Central Bank: questions of autonomy and the mandate

• Discussions about autonomy at the Brazilian central bank (BCB) are not new, but they gained momentum in recent months, including the debate over the mandate that should be pursued.

• We analyzed a sample of 31 central banks. Only Brazil and four others in the sample do not ensure formal autonomy to their central banks. In our sample, laws tend to prioritize price stability.

• Along with analysis of the prevailing legal framework, we modeled the potential impact of the adoption of a dual mandate (inflation and employment) in Brazil. We show that the adoption of a dual mandate would result in higher inflation and de-anchored expectations, without long-term gains in employment. In our view, price stability — and not a dual goal — is the best way for the local central bank to contribute to sustainable economic growth.

Recently, the government presented an agenda of 15 priorities to reduce federal expenses, update tax legislation and strengthen the domestic economy. One of these points addresses central bank autonomy and the nomination, tenure and removal from office of its governor and directors. The possibility of a dual mandate (i.e., a mandate that sets two explicit goals for monetary policy: controlling inflation and employment levels) was also put on the table.

We outline below the mandates and the degrees of autonomy for several central banks around the world, and we explain why establishing a dual goal may undermine monetary policy in Brazil’s case.

The issue of central bank autonomy

Advocates of central bank autonomy argue that this body should work with clear and simple goals and with enough authority to attain them, so that it can maintain its credibility. A credible central bank has greater capacity to influence inflation expectations while supporting price stability with lower volatility in terms of interest rates and employment. Furthermore, autonomy is key to protecting central banks from possible political interference – reducing the risk of fiscal dominance, for instance.

The main argument against autonomy, on the other hand, is the lack of democratic legitimacy, given that central bank governors and directors are not elected by the population (the same applies to heads of regulatory agencies).

According to Grilli, Masciandaro and Tabellini (1991), the degree of autonomy for a central bank has two components: i) political autonomy, as in defining final objectives/goals, and ii) economic autonomy, as in the instruments used to achieve goals.

The U.S. Federal Reserve stands out as the one with the greatest autonomy. In addition to its freedom in terms of instruments, the Fed can interpret its legal mandate, giving priority to one out of three goals set by the Federal Reserve Act (maximum employment, stable prices and moderate long-term interest rates)\(^1\). The

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\(^1\) "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates"
European Central Bank’s goal of price stability is very clearly defined by lawmakers\(^2\). Like the Fed, the ECB also has autonomy to set the quantitative target that will be pursued. The same goes for the Czech Republic, Sweden, Chile and Mexico.

However, other central banks only have economic (or operational) autonomy. In these cases, the government (often working together with the central bank itself) sets the goals of monetary policy, and the central bank has the autonomy to select the instruments it considers best for pursuing those goals. This is the case in Australia, Canada and Colombia, among other countries.

We studied the autonomy of 31 central banks\(^3\), of which only five have no formal autonomy (i.e., set by law). These are Brazil, Thailand, Poland, Norway and China.

**International experience: diverse central bank mandates**

We also studied the mandates of these 31 central banks, and the following aspects stood out:

- Only the U.S. Fed has a multiple mandate, i.e., more than one explicit goal. Importantly, the Fed enjoys political autonomy, and historically it has pursued its mandate without political interference.

- Nowadays, the most common mandates emphasize price stability or currency stability\(^4\) (23 of 31 central banks, or almost 75%).

- Some central banks have a priority mandate, with specific support for other economic policies as long as these do not clash with its primary goal. This is the case for the ECB and the central banks of Hungary and Israel. For instance, the priority is price stability, but if there is no prejudice to this goal, the central bank may support other economic policies that seek to contribute to growth.

- Some central banks have a complex mandate, i.e., there is no priority goal clearly set forth by law. This is the case in Brazil and six other countries.

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\(^2\) “The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies ”

\(^3\) The central banks in our sample and a detailed table are included in the Appendix.

\(^4\) The formula that emphasizes price stability is preferable to currency stability, which may be interpreted as exchange rate stability, for instance.
Autonomy and the mandate of the Brazilian Central Bank

The BCB has no formal autonomy (political or economic). Although it works with de facto autonomy, this is not established by law (de jure). The President of the Republic pledges not to interfere in its technical decisions, but nothing is written about the matter.

Law 4595, enacted in 1964, establishes that “It is the responsibility of the Central Bank of the Republic of Brazil to comply with and ensure compliance with the provisions attributed to it by current legislation and norms issued by the National Monetary Council”. In other words, the BCB’s goals are fully subordinated to the National Monetary Council (CMN), and there is no priority goal clearly established in the law.

In our view, the proposal of establishing formal economic (or operational) autonomy with price stability as a priority goal, would boost the credibility and effectiveness of monetary policy. The inflation target, in turn, should continue to be set by the CMN (a council formed by the Ministers of Finance and Planning and the BCB Governor), so as to ensure the democratic legitimacy of the inflation targeting regime. But even in this case, the BCB would still lack political autonomy.

Would the adoption of a dual mandate in Brazil be worth it?

Investigating how central banks make decisions under an inflation-targeting regime is useful when considering the effectiveness of a dual mandate. Monetary policy decisions (i.e., the determination of nominal interest rates) in such a regime may be described, in a simplified manner, by a Taylor Rule. Broadly speaking, this rule establishes that interest rates depend on inflation expectations (an increase in inflation by 1 pp should prompt a 1.5 pp increase in nominal interest rates) and on the unemployment rate (an increase of 1 pp in unemployment should prompt a 0.5 pp decline in nominal interest rates). The Taylor Rule can be summarized in the equation below (1).

\[ i = \Pi^M + r^* + 1.5 (\Pi^E - \Pi^M) - 0.5 (u - u^*) \]  

(1)

In this equation, \( i \) is the nominal interest rate, \( \Pi^M \) and \( \Pi^E \) are the inflation target and expected inflation, respectively, \( r^* \) is the neutral real interest rate\(^5\), \( u \) and \( u^* \) are the unemployment rate and NAIRU\(^6\), respectively.

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\(^5\) The neutral interest rate is usually defined as one which is consistent with potential output and, consequently, on-target inflation (assuming a credible inflation-targeting regime). The concept is useful to characterize the monetary policy stance.

\(^6\) NAIRU: Non-Accelerating Inflation Rate of Unemployment.
It is important to note that, based on the abovementioned rule, even if central bank mandates do not specify unemployment as a goal, they do react to changes in this variable, for two reasons. First, monetary authorities tend to reflect social preferences and are thus sensitive to fluctuations in employment levels. Second, because the unemployment rate is one of the main drivers of inflation, it must be considered even when the goal is limited to price stability.

**So what is the problem with a formal target for employment?**

The biggest problem is that, in the long run, the monetary authority is able to influence nominal variables, but not real variables. Given the neutrality of money principle, changes in the stock of money affect only nominal variables (such as inflation), but they have no impact on production, employment or income levels, for instance. In other words, if monetary policy was able to affect economic growth or the unemployment rate in the long term, it would make sense to set targets for these variables, and they would probably contribute to social well-being. Unfortunately, monetary policy cannot deliver this. In fact, Brazilian experience shows that greater tolerance of inflation cannot buy economic growth.

Although the central bank is able to affect long-term inflation, it cannot control the neutral real interest rate \((r^* - \Pi^E)\), the long-term unemployment rate \((u^* - \Pi^E)\), or the economic growth rate (which depends on demographic variables, productivity and more).

Thus, pursuing a dual mandate entails risk. Let’s assume that the monetary authority would not only pursue an inflation target, but also an unemployment target, represented by \(u^M\) in the equation below. When a central bank has a dual mandate, the Taylor Rule (1) described above may be re-written as follows:

\[
i = \Pi^M + r^* + 1.5 (\Pi^E - \Pi^M) - 0.5 (u - u^M) \quad (2)
\]

In the long run, due to money neutrality (i.e., considering that \(u = u^*\) and \(i = r^* + \Pi^E\)), equation (2) may be re-written as follows:

\[
(\Pi^E - \Pi^M) = (u^* - u^M) \quad (3)
\]

Equation (3) shows that the greatest risk related to the adoption of a dual mandate is setting an unemployment target \((u^M)\) below neutral unemployment \((u^*)\) – i.e., an unemployment target that would ultimately be inflationary.

In other words, the pursuit of below-neutral unemployment would result in higher inflation and de-anchored expectations, without gains in employment in the long run.

This is not to say that society should not pursue policies that seek a low unemployment rate in the long term. Quite the opposite. Obviously, persistently-high unemployment entails substantial economic and (most noticeably) social costs. Low unemployment should be a priority of the overall economic policy, and many actions can and ought to be implemented, such as strengthening education, streamlining labor legislation, etc. However, using monetary policy to that end tends to deliver innocuous results in terms of employment, which are also counterproductive in terms of inflation in the long run.

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6 The non-accelerating inflation rate of unemployment (NAIRU) is the one that keeps inflation constant (no inflationary/deflationary pressures arising from the labor market).

7 The Appendix shows a numeric example.
Conclusion

The discussion of central bank autonomy is not new in Brazil, but it has resurfaced in recent months. Along with it came the debate over the monetary authority's legal mandate. International experience shows that the vast majority of central banks nowadays have formal autonomy, and the most common mandate prioritizes price stability.

In our view, autonomy for the Brazilian central bank would increase its credibility and the effectiveness of monetary policy. Adopting a dual mandate, however, would not generate positive effects. In the long run, the monetary authority has no control over real variables, so that establishing a dual goal could produce just higher inflation and de-anchored expectations, without gains in employment.

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Julia Gottlieb  
Thales Caramella

References:

### Appendix 1 – Table

<table>
<thead>
<tr>
<th>Country</th>
<th>Formal autonomy</th>
<th>Goal</th>
<th>Year</th>
<th>Description of the goal</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>Yes</td>
<td>Price stability</td>
<td>1996</td>
<td>&quot;The primary objective of the Bank shall be to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic.</td>
</tr>
<tr>
<td>Australia</td>
<td>Yes</td>
<td>Complex</td>
<td>1959</td>
<td>&quot;It is the duty of the Reserve Bank Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank under the Act and any other Act, other than the Payment Systems (Regulation) Act 1998, the Payment Systems and Netting Act 1998 and Part 7.3 of the Corporations Act 2001, are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to: a. the stability of the currency of Australia; b. the maintenance of full employment in Australia; and c. the economic prosperity and welfare of the people of Australia.&quot;</td>
</tr>
<tr>
<td>Brazil</td>
<td>No</td>
<td>Complex</td>
<td>1964</td>
<td>&quot;It is the responsibility of the Central Bank of the Republic of Brazil to comply with and ensure compliance with the provisions attributed to it by current legislation and norms issued by the National Monetary Council.&quot;</td>
</tr>
<tr>
<td>Canada</td>
<td>Yes</td>
<td>Complex</td>
<td>1985</td>
<td>&quot;Regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment.&quot;</td>
</tr>
<tr>
<td>Chile</td>
<td>Yes</td>
<td>Currency stability and normal functioning of domestic and foreign payments</td>
<td>1989</td>
<td>&quot;To ensure the stability of the value of the national currency and the normal functioning of domestic and foreign payments&quot;</td>
</tr>
<tr>
<td>China</td>
<td>No</td>
<td>Complex</td>
<td>2003</td>
<td>&quot;Drafting and enforcing relevant laws, rules and regulation that are related to fulfilling its functions; formulating and implementing monetary policy in accordance to the law; issuing, remint and administering its circulation; [...] maintaining the Renminbi exchange rate at adaptive and equilibrium level; holding and managing the state foreign exchange market and gold reserves.&quot;</td>
</tr>
<tr>
<td>Colombia</td>
<td>Yes</td>
<td>Currency stability</td>
<td>1992</td>
<td>&quot;The Banco de la República will study and adopt the monetary, credit, and exchange measures aimed at regulating the circulation of money and, in general, the liquidity of the financial market and the normal operation of the internal and external payments of the national economy, taking care of the stability of the value of the currency.&quot;</td>
</tr>
<tr>
<td>South Korea</td>
<td>Yes</td>
<td>Price stability</td>
<td>1962</td>
<td>&quot;To contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary and credit policies&quot;</td>
</tr>
</tbody>
</table>
| United States    | Yes             | Employment, Price stability and moderate long-term interest rates | 1977 | "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates consistent with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

| Philippines      | Yes             | Price stability             | 1993 | "The primary objective of the Bangko Sentral is to maintain price stability conducive to a balanced and sustainable growth of the economy. It shall also promote and maintain monetary stability and the convertibility of the peso."                                                                                     |
| Hungary          | Yes             | Price stability             | 2013 | "The primary objective of the MNB shall be to achieve and maintain price stability. Without prejudice to its primary objective, the MNB shall support the maintenance of the stability of the system of financial intermediation, the enhancement of its resilience, its sustainable contribution to economic growth; facilitate the economic policy of the Government using the monetary policy instruments at its disposal." |
| India            | Yes             | Complex                     | 2016 | "The Reserve Bank shall have the objective of maintaining price stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth."

| Indonesia        | Yes             | Currency stability          | 1999 | "The monetary policy shall be emphasized on efforts to maintain the stability of the rupiah value"                                                                                                                          |
| Iceland          | Yes             | Price stability             | 2001 | "The principal objective of the Central Bank of Iceland is to promote price stability"                                                                                                                                                      |
| Israel           | Yes             | Price stability             | 2010 | "To maintain price stability as its central goal; to support other objectives of the Government’s economic policy, especially growth, employment and reducing social gaps, provided that, in the Committee’s opinion, this support shall not prejudice the attainment of Price Stability over the Course of Time; for this purpose, "Price Stability over the Course of Time" means a situation in which the Committee, on the basis of the monetary policy that it has established, expects the inflation rate to be within the price-stability range determined per Subsection (b) within no more than two years; and supporting the stability of the financial system." |
| Japan            | Yes             | Price stability             | 1997 | "The purpose of the Bank of Japan, or the central bank of Japan, is to issue banknotes and to carry out currency and monetary control, [...] Currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy."                                                                                     |
| Mexico           | Yes             | Stability of the purchasing power of the currency | 1993 | "The Banco de México's purpose shall be to provide the country's economy with domestic currency. In pursuance this purpose, its primary objective shall be to seek the stability of the purchasing power of said currency"                                                                                                  |
| Norway           | No              | Complex                     | 1985 | "The Bank shall conduct its operations in accordance with the economic policy guidelines drawn up by the government authorities and with the country's international commitments"                                                                                                                                       |
| New Zealand      | Yes             | Price stability financial stability | 1989 | "The purpose of this Act is to provide for the Reserve Bank of New Zealand, as the central bank, to be responsible for—(a) formulating and implementing monetary policy designed to promote stability in the general level of prices, while recognising the Crown's right to determine economic policy; and (b) promoting the maintenance of a sound and efficient financial system; and (c) carrying out other functions, and exercising powers, specified in this Act."

| Peru             | Yes             | Currency stability          | 1931 | "The purpose of the Bank is to preserve monetary stability"                                                                                                                                                                            |
| Poland           | No              | Price stability             | 1997 | "The basic objective of the activity of NBP shall be to maintain price stability, while supporting the economic policy of the Government, insofar as this does not constrain the pursuit of Reserve objective of NBP..."                                                                                                         |
| United Kingdom   | Yes             | Price stability             | 1998 | "In relation to monetary policy, the objectives of the Bank of England shall be—(a) to maintain price stability, and(b) to maintain the price stability of Her Majesty's Government, including its objectives for growth and employment."                                                                                   |
| Slovak Republic  | Yes             | Price stability             | 1993 | "The primary objective of Národná banka Slovenska is to maintain the price stability"                                                                                                                                                    |
| Czech Republic   | Yes             | Price stability             | 1993 | "The primary objective of the Česká National Bank shall be to maintain price stability"                                                                                                                                                  |
| Romania          | Yes             | Price stability             | 2004 | "The primary objective of the NBG is to ensure and maintain price stability.”                                                                                                                                                           |
| Russia           | Yes             | Complex                     | 1995 | "The goals of the Bank of Russia are to protect the ruble and ensure its stability, promote the development and strengthening the Russian banking system, and maintain the value of the ruble and development of the national payment system, develop the financial market of the Russian Federation and ensure its stability"                                                                                   |
| Sweden           | Yes             | Price stability             | 1988 | "The objective of the Riksbanken's activities shall be to maintain price stability.”                                                                                                                                                     |
| Switzerland      | Yes             | Price stability             | 2003 | "The National Bank shall pursue a monetary policy serving the interests of the country as a whole. It shall ensure price stability: In so doing, it shall take due account of economic developments..."                                                                                                                       |
| Thailand         | No              | Currency stability and payment systems stability | 1942 | "The BOT's objectives are to carry on such tasks as pertain to central banking in order to maintain monetary stability, financial institution system stability and payment systems stability."                                                                                                                   |
| Turkey           | Yes             | Price stability             | 2001 | "The primary objective of the Bank shall be to maintain price stability. The Bank shall determine on its own discretion the monetary policy that it shall implement and the monetary policy instruments that it is going to use in order to maintain price stability..."                                                                                     |
| Eurozone         | Yes             | Price stability             | 1992 | "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies..."                                                                                                                                  |
Appendix 2 – BCB reaction function, a numeric example:

- Unemployment target in a dual mandate \( (u^M) = 8\% \)
- Neutral unemployment rate (effective in the long run) \( (u^*) = 10\% \)

\[
u^* - u^M = 2\%
(P^E - P^M) = 2\%
\]

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