



# No single definition of central bank independence is right for all countries

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## ABSTRACT

A new international data set covering over 100 countries for the period 1990–2004 is used to investigate the relationship between central bank independence (CBI) and inflation. CBI is a combination of *de jure* and *de facto* characteristics. No single mix of characteristics uniquely defines CBI. Consequently, no single definition of CBI is ‘right’ for all countries. The distribution of inflation around the world is concentrated in the tails. Hence, quantile regressions are estimated to investigate the role of CBI. We do find strong evidence that several core elements of what can be defined as CBI do reduce inflation.

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## 1. Introduction

Rarely has so much ink been spilled in economics as in the discussion about the pros and cons of central bank independence (hereafter CBI).<sup>1</sup> The notion of “independence” is a misleading description of the position a monetary authority occupies in the affairs of State. An institution that is typically wholly owned by government<sup>2</sup> can, at best, be autonomous but not entirely independent of government. Unfortunately, the proponents and opponents of central bank autonomy cannot agree on why such an arrangement is beneficial to society. For some (e.g., Forder, 2005), central bank autonomy is a convenient policy that suits certain governments when convenient, while others (e.g., Cukierman, 1992; Eijffinger and De Haan, 1996) view the device as an important ingredient that can lead to a permanent reduction in inflation. Also remarkable perhaps is that, whereas the concept that a central bank acts in the best interests of society when it carries out its functions at arm’s length of politicians is an old one, it is only since the early 1980s that this notion has truly captured the imagination of policymakers. Consequently, this development has stimulated serious academic research at both the empirical and theoretical levels.

However, like the proverbial ‘product cycle’, the popularity of CBI has experienced its share of ups and downs. Curiously perhaps, while the importance of CBI has waned somewhat in the academic literature, as we shall see, it remains a *sine qua non* of good public policy (e.g., Segolato et al., 2007, and references therein). Indeed, it is a testament to the power and influence of the CBI concept that current policy discussions about the role of monetary policy focus on the desirability, for example, of inflation targeting versus other approaches to delivering certain monetary policy outcomes (e.g., Rasche and Williams, 2007, and references therein). Since inflation targeting generally presupposes that the central bank is autonomous<sup>3</sup> one gets the impression that the

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<sup>1</sup> For example, a search of the term in August 2007 returns over 5000 hits on Google Scholar, while an Econ Lit search returns 547 articles on the topic ‘central bank independence.’

<sup>2</sup> Siklos (2002, Table 1.1) shows that for 20 OECD economies and the euro area, 17 of the central banks are wholly owned by the State. Pringle (2005), which covers almost all central banks around the world, also reveals that the overwhelming majority of central banks are State-owned institutions.

<sup>3</sup> See, for example, Bernanke, Laubach, Mishkin and Posen (1999).

question about the importance of CBI as a policy prescription has been replaced with a debate over the appropriate monetary policy regime.

In what follows, I shall argue that this interpretation should not be adopted essentially for two reasons. First, in empirical studies, the concept of CBI has usually been sufficiently loosely defined to fit the particular needs of the group of countries under investigation. For example, CBI is sometimes embodied in the turnover rate of governors (e.g., Dreher et al., 2007) while, in other studies, CBI is a feature either of the political landscape (e.g., Johnson and Siklos, 1996, Banaian and Luksetich, 2001), or some principal component of an existing set of characteristics that define the relationship between the government and the central bank (e.g., Banaian et al., 1998). A large part of the explanation for this outcome resides in the fact that the empirical evidence for, or against, CBI has focused either on the experiences of developed or the less developed world, but ordinarily not both. To be truly meaningful, a useful measure of CBI needs to be applied to as many countries as possible, keeping in mind the inevitable constraints imposed by the availability of limited data as well as variations in the quality of the data across countries. This is especially true of investigations that consider the historical record of the last decade or two, as this is sometimes thought of as a 'golden age' when monetary policy has supplanted fiscal policy as the favored tool of stabilization policy. Consequently, this paper defines CBI as consisting of a combination of core elements. These core elements are chosen based on accepted theoretical arguments linking certain economic, and non-economic, variables to central bank independence and the usual metric used to assess its influence, namely inflation. One of the implications of the results presented below is that attempts to focus either on *de facto* or *de jure* factors to explain CBI's link to inflation misses the point. Instead, a mix of both types of elements is required both on political economy and economic theory grounds.

Since it is argued that CBI is best thought of as a set of distinct core principles, not all countries need possess all of the necessary characteristics at once. As a consequence, there is no reason to believe that a unique mix of the critical elements is 'right' for all countries. This explains the title which is reminiscent of Frankel (1999) who concludes that no single exchange rate regime is 'right' for every country.

The empirical literature, especially in economics, has sometimes tended to shy away from recognizing the fact that CBI is also importantly a political economy issue. Hence, it is difficult to divorce the connection between CBI and inflation from the equally important link between the general political and institutional environment that central banks operate under. After all, since the central bank is a creature of the State, its mandate, and the freedom to carry out its policies can, in principle, vary according to the political motives of the government in power (also see Banaian and Luksetich, 2001). None other than Alan Greenspan (2007) is at pains to point out: "I regret to say that Federal Reserve independence is not set in stone. FOMC discretion is granted by statute and can be withdrawn by statute (op.cit., p. 478).

The rest of the paper is organized as follows. In the next section, I briefly explore the major theoretical and empirical themes that have informed and influenced the debate about CBI over the past two decades. Section 3 defines what is meant by a core set of principles that, together, gives meaning to the CBI concept, and proposes some principles that help identify it. Section 4 provides some preliminary stylized facts, as well as introducing a new data set intended to shed new light on the connection between CBI, as defined in this paper, and inflation that covers many more countries than other studies in the extant literature. Section 5 presents some formal empirical evidence that broadly supports the main contention of this paper namely that, while there are a few common elements across the world linking the general concept of CBI to inflation, no single CBI definition is right for all countries. Section 6 concludes with suggestions for extensions and future research.

## 2. The theoretical and empirical impetus for CBI

CBI has often been seen as the natural outcome of the desire both to deliver 'good' monetary policy, defined as low and stable inflation, and maximize social welfare. In addition, monetary policy has to operate in tandem with a particular fiscal policy stance and an exchange rate regime, both of which are typically chosen by the political authorities.<sup>4</sup>

With these considerations in mind the theoretical literature, either informed by casual evidence, or in more formal empirical studies, has tended to view the central bank as the ultimate guardians of price stability. The resulting conflict between the monetary and fiscal or political authorities gives rise to the now well-known time inconsistency problem (Kydland and Prescott, 1977; Barro and Gordon, 1983) that led to the suggestion that the task of ensuring price stability should be delegated to a relatively more conservative central banker (Rogoff 1985). Alternatively, mistrust of political motives more generally led earlier researchers to advocate rules over discretion in the conduct of monetary policy (Friedman, 1956), or at least the introduction of frameworks for monetary policy that would deliver price stability, as in an inflation targeting strategy (Svensson, 1997; Woodford, 2003). To the extent that time inconsistency leads to the prescription that politicians 'tie their hands', as it were, by granting autonomy to the central bank via a guarantee of non-interference. Presumably, however, the ability of even a relatively conservative central banker to deliver lower inflation ought to be underpinned by institutional, and non-institutional, factors to ensure that the desired outcome is delivered with a minimum of misunderstandings, conflict, or other impediments that might complicate meeting the primary policy objective of the central bank. Of course, not all observers are convinced of the importance of the time inconsistency problem. Blinder (1998), for example, could not recall the conduct of monetary policy at the U.S. Federal Reserve ever being understood in this fashion.

<sup>4</sup> Siklos (2002, Table 5.1) describes the role of central banks in 20 OECD economies in choosing the exchange rate regimes. Generally, the exchange rate regime is chosen by the government although management of reserves is often left to the central bank.

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