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Central bank independence and financial instability

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ABSTRACT

It has been argued that central bank independence (CBI) may not only be beneficial for reaching the objective of price stability, but also for maintaining financial stability. Greater independence from external pressure implies that central banks are less politically constrained in acting to prevent financial distress, while it also will allow them to act earlier and more decisively when a crisis erupts. We estimate the relation between CBI and a newly constructed measure of financial instability using a dynamic panel model for the period 1985–2005 with a large set of control variables. We find a significant and robust negative relation between CBI and financial instability, which is mostly due to political independence.

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1. Introduction

Many central banks have obtained a responsibility for financial stability in addition to their price-stability mandate (Das et al., 2004). Financial stability refers to the smooth functioning of the various components of the financial system, i.e., financial institutions, markets, and payments, settlement, and clearing systems (Čihák, 2007; Oosterloo and De Haan, 2004).

There is a voluminous literature suggesting that central bank independence (CBI) may contribute to price stability (Klomp and De Haan, 2007; Meade and Crowe, 2007; Cukierman, 2008). It has also been argued that independence may foster financial stability. For example, according to Quintyn and Taylor (2003, p. 259), “regulatory and supervisory independence (RSI) – both from the government and the industry – is essential for the achievement and preservation of financial (sector) stability.” Indeed, there is some evidence suggesting that CBI is positively related to financial stability (cf. Garcia Herrero and Del Rio, 2003 and Čihák, 2007).

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In this paper we re-examine the effect of CBI on financial instability using dynamic panel models. An innovation of the paper is that we introduce an alternative measure of financial instability that is based on a factor analysis of various indicators of financial instability. In our analysis we include indicators of banking crises, but also various other variables reflecting instability in other parts of the financial system.

Our CBI data come from [Arnone et al. \(2007\)](#), who have constructed a CBI indicator for many countries for the end of the 1980s and 2003. The indicator is based on the methodology proposed by [Grilli et al. \(1991\)](#) that distinguishes between political autonomy (i.e., the ability of the central bank to select the objectives of monetary policy) and economic autonomy (i.e., the ability of the central bank to select its instruments). Using the information on central bank law reform as provided by [Acemoglu et al. \(2008\)](#) we decide on the value of the CBI index for all years in between those for which [Arnone et al. \(2007\)](#) provide data.

Our sample consists of some 60 countries covering the period 1985–2005. We conclude that there exists a significant negative relation between CBI and financial instability. If we differentiate between political and economic independence, the results indicate that this negative relation is caused by political rather than by economic independence.

The remainder of the paper is structured as follows. The next section discusses why CBI may have an impact on financial instability. Section 3 gives a description of the methodology and data used. Section 4 shows our results on the relation between CBI and financial instability. The final section concludes.

2. CBI and financial instability

There are various arguments why CBI may matter for the stability of the financial system. First, greater independence from outside political pressures implies that the central bank is less constrained in preventing financial distress, which should allow the bank to act earlier and more decisively before a crisis erupts ([Čihák, 2007](#)). When politicians try to interfere, this may cause delays due to possible conflicts of interests. For example, [Alesina and Drazen \(1991\)](#) argue that the presence of multiple veto players in the political system may cause a delayed response to a crisis. Especially if politicians are uncertain of the costs of the crisis, they prefer to delay actions in order to reduce the costs of adjustment that they (or their constituencies) specifically bear, even if the overall costs of adjustment rise. According to [Quintyn and Taylor \(2003\)](#), in almost all of the systemic financial sector crises of the 1990s, political interference in the supervisory process leading to regulatory forbearance was a major factor contributing to the weakening of banks in the run-up to the crisis.

An independent central bank may be better able to maintain financial stability. For example, if the central bank identifies signals of emerging financial sector problems, it can alert financial markets, which is likely to trigger adjustment actions that help to prevent a crisis. Moreover, if the central bank is responsible for micro-prudential supervision, it may require adjustments from specific market players, leading more directly to an adjustment. In contrast, a dependent central bank that is captured by political interests associated with weak financial institutions may not be able to enforce strong and timely prudential action or act as a “whistleblower” ([Čihák, 2007](#)). Likewise, [Hutchison and McDill \(1999\)](#) argue that a central bank that is closely aligned with the government may be more inclined to provide financial support to problem institutions, thereby creating an additional channel for the moral hazard problem.

Second, [Čihák \(2007\)](#) points out that there is a time inconsistency problem in financial stability policy-making that is similar to the time inconsistency problem in monetary policy-making. Following [Čihák \(2007\)](#), the time inconsistency problem can be illustrated as follows. The policymaker has two possible responses in the face of financial instability: “tough” and “lenient.” If the policymaker is able to let the market believe that he is tough, he has a short-term motivation to act leniently in case of financial stress, as the short-term costs will be lower than those of a tough reaction. However, in case of rational expectations, market participants know the policymakers’ incentives and therefore expect the policymaker to be lenient. Similar to the time inconsistency problem in monetary policy, the policymaker needs a commitment device. Delegating the responsibility for maintaining financial stability to an independent central bank, and appointing as its head a person with a strong aversion to financial instability, could be such a commitment device.

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