Special Section on Central Bank Financial Independence and Policy Credibility:
Introduction
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This special section of *IMF Staff Papers* provides a welcome opportunity to highlight an issue that has dwelled in relative obscurity until the past few years—the significance of central bank financial strength and its relevance in determining policy credibility. Central bank financial strength has recently attracted increased attention for various reasons. One of the most prominent is the high level of financial risk being taken by a number of contemporary central banks in the context of an overall decline in nominal interest rates; that is, in the context of declining central bank profitability. The introduction of more refined accounting standards and risk management tools for commercial banks has also contributed to the interest in examining the adequacy of both central bank accounts and accounting.

The first paper in the group, by Alain Ize, takes a close look at the way in which a weak central bank balance sheet can compromise the attainment of central bank inflation objectives. He develops a simple analytical net-worth-based model to assess the need for central bank capital and applies it empirically to several countries where the central bank currently has negative net worth. In one case, Costa Rica, he arrives at the lower inflationary bound beyond which the central bank, as presently structured, would not be able to meet its financial obligations. In that example, as well as in the others, he points out the critical nature of the policy regime for determining the minimum level of central bank capital. He also highlights the cost of foreign exchange reserve accumulation as a key factor determining central bank financial strength and suggests that any central bank recapitalization should trigger an extensive national debate about the role and need for international reserves.

In the second paper, Thomas Cargill discusses the current situation of the Bank of Japan with the aid of historical insights gleaned from the last episode of major country deflation—the Great Depression. In recent years, the Bank's policies have led to an enormous expansion in its balance sheet, to the point where observers both inside and outside the Bank have questioned its capital adequacy. Cargill examines the risk to the balance sheet from an eventual rise in interest rates and concludes that while indeed the Bank of Japan would suffer a considerable loss on its government securities portfolio on a mark-to-market basis, this would be unlikely to impact the Bank's ability to achieve its objectives. He also argues that much of the concern with the Bank's financial strength is the result of a faulty definition of capital adequacy. Adopting an improved measure of central bank financial strength would set the stage for a more enlightened discussion of the financial risk associated with Bank of Japan policy.

The last paper, by Peter Stella, is a broad survey of the issues, and it is intended to stress the importance of central bank financial independence, properly defined, for the credibility and thereby the success of central bank policy. Central bank financial independence is by no means the only requirement for success, but it does play an often overlooked and frequently misunderstood role in setting the policy boundaries within which the central bank can be credible. The paper makes the case for the relevance of central bank financial strength by discussing the large number of countries where central bank financial weakness has either impeded policy formation or become a matter
of public debate. Stella also examines the importance of transparent accounting in providing the foundation for strategic decision making concerning the appropriate extent of central bank financial independence. In conclusion he argues that to properly assess the adequacy of a central bank's financial situation it is essential first to establish the policy framework employed by the bank, then to examine the risks to which it is exposed, and finally to determine the socially desired level of central bank independence.