



## Keynote speech at the 40th anniversary celebrations of the Central Bank of Brazil: 30 March 2005

### FEATURES OF AN EFFECTIVE CENTRAL BANK: SOME LESSONS OF THE PAST DECADE

It is an honour to address such a distinguished gathering of thinkers and policymakers on the occasion of the 40th anniversary of the Central Bank of Brazil.

The past decade and a half has been a period of radical reform for central banks almost everywhere. The starting point was a determination on the part of governments in countries that had seen very high rates of inflation in the 1970s and 1980s, to bring inflation down. This prompted a search for mechanisms that would help governments convince people that they were serious about their anti-inflation commitment. Many countries found that assigning responsibility for monetary policy to an autonomous central bank with well defined objectives sent a clear signal that the commitment to price stability would not be sacrificed for short-term political expediency.

Over the past 15 years, more and more central banks throughout the world have been given such responsibility, and this institutional reform has proved to be more successful than even ardent supporters had hoped. And we can now draw some lessons from the wealth of experience acquired around the world about how to design an effective central bank. This is what I shall talk about today.

The focus of my remarks is on monetary policy – the core function of virtually all central banks.

Two landmarks are important in the recent history of monetary policy in Brazil. The first was the establishment of the Central Bank of Brazil's Monetary Policy Committee (COPOM) in June 1996. This Committee was established to give structure to the monetary policy decision-making process – and to help communication with the public. In less than a decade, this Committee – operating under several governors – has acquired a formidable reputation.

The second landmark was the decision, in June 1999, to adopt an inflation target and to give the central bank full responsibility for implementing monetary policy to achieve this target. This step was designed to provide an anchor for private sector price expectations following the decision to float the currency. It underlined the importance of price stability as the primary objective for monetary policy.

As Governor Bernanke of the US Federal Reserve Board noted in a recent review of inflation in Latin America, “the Brazilian Central Bank took its responsibility seriously”.<sup>1</sup> High inflation – which many feared after the real had been forced to float in 1999 – was avoided. The central bank has tightened monetary policy on several occasions when inflation has moved above the target range. The central bank's resolve was certainly tested by the severe crisis of confidence in 2002 that led to a sharp decline in the exchange rate. Inflation did rise to over 12% – well above target. But tight monetary policies supported by effective fiscal discipline gradually brought inflation back to within single digits.<sup>2</sup>

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<sup>1</sup> “Inflation in Latin America – a new era?”, Remarks by Mr Ben S Bernanke, Member of the Board of Governors of the US Federal Reserve System, at the Stanford Institute for Economic Policy Research Economic Summit, Stanford, California, 11 February 2005.

<sup>2</sup> Bevilacqua and Loyo describe this period as providing a stress test of inflation targeting. See “Brazil's stress test of inflation targeting” in *BIS Policy Papers* (forthcoming).



I hardly need to remind this audience that Brazil's recent experience stands in stark contrast to earlier decades when it experienced hyperinflation. And the success since 1999 has been achieved despite a series of severe economic shocks. I have no doubt that giving the Central Bank of Brazil responsibility for an inflation target contributed in an essential way to the credibility of economic policies, even at the time of great uncertainty in the run-up to the last presidential election. And keeping inflation under control provided the basis for sustaining the solid growth performance that Brazil is now beginning to enjoy.

The task now is to consolidate the very significant progress that has already been made. Two important challenges remain. First, inflation is still too high. At 7.4%, it is well above levels in all major industrial economies – and indeed above levels in many emerging market countries. As you know, efforts to bring Brazil's inflation down are continuing. The central bank has an explicit objective of a price increase in the range of 5% for 2005, and has recently raised interest rates to ensure that this objective is met. Second, markets must be convinced that effective monetary policies are not just a passing fashion, one that might be reversed if political conditions were to change. If Brazil can succeed in this it will be easier to achieve price stability and to bring real interest rates down to the levels found in countries where there is no doubt about the continued ability of the central bank to keep inflation at bay.

The benefits of locking in price stability are great. Inflation is a form of regressive taxation that hits the poor hardest. It also increases uncertainty, which is a key factor that contributes to high real interest rates. Moreover, reducing inflation helps create the conditions needed for the development of deeper financial markets. There is substantial evidence on the positive relationship between financial development and economic growth. Deeper domestic financial markets make the economy more robust in the face of commodity price shocks, or political shocks or sudden shifts in capital market sentiment.

These potential benefits inevitably take time to materialise. But they come more quickly and with less pain if people become convinced that inflation will be kept low. The experience of many countries is that markets are more likely to believe that the commitment to price stability is durable when it is accompanied by institutional reform of the central bank. But what shape should such institutional reform take? What can be learnt from the experience of countries around the world about the design of a successful central bank?

There is of course no single blueprint. There is no unique, optimum governance structure. Each country must find the specific arrangements that are best suited to its own political, historical and cultural traditions. In some countries, informal arrangements have worked well. But most countries have found that stronger, more formal mechanisms work better. The European Central Bank and the Bank of England are two noteworthy examples of central banks that have anchored their monetary policymaking in the law in a manner that ensures continuity in policymaking. In the case of the ECB, the mandate and powers are set out in an international treaty that cannot be altered without the agreement of the countries that ratified it. Many other examples could be cited. According to one large survey that was undertaken recently, about 80% of countries around the world have updated their central bank laws since the early 1990s.<sup>3</sup>

Three central common themes have conditioned these reforms around the world. The first is a clear and precise mandate for the central bank. Governor Meirelles stressed this precept in his inauguration speech, when he said that he was “confident that there is a consensus [...] that a central bank that has been assigned a multiplicity of functions and targets was doomed to fail”. The second theme is the need for the central bank to have the authority and the

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<sup>3</sup> Based on a sample of 100 central bank laws (source: BIS. Details on request).



ability to take effective action to achieve its key objectives. The third is having effective mechanisms to hold the central bank to account – to make sure that it actually achieves the objectives that have been set for it and does so in an efficient manner. Let me consider each theme in turn.

## **Mandate**

Starting with mandates, it is now almost universally recognised that price stability is key, and that targeting inflation can be a very effective means of achieving it. Almost two thirds of the 46 central banks that the BIS surveys regularly on governance matters now have an explicit price stability objective. Other objectives of economic policy matter as well. However, most observers would now accept that price stability is the best single contribution that the central bank can make towards the achievement of other objectives such as sustained growth of output and employment. Accordingly, the inflation targeting approach – or something similar to it – has gained wide acceptance.

Not all inflation targeting frameworks are alike. The most frequent choices are to define a target band for inflation, or to stress a midpoint or point target within a band. In a smaller number of cases (including the United Kingdom), the target is defined as a single number. The time frame for achieving the objective will also vary. Some central banks, such as the ECB, do not pursue an explicit inflation target; but they do provide a clear definition of the level of measured inflation that they consider to be consistent with price stability. The general point is that the inflation targeting approach can be adapted to the circumstances of a particular country.

The mandate and the inflation target need to be supported by appropriate processes. Monetary policy choices about how to meet this target have to be forward-looking, given the significant lags in the effects of changes in monetary policy instruments on inflation. The inflation forecast that the central bank makes is therefore a key element: it provides a consistent framework for summarising the most relevant factors; it imposes discipline on the central bank's policy deliberations; and it can serve as an effective communication tool. But even the best economic forecasts have large standard errors, and significant uncertainty about current conditions is inevitable.

There is, in short, an inescapable element of judgment in monetary policy decisions. One way of ensuring that these judgments are exercised in as professional a way as possible is to publish the deliberations and the supporting material used by the monetary policy board in reaching its decision. I will return to this important issue in a moment when I discuss transparency.

## **Operational effectiveness**

The second major theme of central bank reforms has been operational effectiveness. I will consider three aspects of this: the decision-making process; the appointment of senior officials; and access to sufficient financial resources for the central bank to carry out its work.

Most central banks have found that collegial decision-taking by a policy board has major advantages. It makes it possible to draw on a wider range of experience and expertise in making decisions. It promotes reasoned and informed policy dialogue. It reduces the risk that monetary policy decisions will be subject to behind-the-scenes lobbying or ex post political challenge. And it gives the policy decisions greater legitimacy. It is for all these reasons that the use of monetary policy committees has become the norm. A recent survey by the Bank of England showed that a collegial body is responsible for setting monetary policy in 79 of



88 central banks studied.<sup>4</sup> In the large majority of cases, the role and nature of the monetary policy committee or board is set out in the central bank law, along with provisions on the appointment of board members, the security of tenure they are granted, and the operations of the board.

The board must be constituted in a manner that ensures its impartiality, continuity and competence. This is the reason why the legal provisions governing the monetary policy committee or board of the central bank must give board members the security of tenure that so helps their credibility. Giving central bank policymakers fixed terms of office helps to make the board impartial and professional by shielding it from undue short-term political influence. The vast majority of central bank laws lay down terms of office that are long enough to prevent reappointment considerations from colouring decision-making. According to a BIS study, two thirds of the governors had fixed terms of office that lasted either five or six years.<sup>5</sup> Terms of office of this length exceed the typical electoral cycle, and therefore help to depoliticise the selection process.

Staggering the terms of office for different board members has two main advantages. First, it reduces the risk that the board will be stacked with members of any particular political persuasion. Second, it helps to promote continuity in policymaking and yet provides for the infusion of new ideas, as new members come over time to join those with longer experience on the board. More than 60% of central bank laws do indeed provide for a staggering of the terms of the central bank's board members.<sup>6</sup>

The procedures for appointing and dismissing policymakers are as important as the terms of office. Many central bank laws set out qualifications (and disqualifications) for senior central bankers that are designed to reduce the risk of conflicts of interest. Board members can come from different backgrounds, but they must not be delegates of special interest groups. Dismissal procedures should both specify clearly the grounds on which an official can be discharged and set out transparent procedures that ensure such a step is not taken lightly.

Some countries have mechanisms which ensure that a wide range of political interests are involved in the appointment process and so enhance the legitimacy of the board. In more than two thirds of central banks surveyed recently by the BIS, two or more political bodies are involved in proposing and appointing the candidates. For example, the Chairman of the Federal Reserve is designated by the President of the United States, but this requires the consent of the US Senate. Similar procedures are used in Brazil.

A final precondition for the effectiveness of a central bank is its financial autonomy. This must include giving the central bank full responsibility for the formulation and implementation of its own expenditure budget. Without this, it is much harder for a central bank to sustain the high level of performance that is desirable. The central bank, for instance, needs to engage in extensive economic analysis to carry out its core functions. In order to be able to attract and

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<sup>4</sup> See L Mahadeva and G Sterne, *Monetary policy frameworks in a global context*, Routledge, London, 2000. Similarly, Alan Blinder and Charles Wyplosz note in a recent paper that 29 of 34 central banks covered in the 2000 JP Morgan *Guide to central bank watching* relied on a group to make policy decisions. (See Blinder and Wyplosz, *Central bank talk: committee structure and communication policy*, 2004.)

<sup>5</sup> In some well known cases, the terms are even longer – for example, the President of the European Central Bank and the President of the German Bundesbank are both appointed for an eight-year term.

<sup>6</sup> One way to achieve a staggering of terms is to specify that the term of office of a certain number of board members ends each year, or every other year. Another is to stipulate that the term of office of each position is completed in full – if a board member leaves the board before the end of the term, the remainder of the term is served by a new appointee. For example, at the Swedish central bank and at the ECB this system was introduced by shortening the terms of office for some of the initial appointments, resulting in an ongoing systematic staggering of the terms of all members of the Executive Board.



retain a corps of professionals to do this sophisticated work, the central bank must be able to offer terms and conditions of employment that are comparable with those available in alternative jobs in both the private and public sectors.

Most important of all is that the central bank has sufficient access to resources so that policy objectives are not compromised. The central bank must be able to control the size and composition of its balance sheet in order to engage in the transactions needed to achieve its established monetary policy goals. This could include operations in local money markets to implement monetary policy or foreign exchange intervention. In many cases, the central bank must be able to act on a large scale in financial markets at very short notice.

Similar considerations arise with foreign exchange intervention. When national authorities intervene to moderate an appreciation of the domestic currency, they often have to acquire low-yielding foreign currency assets and issue local currency paper carrying a higher nominal interest rate. In the short run, these operations could very well entail financial losses. But the policy should be judged on whether it serves the national interest – not on whether it yields the central bank profits or losses.

The financial position of the central bank – both in terms of its operational budget and its balance sheet – needs to be strong enough to send a clear signal to markets that it does indeed have the financial resources to achieve its monetary policy goals. Very often such a signal influences market expectations in such a way that it actually reduces the scale of the operations that are needed to reach these goals. Once again, credibility is vital.

How the profits or losses of the central bank are ultimately distributed is of course a different matter. Countries do indeed differ on how they deal with central bank profits. In most countries, central banks retain their profits in order to build up or maintain adequate capital; in others, there are clear and automatic profit-/loss-sharing rules with the government. Whatever the precise mechanisms chosen, the central bank must be held to account in ways that give it the financial autonomy required for its operational effectiveness.

### **Accountability**

This brings me to my third and last theme: mechanisms to ensure the accountability of the central bank. A key element of financial accountability is the review of a central bank's budget and its expenditures. This is a central bank's independence and accountability coverage. And so it is rare, especially in the industrial countries, for parliaments or ministries of finance to have a direct and detailed say on budgetary matters of the central bank. In many cases, a publicly appointed supervisory board, not the government, approves the central bank's operational budget.<sup>7</sup> Such a board reviews the accounts and evaluates whether the central bank's management is making the best use of the final resources at its disposal. Alternative approaches are also possible. For example, a few central banks have a multi-year funding agreement with the government that puts the financing of the central bank's operations in a longer-term, less political context. Whatever the particular mechanism chosen, it is important that short-term or transitory political considerations are neutralised while at the same time keeping the central bank accountable for achieving its medium-term objectives.

Keeping the central bank both autonomous and accountable goes much deeper than just watching over its accounts. The really important question is this: is the central bank achieving its core objective of price stability? Remember that price stability is subject to measurement

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<sup>7</sup> While it is rare for central bank budgets to require approval by the government or the legislature, the vast majority of central banks – more than three quarters in a recent study – provide detailed information on their actual expenditures (for example in reports to the Ministry of Finance, or in reviews held at the legislature).



in a way that the more qualitative objectives of other government agencies are not. Market participants and the average citizen can observe whether or not the central bank has achieved its target.

The central bank needs to demonstrate to an increasingly sophisticated public that its assessment of policy options is balanced, informed and professional. The BIS noted in last year's *Annual Report* that central banks around the world have become more open. Policies that are clearly explained to the public eliminate one source of uncertainty in private sector decision-making.<sup>8</sup>

Inflation reports by the central bank and the prompt publication of the minutes of monetary policy committee meetings are two important tools. A recent cross-country survey of inflation reports published by 20 central banks identified three types of "best practices": first, official reports should include a thorough analysis of economic conditions; second, they should present forecasts of key policy variables such as inflation and output, describing both the central forecast and the risks; third, central banks should explain the reasons for their decisions, including discussions of how policymakers interpret the current situation, the forecast, and the various policy contingencies under consideration. Of the 20 countries examined, it is interesting to note that Brazil ranked third.<sup>9</sup> This is some achievement.

Let me end this talk with the following thoughts. Maintaining and furthering Brazil's achievements in the area of central bank independence and transparency would do much to help Brazil confront the future. It needs to be recognised that financial systems worldwide are becoming more market-oriented and capital markets deeper. Increasingly, the relevant interest rate for governments and corporate borrowers is not the policy interest rate determined directly by the central bank, but the longer-term interest rates established in the financial markets. Increasingly, therefore, the market is watching what the central bank does. If a central bank is too relaxed when the risks of inflation increase, borrowers in the country can be "punished" by wider credit spreads in markets, higher long-term interest rates and much greater volatility. The need to have a credible central bank in this new environment is all the greater. The Central Bank of Brazil has made great progress over several years in gaining the confidence of both the markets and ordinary citizens. Enshrining these good practices in law would greatly help the country consolidate this very important progress.

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<sup>8</sup> See "Communication in monetary policy" in *BIS 74th Annual Report*, June 2004, pp 73-80 ([www.bis.org](http://www.bis.org)).

<sup>9</sup> The first and second rankings were the United Kingdom and New Zealand. See A Fracasso, H Genberg and C Wyplosz, *How do central banks write?*, International Centre for Monetary and Banking Studies (ICMB), Geneva, 2003.