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Central bank independence and economic performance in eastern Europe

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Abstract

Following the breakdown of central planning by the early 1990s, transition economies faced varying measures of the need for economic restructuring and stabilisation. This paper examines both the trends in economic performance in eight eastern European countries and the degree of central bank independence (CBI) granted after reforms. The evidence of the paper indicates that both the measures of CBI and the measures of financial market development (FMD) show significant association with macroeconomic variables. Also, the sample exhibits positive association between CBI and measures of FMD. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Since 1989, the former centrally-planned economies have launched political and economic reforms that included varying degrees of stabilisation, liberalisation, restructuring and privatisation. In countries where decades of central planning prevented the development of market forces and institutional mechanisms for efficient resource allocation, transition to a market economy required substantial institution building. By investigating both the status of central banking reforms and their role in economic performance, this paper focuses on one such aspect of institution building.

A common feature of financial sector reforms in transition economies was replacing the monobank system with a two-tier system that legally separated savings and commercial banks from the central bank (CB).[1] Savings and commercial banks thus emerged out of the

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[1] Thorne (1993) provides a detailed account of bank reforms in Hungary, Poland, CSFR, Bulgaria and Romania.

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former branches of the CB and took over the management of saving and credit transactions with the household and enterprise sectors. The persisting linkages within the financial system and those between the financial system and the enterprise sector, on the one hand, and both of their linkages with the government, on the other, posed impediments for rapid success in stabilising transition economies to varying extents.[2]

In addition to the weak financial system, concentrated industrial structures and large state-owned enterprises of the central planning period enhanced the capacity of enterprises to organise as special-interest lobbying groups. During transition, these enterprises opposed market reforms since they desired to maintain the flow of resources that they were accustomed to obtain, regardless of the degree of their efficiency.[3] Moreover, a sizeable portion of the banking sector that remained state- or enterprise-owned continued to lend to inefficient enterprises.

Local governments also posed an additional source of resistance to bank and enterprise structuring. As fiscal decentralisation of the former socialist states led local governments to assume many social spending functions at the local level, the central government maintained much of the tax collection function. Local governments therefore resisted the privatisation of local enterprises that remained to be their main source of revenue.

Furthermore, in the absence of prudent regulatory and supervisory mechanisms, managers of banks and enterprises that are subject to restructuring often appropriated the profits and assets. Recapitalising such banks and enterprises necessitated large amounts of funds. Given the implied social or political costs of restructuring enterprises that are "too big to fail", fiscal and monetary authorities in many transition economies continued to subsidise them. Thus, the continued flow of funds to inefficient enterprises generated substantial pressure for inflationary monetary expansion in many transition economies.

Inherited economic distortions generated further challenge to stabilisation and market reforms in transition economies. As the inherited monetary overhang and shortages led to high rates of inflation in the periods that followed price liberalisation, expectations of a reform failure and uncertainty about the new relative price structures led enterprises to initially set prices above the market-clearing levels in order to obtain short-term gains. Moreover, as state control over the economy subsided, tax revenues declined,[4] increasing the fiscal deficits and thus pressures for inflationary credit expansion. At the onset of market reforms, most transition economies lacked the institutional mechanisms that were necessary to eliminate inflationary pressures, such as a developed financial sector and a sophisticated tax collection system. The absence of both fiscal and financial discipline aggravated these difficulties in implementing market reforms.

This paper argues that both central bank independence (CBI) and financial market development (FMD) may facilitate market reforms by helping to enforce fiscal and financial discipline. CBI is generally considered a mechanism to separate monetary policy from

[2] During central planning, the central bank provided funds to enterprises, not according to enterprise efficiency, but according to a central plan. As a result, banks lacked incentives to avoid risk and thus a large portion of a bank portfolio typically consisted of non-performing or low-quality enterprise loans, generating a great source of pressure on central bank financing.

[3] See Olson (1995) for the case of the former Soviet Union.

[4] McKinnon (1992) gives examples to this phenomenon from the USSR and China. The same phenomenon can also be observed in other transition economies, such as Poland, Hungary and Romania.