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The benefits of central bank's political independence

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Abstract

We consider a two-tier model of monetary policy where the central banker is both subject to the explicit influence of elected political principals through contracts and the implicit influence of interest groups willing to capture monetary policy. We analyze the impact of granting independence to the central banker on the scope for capture and the agency costs of delegating the monetary policy to a central banker. Political independence increases those agency costs but significantly stabilizes the politically induced fluctuations of inflation and improves ex ante social welfare.

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1. Introduction

Our current understanding of how the design of credible monetary institutions ensures greater economic stability has been significantly improved by the contracting approach pushed forward by Walsh (1995), Persson and Tabellini (1993) and Svensson (1995). This principal–agent literature argues that the inflationary bias due to the time inconsistency of monetary policy[1] can be avoided by delegating through contract the implementation of this policy to a central banker (thereafter CB) who is separated

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[1] See Barro and Gordon (1983).

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from the main government body.[2] This physical separation is often viewed as an ingredient of the CB's independence from the political sphere since it certainly insulates somewhat monetary policy from the day-to-day influence of political authorities and from fluctuations in the preferences of those political principals. However, the flip-side of this separation is that the CB may then be subject to various political pressures coming from organized interest groups willing to push their own views of what should be monetary policy.[3]

In this paper, we combine those two elements to obtain a more complete view of the political mechanisms which influence monetary policies. The CB is both subject to the explicit influence of elected political principals and to the implicit influence of interest groups which want to capture monetary policy. The choice of the CB legal status, i.e., whether he is independent or affiliated to the elected political principals, affects then the scope for capture of the monetary policy by private interests and different institutional choices lead to quite different policy outcomes. Under independence, the CB is less controlled by political principals and more responsive to interest groups. However, this status also isolates monetary policy from fluctuations in the identity of the elected political principals. As a result of this trade-off, the independence of the CB appears as an institutional best response to the threat of capture under political uncertainty.

Our view of central banking as balancing political versus private interests influences on monetary policy is inherited from Friedman (1962, 1972). According to him, central bank independence "embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything at the mercury of every whim of the current political authorities" but the flip-side of independence is that the CB becomes too much receptive to the "point of view of bankers", an organized interest group attempting to influence monetary policy. Consequently, Friedman rejected CB independence arguing that if elected politicians cannot be trusted for the conduct of monetary policy, "money is too important to be left to central bankers". The extreme solution suggested by Friedman was an inflexible monetary rule (a fixed growth rate of money) in order to "insulate monetary policy both from the arbitrary power of a small group of men not subject to control by the electorate and from the short-run pressures of partisan politics". This policy has of course a very high social cost both in terms of stabilization and in terms of non-responsiveness to changes in the preferences of society. In this paper, we take a less rigid view of what should be monetary policy

[2] A second standard solution to the credibility problem is to rely on reputation (see Rogoff (1989) for a survey). However, this non-institutional solution suffers from the well-known existence of multiple equilibria some of which still leave some room for discretionary policy. A third solution is to delegate the implementation of monetary policy to an inflation averse CB as in Rogoff (1985). As stressed by Walsh (1998, Chapter 8), this approach suffers from the fact that nothing prevents further delegation by the CB himself and, more importantly, from the fact that governments may find hard to distinguish among various central bankers with different preferences.

[3] As an example of capture of a CB, Cukierman (1998, Chapter 23) reports that, post to First World War, allies insisted on granting independence of the German CB from the German Chancelor to insulate this CB from the government's political pressures. This resulted in discount bills for private industrialists and bankers who, after the change, had better representation on the Board.