pressure on the central bank is a nationalist executive or nationalist ruling party. Nationalism is distinct from, but frequently associated with, populism. Thus, the strong association between nationalism and political pressure on central banks seems to support the view of Rogoff and others that populist leaders are challenging central bank independence (see Goodhardt and Lastra 2017).

An alternative source of data on populism is the Global Populism Database (Hawkins et al. 2019). In this dataset, political leaders’ speeches are coded to classify their degree of populist rhetoric. Figure 2 shows the share of countries with leaders classified not populist facing political pressure on the central bank at some point in my sample, compared to the share with political leaders classified as somewhat populist, populist, or very populism facing political pressure on the central bank. Political pressure is about twice as prevalent for the populist group compared to the non-populist group.

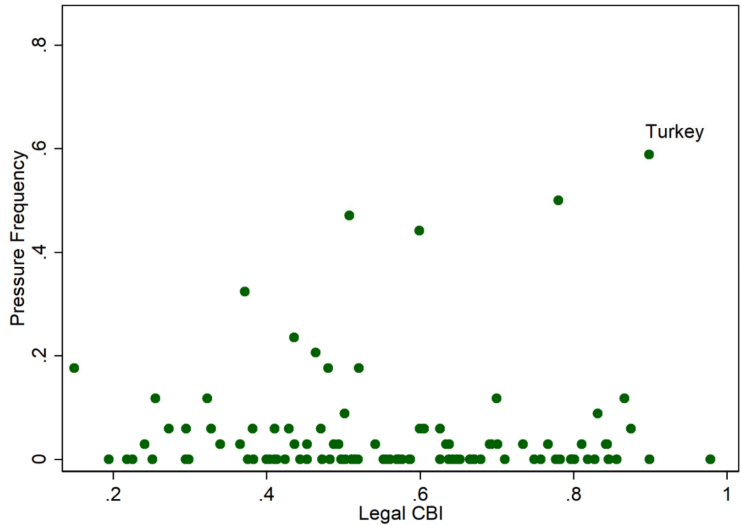
Figure 2. Populism and political pressure on central banks.



Populism data is from the Global Populism Database (Hawkins et al. 2019), which covers 32 central banks, of which 19 are in countries with a somewhat populist, populist, or very populist leader based on codings of leaders’ speeches. Data on political pressure on central banks is from Binder (2019) from 2010Q1 through 2019Q1.

How does political pressure on central banks correspond to legal central bank independence? Are central banks with strong legal protections on their independence protected from political pressure? The answer seems to be no. I find that legal CBI, as measured by Garriga (2016), is virtually orthogonal to frequency of political pressure. And there are plenty of examples of central banks with strong legal CBI that face political pressure. For example, Turkey’s central bank has a legal CBI index of 0.9 on average since 2010, which puts it around the 90<sup>th</sup> percentile, but faces political pressure in 60% of the quarters in my sample. The lack of a clear relationship between legal CBI and political pressure can be seen in Figure 3.

Figure 3. Legal central bank independence and political pressure on central banks.



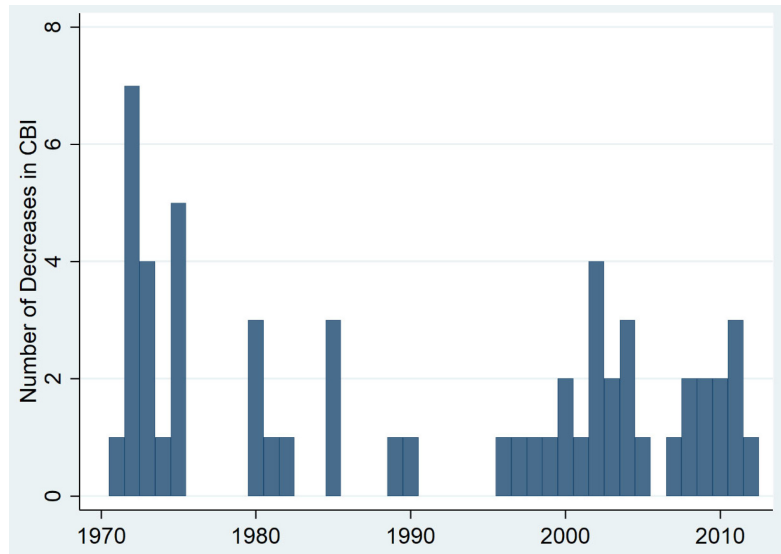
Legal CBI is from Garriga (2016), and refers to the average since 2010. Pressure frequency is the fraction of quarters since 2010 for which the central bank faces reported political pressure, from Binder (2019).

Moreover, it is political pressure on central banks, rather than legal independence, that seems to have more explanatory power for inflation. I find that even when the central bank reportedly resists the political pressure, inflation still tends to rise following an episode of pressure. Perhaps even if the central bank does not change its monetary policy in response to political pressure, the pressure damages central bank credibility. The possibility that it might respond to pressure leads to higher inflation expectations and in turn to higher inflation.

While political pressure on central banks is a frequent phenomenon, reductions of central banks’ legal independence are relatively rare. Figure 4 shows the number of decreases of legal CBI reported in Garriga’s dataset each year from

1970 through 2012. Note that about 1.5% of central banks experience a reduction in legal CBI each year from 2010 through 2012. In the late 1980s through the early 2000s, reductions in legal CBI were even more rare, as the trend toward greater CBI was in full force (see Figure 5).

Figure 4. Reductions in legal CBI by year.



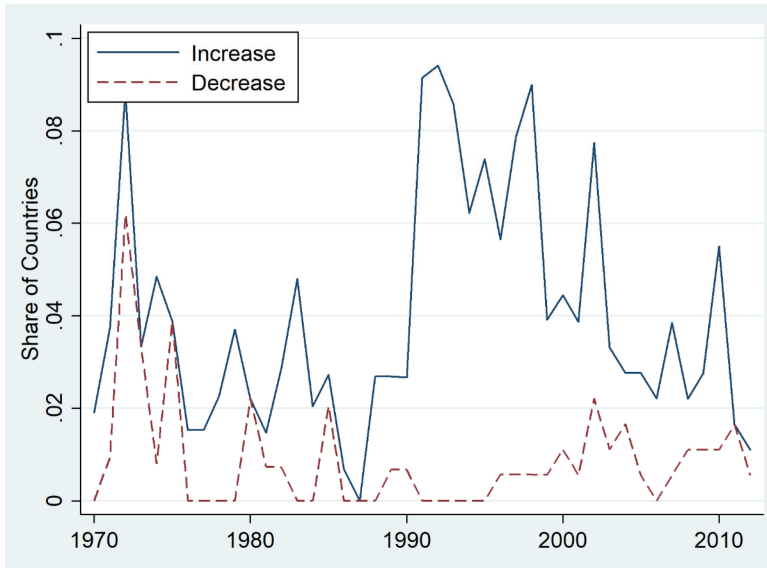
Data is from Garriga (2016)

The only central bank to have a recorded reduction in legal CBI in 2012 is Argentina. The Argentina case is especially interesting, and was reported in a Wall Street Journal article called “Kirchner Grabs the Central Bank” on April 1, 2012. The article notes that the central bank’s single price stability mandate was replaced by a three-pronged mandate to provide “growth with social fairness and financial stability” in addition to price stability. For this reason, in Garriga’s dataset we observe a reduction in the “objective independence” subcategory.

The article also explains that President Cristina Fernandez de Kirchner had relied on generous government spending to maintain her popularity, and in 2010 began dipping into the central bank’s excess reserves to finance these expenditures. This prompted the resignation of central bank governor Martin Redrado in January 2010. Redrado was replaced with the “more compliant” Mercedes Marc? del Pont. The 2012 reforms to the central bank’s charter eliminated a requirement that base money be backed by international reserves and unavailable for the government to borrow. Instead, the central bank board would come up with a formula for the amount of required reserves, and excess reserves would be available for the government to borrow. My dataset records political pressure on the

central bank in Argentina in 2010, 2011, and 2012. The political pressure on the central bank culminated in reductions of the bank's legal independence.

Figure 5. Increases and decreases in CBI over time.



Data is from Garriga (2016)

### 10.3. POLITICAL PRESSURE AND CBI: LOOKING AHEAD

It seems plausible that as political pressure on central banks becomes more prevalent and more normalized – which seems likely to be the case as populist undercurrents are strong – that legal changes to central banks could also become more prevalent, as CBI become less enshrined internationally. Though legal CBI data for the past few years is not yet available, there are some noteworthy examples of changes to central bank legislation, such as the 2018 Amendments to the Reserve Bank of New Zealand (RBNZ) Act.

The RBNZ, famously, was the first central bank to adopt an explicit target for inflation as the primary monetary policy objective. The 2018 amendments replace the inflation target with a dual mandate (so the “objective independence” subcategory of Garriga’s index should decrease). At the same time, the amendments assign monetary policy responsibility to a committee, rather than a single governor. Controversially, this committee includes a Treasury representative. See Binder (2019b) for a discussion of the political history of these amendments. The New Zealand First party, which has populist tendencies, was very influential in this history.

As I discuss in Binder (2019b), the prevalence of political pressure on central banks may be related to what Haldane (2017) describes as the “twin deficits” of understanding and trust in central banks. Especially in the aftermath of the financial crisis and Great Recession, many central banks face these deficits. The financial crisis revealed the scope and magnitude of their powers and in many cases led to dissatisfaction with how these powers were used. Some central banks resorted to unconventional policies that were more politically controversial because of their more obvious distributional implications.

Since natural interest rates ( $r^*$ ) seem to have fallen, the effective lower bound (ELB) may be more likely to bind in the future, prompting further use of unconventional and even quasi-fiscal policies. This may well invite further attempts by politicians to interfere in the monetary policymaking process, especially in countries where many years of low inflation have made the risk of inflation seem more distant.

Central banks are putting increasing efforts into their attempts to communicate with the general public, but reaching households and shaping their beliefs and expectations remains a major challenge (Binder 2017). But politicians are often quite astute at communicating with the public and influencing the media agenda. Thus media coverage of central banks may be driven in large part by politicians, rather than by central banks themselves (Binder 2018). In the face of increasing political pressure, central banks may need to even rethink their frameworks, with a goal of making monetary policy more “pressure proof” and easier to communicate with politicians and the public. For example, a single and explicit target, like a nominal GDP target, might be less subject to political pressure than a dual mandate.

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