The Case for Central Bank Independence

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It has been theorised that insulating a country's monetary authority from political influence has a beneficial impact on the nation's economic health. Empirical evidence shows that the degree of independence a nation's monetary authority enjoys correlates with lower and more stable levels of inflation. It does not appear, as some critics claim, that this price stability is achieved at the expense of real economic output. On the contrary, there is evidence to suggest that central bank independence is associated with stronger levels of economic growth. Therefore, governments would do well to uphold the independence of central banks.

Central bank independence refers to the degree to which a state's monetary authority is insulated from political influence. The logic behind central bank independence is that subjecting the monetary authority to influence from elected politicians, and thereby indirectly to public opinion, would be detrimental to the country's economy. In democratic states, the regular election cycle impedes long term economic planning. The gains in output generated by expansionary monetary policy manifest themselves before the resultant rise in inflation. This encourages politicians in power to implement expansionary policies in the periods before elections: the rise in output will help win the favour of the public, and any resulting rise in inflation will not be felt until after the election takes place. This deviation from optimal long term goals in favour of short term political expediency is referred to as time-inconsistent policy (Laidler and Robson 2004). Compared to a scenario in which decision makers have no incentive to eschew long term planning, such short term thinking will result in a higher average rate of inflation, with growth remaining the same or lower over the long run.

Additionally, politicians will seek to broaden their support by appealing to the various interest groups which compose the electorate. While the public in general may be averse to inflation, it is unlikely to be the foremost concern of any particular group. Farmers and fishers will likely be more concerned about subsidies for their industries than about price stability, and students will likely put greater emphasis on investments in education. In order to win the support of such groups, politicians will pledge to increase government spending in their areas of interest. Because increasing taxation would be politically unpopular, deficits incurred in such a manner are often financed through the central bank, resulting in monetary expansion and higher inflation (Laidler and Robson 2004). As such, even though the public does value low inflation, it will not be the deciding factor for most individual voters, the cumulative effect of which will be a higher rate of inflation than the populace actually desires.

The solution is to remove the reins of monetary policy from the hands of elected politicians and delegate the task to a separate body with a mandate to maintain price stability. Free from the constraints imposed by public opinion, an independent central bank would be able to stabilise inflation at a lower level than would be possible if it were beholden to an elected government.

Empirical evidence supports this line of reasoning. Alesina and Summers (1993) use an index to rank several OECD countries by degree of central bank independence, then compare these rankings with average national inflation rates between 1955 and 1988.[1] The degree of independence of a central bank is measured in terms of political and economic independence. Economic independence refers to the conditions under which the central bank is required to finance government deficit, and the political independence of the banks is based on such factors as the government's ability to appoint members of the governing board, government representation on the governing board, and to what degree monetary decisions require government approval. The study finds a "near perfect" negative correlation between average rates of inflation and the degree of central bank independence. The countries with the two most independent central banks, Switzerland and Germany, enjoyed the lowest average inflation among the countries observed (approximately three percent), while the three least independent central banks in Italy, Spain and New Zealand, corresponded to the three highest average inflation rates, all being over seven percent. The study also shows a strong negative relationship between central bank independence and variability in the inflation rate, which is itself undesirable in that it creates market uncertainty.

The case for central bank independence is further supported by the findings of a recent study by Jacome and Vazquez (2008), which looks at central bank independence and inflation rates in developing economies in Latin America and the Caribbean between 1985 and 2002. [2] In the 1990s, many countries in this region implemented reforms to increase the independence of their central banks. Inflation rates fell across the region from an average of approximately fifty percent in 1985 (excluding cases of hyper-inflation) to around seven percent in 2002.[3] The study finds that countries in the region experienced an average inflation rate of 49.53 percent during their pre-reform periods, which dropped dramatically to an average of 11.53 percent during the countries' post-reform periods. This evidence strongly suggests inflation can be greatly reduced through strengthening central bank independence.

The effects of central bank independence on the real economy are also worth discussing. Some critics allege increased central bank independence brings about lower inflation at the expense of real economic output (which would entail higher unemployment), the

[1] The countries included were Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States of America.
[2] The study employs four different measures of central bank independence: the CWN index, the CWNE index, the index developed by Grilli et al. (1991), and an index based on the turnover rate of central bank governors.
[3] It should be noted that the study concludes that this drop in inflation rates was due only in part to increased central bank independence, being a product of various macroeconomic reforms.

reasoning being that the more independent the central bank is, the less it is willing to engage in active policy intervention to counter cyclical downturns in the economy (Alesina and Summers 1993). Empirical evidence points to the contrary however, as demonstrated by the work of De Long and Summers (1992, 13-16), who compare the level of real GDP per worker between 1955 and 1990 in several OECD countries and compare growth rates to central bank independence.[4] While a simple comparison between growth in output per worker and central bank independence reveals a slightly negative relationship, this fails to take convergence effects into account. The countries in the study with more independent central banks also tended to have higher output per worker levels in the year the study began. Because of diminishing returns in output from capital, the countries with less capital per worker at the beginning of the observed period would be expected to experience faster rates of "catch up" growth than those countries where capital per worker was already relatively high. Adjusting for convergence effects by holding the level of initial output per worker constant, the relationship between growth in output and central bank independence is positive. One possible explanation for this positive relationship is that, since protecting a central bank from political influence makes for more predictable monetary policy, strengthening central bank independence reduces the risk premia in real interest rates and so positively affects the real economy (Alesina and Summers 1993, 152). It is also likely that markets simply work more efficiently in the low inflation environment nurtured by independent central banks, high inflation environments containing greater uncertainty and price distortions.

Thus, the conclusion reached is that strengthening the independence of central banks is the advisable course of action. If monetary policy is left in the hands of elected politicians, who are beholden to public opinion, short term political expedience will be pursued to the detriment of long term economic health. Empirical evidence supports this reasoning: countries whose central banks enjoy greater degrees of independence experience lower and more stable inflation rates, and, rather than accomplishing this at the expense of real economic output, may actually achieve greater rates of growth than they otherwise would.

[4] The set of countries is the same as in Alesina and Summers (1993).

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