Journal of Monetary Economics 49 (2002) 237–264

Journal of MONETARY ECONOMICS

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Central bank reform, liberalization and inflation in transition economies—an international perspective ☆

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Received 13 July 2000; received in revised form 20 March 2001; accepted 31 May 2001

Abstract

This paper develops extensive new indices of legal independence (central bank independence (CBI)) for new central banks (CBs) in 26 former socialist economies. The indices reveal that CB reform in the FSE during the 1990s has been quite ambitious. In spite of large price shocks, reformers in those countries chose to create CBs with levels of legal independence that are substantially higher, on average, than those of developed economies during the 1980s. The evidence in the paper shows that CBI is unrelated to inflation during the early stages of liberalization. But for sufficiently high and sustained levels of liberalization, and controlling for other variables, legal CBI and inflation are significantly and negatively related. These findings are consistent with the view that even high CBI *cannot* contain the initial powerful inflationary impact of price decontrols. But once the process of liberalization has gathered sufficient momentum legal independence becomes effective in reducing inflation. The paper

☆ This is a revised version of CEPR Discussion Paper number 2808, May 2001. Previous versions of the paper were presented at the June 1998 Fourth Dubrovnik conference on Transition Economies, and at the July 2001 Meeting of the Western Economic Association. We gratefully acknowledge the help of Maureen Brown, Robert Christiansen, Patrick Conway, Cevdet Denizer, Jan Fidrmuc, Alan Gelb, Joel Hillman, Ricardo Lago, Gideon Schurr and Andrezej Slawinski in assembling parts of the data set used. We also benefitted from the criticisms and suggestions of an anonymous referee, Vache Gabrielyan, Robert King, Ricardo Lago, Sergei Novik, Heikki Oksanen and Daniel Treisman.

The basic data underlying this paper appears in the four appendix tables and is available electronically.

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PII: S0304-3932(01)00107-6

also presents evidence on factors that affect the choice of CBI and examines the relation between inflation and CBI in a broader sample.

JEL classification: E5; P2; K1; P16

Keywords: Central banks; Legal independence; Transition economies; Inflation; Reform

1. Introduction

The, still ongoing, process of transition from plan to market in the former socialist economies (FSE) involves a fundamental process of change in the structure of those economies. In their attempt to create the institutional infrastructure needed for a market economy governments of the FSE scrapped old institutions and replaced them with new ones that were often patterned after similar institutions in the Western democracies. One element of this process was the creation of a Western type central bank (CB). Practically, all FSE either created a totally new CB by breaking the, typically socialist, Monobank into a CB and a private banking system or, in the case of several Central and East European (CEE) countries, substantially upgraded the legal independence of their preexisting CBs. Within a span of 8 years (1991–1998) *all* FSE created completely new CB laws, or reformed existing laws, at least once and sometimes even twice. Although there are substantial cross country variations among these new CB laws practically all of them embody substantially higher levels of independence than was the case in the pre-reform period.

Prior to, and in some cases after, the enactment of the CB law most transition economies experienced high and variable inflation. In some cases those inflationary episodes even assumed hyperinflationary dimensions.[1] The conjunction of high inflation and of CB reform provides a unique opportunity to examine the relationship between inflation and central bank independence (CBI) in environments with major structural changes and high inflation.

This paper has two major purposes. The first is to document and quantify the cross sectional and over time variation in the level of legal CBI in transition economies in a manner that allows systematic comparisons with the independence of CBs in more mature market economies. The second is to examine whether higher *legal* CBI is associated with lower inflation as is the case in developed economies.[2] This negative association between inflation and legal independence is not obvious a priori for several reasons. First, as is the case in non-FSE developing countries, legal independence may be a poor proxy for actual independence because of substantial

[1] An informative overall summary of the evolution of inflation in FSE appears in Stern (1996).

[2] Early evidence on inflation and CBI appears in Grilli et al. (1991), Cukierman (1992), Cukierman et al. (1992) and Alesina and Summers (1993). Recent surveys of this and later work are Eijffinger and De Haan (1996) and Cukierman (1998).