

Research on the Independence of the Central Bank and Its Inspiration to the PBC

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ABSTRACT

The central bank of a country generally undertakes important tasks such as stabilizing prices, preventing high inflation and conducting financial supervision. It plays a vital role in a country's economy and financial market. The central bank's monetary policy has implications for all industries. In order to study the independence of my country's central bank, this article first defines the independence of the central bank at two levels, analyzes several typical foreign banks of the Federal Reserve, the Bank of Japan, and the Bank of Korea, and then analyzes the independence of the People's Bank of China. An in-depth interpretation of the current situation is analyzed, and some suggestions for improving the independence of the People's Bank of China is put forward in this paper.

Keywords: *central bank independence, The People's Bank of China, conservative banker theory, monetary policy*

1. INTRODUCTION

During the First World War, various countries issued excessive currency to prepare for war funds, and central banks completely served the government and war, and their independence was completely lost. This led to hyperinflation in many countries after the war, and countries generally began to restore central bank independence. Nowadays, discussions on the independence of the central bank are still hot [1]. In today's world economic environment, the central bank plays a pivotal role in the financial market of a country and the daily life of the people. The central bank plays a pivotal role in the country's economic development and social environment. Stability and other aspects are crucial. However, for the central bank, its independence is very important and is a key factor in affecting its efficient realization of functions. Since the First World War, the independence of central banks has attracted the attention of the international community [2]. And relevant theories about the independence of central banks have emerged and reached maturity. Since the reform and opening up, the independence of central bank in my country has gradually received attention. Research on the independence of central banks in major countries in the world has profound guiding significance for improving the independence of China's central bank.

2. Overview of Central Bank Independence

The independence of the central bank is mainly reflected in the degree to which it can independently formulate and implement monetary policies. Its essence is reflected in the relationship between the central bank and the government. In layman's terms, the central bank is affected by the decision-making and implementation of monetary policies. However, the academic circles have not yet come to a unified conclusion on the connotation of the independence of the central bank. After consulting many materials, this article provides the following definitions of the independence of the central bank.

2.1. Relationship Between the Central Bank and the Government

The essence of the independence of the central bank is the relationship between the central bank and the government. Satisfying the following conditions indicates that the central bank has strong independence. First of all, at the organizational and personnel level, the central bank is not affiliated with government agencies [3-4]; The central bank president, directors and other major members are not appointed by the government, and have the freedom of appointment and dismissal. Secondly, at the level of formulating and implementing monetary policy, the central bank can independently formulate and implement monetary policy, adjust deposit reserve policy, rediscount policy and open market operation without following the will of the government. Thirdly, in the aspect of financial freedom, the central bank has the right of economic

independence and is not restricted by the government's finance.

2.2. Relationship Between the Central Bank and the Financial Market

The relationship between Bank of China and the financial market is mainly reflected in two levels, one is the domestic financial market, and the other is the international financial market. First, the central bank is independent of the domestic financial market. The central bank is different from financial institutions such as commercial banks. It is independent of financial institutions and assumes the responsibilities of issuing banks and banks, and supervises various financial institutions to ensure the financial market's Healthy and stable [5]. Secondly, the central bank is independent of the international financial market. When the central bank participates in the international financial market activities, the central bank of a country must stand under the actual conditions of its own financial market, maintain the stable development of its own financial market, and serve its own economy.

3. ANALYSIS OF CENTRAL BANK INDEPENDENCE IN TYPICAL COUNTRIES

Regarding the analysis and research on the independence of central banks, this article can be roughly divided into three types: one is a highly independent central bank, typical representatives are the Federal Reserve and the Federal Bank of Germany; the other is that it is legally subordinate to the government, but it is substantially more independent. The typical representative of a strong central bank is the Bank of Japan; the third is a central bank with poor independence, which is typically represented by China, South Korea and Australia. The main indicators for evaluating the independence of the central bank are as follows: firstly from the legal definition level, secondly in the main personnel appointment and dismissal, thirdly in terms of financial freedom, and finally in terms of monetary policy. Through the comprehensive analysis of these four levels, the development model of the country's central bank is derived. Table 1 below is a comparative analysis of the independence of major foreign central banks.

Table 1 Example analysis of three typical foreign central banks

| | | Legal definition | Personnel appointment | financial freedom | Monetary Policy |
|--|-----------|---|---|--------------------------|--|
| Independent central banks (Federal Reserve, Deutsche Bundesbank) | U.S.A | Completely independent | Appointment and removal of the president after the Senate agrees Staggered tenure | Completely independent | Completely independent Independently formulate and implement monetary policy without government restriction |
| | Germany | Completely independent | Personnel appointment and removal are independent of the federal government | Completely independent | Completely independent Not restricted by the federal government |
| Legally weaker central bank (Bank of Japan) | Japan | Not completely independent The name belongs to the province of Tibet | Nominated and appointed by the Cabinet and the Minister of Finance Term is not staggered | Not independent | More independent Independently formulate and implement monetary policy |
| Less independent central bank (Bank of Korea) | Korea | Not independent | Nominated and appointed by the Minister of Finance Term is not staggered | Not independent | Legally independent In fact, it is controlled by the government |
| | Australia | Not independent | Appointed by the Federal Governor Term is not staggered | Not independent | Not independent |

3.1. Analysis of Fed Independence

Among the more independent central banks, the Federal Reserve (Full name: Federal Reserve System) is the most typical. The Federal Reserve is responsible for the management and monitoring of the U.S. financial markets, maintaining U.S. financial stability, independently formulating and implementing monetary policies, and maintaining the stability of U.S. prices. At the legal level, the Federal Reserve Act provides that the Fed is free to take relevant actions and formulate and implement various monetary policies without interference from the President and other agencies. This gives the Fed a high degree of independence at the legal level. At the personnel appointment and removal level, the seven Fed board members (including one chairman and one vice chairman) are appointed by the president after the Senate has passed them. The chairman's term of office is 14 years, and the term of office of the president is staggered. At the financial level, the Federal Reserve has sources of funding, operates independently, and does not need government funding support, and is not subject to government funding constraints [6-7]. At the monetary policy level, the Fed can independently formulate and execute monetary policy without the approval of the President or other agencies.

3.2. Analysis of the Independence of Japanese Bank

The Bank of Japan is the central bank of Japan. At the legal level, the Bank of Japan is subordinate to the Ministry of Finance, and does not have organizational independence. At the personnel level, the governor and directors of the Bank of Japan are appointed by the Cabinet and the Minister of Finance, and the term of office is not staggered with the Minister of Finance, and they are not sufficiently independent in terms of personnel. At the financial level, the profits and losses of the Bank of Japan belong to the fiscal sector and have no financial autonomy. In terms of monetary policy implementation, when the Bank of Japan Policy Committee formulates monetary policy, government members can only participate in it, but cannot exercise voting power. Therefore, the Bank of Japan is essentially guaranteed a high degree of independence in monetary policy formulation.

3.3. Analysis of the independence of Korean Bank

The Central Bank of Korea has undergone a series of reforms. Today, the central bank is the Bank of Korea, and its highest authority is the Currency Committee. Legally, the Bank of Korea is under the Ministry of Finance. In terms of personnel appointment and removal, the main personnel appointment and removal power of the Bank of Korea is in the hands of the Minister of Finance and the President. At the financial level, the Bank of Korea has no

financial freedom. At the level of monetary policy, nominally it has the power to independently formulate monetary policy, but in reality it is largely controlled by the Ministry of Finance and the President.

4. ANALYSIS OF THE CURRENT STATUS OF THE INDEPENDENCE OF PBC

China is a typical country on the path of transformation and development. The People's Bank of China has also explored the road of independence for a long time. Only by studying the status quo of its independence can we find the source of its problems and provide more information for the development of the independence of the People's Bank of China. When studying the independence of the People's Bank of China, this article selects the following five measurement indicators: legal definition, personnel appointment and removal, financial independence, monetary policy, and functional objectives. Next, we will introduce the independence of the People's Bank of China from these five levels and recognize the current status of the independence of the People's Bank of China.

4.1. The Independence of Legal Definition

The "People's Bank of China Law" stipulates that the People's Bank of China is subordinate to the State Council and is a ministerial-level institution under the State Council. The legal status of the People's Bank of China is very clear. It is subordinate to the State Council and cooperates with the work of the State Council and related agencies. Therefore, the People's Bank of China is not independent of the government at the legal level.

4.2. The Independence of Personnel Appointment and Removal

The "People's Bank of China Law" stipulates that the People's Bank of China implements a system of governor responsibility. The candidate for the governor is nominated by the Premier of the State Council, then voted by the National People's Congress, and appointed by the President of the People's Republic of China after approval. It can be seen that the State Council has the right to nominate the governor of my country's central bank. Not only that, the members of the Monetary Policy Committee are also appointed and removed by the State Council. Except for a professional authority, they are all government officials. Therefore, the decisions of the Central Bank and the Monetary Policy Committee are often consistent with the will of the government, which shows that the independence of the People's Bank of China is at a relatively weak stage.

4.3. The Independence of Financial Independence

In terms of financial freedom, the People's Bank of China is affiliated to the State Council, and its losses are borne by the state finances. The profits of its business must also be turned over to the treasury. It cannot operate independently and is responsible for its own profits and losses. This also means that the central bank's funds come from the government. In addition, the People's Bank of China prohibits the provision of loans to the central government and governments at all levels. The People's Bank of China can only provide relevant advice in the process of government financing and assume the role of "think tank", and has no right to directly provide financing. The Central Bank of China is obviously controlled by the government in terms of funds and cannot achieve financial independence.

4.4. The Independence of Monetary Policy Level

The People's Bank of China has the function of formulating and implementing monetary policies. The monetary policy tools of the People's Bank of China include: the legal reserve fund system, the rediscount system, and open market operations. However, the monetary policy formulated by the People's Bank of China is often highly consistent with the government's will, and it is often in the same direction as the fiscal policy. The government's will is very obvious in monetary policy. In addition, the important decisions and monetary policies of the Monetary Policy Committee of the People's Bank of China must be approved by the State Council before they can be implemented, which also largely limits the independence of the central bank.

4.5. The Independence of Functional Objective Level

The People's Bank of China now adopts a multiple target system: stable prices, maintaining economic growth, full employment, and maintaining a balance of international payments. But in fact, there are often inherent contradictions between these goals. For example, there is a contradiction between price stability and economic development. It is necessary to maintain the stability of the renminbi currency while also serving the stable development of the economy. In many cases, it is difficult to balance. When the contradiction becomes prominent, the central bank's goal of currency stability often gives way to economic development, leading to a decline in currency value. The central bank's goal of stabilizing the value of the currency to the economic development goal is not good. This has caused the central bank to lose its independence to a large extent and become a loyal executor of the will of the government. "Fever",

over-issuance of currency, triggered a series of serious social problems.

5. SUGGESTIONS ON IMPROVING THE INDEPENDENCE OF THE PBC

5.1. Demonstration of Independence Theory

Next, this paper will use dynamic inconsistency theory and "conservative banker" theory to demonstrate the relationship between central independence and social welfare. Dynamic inconsistency means that a monetary policy is the best choice when it is formulated. However, with changes in actual conditions and investor expectations, it is not the best choice when implementing the monetary policy. In essence, the policy has the characteristic of lagging. To solve this problem, it is necessary to use an extremely conservative banker in charge of power. This banker is extremely averse to inflation and vigorously maintains currency values and stabilizes prices. The paper introduces the social loss equation of conservative bankers:

$$L=1/2[a(\pi-\pi')^2+(y-ky')^2]$$

Social loss (L), central bank monetary weighting tendency (a), actual inflation rate (π), target inflation rate (π'), actual output (y), ky' (target output). $a>1$ means that the central bank focuses on suppressing inflation; $a<1$ means that the central bank focuses on promoting employment and boosting the economy. $k>1$, which means that the social optimal output is higher than the social natural output.

Under normal circumstances, the central bank's monetary policy is dynamic and inconsistent, implementing discretionary monetary policy. However, "conservative bankers" will choose to implement conservative monetary policies and are more willing to adopt relatively small changes in the face of external interference. Under the circumstance, the public's expected inflation will also fall to a smaller extent, making actual inflation close to expected inflation. To sum up, even if the central bank chooses to implement monetary policy, "conservative bankers" will pay more attention to suppressing inflation in order to maintain the independence of the central bank, while at the same time there is a certain degree of flexibility. From this we can see that the independence of the central bank is extremely important for social welfare, maintaining currency values, and maintaining price stability.

This does not mean that the greater the independence of the central bank, the better. The national conditions of each country are different. Political systems, economic systems, cultural concepts, and traditional ideas all affect a country's central bank system, which also determines what kind of system the country is suitable for. In China, it may not be suitable to implement a completely independent central bank system like the United States and Europe. China should also gradually improve the independence of the central bank, balance the relationship between the

central bank and the government, and find the best balance. But I think that in the overall direction, China should gradually increase the independence of the People's Bank of China.

5.2. Four-level Recommendations for Improving the Independence of the Central Bank

5.2.1. Substantively enhance the legal status of the central bank

Under the existing legal system, the central bank is subordinate to the State Council, which reduces the central bank's independence in terms of legal status. In light of the reality of our country, the Central Bank of China is currently unable to reach some highly independent central banks such as the Federal Reserve and European Banks, but it should also change the existing central bank subordination to the State Council. Only by legally stipulating that the central bank is independent of the government can it be able to distinguish its functions and objectives from the government, and perform their own duties. It also solves the potential danger of the government using its power to oppress and interfere with the central bank's monetary policy. For example, the Bank of Japan is subordinate to the Ministry of Finance and Economics. Even if it is currently independent, it is inevitable that the government will use its power to force it to obey the government's will under special circumstances.

5.2.2. Pay more attention to professionalism in personnel

Among the current members of the Policy Committee of the People's Bank of China, only one is an authoritative professional in the financial sector, and the other members are government officials, which is not conducive to the scientific nature of policy making. My country should learn from the relevant experience of the Federal Reserve, increase the proportion of professionals in the monetary policy committee and ensure that policy decisions are professional and scientific. In addition, the Central Bank Policy Committee should also recruit people from all major regions, so that policy formulation can take into account the conditions across the country. In terms of personnel appointment and removal, the State Council has reduced the control of the State Council over the appointment and removal of the main leaders of the central bank, making the central bank more professional and independent in personnel matters.

5.2.3. Enhance the economic autonomy of the People's Bank of China

There are two advantages in enhancing the financial autonomy of the People's Bank of China. The central bank achieves independent operation and is responsible for its own profits and losses. On the one hand, it helps the central bank to get rid of the government's financial control and enhances the central bank's independence in formulating and implementing monetary policies; On the other hand, it is conducive to the central bank's when it comes to monetary policy, it is more prudent because banks need to independently bear operating risks.

6. CONCLUSION

The central bank occupies an important position in the economic structure of a country, and it also plays a pivotal and irreplaceable role. It positions the central bank reasonably, improves the independence of the central bank, and seeks the best balance between the central bank and the government. The People's Bank of China can determine its position and improve its independence, which can promote a more reasonable monetary policy in China, maintain the health and stability of China's financial market, and promote the sustainable development of China's economy. Enhancing the independence of the People's Bank of China is a direction that China needs to explore.

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