

Why are price stability and statutory independence of central banks negatively correlated? The role of culture

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Abstract

This paper investigates whether in OECD countries the negative relation between central bank independence and inflation is related to culture, in the sense of common values and norms. It appears that inflation is lower in countries where people dislike uncertainty. Countries, where inhabitants perceive that there should be an order of inequality and a centralisation of authority, are characterised by a dependent central bank and, to a lesser extent by relatively high inflation rates. Hence, the national attitude towards inequality among people appears to be a third factor explaining the negative correlation between inflation and the degree of central bank independence.

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1. Introduction

There is overwhelming empirical evidence (surveyed in [Berger et al., 2000](#); [Eijffinger and De Haan, 1996](#)) supporting the proposition that, in cross-country analyses, an independent central bank (measured by an index of legal independence) and low rates of inflation are negatively correlated. Until recently, this correlation was assumed to confirm a causal relation from central bank independence to inflation rates.

The causation assumed from central bank independence to inflation performance is coming under question. It has been suggested that the negative correlation between

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inflation and central bank independence is caused by a third factor. Candidates for this third factor are the opposition of the financial sector against inflation (Posen, 1995), the nation's degree of inflation aversion (De Belle, 1996), social cohesion (Prast, 1998), nationwide consensus (De Grauwe, 1998), and culture and tradition of monetary stability (Berger et al., 2000; Eijffinger and De Haan, 1996). Empirical analysis has been restricted to a large number of investigations of the influence of central bank independence on inflation and a few studies on the determinants of central bank independence (see, e.g. De Haan and Van't Hag, 1995; Eijffinger and Schaling, 1996; Moser, 1999).

As far as I know, only three empirical studies (Posen, 1995; Hayo, 1998; Moser, 1999) take the suggestion seriously that inflation and central bank independence are (partly) determined by the same set of variables. In Posen's study, this third factor is the effective financial opposition to inflation. A crucial assumption of his approach is that the financial sector dislikes inflation. Posen (1995, p. 257) claims that the bankers' vulnerability to inflation is well established although he admits that this attitude is not yet fully explained. On the contrary, recent studies find a positive (though not always significant) relation between the net interest margin and bank profitability, on one hand, and inflation, on the other (Demirgüç-Kunt and Huizinga, 1998, pp. 19 and 20). Van Lelyveld (2000, Chapter 7), therefore, estimates the country specific influence of inflation on the commercial banks' profitability. This sensitivity to inflation is regarded as the banks' preference for inflation and is used for improving the index of Financial Opposition to Inflation (FOI). This 'true' FOI is strongly correlated with inflation. Van Lelyveld interprets this empirical result as that a high level of inflation forms an incentive for banks to lobby for a dependent central bank. Just the opposite causal direction as put forward by Posen. Moreover, De Haan and Van't Hag (1995) only find mixed support for Posen's hypotheses.

Hayo (1998) introduces the concept of an inflation culture, which in his view leads to a national consensus on price stability and central bank independence. The inflation culture is the result of a historical feedback process where inflation aversion and central bank independence reinforce one another. Hayo approximates inflation aversion by means of the sensitivity of people's preference for low inflation to changes in the actual level of inflation. Various issues of the Eurobarometer are used for estimating this sensitivity.¹ It appears that the proxies of inflation aversion have a significant negative correlation with inflation. "The indicators of economic and political independence of the central banks are positively correlated with the estimated sensitivity parameters. In most cases, though, this correlation is not significant" (Hayo, 1998, p. 258). Hayo's approach has two drawbacks. First, due to data limitations, the analysis is restricted to European countries and partial correlations. Second, his paper does not provide a theory to explain why in one country the historical feedback process leads to low inflation and an independent central bank and in the other to high inflation and a dependent central bank.

Moser (1999) argues that the level of independence of the central bank is related to the (non)existence of checks and balances among political decision bodies (parliamentary chambers, executive, or the people in the case of a referendum or direct democracy). Countries in which these bodies are independent of each other are characterised by an

¹ The Eurobarometer is a survey regularly conducted in European Community members countries. Generally, around 1000 respondents are interviewed in each country.

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