Mojmír Hampl: Central bank independence in practice - the case of the Czech Republic

Speaking points by Mr Mojmír Hampl, Vice Governor of the Czech National Bank, at the Annual Research Conference of the Central Bank of Ukraine, Kiev, 1 June 2018.

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Ladies and Gentlemen,

Before I begin my talk in earnest, I would like to thank the organizers for inviting me to this inspiring event. It is an honor to participate in such a distinguished panel. And it is a particular pleasure for me to visit Kiev, one of the great historical pivots of Europe and also a city with immense economic potential. The latter, I believe, can be said about Ukraine in general.

The topic of this panel and the entire conference is monetary-fiscal interactions. This is an important issue, and I am convinced that a good working relationship between the central bank and the government is imperative for the proper counter-cyclicality of economic policy. My intention today, however, is to offer a related but cautionary tale. I will talk about central bank independence, with an emphasis on the experience of my own country.

Few economists nowadays doubt the importance of central bank independence for achieving price stability. For example, the latest meta-analysis of this research question summarizes 300 empirical estimates from dozens of studies and finds strong evidence that independence is crucial for delivering low inflation (Iwasaki and Uegaki, 2017). This finding holds for both developed and emerging economies, as the authors clearly show.

But many economists in this stream of literature, most prominently Alex Cukierman, stress that it is not enough to have independence enshrined in the central bank's charter. Legal independence is a necessary condition for actual independence, but not a sufficient one. I would say that actual independence is a state of mind of central bankers. This state of mind, then, determines the outcome of monetary policy and is imperative for providing price stability.

So how can actual independence differ from legal independence? The key condition for actual independence is the de facto impossibility to dismiss central bank board members. In fact, the charters of almost all central banks around the world (including the National Bank of Ukraine and the Czech National Bank) allow for board members to be dismissed under some very specific conditions. But the applicability of these conditions varies widely, depending on custom and – crucially, I believe – the central bank's standing in society.

This observation brings me to an important point I want to make. Even if a central bank is actually independent from the government, it cannot over the long term act in direct contradiction to the preferences of society. For example, if the population is not averse to modest inflation, the central bank will have a hard time imposing an ultra-low-inflation environment, with all the associated costs and benefits, over the long run.

The experience of the Czech National Bank, perhaps, serves as a case in point, although in the opposite direction. In general, Czechs despise inflation, and the central bank needs to explain repeatedly why it uses the worldwide standard of a 2% inflation target instead of targeting literal stability of the CPI level, or 0% inflation. Already many decades before the era of independent monetary policy, in the early 1920s, Czechoslovakia pursued a strategy of deliberately strengthening the national currency. This policy resulted in deep deflation, in strong contrast to the hyperinflations seen at that time in neighboring countries (Austria, Germany, Hungary, and Poland; see Sargent, 1982).

So, it comes as no surprise that the Czech National Bank is rarely applauded for cutting interest rates, while hikes are often welcomed by a majority of the population. An important public-relations test arose for the Bank in 2013, when interest rate cuts proved insufficient to return inflation to the target. Inspired partly by one distinguished member of today's panel, the Czech National Bank adopted an exchange rate commitment to keep the currency from appreciating.

The commitment was terminated a year ago. Since then, studies by the IMF and academics alike have pointed to large benefits of the policy in terms of reducing unemployment, lifting GDP growth, and preventing deflation. Within two years after the commitment's enactment, the Czech Republic – at least in part thanks to the commitment – turned from a de facto sick man of Europe to one of the fastest-growing economies with the lowest unemployment rate in the entire EU.

When I attend conferences and seminars at other central banks, my foreign colleagues often assume that such a policy must have been tremendously popular. Indeed, the economics behind it is straightforward, and the resulting boost to peoples' wages is hard to deny. In spite of that, the exchange rate commitment caused the sharpest ever deterioration of public confidence in the Czech National Bank: from around 75% to around 50%. Confidence only recovered after the commitment was terminated. These were precisely the times when its hard-won independence had to be put to work.

Thus, central bank independence built into the country's law code is a treasure without which price stability is rarely possible. But equally important is the perception of independence by central bankers themselves. This perception, in turn, depends on the compatibility of the monetary policy regime with the preferences of the population. It is often overlooked, however, that central bankers have an impact on these preferences. Rhetoric matters a great deal, and communication is now one of the most potent tools of monetary and other policy.

True, enhancing financial literacy and altering public preferences in the process is a thankless, tiresome, long-term job, one that is often only appreciated years or even decades later. The man responsible for instilling a low-inflation mentality in Czechs, Alois Rašín, was shot dead in 1923 by a young communist. At that time, Rašín's policies were very unpopular among some groups of the population. But nowadays his legacy underpins the thinking of Czechs about inflation, for better or worse, and through that, the stability of the Czech currency.

Thank you for your attention.

References:
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