



Central bank independence and transparency: Evolution and effectiveness

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ABSTRACT

Over the past two decades, the pace of central bank reforms in terms of institutional independence and transparency has been particularly brisk. This paper examines the current level of central bank independence (CBI) and transparency in a broad sample of countries using newly constructed measures, and looks at the evolution in both measures from an earlier time period. The legal independence of central banks has increased markedly since the 1980s, while the rise in transparency since the late 1990s has been less impressive. Exploiting the time dimension of our data to eliminate country fixed effects and using instrumental variable estimation to overcome endogeneity concerns, we present robust evidence that greater CBI is associated with lower inflation. We also find that enhanced transparency practices are associated with the private sector making greater use of information provided by the central bank.

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1. Introduction

While central banks have existed since the seventeenth century, their purpose, functions and operations have evolved over time. The pace of reform in recent years has been particularly brisk. This paper focuses on reforms that bear on monetary policy (as opposed to those that relate to financial regulation and supervision, although here too reform has been widespread). Reforms have been focused in three areas in particular. First, the legal statutes governing central banks' operations and relations with other branches of government have been revised or rewritten in many countries, with a focus on increasing institutional independence from the executive. Second, as central banks have become more autonomous, efforts have been made to enhance their accountability. Third, central banks have attempted to become more transparent in their operations. This last change is both a complement to increased accountability and related to changes in how monetary policy is conducted, notably to the introduction of inflation targeting.

In an attempt to quantify some of these developments, this paper details new measures of central bank independence and transparency.¹ It provides a detailed account of the construction of the indices and also relates the indices to underlying economic and sociopolitical variables, as well as analyzing their effects on variables of interest. Two results are particularly worth highlighting. First, controlling for country fixed effects by taking first differences, we find robust evidence that central bank independence (CBI) reduces inflation. This effect is robust to controls for endogeneity and measurement error via instrumental variables estimation. Second, we present evidence that greater central bank transparency leads the private sector to make greater use of information provided by the central bank when making forecasts, consistent with the predictions of a simple signal extraction model.

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¹ See also Crowe and Meade (2007).

While there have been some recent measures of transparency and independence for subsets of countries (Eijffinger and Geraats, 2006; Cukierman et al., 2002; Jácome and Vázquez, 2005), the measures here cover a more comprehensive set of countries and offer a more current picture.² Our measures also facilitate a comparison over time. In the case of the independence measure, the comparison is between the original index constructed by Cukierman et al. (1992) covering the 1980s, and our index which is based on a database of central bank laws held by the IMF and is current through 2003. For our transparency index, which broadly follows the methodology of Geraats (2002) and Eijffinger and Geraats (2006), the comparison is between the late 1990s and 2006. The earlier measure is based on the results of the survey of central banks presented by Fry et al. (2000), while the updated measure is based on our reading of central bank transparency practices based on their websites and published documents.

The literature on CBI is voluminous (Eijffinger and de Haan, 1996; Berger et al., 2001 provide useful summaries). Its theoretical impetus came from the time inconsistency problem (Kydlund and Prescott, 1977; Barro and Gordon, 1983) and the solution offered by delegation to a conservative central banker (Rogoff, 1985) or to any independent policymaker with suitable incentives and a well-specified mandate (Walsh, 1995). In practice independence tends to follow one of two models (DeBelle and Fischer, 1995; Fischer, 1995): *goal independence* (where the central banker has autonomy to follow his own policy prerogatives) or *instrument independence* (where the central banker sets a policy instrument in pursuit of a goal specified by the government).

Central bankers themselves, and some other commentators (Blinder, 1998), have been critical of the academic literature's focus on time inconsistency, arguing that it is not a relevant concern for modern central banks, particularly in industrial countries. The rationale for delegation can then be motivated by other concerns, including political economy factors (Crowe, 2008-this issue; Cukierman and Gerlach, 2003; Goodman, 1991; Hayo, 1998; Lohmann, 1998). Whatever its theoretical merits, the case for CBI appears to have been accepted, with a sharp increase in autonomy since economists first started measuring it seriously in the late 1980s, as outlined in Section 2 below. Greater independence has occurred across all groups of countries, but has been particularly marked for developing and emerging market economies.

While the theoretical case for CBI appears to have been accepted, empirical studies have found surprisingly limited evidence of independence delivering its promised anti-inflation benefits in practice. Hence, while the earliest studies of CBI focusing on a fairly narrow subset of industrial countries delivered this result (the best known of which is Alesina and Summers, 1993), later studies covering a wider set of developing and industrial countries have found more equivocal results (see Eijffinger and de Haan, 1996; de Haan and Kooi, 2000; Klomp and de Haan, 2007; Sturm and de Haan, 2001). In Section 4 of the paper we revisit this relationship exploiting the time dimension of our data and find relatively robust evidence for the negative relationship between CBI and inflation predicted by theory.

As central banks have become more independent, so the demand for transparency has increased, both for reasons of accountability and legitimacy, and to guide the expectations of financial market participants (whose appetite for information has expanded as financial markets have become broader and deeper). With respect to financial markets, central banks have also attempted to increase monetary policy effectiveness by using communication and transparency practices to shape expectations of future policy decisions and hence influence rates across the term structure (not just at the short end, over which they have some direct control).³ Monetary policy has also become more information-intensive with the increasing popularity of inflation targeting (IT) over simpler policy anchors such as a fixed exchange rate or money aggregate rule. Hence both the supply of and demand for central bank transparency seem to have increased (Blinder et al., 2001; Faust and Svensson, 2001; Geraats, 2002).

However, Section 3 of this paper presents evidence that, over the subset of industrial and emerging market economies analyzed here, overall levels of transparency have not increased significantly since the late 1990s. This result may reflect the short time period over which we measure the change and may be biased by some sharp drops in reported transparency which, in some cases, could be related to the different methodologies used to collect the underlying data in 1998 compared to 2006.⁴ Some specific examples of institutional reform – notably the creation of the European Central Bank (ECB) and the introduction of IT in a number of countries since 1998 – are associated with large and statistically significant increases in recorded transparency (Crowe and Meade, 2007).⁵

Increased central bank transparency can have a number of implications for macroeconomic variables (Geraats, 2002, provides a survey) but these tend to be rather model-specific and general lessons are hard to tease out. Transparency tends to be beneficial when information asymmetries are themselves the cause of inefficiencies in the economy, but can be costly in a second-best environment where the central bank is able to offset other inefficiencies by exploiting its informational advantage.⁶ Ultimately, however, the question of whether central bank transparency delivers tangible benefits is an empirical one, and one that we address

² Some other researchers are producing similar indices with an expanded coverage: see Arnove et al. (2006) and Dincer and Eichengreen (2007).

³ Other motivations for transparency have been suggested as well. For instance, the need for transparency may reflect public attitudes (Hayo, 1998), particular aspects of the political system (Keefer and Stasavage, 2003), or competing interest groups (Posen, 1993).

⁴ In particular, the self-reported nature of the 1998 data and language barriers in interpreting the degree of transparency in 2006 may have introduced upward biases in recorded transparency in the earlier period and downward biases in the later period.

⁵ Dincer and Eichengreen (2007) do find that transparency has increased generally, although their unlikely finding that no country's central bank has seen a decrease in transparency between 1998 and 2006 might lead one to question their methodology.

⁶ Not all contributions fall into this categorization. For instance, Morris and Shin (2002) argue that transparency could be costly if private sector agents put too much weight on the central bank's public signal because they are attempting to second-guess each other and the public signal acts as a focal point for higher order beliefs. This model is related to models of strategic forecasting (see, for instance, Ottaviani and Sørensen, 2006). Note though that Svensson (2006) raises doubts over whether the parameter range necessary to deliver costly transparency in Morris and Shin's model is likely to hold in reality – although Morris et al. (2006) provide some counter-arguments.

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