A Dual “Democratic Deficit”?  
Internationalization and Accountability in Post-Communist Central Banking

Juliet Johnson  
Associate Professor  
McGill University  
Department of Political Science  
855 Sherbrooke Street West  
Montreal, Quebec  H3A 2T7 Canada  
juliet.johnson@mcgill.ca

Abstract

Although policy makers and academics have long debated whether or not democracies should grant independence to their central banks, to date this debate has focused almost exclusively on long-established democracies. The massive, simultaneous spread of both democracy and central bank independence to the post-communist world since the 1990s represents an important opportunity to revisit this issue. Both sides in the existing debate view granting central bank independence as a domestic decision made for domestic economic reasons after domestic political consideration. In contrast, post-communist independent central banks began their lives burdened with a dual democratic deficit. Not only were they predominantly developed by and for international actors, but this rapid process occurred without building significant domestic support for these institutions. This paper explores the problematic implications of this dual democratic deficit and discusses how central banks might be better incorporated into democratic polities without compromising their countries’ economic health.

Draft: Please do not cite without author’s permission. Comments welcome.
“I hear, but I do not listen.” With these infamous words refusing European leaders’ increasingly desperate requests that he cut interest rates in April 2001, European Central Bank President Wim Duisenberg captured the essence of central bank independence. Democratic governments grant central bankers independence in the name of the greater public good, on the grounds that a monetary authority divorced from the political system can take necessary but unpopular economic measures. Yet these central banks also represent exceedingly powerful institutional tools. Central banks are the “brains” of modern capitalist economies. Their policies can affect prices and wages, determine whether an economy grows or stagnates, and influence who wins or loses financially. A central bank can bail out commercial banks, play a key role in foreign policy by manipulating exchange rates, and sometimes even wield immense control over foreign economies whose monetary systems use or are pegged to its currency. Central banks, therefore, can strongly influence democratic politics by adopting policies that affect the health of the economy and the distribution of economic resources. As U.S. Federal Reserve Chairman Alan Greenspan observed, “A central bank in a democratic society is a magnet for many of the tensions that such a society confronts.”

For this reason, both policy makers and academics have engaged in an extensive debate on the relationship between democratic regimes and independent central banks. While analysts agree that granting independence to central banks reduces the power of elected officials to affect monetary policy, the dispute centers on whether or not this represents a worthwhile tradeoff. Those in favor of central bank independence argue that economic necessity drives democratic states to create independent central banks, preventing government officials from manipulating monetary policy for short-term political gains that stoke subsequent inflation. Granting independence to central bank technocrats removes this temptation and engenders macroeconomic stability and predictability. On the other hand, those wary of central bank independence argue that independent central banks do not contribute to greater economic growth and that central banks should be subject to greater democratic oversight because their policies have significant distributional implications.

To date, this debate has focused almost exclusively on central bank independence in long-established democracies. The massive, simultaneous spread of both democracy and central bank independence in the post-communist world since the 1990s represents an important opportunity to revisit this debate in light of the post-communist experience. The existing literature frames and justifies the decision to grant independence to a central bank as a domestic decision made primarily for domestic economic reasons after a domestic political debate. As such, the central bank, though independent, has a firm domestic political mandate for its mission.

For post-communist central banks, however, the situation is more complicated. Independent central banks arose in these countries primarily in order to signal monetary policy credibility to international financial actors, and the transnational central banking community played a key role in transforming these command-era institutions. As a result, post-communist central banks began their lives burdened with a “dual democratic deficit.” Not only were they developed in great part by and for international actors, but
this rapid process occurred without the need to build extensive domestic support for these institutions.

In this paper, I explore the implications of this dual democratic deficit. I begin by discussing the concept of central bank independence, and then review the arguments for and against central bank independence in the established democracies. The following section brings this debate to the post-communist world, demonstrating that traditional arguments in favor of central bank independence prove to be weaker in this context, both because of the central banks’ international roots and because of post-communist economic conditions. In order to justify the democratic cost of independence, post-communist central banks must demonstrate their economic effectiveness and retroactively build broad domestic constituencies. To date, neither has occurred. Instead, most post-communist central banks have become politically embattled and progressively weakened institutions. I further illustrate this point with a brief discussion of the Russian case. In the conclusion, I look at how central banks might be better incorporated into democratic polities without compromising their countries’ economic health.

What is Central Bank Independence?

Central bank independence (often abbreviated as CBI) is somewhat of a misnomer, as no domestic economic institution can be completely free from politics. All central bankers must take political sentiment into account in at least a minimal way or risk losing their independent status. In addition, most independent central banks are bound by certain transparency guidelines, which may require them to report formally on their activities to an elected legislature, to publish the minutes of their board meetings, or to otherwise justify their decisions and performance. However, “independent” central banks are significantly shielded from the political process through laws granting them extensive autonomy from elected authorities. For this reason, it makes little sense to talk about central bank independence in consolidated authoritarian states not underpinned by the rule of law. Central bank independence is a feature of democratic polities designed to mitigate a specific deficiency of democratic systems (politicians’ temptation to spend freely before elections).

Like democracy itself, central bank independence exists on a continuum rather than as an either/or proposition. A cottage industry measuring CBI has emerged among economists, who look primarily at the legal statutes governing a central bank’s operations to determine its level of independence (Cukierman 1992; Alesina and Summers 1993; Elgie 1998; Cukierman, Miller et al. 2002). In doing so, they evaluate a central bank’s formal political and economic independence. A central bank is at its most politically independent if its governor enjoys a term of at least eight years, if its board members hold lengthy terms out of sync with the electoral cycle, if the appointment process is clear and relatively apolitical, if the governor and board members are required to possess particular professional qualifications, if the governor and board members are prohibited from simultaneously holding other posts, and if there are no government representatives on its board. A central bank is at its most economically independent if it has a clear legal
mandate to protect price stability, if it alone determines monetary policy, if it controls its own budget and salaries, if it is forbidden to finance the government, and if it has developed a range of monetary policy instruments (such as the ability to conduct open-market operations). The underlying presumption is the more independence, the better. While no central banks unambiguously meet all of these criteria, many exhibit high levels of *de jure* independence.

Measuring a central bank’s *de facto* independence is more complicated but equally necessary. Statutory guarantees of independence may over time become subordinated to harsh political realities, a pattern that *de jure* measures alone would fail to capture. To gauge a central bank’s *de facto* independence, analysts look at the rate of central bank governor turnover (are governors regularly forced to leave office early?) and at monetary policy conflicts between the government and the central bank (does the central bank win these battles or is it forced to compromise?). While fewer studies work with *de facto* measures, those that do find that such *de facto* independence has grown stronger as well, especially in the more established democracies.

**The Case for Central Bank Independence**

Advocates of central bank independence argue that domestic economic necessity drives democratic states to create independent central banks. According to this view, independent central banks promote lower inflation because they curb politicians’ ability to manipulate the money supply to create short-term growth (and political credit) at the expense of longer-term macroeconomic stability (Rogoff 1985; Fratianni 1997; Miller 1998). Empirically bolstering this position, quantitative studies have consistently found a link between higher levels of CBI and lower levels of inflation in established democracies (Cukierman 1992; Alesina and Summers 1993; Berger, De Haan et al. 2001). Bernhard (2002) further argues that CBI can reduce intra-party and intra-coalition conflict over monetary policy, because political leaders can no longer be blamed for unpopular decisions. If an independent central bank can serve as a convenient scapegoat for important but temporarily painful or divisive economic policies, so much the better. Such independent central banks bring credibility and stability to monetary policy regardless of changes in government.

Therefore, independent central banks represent a public good for democracies. The public prefers a lower rate of inflation than would obtain if elected politicians controlled the central bank, and so granting central banks independence ensures that this public preference will be respected. Independent central banks, like independent judiciaries, electoral commissions, or anti-corruption agencies, act as agents of “horizontal accountability” in democratic polities (O’Donnell 1998; Schedler, Diamond et al. 1999). Moreover, because guiding macroeconomic policy is a complicated, arcane, and delicate task beyond the comprehension of most non-economists, highly educated central banking professionals are best qualified to make these decisions. Delegating authority over monetary policy to such technocrats requires a government to tie its own hands for the greater economic good of the country, a decision that most do not take lightly or easily.
As Lijphart (1999) finds, “consensus democracies” (democracies of higher quality) are more likely to grant independence to their central banks than are other kinds of democratic states. On these manifold grounds, the institution of central bank independence became embedded in many established democracies and has since spread widely throughout the world.

The Case against Central Bank Independence

Critics of central bank independence counter these claims with two inter-related arguments: 1) Independent central banks do not improve their countries’ overall economic well-being; and 2) Granting independence to central banks violates important tenets of democratic governance. These critics further point out that because the empirical evidence justifying central bank independence on economic grounds is weak, we should instead turn to political, ideological, and distributional explanations for the rapid international spread of central bank independence (Bowles and White 1994; Grabel 2000; McNamara 2002).

The evidence clearly shows that CBI contributes to low inflation in established democracies. This should not be surprising, because central bankers as a group are intensely committed to maintaining price stability – that is, an inflation rate as low as possible (Blinder 1998; Marcussen 1998; Kirshner 2003). For example, the independent European Central Bank sets its inflation target at “below, but close to, two percent.” In his survey of 84 central bank governors, Princeton economist and former Vice Chairman of the U.S. Federal Reserve Board of Governors Alan Blinder (1999) found that the central bankers deemed “credibility” (interpreted as a credible dedication to price stability) to be “of the utmost importance” for a central bank, giving this value an incredible rating of 4.83 on a 5-point scale. However, studies reveal that the economic logic behind CBI rests on two mistaken assumptions about inflation and economic outcomes: that independent central banks can reduce inflation at less cost than can more politically dependent ones, and that independent central banks’ rigorous inflation-fighting efforts contribute to economic growth.

CBI advocates have long believed that independent central banks can reduce inflation at a lower societal cost – that is, with fewer negative effects on employment and output – than can dependent ones because societal actors trust independent central banks to do what they say they will do. Therefore, these actors will quickly adjust their expectations and wage demands in response to central bank policies. Both the central bankers and the economists in Blinder’s survey ranked this as the second most important reason (out of seven possible choices) for central banks to maintain their policy credibility. Unfortunately, extensive empirical evidence indicates that CBI either has no effect in this realm or actually raises the societal costs of disinflationary policies (Blinder 1999; Down 2004). As Down puts it, “in short, more independent central banks appear to conduct more costly disinflations than their politically dependent counterparts” (401). This probably occurs because independent central bankers are so concerned with lowering inflation and preserving their reputations as credible inflation fighters that they tend to
adopts overly tight monetary policies. As Nobel Prize-winning economist Joseph Stiglitz (1998) has observed, “the separation between expertise and values is not as clear as it is sometimes depicted. For instance, I was repeatedly struck by how those who . . . worried more about inflation and less about unemployment, also more frequently saw inflation lurking around the corner” (217).

Similarly, economists widely concur that central bank independence has no measurable impact on economic growth (Alesina and Summers 1993). This is because, as further studies demonstrate, steadily moderate levels of inflation (up to 20% annually) appear to have no deleterious effect on economic growth – and may actually be beneficial in maintaining higher employment levels (Barro 1995; Kirshner 2003). Neither does evidence indicate that such moderate inflations exhibit a tendency to “take off” into unquestionably damaging hyperinflations. Yet the vast majority of central bankers believe that only very low levels of inflation (between 1-3 percent per year) can provide the conditions for sustainable economic growth, as a quick perusal of central bank websites clearly reveals.\(^3\) If independent central banks lead costly disinflations and do not clearly contribute to economic growth, then the uncompromising anti-inflationary perspective ingrained into central bankers and used to justify central bank independence rests on shaky empirical grounds.

Critics attack central bank independence even more forcefully on three political criteria. First, they insist that CBI violates a fundamental principle of democratic governance by concentrating immense power in the hands of one unelected individual, the central bank governor (Stiglitz 1998). British parliamentarians and academics have similarly argued that CBI contradicts the British political system’s founding principle of parliamentary sovereignty (Busch 1994). Second, they point out that monetary policy is no more complicated, technical, or arcane than many other issue-areas such as health care, taxation, or foreign policy, and as such it has no special qualities requiring its insulation from democratic control and debate (Berman and McNamara 1999).

Finally, and most importantly, critics argue that central bank decisions are inherently political because they have major distributional effects. Placing monetary policy in the hands of unelected central bank technocrats not only fails to de-politicize the process, but grants a permanent economic advantage to those groups favored by inflation-averse policies, particularly the investing and banking communities (Bowles and White 1994; Berman and McNamara 1999). Although any inflation harms creditors, it can be a boon to debtors, and tight monetary policy usually involves real tradeoffs in terms of employment and output. As Stiglitz (1998) notes, “typically, those who make the decisions are not representative of society as a whole . . . In many countries, bankers are disproportionately represented . . . Few countries ensure that workers and their interests are represented, even though the actions of the central bank have a vital impact on them” (217). Berman and McNamara (1999) cite the European Central Bank as an example of European financial and business elites wielding their influence to create an institution that would represent their own economic interests after the Euro’s introduction. In short, CBI’s critics argue that it cannot be justified either on economic or political grounds, and
that central banks should therefore be subject to much greater democratic inclusion and oversight.

Central Banks and Domestic Support

Granting central banks independence contributes to low inflation and prevents government officials from using central bank resources for their own political or economic advantage. At the same time, independence arguably leads central banks to overemphasize inflation fighting at the expense of other worthy economic goals. Are independent central banks good institutional investments for democratic states? It depends in part on whether there is a broad domestic consensus favoring very low inflation and agreement that central bank independence is the best way to maintain it. In countries such as Germany and the United States, for example, CBI emerged after a long domestic debate and process of political consensus-building. Highly independent central banks can operate effectively over the long term only if key domestic actors want them to do so and only if some agreement exists on the value of their basic inflation-fighting principles.

Central bank independence at a minimum requires support from the government, the financial sector, and the broader public in order to thrive legitimately in a democracy. The government must first grant independence to the central bank and then respect the bank’s independence in practice. Politicians would not agree to do so unless they felt it provided them some advantage (electoral or otherwise), even if only over the long term (Boylan 1998; King 2005). Governments and central bankers do “talk” to each other through public and private channels in order to influence each others’ activities and achieve cooperation. For this to work, there has to be some common ground, some acceptable compromise position – in practice, this means a government commitment to relatively low inflation. Similarly, CBI must be supported by the financial sector. In fact, Posen (1995) has argued that greater financial-sector influence, rather than CBI itself, explains the observed inverse relationship between CBI and inflation levels. Others argue that because low inflation protects creditors, the close relationship between central banks and the financial sector helps to explain the persistent political influence of low-inflation ideas (Epstein and Schor 1990).

Most important, though, is a broader public consensus on the value of low inflation (Strieborny 2003). The German Bundesbank’s persistent political support and its success in taming inflation rested on the German public’s deep-seated fear of inflation instilled through two devastating hyperinflations (Berger and de Haan 1999). In addition, while the connection between public attitudes and inflation levels has not received extensive scholarly attention, Hayo (1998) found in an intriguing study of nine EU countries that inflation levels were more closely related to public opinion about inflation than to the extent of central bank independence. Put a different way, independent central banks are only democratic and viable “as long as the public’s ‘perceived consensus’ about economic policies and macroeconomic outcomes is real” (Freeman 2002). Central bank
independence must be democratically legitimated through building and maintaining broad domestic support.

**CBI and Democracy in Post-Communist States**

Central bank independence began to sweep through East European and Eurasian countries immediately after the fall of their communist governments. The newly democratic states (and many not-so-democratic ones as well) adopted legislation granting significant independence to their central banks as a part of a broader wave of massive institutional transformation. Independent central banks symbolized sovereignty and economic respectability to these states, and as such were adopted without much discussion. They thought, logically, that since advanced industrial democracies have independent central banks, perhaps we should too.

As we have seen, the established democracies instituted central bank independence for domestic economic reasons (to tie politicians’ hands), through domestic means, and often based on domestic support for low inflation. Given the tradeoffs inherent in central bank independence, such domestic roots provide at least a minimal level of democratic legitimacy for these institutions. In contrast, international forces justified and actively instituted central bank independence in the post-communist states. This inborn “dual democratic deficit” proved problematic as these central banks later attempted to assert their authority in the face of difficult transitional economic conditions and increasingly skeptical publics.

As international advocacy for central bank independence moved to less-developed countries and then to post-communist states, the proposed justification for adopting this institution underwent a subtle change. No longer did it privilege a domestic economic rationale; instead, these countries should grant independence to their central banks in order to demonstrate “credibility” to international actors. By signaling a government’s commitment to macroeconomic stability, CBI would lead to increased foreign investment and greater support from international financial institutions (Maxfield 1997). Therefore, unlike in earlier cases, CBI was instituted not as a response to domestic inflation or political malfeasance, but primarily as a way to entice international investment. Supporting this view, Polillo and Guillen (2005) found in their study of 71 countries between 1990 and 2000 that increased exposure to foreign trade, foreign investment, and multilateral lending – but not domestic political or economic variables – led to increased CBI levels. Without a strong domestically rooted justification for their creation, independent post-communist central banks faced an uphill battle to prove their worth.

Complicating matters further, a transnational policy community of central bankers, rather than domestic actors, played the key role in transforming post-communist central banks (Johnson 2002). This transnational network encompassed the central banks in the advanced industrial democracies (engaging both current and former central bankers), the Bank for International Settlements (BIS, the “central bankers’ bank”), and the departments responsible for working with central banks within the international financial institutions (e.g., the IMF’s
Monetary and Exchange Affairs Department). Beginning in the late 1980s, they devoted millions of dollars and person-hours to training and technical assistance programs. Established central bankers integrated the post-communist central bankers into their community, transferred their views on the proper role of central banks, and led hands-on efforts to develop modern tools of central banking.

Technical assistance programs focused both on introducing new central banking legislation and on developing the organization and infrastructure of the central banks. In the legal arena, established central bankers suggested extensive reforms, highlighted the importance of legal independence for central banks, encouraged borrowing from Western models, and in many cases actually participated in writing new laws. Technical assistance also came in the form of both short-term missions (usually IMF sponsored) and long-term advisors (“resident experts”) from established central banks. These efforts included everything from developing monetary policy tools, to improving payments systems, to creating entirely new statistics and internal audit departments.

In terms of training, the intensive international efforts included conducting seminars either at the donor’s or at the recipient’s central bank, founding instructional centers (such as the Bank of England’s Centre for Central Banking Studies) designed to teach specialized banking skills, and accepting post-communist central bankers for residential internships. Over 25 different central banks regularly provided such specialized training courses and internship opportunities. These programs not only aimed to pass on the knowledge necessary to run a Western-style central bank, but to inculcate post-communist central bankers with the culture and values of the broader central banking community.

These central bank training and technical assistance programs were stunningly successful, in marked contrast to most other international aid programs in the post-communist world. Legislation supporting and deepening central bank independence swept through the region. Central banks underwent massive reorganizations, created a range of new departments, and integrated new technology and tools into their operations. Most importantly, the central bankers themselves gained valuable expertise. In my own research on post-communist central bank transformation, the central bankers stated in interview after interview that the technical assistance and training programs had been vital to their work, and that they had developed important, lasting contacts with other central bankers during this process.

Moreover, this international training and exposure encouraged them to think like typical central bankers. For example, my survey of 144 Hungarian and Kyrgyz central bank staffers in 2000-01 found that they “agreed” or “strongly agreed” that a central bank’s primary goal should be to insure price stability, that central banks should be independent, that central banks alone should determine monetary policy, and that independent central banks contribute to economic growth. It is important to stress that this internal central bank transformation did not occur through a fundamentally coercive process. As my interviewees in the transnational central banking community continually emphasized, change occurred in post-communist central banks only after the bankers themselves understood and came to agree with the new principles. Similarly, post-communist central bankers did not report making changes against their wills or under duress. Through this international integration process, the post-
communist central bankers grew to have more in common with central bankers abroad than with other political and economic actors in their own states. The result – Western-style central banks and central bankers, but without clear domestic constituencies and faced with unusually complicated economic challenges.

Could these transformed central banks prove their economic efficacy and retroactively build domestic constituencies? Unfortunately, this has proved too great a challenge for most. On the economic front, evidence indicates that in post-communist economies, central bank independence has had at best a mixed relationship to inflation and no relationship to economic growth. For example, Cukierman et al. (2002) found that central bank independence and inflation are not related in transition states until after they have reached “high and sustained” levels of economic liberalization. Nor does CBI appear to contribute to increased foreign investment or trade (Polillo and Guillen 2005). The independent central banks also failed to head off several serious currency and banking crises in the 1990s. Independent central banks, at least so far, appear unable to achieve their promised economic benefits to post-communist states.

None of this should be surprising, and the central bankers themselves cannot be faulted. Rather, post-communist conditions have severely limited the central bankers’ actual influence over their domestic economic environments. They have experienced four basic problems in this area: poor transmission mechanisms for monetary policy, insufficient monetary sovereignty, incompatible fiscal policies, and economic uncertainty. Post-communist states do not yet possess deep financial markets or sophisticated commercial banks, meaning that central bank attempts to affect the money supply through open market operations, reserve requirements, and such can prove ineffective or unpredictable. For example, Brada and Kutan (2002) argue that external factors rather than central bank policies have actually determined inflation rates in the Czech Republic, Hungary, and Poland. Many post-communist states also experienced an explosion of barter and dollarization, further limiting their central banks’ room for maneuver. Uncooperative political leaders often engaged in expansionary and uncoordinated fiscal policies, even if the central banks themselves refused to lend to the government. In addition, all post-communist central bankers faced the broader problem of the economic uncertainty and unpredictability that naturally accompanies any revolutionary transformation process.

Therefore, while post-communist central banks were granted independence, charged with fighting inflation, and given the modern tools with which to do it, their domestic economic environments often thwarted their best efforts. In the process, many post-communist central banks became scapegoats for currency crises and recessions precisely because their independence made them tempting political targets. While established central banks with political capital to spend can usefully play such a “scapegoat” role on occasion, it proved dangerous for newly independent central banks that lacked existing reservoirs of support.

Indeed, these economic failings made it progressively more difficult for post-communist central banks to develop the broad domestic constituencies that they had lacked at birth. As the Hungarian and Kyrgyz central bankers admitted in my surveys, they enjoyed little
support from their governments and publics. Central bank independence has been challenged across the post-communist world, from countries that have consolidated their democratic policies to those whose earlier democratic promise has since faced significant setbacks. This has occurred even in the prospective European Union states, where entry conditions required the establishment of central bank independence. In both Hungary and the Czech Republic, for example, political leaders shuffled central bank boards and revised central bank legislation in 2004-05 in attempts to bring the banks under greater government influence. In short, the institution of central bank independence has a low level of domestic support – and thus insufficient democratic legitimacy – in much of the post-communist world.

**Does CBI Matter in Russia?**

Should we mourn, celebrate, or reserve judgment on this de-legitimization of post-communist central bank independence? The Russian case demonstrates that there is no easy answer to this question. The Central Bank of Russia (CBR), once a fairly independent institution, has lost significant policy autonomy under President Vladimir Putin’s government. But while reining in the CBR may actually benefit Russia economically in the short term, in the long-term it has problematic political and economic implications.

To be considered independent, a central bank must have both formal legal autonomy and *de facto* policy autonomy. The highly unpopular CBR lost ground in both areas under Putin, although more in practice than in law. The CBR has enjoyed a relatively high level of legal independence since the mid-1990s, on par with that of the U.S. Federal Reserve. However, after a year of acrimonious debate, in July 2002 Putin signed amendments to the Law on the Central Bank giving a National Banking Council (NBC) greater control over CBR activities. The twelve-member NBC includes three representatives from the government, three from the presidential administration, five from the legislature, and only one from the CBR. The NBC takes much of the responsibility for monetary policy making and internal financial decision making out of the CBR’s hands, increasing the CBR’s accountability to the government but decreasing its formal autonomy.

More important, however, has been the decline in the CBR’s *de facto* autonomy under Putin. By ousting the CBR’s influential governor Viktor Gerashchenko in March 2002 and, in effect, subordinating the CBR to the Finance Ministry, Putin ensured that the CBR could no longer fight policy battles with the government. For example, Putin and the Finance Ministry have forced the CBR against its will to adopt mutually exclusive policy goals: simultaneously restraining inflation and maintaining a stable ruble. Both record high oil prices and the fall of the US dollar have put massive upward pressure on the ruble. The government wanted to restrain the ruble’s rise in order to protect domestic manufacturers, whose products become progressively less competitive in comparison with imports and internationally as the ruble appreciates. Following the government’s charge, the CBR bought dollars and printed rubles, running its foreign exchange reserves to record levels and spurring inflation. In April 2004 Putin increased the pressure by
instructing the CBR to limit the ruble’s rise against a dollar-euro basket to between 5 and 7 percent during the year – but without changing the previously agreed-upon inflation target of 8-10 percent. The International Monetary Fund has complained about the CBR’s concern with ruble stability rather than inflation since 2002, and blames “external pressures” for forcing the CBR’s hand.

A previously independent CBR had failed to provide three key expected economic benefits, however, raising the question of whether central bank independence had helped Russia. First, when independent the CBR could not consistently restrain inflation, especially in the early 1990s when the still-evolving CBR’s unorthodox policies directly contributed to massive spikes in prices. More importantly, the concern over inflation and CBI presumes that fighting inflation should always be the primary goal of the central bank. Despite IMF concerns, Putin’s preference for preserving exchange rate stability at the expense of moderate inflation may be defensible, especially given the macroeconomic pressures involved in dealing with unusually high oil prices.

Second, the central bank’s independent status did not affect Russia’s credibility with international markets. Putin’s Russia saw an overall rise in foreign investment at the same time that central bank independence declined precipitously. The reason is simple – central bank independence sends a far less important signal to international markets than budget, tax, and privatization policies in post-communist states, especially in resource-rich countries like Russia. Indeed, only six years after Russia’s devastating financial meltdown, 70 percent of Certified Financial Analysts polled in November 2004 saw the Russian investment market as “attractive” or “very attractive.” The Yukos affair did far more relative damage to Russia’s international standing, especially since the central bank did not enjoy much international respect in the first place.

Finally, contrary to conventional expectations, Russia’s commercial banks did not support the central bank’s independence. Instead, commercial banks had actively lobbied against CBR plans to allow foreign banks to compete in the domestic market, to press for greater transparency and accountability in banking, and to deal with the numerous problem banks in Russia. In previous years the banks also preferred an inflationary monetary policy because of its potential for quick profits. With a powerful government committed to at least some reform of the commercial banking system, a dependent CBR may ironically find it easier to ignore the demands of commercial bankers and clean up this troubled sector.

In short, a politically dependent CBR does not necessarily have the downsides that proponents of central bank independence might expect, and it has had the added benefit of improving policy coordination among the CBR, the Finance Ministry, and the government more broadly. In the long run, however, a completely dependent CBR could represent a significant problem for Russia. The CBR’s de facto subordination means that its activities are even less transparent than before, and increases the potential for governmental abuse of the CBR’s influence. If the economy grows worse in Russia, could the government restrain itself from using the CBR’s extensive financial resources to shore up its popularity? Although independent central banks can be criticized for their
undemocratic nature, a central bank that is merely one more tool in a centralized state apparatus would represent a much greater threat to Russia’s embattled democratic institutions. In the end, there is something to be said for “horizontal accountability.”

Reconciling CBI and Democracy

International goals and actors transformed post-communist central banks into independent would-be guardians of price stability, but at the cost of democratic legitimacy. The successful international efforts encouraging post-communist states to grant legal independence to their central banks before these banks possessed the abilities or support necessary to manipulate their economies have allowed elected politicians to unfairly shift blame onto the central banks for crises and recessions. Furthermore, the highly inflation-averse economic philosophy instilled in the post-communist central bankers put them further at odds with many domestic interest groups, who argued that their transitional economies required a more moderate level of inflation in order to achieve rapid adjustment and growth. Faced with difficult economic conditions and lacking firm domestic constituencies, these central banks now often find their autonomy restricted and their policies challenged. The post-communist central banks’ initial dual democratic deficit has blossomed into a full-scale crisis of legitimacy.

While this development has implications for debates over both international assistance and macroeconomic policy making, its most important message reaffirms the need for central bank independence to rest on a firm democratic foundation. Independent central banks are highly professional repositories of economic expertise, and they successfully prevent politicians from egregiously abusing monetary policy. At the same time, central bankers tend to favor a specific macroeconomic philosophy that carries significant distributional consequences. Therefore, building democratic support for central bank actions without also subjecting the central banks to undesirable political manipulation requires modifying, not rescinding, central bank independence.

Although central bank board members should be prohibited from simultaneously holding other positions, they should be drawn from a broad range of society rather than predominantly from the financial community. This would help to ensure greater democratic legitimacy for a board’s policy decisions. Similarly, governments should reserve for themselves the right to set monetary policy goals, including specific inflation targets, and charge the central banks with meeting them. This puts distributional questions back into the hands of elected officials while leaving policy implementation to the experts. Governments retaining this power may very well listen to their central bankers and continue to set low inflation targets (as occurs in Britain), but then they, not the central bankers, must justify the decisions and take responsibility for the outcomes. Finally, central bank activities must be made as transparent as possible. At a minimum, central bankers should publish the minutes of their meetings and regularly explain the specific goals, means, and consequences of their monetary policies to elected officials and the public.
Given these constraints, however, central bankers should be free to carry out their
government’s macroeconomic policy directions as they see fit, and should retain
complete financial independence from the government – meaning no loans to the
government and no state control over central bank budgets or salaries. Such measures
would provide democratic accountability without permitting populist abuse. While these
recommendations apply to all independent central banks, they carry particular relevance
for post-communist states. In order to retroactively build democratic legitimacy, post-
communist central banks need to repair their relationships with the public and return
ultimate responsibility for macroeconomic policy decisions to elected officials. The
central bankers may not always approve of the resulting policies or outcomes, but no one
should ever get exactly what they want in a democracy.
References


Since New Zealand adopted an explicit inflation targeting policy in 1989, many other established central banks have followed its lead, including the ECB and the central banks of Australia, Canada, Korea, Israel, Sweden, Switzerland, and the United Kingdom. All of these banks have targets set at 3% or less. The Reserve Bank of Australia’s website is especially interesting in this regard. It states that “The Board's obligations with respect to monetary policy are laid out in . . . the Bank's charter,' [which] says: ‘It is the duty of the Reserve Bank Board . . . [to] contribute to the stability of the currency of Australia, the maintenance of full employment in Australia, and the economic prosperity and welfare of the people of Australia.’ Since 1993, these objectives have found practical expression in a target for consumer price inflation, of 2-3 per cent per annum. . . . In the long run, this is the principal way in which monetary policy can help to form a sound basis for long-term growth in the economy.” In sum, even though price stability is not among the Bank’s three legal goals, it believes that a strict focus on low inflation alone will best forward these goals.

In addition, a study by Cukierman et al. (2002) found that legal increases in CBI were not related to inflationary episodes in transition states.