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Why China's Central Bank Is OK Being Dependent on the Government

Headquarter of People's Bank of China(PBOC), China's central bank, in Beijing.

Associated Press/Xinhua

China's central bank isn't politically independent. Before it makes big decisions it needs approvals from either the top bodies of government or the Communist Party—and sometimes both.

People's Bank of China Gov. Zhou Xiaochuan says that's OK with him. The arrangement benefits China's efforts to remake the economy, Mr. Zhou told an international conference this spring. "If the central bank and other regulators were not part of the government, it would be very difficult to co-ordinate and push forward reform policies," he said.

What to make of this? One possibility is that Mr. Zhou acts as cheerleader because he has no other option. China's top leaders have a long list of reforms, but none of them include central bank independence. What would be served by Mr. Zhou making a pitch for independence?

"Leaving politics aside, a century of history and oodles of empirical work show clearly that a central bank that is independent but still accountable is better able to make the credible commitments and hard decisions that we expect of monetary policy makers and then stick to them," says University of California at Berkeley economic historian Barry Eichengreen. Exhibit No. 1 is Federal Reserve Chairman Paul Volcker's decision in the 1980s to raise interest rates through the roof to battle stagflation – and to stick to his decision despite being pilloried by lawmakers and taunted by farmers who blocked the Fed's entrance with their tractors.

But a number of economists argue that Mr. Zhou has a point: Independence might be critical in wealthy developed nations, especially democracies, but not so much in developing ones. As part of the government and party apparatus, the PBOC plays a significant role in economic policy bodies. Mr. Zhou's deputy, Yi Gang, for instance is a senior member of the group that advises the ruling seven-member Politburo Standing Committee on economic-policy decisions.

"The central bank in its current role has the opportunity to weigh in on almost every economic decision," says Nichols Lardy, a China specialist at the Peterson Institute of International Economics. "If you're independent, you have to stick to your knitting and guard your independence," he says. Otherwise, adversaries will try to chip away at the central bank's mandate.

The lack of independence, of course, cuts both ways. During the tenure of Premier Wen Jiabao, from 2003 to 2013, Mr. Zhou was often on the outs, say Chinese officials, because the central bank thought Mr. Wen was pushing banks too hard to finance stimulus spending. The result was a credit bubble that China is currently trying to deflate without wrecking the economy.

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Now, with Xi Jinping in power and economic reform on every Chinese leader's lips—though that's not necessarily reflected in their actions—Mr. Zhou is in a more powerful position. Mr. Xi gave him a third term even though Mr. Zhou passed the retirement age of 65. Mr. Zhou can also count on support from another Politburo Standing Committee member, Wang Qishan. Mr. Wang now heads the party's anti-corruption drive, but before that he was involved in economic policy and is a longtime ally and friend of Mr. Zhou.

Cornell University economist and China scholar Eswar Prasad ticks off a number of developing-nation central banks that lack formal independence but still play powerful roles in their nations' economies. The Reserve Bank of India reports to the finance minister, he says, "but has been able to get de facto operational independence through the skill of past governors." Brazil's central bank chooses an inflation target jointly with the Brazilian government, not on its own.

Many developing nations' central banks try to limit the influence of politicians by adopting rigid inflation targets for their monetary policy. Aiming for certain inflation numbers guides policy actions – often higher interest rates and tighter budgets–and helps insulate the bank from excessive political pressure.

"Once they get buy-in from the government for the framework and the (inflation) target itself," says Mr. Prasad, "de facto operational independence becomes essential."

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