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Central Bank independence: Low inflation at no cost? A numerical simulations exercise

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Abstract

The independent nature of the Central Bank is often associated with achieving low and stable inflation. Further to that the merits of independence are stretched to achieving low(er) output variability when compared to a government run monetary policy. In this paper we use the Alesina (1989) and Alesina and Gatti (1995) model to examine how often an Independent Central Bank can achieve an improvement on both counts. To do that we run numerical simulations where we change the ex ante probability of elections (and hence the degree of electoral uncertainty) with a view to determining how the private sector's perceptions affect the level of output variability. Our conclusions agree with the Alesina and Gatti assertion that there will exist occasions when all political parties will be better off by consenting to the running of monetary policy by an independent institution but more often than not this comes at some cost to output. On theoretical grounds therefore, the trade-off between inflation and output variability (à la Rogoff) is still a valid one.

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1. Introduction

As more and more monetary authorities are granted political and economic independence, the gains in inflation achieved are measured against the ability to sustain and promote growth. And while the benefits in terms of inflation are widely accepted, there is no consensus as to whether output variability also benefits. A number of theoretical attempts find that Central Bank independence [2] (CBI) comes at no cost to output variability. Alesina and Summers (1993) find no relation between the variability of output growth and legal independence within industrialised countries and therefore, advocate that independence is an institutional feature worth adopting. Crosby (1998) reverses the causality by arguing that countries that have lower output variability are more likely to choose to have an independent Central Bank. Rogoff (1985) in turn finds a clear trade-off between inflation and stabilisation policy. And since the former benefits from greater independence, the latter suffers.

Alesina (1989) and Alesina and Gatti (1995) (from now on AG) justify the output gains of CBI by linking inflation and output variability to electoral uncertainty. They thus argue that in a world in which political parties are polarised in terms of their preferences, the possibility for time inconsistent behaviour is exacerbated. Keen to correctly anticipate the future, the private sector is adversely affected by this uncertainty and therefore, prefers to delegate monetary policy to a conservative body that is not subject to elections. This has two effects: first it guarantees the achievement of monetary objectives and second, it reduces the degree of uncertainty which affects the variability of output. For an appropriate choice of preference parameters, the authors argue, monetary discipline comes at no extra cost to output. And it is therefore, to the advantage of all political parties to co-operatively establish an independent Central Bank with appropriate preferences that will ex ante deliver both lower inflation as well as output variability.

Correct though it is, we will argue in this paper that such a result is also incomplete. The authors present their analysis in a two-party system when the probability of each of the parties getting elected is equal to 50%. This is arguably the highest degree of uncertainty (and therefore one which is interesting in its own right) but fails to acknowledge two relevant issues; first, that the probability that any given party will be elected may in fact be something different to 50% and second, and more important, that this probability may vary from one electoral period to an other. The institutional set-up associated with independence on the other hand, is one that cannot change from one electoral cycle to the next to accommodate alterations in electoral preferences. We will therefore argue that if the benefits of Central Bank independence are linked to electoral uncertainty, then it is important to show how they alter with the likelihood of the outcome of elections. The analysis will show that under different levels of political uncertainty (i.e. varying electoral ex ante probabil-

[2] Independence in the sense of the ability to pursue price stability free of political influence.