Informed Consent or Inappropriate Bondage?
Central Bank Independence and Democratic Governance in the Post-Communist World[1]

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In the late 1980s an international consensus emerged on the desirability of formally insulating domestic monetary authorities from direct government influence, on the grounds that an independent monetary authority can best take the sometimes unpopular measures necessary to keep inflation low. Acting on the consensus typically meant passing legislation protecting a country's central bank from political interference in monetary policy making and implementation. Around the world, governments in the advanced industrial democracies began granting independence to their central banks in order to tie their own hands in the name of the greater public good.

At this auspicious moment, communist regimes collapsed in East Europe, the Balkans, and Eurasia. Post-communist governments quickly embraced the new international consensus on central bank independence. As Cukierman, Miller, and Neyapti demonstrate, by the mid-1990s every single post-communist government had passed legislation granting significant independence to its central bank.[2] In fact,about one-third gave their central banks more independence than the German Bundesbank, then the gold standard of central bank independence. Nor was this top third merely the "usual suspects" in East Central Europe – it included states as diverse as Armenia, Moldova, the Czech Republic, and Kazakhstan. Legislating central bank independence does not mean that a government will necessarily respect its own laws in practice, but it does indicate that post-communist governments agreed that passing these laws had real value. These countries all made the choice, at least on paper, to shield their monetary authorities from the political process.

In the following pages, I examine why post-communist governments eagerly adopted central bank independence, why most soon came to regret it, and why, despite these second thoughts, central bank independence remained strong throughout much of the region. I argue that post-communist governments initially granted independence to their central banks because of international norms and material incentives, not because they understood or believed in the overriding importance of domestic price stability. Once the true implications of central bank independence in the transitional economic environment became clearer over time, many governments attempted to rein in their central banks' power. While governments in some states (particularly in the former Soviet Union) successfully did so, in many others governments failed to undermine central bank independence because of strong international pressures to maintain the institution. As a result, post-communist central banks typically enjoyed greater support

[1] This paper is excerpted from my book manuscript in progress, *Priests of Prosperity: The Transnational Central Banking Community and Post-Communist Transformation.*

[2] Cukierman, Miller, and Neyapti 2002. In confirmation, Maxfield 1997 found that the average level of statutory central bank independence in 14 post-communist states from 1990-94 (using Cukierman, et al.'s coding) was .45, comparable to Western Europe's .46 ranking.

internationally than within their own countries, an inversion of the democratic principles that theoretically justify central bank independence.

What is Central Bank Independence?

Central bank independence is somewhat of a misnomer, as no domestic economic institution can be completely free from politics. Central bankers must occasionally take political sentiment into account or risk losing their independent status. Transparency guidelines also bind most independent central banks, 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. Nevertheless, laws granting central banks extensive decision-making and financial autonomy from elected authorities can significantly shield central bankers from the political process.

Most social science research on post-communist central banking has focused tightly on central bank independence: how to measure it, whether or not it is useful, and why it is so high. A cottage industry measuring CBI emerged among economists, who look at the legal statutes governing a central bank's operations to evaluate its political and economic independence.[3] As Arnone et al note, although a variety of CBI measures exist, policy makers generally agree that four broad principles represent the mainstay of legal CBI: price stability should be the main goal of monetary policy, central bank lending to the government should be restricted or eliminated, central banks should set their policy rates autonomously, and the government should have no role in policy formulation (for example, seats on the central bank's board). There are other common but relatively less important measures as well. Such measures deem a central bank more politically independent if its governor enjoys a term of at least six to eight years, if its board members hold lengthy terms not synchronized with the electoral cycle, if the appointment process is clear and relatively apolitical, if the governor and board members must possess particular professional qualifications, and if the governor and board members may not simultaneously hold other posts. A central bank is considered more economically independent if it controls its own budget and salaries, if it does not conduct banking supervision, and if it possesses a wide range of monetary policy instruments. The underlying presumption is the more independence, the better.

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[3] The leading initial studies measuring CBI were Cukierman 1992 and Grilli, Masciandaro, and Tabellini 1991. Studies comparing CBI in transition states include Cukierman, Miller, and Neyapti 2002; Dvorsky 2000; Maliszewski 2000; Neyapti 2001; Elgie 1998; Berger, De Haan, and Eijffinger 2001; Siklos 1994; Hochreiter and Kowalski 2000; Radzyner and Riesinger 1997; Arnone et al. 2007; Mahadeva and Sterne 2000; Loungani and Sheets 1997; Lybek 1999. All find a generally high level of legal central bank independence in the post-communist world, both in absolute terms and in comparison to other regions. For example, in the most recent study Arnone et al write that "Central banks of countries in transition have reached CBA [central bank autonomy] scores that are comparable with, and sometimes even higher than, CBA in the advanced economies." Mahadeva and Sterne also confirm this result in their survey of 94 central banks, finding that industrialized and transitional states both had high degrees of *de jure* independence, with developing states lagging considerably behind.

CBI advocates argue states create independent central banks for domestic economic reasons.[4] 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. Empirically bolstering this position, quantitative studies have consistently found a link between higher levels of CBI and lower levels of inflation in established market democracies. Others also argue that CBI can reduce political 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. 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 what Guillermo O'Donnell has called agents of "horizontal accountability" in democratic polities.[5] CBI proponents also imply that 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 technocrats requires a government to tie its own hands for the greater economic good of the country.

Importantly, this policy consensus rests on shaky empirical foundations. True, statistical evidence shows that CBI contributes to low inflation in advanced industrial democracies.[6] 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.[7] For example, the independent European Central Bank sets its informal inflation target at "below, but close to, two percent." Alan Blinder, the Princeton economist and former Vice Chairman of the U.S. Federal Reserve Board of Governors, found in his survey of 84 central bank governors that these central bankers deemed "credibility" (interpreted as a credible dedication to price stability) to be "of the utmost importance" for a central bank.[8] But the economic logic behind CBI rests on two controversial assumptions about inflation and economic outcomes: that independent central banks can reduce inflation at less cost than can more politically dependent ones, and that

[4] Major academic proponents include Rogoff 1985; Alesina and Summers 1993; Fratianni, Hagen, and Waller 1997; Bernhard 2002, among many others.

[5] Schedler, Diamond, and Plattner 1999; O'Donnell 1998

[6] Some analysts think that even this correlation is spurious, arguing that domestic cultures supporting low inflation, conservative commercial financial sectors, and other related variables are the causal factors behind both CBI and low inflation. Hayo 1998; Hayo and Hefeker 2002; Posen 1995; Campillo and Miron 1997; McNamara 2002

[7] Blinder 1998; Marcussen 1998; Kirshner 2003.

[8] Blinder 1999

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 people trust independent central banks to do what they say they will do. Therefore, they 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.[9] This likely occurs because independent central bankers are so concerned with lowering inflation and preserving their reputations as credible inflation fighters that they will sometimes adopt overly tight monetary policies. As Joseph Stiglitz observed, "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."[10]

Similarly, even sympathetic economists have generally failed to find a measurable impact of central bank independence on economic growth.[11] This is because, as further studies demonstrate, steadily moderate levels of inflation (up to 20 percent annually) do not necessarily retard economic growth and may be beneficial in maintaining higher employment levels.[12] Neither does evidence indicate that such moderate inflations exhibit a tendency to "take off" into unquestionably damaging hyperinflations. Yet central bankers tend to believe that only very low levels of inflation (between 1-3 percent per year) can provide the conditions for sustainable economic growth.[13]

The empirical case for central bank independence suffers further when one moves beyond the realm of advanced industrial democracies, as economic studies often fail to find a robust link between legal CBI and inflation in developing and transition countries.[14] Cukierman et al and Maxfield note that CBI and inflation are not correlated in developing countries.[15] In transition countries, both Cukierman et al and Maliszewski

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[9] Down 2004; Blinder 1999; Kissmer and Wagner 2004

[10] Stiglitz, "Central Banking in a Democratic Society," 217.

[11] Alesina and Summers 1993.

[12] Kirshner 2003; Barro 1995

[13] Since New Zealand adopted an explicit inflation targeting policy in 1989, many other established central banks have followed its lead, including the central banks of Australia, Canada, Korea, Israel, Sweden, Switzerland, and the United Kingdom. All of these banks have targets set at 3 percent per year or less.

[14] An exception is Loungani and Sheets 1997, who do find a connection in their study of transition economies. However, Kissmer and Wagner 2004 point out that this study looked only at inflation in a single year (1995) and most of the central banking statutes had only recently been enacted, calling its robustness into question. When Cukierman et al 2002 re-ran the analysis with their indices and broader time periods, the relationship disappeared.

[15] Cukierman 1992; Maxfield 1994

find that central bank independence can contribute to lower inflation rates, but only once the country has already achieved high and sustained levels of economic liberalization. Arnone et al also find that CBI may contribute to lower inflation rates in transition countries, but that factors such as globalization and policy learning effects are far more important determinants of inflation.

Outside 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.[16] British parliamentarians and academics have similarly argued that CBI contradicts the British political system's founding principle of parliamentary sovereignty.[17] 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.[18]

Finally, critics argue that central bank decisions are inherently political because they have major distributional effects. Placing monetary policy in the hands of central bankers 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.[19] Although any inflation harms creditors, it can be a boon to debtors, and tight monetary policy usually involves tradeoffs in terms of employment and output. Berman and McNamara cite the European Central Bank as an example of European financial and business elites wielding their influence to create an institution to represent their own economic interests after the Euro's introduction.[20] In sum, CBI's critics argue that it cannot be justified either on economic or political grounds, and that central banks should be subject to greater political inclusion and oversight.

Central Bank Independence in the Post-Communist World

Given these legitimate concerns over independent central banks' efficacy and accountability, why did post-communist governments all pass laws granting significant independence to their central banks in the early 1990s? I argue that the pro-CBI international consensus at that time, the uncertainty of the transition, and the drive to establish economic sovereignty explain the rapid initial spread of CBI across the post-communist states.[21] In particular, the international consensus encouraged post-communist

[16] Stiglitz 1998.

[17] Busch 1994.

[18] Berman and McNamara 1999

[19] Bowles and White 1994; Berman and McNamara 1999

[20] Berman and McNamara 1999

[21] The only example of internationally imposed CBI occurred in Bosnia-Herzegovina. Article VII of the Dayton peace agreement of November 1995 guaranteed the central bank's independence and required that

governments seeking solutions to new problems to borrow components of existing central bank legislation primarily because of its symbolic and ready-made qualities, not because of an understanding and acceptance of CBI's domestic economic implications.[22]

Only emulation of an internationally approved institution in the face of uncertainty can explain why post-communist states initially granted significant legal independence to their central banks so rapidly, most in 1990-92. Only two countries, Hungary and Bulgaria, had signed IMF standby agreements before passing their first post-communist central banking laws and only two more, Albania and Romania, signed their first standby agreements within a year of their initial central bank laws. Most passed their first central banking laws before even applying for IMF membership, so IMF loan conditionality cannot explain widespread CBI adoption. Small, resource-poor countries and large, resource-rich ones alike passed CBI laws. Relative trade openness and FDI do not explain the widespread initial passage of CBI laws or the later variations in CBI levels.[23] Countries experiencing high inflation and those as yet without serious inflation problems passed CBI laws, as did those in every post-communist region, from East Central Europe to Central Asia.[24] Both newly Western-oriented democracies like Poland and inward-looking autocracies led by Soviet-era elites like Uzbekistan introduced such laws. In fact, only civil war stopped post-communist governments from immediately adopting important elements of CBI (in rump Yugoslavia and Tajikistan), and at that only temporarily.

Marcussen, Quaglia, Grabel, and McNamara all argue that given the widespread international consensus on CBI, follower countries choose to adopt it primarily in pursuit of international legitimacy and recognized sovereignty regardless of its "fit" with domestic conditions.[25] As Marcussen observes, "sometimes states simply adopt a certain organizational structure such as a central bank because the act in itself will classify the state as being modern and developed and thereby a legitimate actor in world society."[26] This does not necessarily mean that introducing CBI is a bad idea, but that by doing so governments are conforming to international expectations rather than responding to specific domestic demands. For example, many post-communist governments passed laws limiting central bank participation in the primary securities market before they had even begun issuing government securities, much less had secondary markets for them.

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its first governor be a foreigner. A New Zealand central banker, Peter Nicholl, served for five years as its first governor.

[22] Epstein 2008 similarly emphasizes varying domestic openness to international influences (what she refers to as the "social context" of reform) in explaining differences in both legal and actual CBI in post-communist states.

[23] Polillo and Guillen 2005

[24] Cukierman finds that inflation does not significantly affect CBI levels in the post-communist world. Both Quaglia 2005 and Marcussen 2005 point out that CBI adoption and inflationary experiences are not closely related in the rest of the world, either.

[25] McNamara 2002; Quaglia 2005; Marcussen 2005; Grabel 2000

[26] Marcussen 2005

Many laws also limited central bank financing of the government well before it was realistically possible to do so in practice, given underdeveloped or nonexistent securities markets and taxation bureaucracies. Therefore, as McNamara argues:

> The spread of central bank independence should be seen as a fundamentally social and political phenomenon, rooted in the logic of organisational mimicry and global norms of neoliberal governance. Organisational models are diffused across borders through the perceptions and actions of people seeking to replicate others' success and legitimise their own efforts at reform by borrowing rules from other settings, even if these rules are materially inappropriate to their local needs.[27]

Importantly, although many critics of the "Washington consensus" lump central bank reform together with other so-called neoliberal reforms prescribed to post-communist states (such as rapid price and trade liberalization, privatization, and fiscal reform), it did not spread merely as a part of a broader reform package. It had its own community of advocates, its own separate justifications, and spread more widely and rapidly. CBI's most vocal advocates were the West European central bankers, at that time busily crafting the rules for European Monetary Union.

The international call for CBI had immediate resonance in the post-communist world because of the uncertainty and upheaval engendered by the collapse of communist-era political and economic institutions. The two pillars of the communist system – the Communist Party and the command economy – had lost their integrity and legitimacy. As the previous order came into question, economic systems fell into disarray, and a scramble to gain control over material resources ensued. Government officials, enterprise directors, and entrepreneurs of various sorts began to formally and informally appropriate property previously "owned" by the state. Currencies often became unstable, and in many countries dollarization, arrears, and barter began to proliferate. Trade relationships faltered badly as well, as countries found their traditional Soviet bloc trade partners often unwilling to or incapable of maintaining their previous ties. Faced with the unprecedented and daunting task of managing an inherently unmanageable economic transformation, new post-communist governments avidly sought help. As King notes, "ideas are most important during periods of uncertainty or in complex and technical issue areas. These situations obscure the distributional effects of a given institutional arrangement or policy choice, making it difficult for interest groups to identify where their interests lie."[28] In terms of central banking, it was clear that command-era central banks needed new mandates and capabilities to function within the chaotic yet increasingly market-oriented environment. Under these circumstances, it made perfect sense to borrow institutional models from elsewhere. For example, Hungary, Poland, and Czechoslovakia modeled their central bank legislation after the German law on the Bundesbank, while Slovenia copied both Austrian and German laws. Given that the international community consistently accepted and promoted one particular model of central banking – the independent, conservative central bank – it should not be surprising that this institutional form proliferated.

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[27] McNamara 2002

[28] King 2005

The international consensus around CBI also meant that post-communist governments believed that adopting CBI would yield greater international resources and legitimacy. Once CBI came to be considered "best practice" among the advanced industrial democracies, international financial institutions and foreign investors began to view CBI as one indication that a country's leaders were committed to economic stabilization. Many post-communist governments therefore hoped that CBI legislation would serve as a cheap yet effective signal leading to increased foreign investment and support from international financial institutions. Although this initial introduction of CBI did not meaningfully affect foreign resource flows to post-communist states, the more important fact is that post-communist governments believed that it might. International advisors reinforced this belief, emphasizing that independent central banks were important indicators to the outside world that a country was serious about reform.

More fundamentally, post-communist leaders' desire for their states to be taken seriously, to be considered legitimate members of the international system, meant adopting institutional forms characteristic of independent states. In 1990, former U.S. Federal Reserve governor Paul Volcker kicked off a conference on central banking in emerging markets by wondering aloud why post-communist leaders had become so enamored of independent central banks, pointing out that there are plenty of other effective ways to stabilize currencies, that socialist economies historically had a good record on inflation, and that central banks can actually become engines of inflation rather than the reverse. Given this, he said, "it seems to me . . . the reason that there is so much talk about central banking is that it is very much tied up with ideas of sovereignty, of autonomy, of discretion, and of economic policy making."[29] Most post-communist countries had not experienced meaningful sovereignty for years and in some cases had never done so, and establishing internationally respected and recognized state institutions seemed vital in the early years of transition. Eastern central bankers especially embraced the conflation of sovereignty for their countries with sovereignty for their institutions. For example, the governors of the three Baltic central banks met in August 1990 to declare support for "the idea that the central banks should be independent of USSR banks, as well as of their own governments."[30] By borrowing Western economic practices, they both affirmed a desire to grow wealthy through engagement with the West and rejected their previous, enforced identification with the Soviet Union. Even the leaders of the Russian Federation at first strongly identified as Western-oriented, and thus "progressive."

Domestic Challenges to CBI

However, after the initial honeymoon period many post-communist political leaders came to regret their earlier decisions to grant so much independence to their central banks. They found that the central banks' conservative monetary policies often conflicted with their domestic development plans, and that the central banks could not always prevent

[29] Quoted in Federal Reserve Bank of Kansas City 1990

[30] "Baltic Central Bank Leaders Urge Independence," Vilnius Domestic Service, 28 August 1990, translated in FBIS-SOV 90-168, 29 August 1990, p. 65.

banking and currency crises. Post-communist governments often did not support their central banks' conservative monetary policies with fiscal restraint, so the governments and central banks regularly worked at cross purposes. As time went on, politicians became more confident about challenging central bank policies when they appeared to conflict with government spending priorities. As a result, most central banks across the region experienced attempts, both formal and informal, to rein in their independence by the late 1990s.

Why did this occur? Independent central banks ultimately require support from the government, the financial sector, and the public in order to thrive. The government must not only grant independence to the central bank and then respect the bank's independence in practice. 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 common ground, which in practice means a general government commitment to relatively low inflation and belief in the central bank's technocratic expertise. Similarly, CBI must be supported by the financial sector. Posen has argued that greater financial-sector influence, rather than CBI itself, actually explains the inverse relationship between CBI and inflation levels in the advanced market democracies.[31] 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.

Also important is a broader public consensus on the value of low inflation. The German public's previous experience of devastating hyperinflations contributed significantly to the Bundesbank's political support and its success in taming inflation. One 1998 study of nine EU countries found that inflation levels were more closely related to public opinion about inflation than to the degree of central bank independence.[32] Put a different way, independent central banks may only be viable "as long as the public's 'perceived consensus' about economic policies and macroeconomic outcomes is real."[33] In short, central bank independence must be legitimated through building and maintaining broad domestic support. 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.

But in post-communist states, governments typically supported central bank independence initially primarily because of external incentives rather than an intrinsic belief in its worth as an institution. Post-communist publics, governments, and commercial banks exhibited little demand for conservative macroeconomic policy-making. As one Hungarian central banker lamented, "People on the street I'm sure do not have the faintest idea about the National Bank or monetary policy. Of course, the people on the street is one question, but if people in the parliament haven't got the faintest idea .

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[31] Adam Posen, "Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence," *NBER Macroeconomics Annual* (Cambridge, Mass.: MIT University Press, 1995).

[32] Bernd Hayo, "Inflation Culture, Central Bank Independence, and Price Stability," *European Journal of Political Economy* 14:2 (1998): 241-263.

[33] John R. Freeman, "Competing Commitments: Technocracy and Democracy in the Design of Monetary Institutions," *International Organization* 56:4 (2002): 890-891.

. .”.[34] In addition, the financial sectors of these countries did not necessarily welcome independent central banks either, as the central banks took an active role in financial sector transformation that placed continuing constraints and pressures on commercial banks. Nearly two decades after the transformation began, long-time Czech National Bank governor Josef Tošovský neatly summed up the central banks’ predicament:

> In the advanced market economies, central bank independence has grown as the political authorities and the public have gradually become aware of the advantages for the whole economy of low inflation and stable growth. . . . In general, transition economies formally embraced most of the European legal framework’s elements defining the position of central banks. But the principle of central bank independence embodied in that framework has not yet been fully accepted by the public and especially by politicians. When macroeconomic imbalances accumulated, central banks often had the unpopular task of announcing the bad news. If in addition a central bank responded with an appropriate tightening of monetary policy, it fell into even greater disfavor, being blamed for the slowing of growth, increasing unemployment, and social unrest. The reaction of governments or representative bodies was to try to get them under control. This political pressure has been a fact of life for the central banks of most countries in our region. I see this as a symptom of the immaturity of the transition economies . . . .[35]

Surveys I conducted among Hungarian, Czech, and Kyrgyz central bankers reflected this belief (Table 1). Most central bankers found that a decade after the transition began, their countries’ political executives, commercial bankers, and publics did not necessarily understand their work, despite the central banks’ intensive publicity efforts. Moreover, while Hungarian central bankers agreed that commercial bankers understood the NBH’s work, this did not translate into commercial bank support for the NBH. Indeed, respondents in all three central banks felt at best lukewarm about the support they received from politicians in power, commercial banks, and the public. At the far end, Kyrgyz central bankers actively disagreed with the statement “commercial bankers support the work of my central bank.” Notably, these central bankers felt unloved even before they faced several serious political attacks on their independence that occurred in the years after the survey was conducted.

Not only did other domestic actors often not support their central banks’ goals, the central banks themselves had great difficulty carrying out their mandates. While no central bank can create macroeconomic stability on its own, the complex transitional economic conditions meant that post-communist central bankers faced a far more difficult task than did central bankers in established market economies. Post-communist states had shallow financial markets, meaning that central bank attempts to affect the money supply through indirect instruments too often proved ineffective or unpredictable. In addition, post-communist central banks struggled with the broader problem of the uncertainty that accompanies a complete switch in economic systems. As one Czech central banker admitted to me, “Traditional theoretical concepts just don’t work very well yet, although they’re starting to get more typical. Ten years just isn’t enough data on

[34] Personal interview, National Bank of Hungary, Budapest, Hungary, March 2000.

[35] Josef Tošovský, Governor of the Czech National Bank, “Ten Years On: Some Lessons from the Transition,” Per Jacobsson Lecture, September 2000, Prague. Available from the CNB website, http://www.cnb.cz/www.cnb.cz/cz/konference_projevy/vystoupeni_projevy/download/mmf_per_jacobsson.pdf. Accessed April 10, 2006.

which to build models."[36] Therefore, while post-communist central banks were tasked with maintaining price stability and had developed a full range of policy tools by the mid-1990s, they could not influence macroeconomic conditions as effectively as the central banks after which they were modeled.

Under these conditions, it is not surprising that Cukierman et al found that increased central bank independence was typically unrelated to inflationary episodes in post-communist states.[37] Similarly, in a 2000 study of the five East Central European states then closest to EU accession, Dvorsky found that despite high levels of legal independence, the main causes of inflation were beyond central bank control.[38] Brada and Kutan went even further, crediting external factors for inflation reduction in the Czech Republic, Hungary, and Poland and arguing that "monetary policy [in these countries] as yet rests on relatively weak financial markets and institutions, and it operates in an environment where the agents it seeks to influence may react to monetary policy in undesirable ways or not at all."[39] Several post-communist central banks later made their credibility problems temporarily worse by adopting inflation targeting as the basis for monetary policy. When a central bank commits to an inflation target, it assumes responsibility for meeting that target. Every time a central bank misses its inflation target, it undercuts its authority and credibility regardless of its actual role (usually minimal in post-communists states) in causing that failure.

Post-communist central bankers thus found themselves in a difficult position. On the one hand, they were legally independent and held publicly responsible for maintaining low inflation and a stable financial system. On the other hand, despite their advanced institutional capabilities, even monetary sources of inflation were often beyond their control. This made it easy for governments and other domestic actors to use the central banks as scapegoats for poor economic results. Indeed, the very independence and mission of the central banks invited such criticism, because these principles assumed the effectiveness of central bank policies. Not surprisingly, the most significant political challenges to post-communist central banks occurred during currency and banking crises. In countries as diverse as the Czech Republic, Russia, Kyrgyzstan, and Bulgaria, central bank policies were blamed for massive, rapid currency devaluations. Only the central banks running currency boards managed to escape sustained political criticism, as they lacked monetary policy discretion.[40] Likewise, central bankers were often criticized both for wanting to close problem banks (before banking crises), and for not having closed problem banks fast enough (after banking crises). The more difficult the domestic political environment, the more frustrated post-communist central bankers became. Such

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[36] Personal interview, Vojtěch Benda, Banker, Real Economy Division, Czech National Bank, May 25, 2000.

[37] Cukierman et al 2002

[38] Dvorsky 2000

[39] Brada and Kutan 2002:8

[40] The currency board states were Estonia (as of 1992), Lithuania (as of 1994), Bulgaria (as of 1997), and Bosnia-Herzegovina (as of 1998).

conflict promoted the “decoupling” of the central banks’ “general values” from “practical action,” often engendering outwardly Western-style central banks that become progressively isolated domestically.[41]

External Enforcement of CBI

In some post-communist countries such as Russia, the backlash against central bank independence led to a reduction in the central bank’s powers and greater coordination between the central bank and government in making and implementing monetary policy.[42] Where central bank independence remained strong, however, it was typically due to perceived and actual external pressures. Chief among these were IMF threats to withhold funding, EU accession requirements, and the blow to the state’s international reputation that the disapproval of the international financial community would bring. As long as these pressures remained salient to post-communist governments, their central banks remained independent despite domestic debates over their policies and efficacy. While this occurred throughout the region, here I will focus briefly on the fairly typical examples of the Czech and Slovak Republics. Beginning in the mid-1990s disgruntled governments in both countries tried to amend their laws in order to strip their central banks of key aspects of independence, only to be thwarted by the increasingly self-confident central banks and their international support networks.

While both the Czech National Bank (CNB) and National Bank of Slovakia (NBS) started out with significant government support, clashes over “too restrictive” monetary policies and damaging banking crises had engendered more antagonistic government-central bank relationships by the mid-1990s. Both governments eventually attempted to gain more control over their central banks by revising central bank legislation to reduce their independence, the Slovak government in 1997 and the Czech government in 2000. Both central banks fought these attempts vigorously, defending their internationally legitimized beliefs and practices in parliament and the press. In the end, neither government successfully undermined its central bank’s legal independence during these episodes, primarily because of external pressures not to do so. While IMF pressures played the key role in Slovakia, EU requirements did so in the Czech Republic.

In Slovakia, tensions between the NBS and the Mečiar government heated up in late 1996 when the NBS significantly tightened monetary policy after the government approved a budget for 1997 with a planned deficit of 3.7 percent of GDP. Although the government heavily criticized the NBS and appointed its former deputy finance minister to the NBS board in response, Governor Masar remained defiant, stating that “we are not stepping aside from our monetary goals.”[43] In October 1997 the government, fed up with its uncooperative central bank, proposed an amendment to the Act on the NBS that would significantly reduce its independence. Measures in the amendment included requiring

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[41] See Meyer 1997

[42] Johnson 2006a

[43] Tatiana Vacova, “Slovak central banker reaffirms tight money policy,” *Reuters News*, March 5, 1997

parliament to approve the NBS budget, increasing the limit for NBS financing of the budget deficit through treasury bill purchases from five to ten percent, and raising the number of banking council members from eight to ten (of which five would be appointed on the Finance Minister's recommendation). The Mečiar cabinet approved the amendment while Masar was away representing the NBS in Indonesia, despite his protests.[44]

However, the Slovak parliament still had to approve the amendment. Masar argued that the amendment could threaten the stability of the Slovak koruna and that the NBS, as the only state institution with some autonomy from the government, should not be undermined.[45] Unmoved by Masar's concerns, parliament approved the first reading of the amendment on November 12, sending it to committee for further discussion.[46] At that point, everything changed. An IMF mission to Slovakia released a report on November 13 heavily criticizing the proposed amendments. Masar went on the offensive, downplaying his domestic arguments and instead pointing out that the IMF and international rating agencies would react negatively towards Slovakia if the amendment passed.[47] In the debate in parliament before the vote, Masar quoted directly and at length from the critical IMF report.[48] He also noted that EMU entry required central bank independence. With Slovakia dependent on IMF loans, interested in international investment, and recently rebuffed from being named to the first round of prospective EU entrants, Masar's invocation of international opinion did the trick. Although Finance Minister Sergei Kozlik countered that "many instructions passed to us by important institutions . . . are not always applicable in countries that are undergoing transition," Masar's appeal raised concerns among the ruling HDSZ's two smaller coalition members.[49] Faced with dissent, parliament postponed the final vote until December.

Furious, Mečiar stepped up his attacks on the NBS, not only criticizing its monetary policy but blaming it for inappropriate supervision of the Investment and Development Bank (which the NBS had recently placed under forced administration) and for overspending on its lavish new headquarters building downtown.[50] He painted a

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[44] *CTK Business News*, "Slovak cabinet ignores NBS remarks on amendment to NBS Act," October 1, 1997

[45] Peter Laca, "Slovak cbank says draft threatens crown stability," *Reuters News*, October 6, 1997; *The Wall Street Journal Europe*, "Slovak Central Banker Questions Reorganization Plan," October 7, 1997, p. 10

[46] Peter Laca, "Slovak parl votes cbank law to second reading," *Reuters News*, November 12, 1997

[47] *Reuters News*, "Slovak NBS governor urges parl't to reject NBS law," November 21, 1997; *CTK Business News*, "Parliament to decide on NBS's autonomy next December," November 21, 1997

[48] *BBC Monitoring Service: Central Europe & Balkans*, "Central bank chief, minister clash over law curbing central bank independence," November 24, 1997

[49] *Central Europe & Balkans*, "Central bank chief, minister clash over law curbing central bank independence," November 24, 1997; Peter Laca, "Decision on crucial Slovak cen bank law postponed," *Reuters News*, November 21, 1997

[50] *BBC Monitoring Service: Central Europe & Balkans,* "Central bank responsible for bank crisis – premier," December 24, 1997. The CNB was also criticized for the amount it spent on renovating its downtown Prague headquarters, costing it public support.

picture of a rogue bank out of control, one which needed more government oversight to restrain its worst impulses. Nevertheless, Mečiar failed to persuade his party's coalition members. By this point both smaller parties had expressed disapproval of the amendment, forcing yet another postponement of the vote until February 1998.[51] At the same time, the NBS confirmed it would retain a tight monetary policy in 1998, despite government pressures.[52] The amendment to the Act of the NBS, so heavily promoted by the Mečiar government, finally died on the vine. The next significant amendment to the Act, passed easily in April 2001 under a more sympathetic government and with an eye towards EU requirements, increased the NBS's supervisory powers, changed its main goal from currency stability to price stability, and forbade the NBS from financing the budget through treasury bill purchases.[53]

Like the NBS, the CNB avidly pursued monetary convergence with Europe and enjoyed relatively solid political support in its earliest years. But the CNB's formerly secure status came into question after a serious currency crisis in May 1997. The ensuing economic turmoil contributed to the resignation of Prime Minister Václav Klaus (head of the Civic Democratic Party, ODS) and his temporary replacement by CNB governor Tošovský in December 1997.[54] Tošovský led a caretaker government until Miloš Zeman's newly elected Social-Democratic (CSSD) minority government took power in July 1998. Circumstances surrounding the 1997 events turned both Klaus and Zeman against the CNB. Klaus blamed the CNB's tight monetary policy for the 1997 crisis and his own political troubles, while Zeman blamed the same restrictive CNB policies for the Czech Republic's slow post-crisis recovery.[55]

Ironically, Zeman and Klaus used the need to harmonize the Act on the CNB with the EU *acquis* in 2000 to rein in the independence of the central bank. In preparing the Act's amendment, Klaus's ODS introduced new limitations on the CNB, including a requirement to set the inflation target in consultation with the government, to get parliamentary approval of the CNB budget, and to get governmental approval of the president's choice for the CNB governor and board. Visually capturing the moment, the May 29 cover of the Czech economic weekly *Euro* featured a doctored photo of Tošovský wearing studded leather S&M restraints around his neck and hands, being pulled backwards by a chain presumably held by Klaus.[56] Zeman's government accepted

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[51] *CTK Business News*, "Voting on controversial amendment to NBS Act postponed again," December 16, 1997

[52] Peter Javurek**, "**Slovak Cbank Sets Up Showdown With Tight 98 Policy," *Reuters News*, December 18, 1997

[53] Sobek 2003

[54] It was at this moment that the CNB took the opportunity to introduce inflation targeting, thereby fundamentally changing Czech monetary policy under an unelected caretaker government headed by the CNB governor.

[55] Klaus 2000; Bönker 2006

[56] "Zákon o ČNB: Pokušení prof. Václava [Law on the CNB: The Temptation of Prof. Vaclav]," *Euro*, 22, May 29, 2000.

Klaus's proposals in June 2000. The IMF, ECB, and European Commission all spoke out against the draft amendment, as did the CNB and President Václav Havel. Nevertheless, the CSSD and ODS-dominated parliament not only passed the amendment, but overrode Havel's veto. The revised Act on the CNB took effect in January 2001. It briefly seemed as if CBI had suffered a devastating blow in the Czech Republic.

The influence of international institutions ultimately foiled Klaus and Zeman's efforts, however, as the CNB's protected constitutional status and EU accession pressures undid the amendment's damage to CBI. The first strand unraveled as Zeman unwittingly pushed his luck with the CNB. In November 2000, Tošovský resigned from the CNB to head the Financial Stability Institute at the BIS, and President Havel appointed Zdenek Tůma as his replacement. The Zeman government appealed the appointment to the Constitutional Court, arguing that the appointment should have required governmental approval. In response, the Constitutional Court not only rejected the government's petition, but declared that the portion of the amendment on appointments violated the CNB's independence and was thus unconstitutional. The 1993 Constitution's protections for CBI, inspired by international experience and advice, successfully shielded the CNB from this challenge seven years later. Then, under pressure from the EU – which argued that the other ODS-sponsored parts of the 2000 amendment contradicted the *acquis* – a new amendment fully restoring the CNB's previous status came into effect in May 2002.

The CNB had continued to keep a tight hold on monetary policy throughout this period of turmoil, to the chagrin of Czech politicians, academics, and businesspeople. In a survey of articles in the leading Czech financial newspaper from 1997-2005, Geršl found that every government comment expressing dissatisfaction with the CNB signaled the CNB to ease monetary policy. The signals from other interest groups did the same: the financial sector (70%), employers (100%), unions (100%), and "others" (96.5%).[57] The CNB remained unmoved. In the end, the 2002 amended Act on the CNB protected the CNB's independence, changed its primary objective to price stability, and prohibited it from providing short-term credit to the government. Like the NBS, with external support the CNB emerged from this challenge strengthened both in law and in practice.

With EU entry in May 2004, however, Czech and Slovak central bankers lost a key element of international pressure to maintain their independent status. The uncertainty of their domestic support encouraged the central bankers to press for Euro adoption faster than many domestic politicians and the EU preferred, and faster perhaps than was economically advisable.[58] Without consistently effective tools to address inflation and with price stability threatened by increasing budget deficits, the central bankers turned to the Maastricht criteria and the Euro to attempt to restrain their governments' fiscal policies. The East European central bankers hoped that the Euro and ECB would more firmly tie their governments' hands for them, enforcing macroeconomic discipline in a way that they themselves could not. However, although independent central banks can increase the credibility of monetary policy, macroeconomic stability ultimately requires coordination and cooperation between monetary and fiscal authorities. In the EU, already under fire for its own alleged democratic deficit, such coordination problems will become especially salient as these

[57] Geršl 2006

[58] Johnson 2006b

new-member states without solid democratic support for independent central banks join the Euro zone.

Central Bankers and Democratic Accountability

The spread and international enforcement of CBI in the post-communist world raises important questions about CBI's effect on democracy and sovereignty. Central bank independence has affected the post-communist world in complex ways. It has strengthened these states by helping to build important domestic institutions, while simultaneously undermining them by privileging a particular narrow vision of monetary policy making actively promulgated by central bankers and international financial institutions in the advanced industrial democracies.

Creating market-oriented central banks served both economic and symbolic purposes for post-communist states. Post-communist states understood that solid central banks were vital to establishing monetary sovereignty over their own territories, and also represented an important step in disaggregating the cross-regional command economic structures. At the same time, these independent post-communist central bankers quickly became integrated into the transnational central banking community and began to act as "enablers of globalization," smoothing the way for increased economic interdependence by promoting ideas and policies favorable to more integrated international capital markets. As a result, through the integration process the post-communist central bankers often grew to have more in common with central bankers abroad than with other political and economic actors in their own states.

International influences thus 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 allowed elected politicians to 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 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 often found their autonomy restricted and their policies challenged.

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 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 arguably requires modifying 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. 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.

Table 1: Domestic Support for Central Banks

	Hungary		Czech Republic		Kyrgyzstan	
	Mode	*Median*	*Mode*	*Median*	*Mode*	*Median*
The executive supports the work of my central bank	3	3	3	3	3	3
The executive understands the work of my central bank	3	3	3	3	3	3
Commercial bankers support the work of my central bank	3	3	3	3	2	2
Commercial bankers understand the work of my central bank	4	4	3	3.5	3	3
The public supports the work of my central bank	3	3	3	3	3	3
The public understands the work of my central bank	2	2	3	3	3	3

Where 5 = strongly agree, 4 = agree, 3 = neutral, 2 = disagree, and 1 = strongly disagree

National Bank of Hungary N = 86, Survey conducted March 2000 at NBH headquarters
Czech National Bank N = 33, Survey conducted June 2000 at CNB headquarters
National Bank of the Kyrgyz Republic N = 66, Survey conducted May 2001 at NBKR headquarters

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