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Reconsidering central bank independence

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Abstract

In this paper, we survey the case for central bank independence (CBI). We conclude that CBI is neither necessary nor sufficient for monetary stability. CBI is just one potentially useful monetary policy design instrument among several, and CBI should not be treated as an exogenous variable. Instead, the question that should be addressed is why societies decide to make their central banks independent? The reasons why CBI is chosen are related to legal, political, and economic systems. A number of empirical studies find correlations between CBI and low inflation rates. Endogeneity of CBI suggests, however, that the correlation has no implications for causality.

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1. Introduction

Central bank independence (CBI) has become one of the central concepts in monetary theory and policy. The virtue attributed to CBI is that it contributes to attaining the objective of long-term price stability. The idea has also found confirmation in the fact that more and more countries in the OECD and beyond have made their central banks

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independent. The culmination of this trend is the European Central Bank (ECB) that, according to its statutes, is the most independent central bank of all.

In this paper, we survey and re-evaluate the case for CBI. Compared to other surveys (see Eijffinger and de Haan, 1996; Berger et al., 2001a), which confirm the conventional wisdom, we focus on a selection of critical papers. Our conclusion is that CBI is neither necessary nor sufficient for monetary or price stability. CBI is not necessary for achieving price stability, because CBI is just one means among several that can be employed for fulfilling this objective. CBI is at the same time not sufficient for price stability, and should not be treated as exogenous, because of the question why central banks are made independent. It follows that it is wrong to regard CBI as a cause of low inflation rates.

We begin by reviewing the theoretical foundations of central bank independence. First, we summarize the models used to make the case for CBI. Then we point to serious theoretical problems with the standard argument that CBI is the optimal choice of a monetary policy design instrument. Although these problems are stated in the literature, the typical conclusion is that CBI is the best workable way to achieve low rates of inflation (see, for example, Berger et al., 2001a). We do not find this general conclusion to be justified by empirical analysis.

Second, we consider alternative monetary policy design instruments that can achieve low inflation rates. We focus on fixed exchange rate and currency board arrangements, inflation targets, and central bank contracts, which have equally or more favorable theoretical properties than CBI and have been successfully implemented. At the same time, every approach comes with at least one disadvantage, and no design instrument is optimal under all conditions.

Third, in a number of empirical studies, researchers found CBI to be correlated with low inflation rates. A typical policy conclusion based on this finding is that the creation of an independent central bank will bring about price stability. We argue that this conclusion is not warranted because of the endogeneity of CBI. Even if we measure the right thing and if there is strong evidence for a relationship between CBI and inflation, there is no reason to expect that this finding will be policy robust. In other words, this correlation does not indicate causality. Instead, at least two decisions determine the choice of CBI by a society. There needs to be a decision on whether price stability is a major economic policy objective. If this decision is made in the affirmative, a question follows about the appropriate choice of a monetary policy design instrument. The "true" cause underlying the empirical relationship between CBI and low inflation rates is accordingly the social choice in favor of a stability-oriented monetary system.

Based on these considerations, we set out theories and empirical evidence regarding the decision to make price stability an aim of economic policy. The two main explanations are (1) the idea of an "inflation culture" in societies that opt for a stable monetary regime or (2) that interest groups are able to influence the government regarding monetary policy.

Then we proceed to show under which conditions societies will choose CBI as opposed to alternative monetary policy design instruments. Here we consider three determinants: a society's legal, political, and economic systems.

The conclusion summarizes the main arguments and suggests directions for further research.