International Review of Economics and Finance 33 (2014) 217–227

Contents lists available at ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

The credibility of monetary policy announcements: Empirical evidence for OECD countries since the 1960s

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ARTICLE INFO

Article history:
Received 3 October 2013
Received in revised form 16 May 2014
Accepted 19 May 2014
Available online 25 May 2014

JEL classification:
E31
E50
E52

Keywords:
Monetary policy
Price stability
Central bank independence
Monetary commitment
Credibility

ABSTRACT

Monetary policy rules have been considered as fundamental protection against inflation. However, empirical evidence for a correlation between monetary commitment to rules and price stability is relatively weak. We discuss likely causes for this weak link and argue that monetary commitment is not necessarily credible by itself without adequate policy assignment and an institutional framework enforcing the commitment. We further propose a proxy variable for monetary credibility in an empirical assessment of our theoretical arguments based on panel data covering 22 OECD countries and five decades. Results confirm the crucial role of a credibly backed monetary commitment for price stability.

1. Introduction

In the last two decades, there have been low inflation rates in many countries and a widespread consensus among policymakers, central bankers as well as economists about the virtues of price stability and the need for the independence of central banks from daily politics. However, latest developments in OECD countries have put this consensus into question and have cast doubt about future low inflation policies. The Federal Reserve has spent billions of US dollars to purchase US government bonds and other assets in the context of its policy of quantitative easing. In addition, the European Central Bank's introduction of the Outright Monetary Transactions (OMT) program and the announcement to do “whatever it takes” to rescue the Euro can be interpreted as a move towards a policy of indirectly and conditionally financing public debt without limits. It cannot be easily judged whether this policy move has been a voluntary action by the ECB or a reaction to explicit pressure from politicians. In any case, these developments have raised fears that, at least over the long term, price stability in the developed world is under threat which could have negative consequences for both economic growth and distribution. The history of central banking indeed shows that the political pressure on central banks to accommodate fiscal needs increases in times of fiscal problems. This phenomenon is often referred to as “fiscal dominance”. Wood (2005, p. 6) has put it as follows: “In any case, monetary policy is at bottom a political decision.”

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http://dx.doi.org/10.1016/j.iref.2014.05.005
1059-0560/

Against this background, the question again emerges of which institutional arrangement is suited best for preventing inflation not only in the developing world, but also in Europe and the United States. To approach an answer to this question, it seems worthwhile to take a look at the long-term development of inflation rates in developed countries. In this paper, we focus at this long-term perspective in order to identify the drivers of inflation in OECD countries since the 1960s. A focus lies on the institutional setting that governs the relation between central banks, governments and the public. In particular, it is necessary to inspect aspects of reputation and credibility of monetary policy more closely.

Why is the analysis of credibility so important? The parallel developments of world-wide decreasing inflation and increasing central bank independence (CBI) is backed by the direct statistical relationship between legal CBI and price stability which is strong for developed countries, but somewhat weak when calculated for both developing and developed countries (Arnone, Laurens, & Segalotto, 2006b; Arnone, Laurens, Segalotto, et al., 2006a; Klomp & de Haan, 2010). It is even more doubtful whether the observed correlation also reflects a causal relationship from high CBI to low inflation as there may be other drivers of the relation between CBI and inflation (e.g. Berger, de Haan, & Eijffinger, 2001).

Recent contributions to the literature treat central bank independence as endogenous and the result of political interests (e.g. Crowe & Meade, 2007). Others discuss the question of whether or not the recent global financial and economic crisis has substantially changed the role of central banks and their independence (Capie & Wood, 2012; Cukierman, 2013; Walsh, 2011). Therefore, it is worthwhile to rethink the role of monetary policy rules. It seems insufficient to trace back inflation exclusively to political commitment to a certain monetary policy framework. Instead, the focus has to be shifted towards the question of what makes a monetary policy rule credible. In our paper, we contribute to the literature in the following way: We first discuss briefly several aspects of monetary commitment, including central bank independence, governance, transparency and accountability. We argue that none of these concepts is sufficient to make monetary policy credible. For this purpose, workable enforcement mechanisms must be established in the institutional setting. Following this theoretical assessment, we empirically test the derived hypotheses. To this end, we propose a proxy variable for our theoretical concept of monetary credibility and apply this variable in a panel analysis covering 22 OECD countries and five decades beginning with the 1960s. In our novel empirical approach, we focus on data averaged over whole decades in order to identify the long-term determinants of inflation and the role of monetary commitment and credibility irrespective of short-term shocks.

The remainder of this paper is organized as follows. In Section 2, we present a discussion of different institutional aspects of monetary policy. Section 3 is dedicated to credibility of monetary policy rules. We derive hypotheses on the effects of monetary policy commitment and monetary policy credibility on inflation performance. In Section 4, the variables and data are introduced. The empirical assessment of the hypotheses for two samples of OECD countries over five decades is presented and discussed in Section 5. In Section 6, we draw policy conclusions from our results.

2. Institutional set-up of monetary policy

Monetary policy rules and the position of the central bank in the policy assignment have been discussed in the literature extensively for about 50 years. Although a widespread common belief that monetary policy should be rule-bound and that central banks should be granted central bank independence has been developed over time, there is still controversy about details and about empirical evidence. Basic contributions to the field have been made by different schools of thought. Friedman (1969) suggested a strict rule by which money supply should grow at a constant rate per period (the so-called *k*-rule). Brennan and Buchanan (1981) as well as Hetzel (1997) argue with multiple principal–agent problems between the public as principal and the government as well as monetary policymakers as agents (McCallum, 1997). This justifies defining monetary commitment as a constitutional decision. This view is strengthened by the neoclassical approach as put forward among others by Kydland and Prescott (1977) as well as Barro and Gordon (1983). The basic institutional setting to solve the principal agent problem is to grant the central bank political independence from the government. CBI implies that the central bank is given a constitution defining goals (instrument independence, Debelle & Fischer, 1995), giving the bank an organizational structure, restricting the influence of government and prohibiting credit from the central bank to the government. Thus defined CBI is measured as the simple sum or as a weighted or unweighted average of the various properties of central bank legislation (e.g. Cukierman, 1992; Grilli, Masciandaro, & Tabellini, 1991; Parkin & Bade, 1978).

The literature on CBI shows a strong and robust relationship between CBI and price stability. However, the empirical evidence is not as clear when looking at the correlation between CBI and price stability in developing countries (Klomp & de Haan, 2010; Arnone et al., 2006a). It seems that heterogeneity with respect to the development level of countries plays a major role. In those countries where the rule of law is generally accepted, the legal status of the central bank is decisive for the success of its policy. By contrast, for developing and transition countries, this relation is not that robust. Legal measures of CBI do not indicate a strong impact on inflation. The most significant negative correlation can be found between de facto CBI measured as the turnover rate of central banks' CEOs and inflation (Crowe & Meade, 2007; Jàcome & Vázquez, 2008; Siklos, 2008; Vuletin & Zhu, 2011). This result cannot be satisfying, as both the turnover rate and inflation may be caused by the same exogenous variable.

In addition, Forder (1996) argues that the concept of statute reading to identify the "true" independence of a central bank is methodologically flawed, as it gives no credit to informal rules and to actual behavior. For instance, the central bank's ability to conduct monetary policy may be limited despite a high degree of CBI due to exchange rate regimes set up by the government. He also claims that the statute of a central bank does not allow assessing the government's commitment to stability.

These criticisms triggered a number of attempts to deepen and broaden the analysis. Arnone and Romelli (2013) concentrate on CBI changes as structural breaks. They show that reforms change the inflation dynamics. Others have broadened the issue by highlighting the role of transparency and accountability of central banks (e.g. de Haan, Sylvester, Eijffinger, & Waller, 2005; Rhee & Turdaliev, 2013). In their analysis, de Haan et al. (2005) define transparency as the extent to which the central bank informs the public