Independence and Responsibility of Central Banks

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Central banks neither evolved spontaneously for some economic reason, nor were set up out of necessity, but were established by governments for political reasons (usually to finance the governments). They could never come to existence without governmental power behind them, and at least some of them would disappear if their governmental protection ended. Nonetheless, they have evolved through the time (and have changed their environment as well) in such a way that now they subserve important economic goals and have a vital role in modern economies. They have captured great economic power—most people even cannot image the world without them.

Both experience and the public choice theory shows us that the central banks might be dangerous for the society if misused by the government—and it shows us some reasons why governments are tempted to misuse them as well. That is why there is strong pressure to make these potentially dangerous organizations independent of the government. But such independence rises a new problem: accountability, responsibility, and legitimacy of the central banks.

The common view that stresses the central bank's independence on the government neglects the fact that the management of the central bank is (by definition) a bureaucracy that has its own goals. Some of these goals are compatible with the government's goals, while others are not. Moreover, it neglects also the fact that there can be other special-interest groups that can try to threaten or bribe the central bank's bureaucracy to act in favor of them. There is also a great information asymmetry that makes it difficult both for the government and the public to check the central bank's actual performance. The information asymmetry opens the central bank's management to informal hidden influence of the government making the expected benefits of the independence questionable. Thus contrary to its intention the formal independence of the government may open the bank to even stronger informal pressure of the government—or under another conditions to a pressure of other special-interest groups.

Under the present institutional setting the actual performance of the central bank is determined not only by the degree of its independence of the government, or by a possibility to subdue it to a rule, but by more broader spectrum of influences. A more general theory based on the principal–agent approach and a theory of bureaucracy is needed. A general “optimal”solution that will balance the independence and accountability of a central bank may not exist (possibly except privatization, i. e. destruction of the central banking system).

In the paper we will use an principal–agent and bureaucratic approach to the central banks analysis. We will show that the central bank is a poorly constraint agent of the government which is a poorly constraint agent of the public. We will analyze objectives of all important players: of the government, of the central bank's management, of selected special-interest groups, and of the public. We will show how relative power of these groups can affect the actual monetary policy making the formal dependence or independence of the central bank on the government only one of the variables influencing the actual outcome—perhaps a variable of a minor importance. We will show that if the relative power of the different players change the actual monetary policy can change as well—under the same institutional framework.

We will also briefly mention other examples of the above stated problem—showing that similar problems we face with many governmental agencies.