When central bank independence becomes a condition for International Monetary Fund loans

Independent central banks tend to make anti-inflation policy promises credible and lead to greater economic stability. This is because they are bound by their legal mandates to price stability, while not competing for popular votes. ***Bernhard Reinsberg, Andreas Kern,*** *and* ***Matthias Rau-Göhring*** *write that an independent monetary authority also insures against the misuse of International Monetary Fund bailout loans. Their research finds that following IMF programs conditioned on central bank independence, the political pressure regarding monetary policy eases.*

The International Monetary Fund (IMF) is infamous for its economic policy prescriptions that seek to liberalise markets, deregulate prices, and privatise state-owned enterprises. Countries in economic trouble need to commit to implementing such economic policies to access fresh loans from the institution. A less well-known policy condition that regularly finds itself in IMF programs requires countries to strengthen the independence of their central banks. Our latest research explains why.

Why central bank independence matters to the IMF

Central bank independence (CBI) is a cornerstone of prudent economic policymaking. A seminal paper by economist Kenneth Rogoff explains why: governments find it hard to credibly commit to low-inflation policies because they cannot resist the temptation to inflate the economy ahead of elections, tapping their money-printing presses. Following this logic, delegation of monetary policy can make anti-inflation policy promises credible. This is because independent central banks are bound by their legal mandates to price stability while not competing for popular votes. But why has central bank independence become a knock-out criterion in many IMF programs?

By insisting on reforms toward greater central bank independence, the IMF pursues several objectives. In the short term, vesting monetary policymaking authority in an independent central bank promises assurance against misuse of IMF bailout funds. A salient feature in IMF lending is that funds are often disbursed through national central banks. But politically captured central banks help governments to foot their bill through data manipulation and misreporting.

A prime example is Tajikistan. When rescuing Tajikistan from the brink of default in 2005, the IMF audit overlooked an important credit guarantee scheme of the central bank that guaranteed the financial claims of politically well-connected banks with almost all its foreign reserves. Not having included conditions towards strengthening central bank independence and transparency in its initial lending program, the IMF stood by as “Tajik authorities were able to doctor data on national reserves” to allow high-ranking government officials to siphon almost $300 million out of the country. Hence, divorcing central banks from political interference and increasing the transparency of financial accounts is a key step to prevent fraud in using IMF funds.

The benefits of central bank independence in the context of IMF lending extend beyond the short term. By dissolving central banks from government executives, the IMF can lock in “sound” monetary policies that help countries comply with IMF macroeconomic policy prescriptions. This increases the chance that countries complete IMF-supported lending programs and helps restore investor confidence in the long-term recovery of crisis-ridden countries.

New data on central bank independence conditionality

To create a systematic database of central bank independence conditionality, we relied on the IMF Monitor Database and identified 596 relevant provisions from over 38,000 individual policy conditions in 124 countries from 1980 to 2012. We find that CBI conditionality is common, featuring in up to one-fourth of all active IMF programs in this period.

CBI conditionality continues to be relevant today. Ecuador provides a case in point. Seeing the Ecuadorian economy steering off a financial cliff in 2020, the IMF held back a much-needed $6.5 billion loan until the government legislated greater political independence for the central bank. Ecuador is no exception: Argentina, Jamaica, Mauritania, and Mongolia can be found on the long list of IMF clients that were incentivised this way to surrender control over their money printing presses.

Bringing transparency where it is most needed

If CBI conditionality is so beneficial, why is it not included in every IMF program? Any package of IMF conditions is the outcome of a bargaining process between the IMF and borrowing governments. Assuming the IMF would always be interested in having CBI conditions, we turn to the cost-benefit calculus of governments. From the perspective of a borrowing government, the benefits of CBI conditions of restoring market credibility must be balanced with the costs of losing a powerful instrument to boost economic prospects. In countries where few institutional checks and balances exist to limit a government's meddling into economic policymaking, central bank independence is a politically less bitter pill to swallow but effective in restoring market confidence. In related research, we show that CBI conditionality is indeed effective in promoting central bank independence and leads to greater economic stability.

Our results have important policy implications. In times of growing political pressure on independent central banks, such as in the recent wave of populism, the IMF can be a "white knight" in their defence. We find evidence that this is the case. Following IMF programs with CBI conditionality the political pressure on national central banks eases. With its power to withhold funds, the IMF is in a key position to effect institutional reforms that would otherwise be difficult to sustain.

Author's disclaimer: This article should not be reported as representing the views of the European Central Bank (ECB). The views expressed are those of the authors and do not necessarily reflect those of the ECB.

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Notes:

- *This blog post is based on The political economy of IMF conditionality and central bank independence, European Journal of Political Economy.*
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