Central bank independence and inflation in Africa: The role of financial systems and institutional quality

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Abstract

The study examines the effects of financial systems and the quality of political institutions on the effectiveness of central bank independence in achieving lower inflation. Drawing from the fiscal theory of price level (FTPL) and political economy of macroeconomic policy (PEMP) literature; we estimate a panel regression model, using Two Stage Least Squares instrumental variables procedure, on a sample of 48 African countries over the period 1970–2012. The study finds that central bank independence-inflation nexus is dependent on the model, sample and estimation technique used. After accounting for various control variables and introducing inflation targeting as an additional explanatory variable, the study shows that, unlike in developed countries, CBI is not sufficient in achieving lower inflation in Africa and the developing world. However, common to developed, developing and African countries, is that, higher central bank independence is more effective in lowering inflation in the presence of high levels of banking sector development and institutional quality. The findings of the study also show that while stock market development enhances the effectiveness of CBI in developed and developing countries, it has no significant effect on CBI effectiveness in Africa.

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1. Introduction

Price stability has been an important public policy goal and the independence of the central bank, has been identified by extant literature to be a determinant in achieving lower inflation rate. Central bank independence (henceforth CBI) is the freedom of monetary policymakers from direct political or governmental influence and direction, in the conduct of monetary policy (Walsh, 1995). It is the separation of the authority that prints money (the central banks) from the authority that spends it (the treasury). It is expected that, with this separation of authorities, central banks can focus on achieving price stability. Financial development has also been established to improve monetary policy effectiveness (Krause and Rioja, 2006) through its role in effectively transmitting policy rate changes to the economy and allowing the central bank to better target inflation based on the adequacy of information provided by the financial system as well as the amount of money in the economy, that passes through the financial system. Institutional quality has also been identified as a favourable determinant of inflation performance (Hielscher and Markwardt, 2012) as it ensures that political authorities are held accountable for their actions including the ability to address society’s welfare such as having low inflation rates (Rogoff, 1985). While financial development and institutional quality have widely been empirically established to lower inflation, the empirical results for central bank independence and inflation is mixed (Klomp and De Haan, 2010). Particularly while in developed countries, CBI leads to lower inflation, in developing and African countries, studies have not found any relationship between CBI and inflation, except for CBI governor turnover rates in some studies (Cukierman, 2008). Cukierman (1992) in not finding a significant relationship between legal CBI and inflation in developing countries attributed it to wide divergences between actual practice and the law in such economies. This has led others in recent times to argue that, there could be conditions under which CBI leads to lower inflation, and the financial system and institutional quality could be important to the effectiveness of central bank independence in achieving price stability (Posen, 1995: Klomp and De Haan, 2010; Hielscher and Markwardt, 2012). This however, is yet to be fully explored empirically particularly in Africa.

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As shown in Fig. 1, though inflation rates all over the world have been on a decline since the 1970s, there are marked differences in the levels of inflation among developed, developing and African countries, developed countries have had the lowest inflation rates while Africa has had the highest rates of inflation. Reducing inflation is therefore still a top priority for many African governments and policy makers.

Since Cukierman (1992), there have been brisk and significant institutional reforms in African jurisdicons, on improving good governance and sound economic management policies (Crowe and Meade, 2008). These have been fostered by the promotion of regional organisations such as ECOWAS, African Monetary Union (AMU), and South African Development Community (SADC).

Financial development has been established to improve monetary policy effectiveness (Krause and Rioja, 2006). This enables central banks to better target inflation and for policy rate changes to have the maximum effect on credit growth and supply. Particularly, in markets where credit is made to private businesses and households, inflation erodes the value of debt to be repaid and as such the central bank is pressured to ensure that inflation remains low so as to preserve the value of credit given. Low inflation also enables repayment of loans and reduces non-performing loans which can negatively affect the financial system. As such in highly developed financial markets, independent central banks work towards achieving much lower inflation rates since not doing so may widely affect financial systems negatively.

Political stability has also been identified as a favourable determinant of inflation performance (Hielscher and Markwardt, 2012). Posen (1995) also argues that political institutional characteristics such as those reflected in democracy, accountability, rule of law and bureaucratic systems are needed to improve the credibility of the monetary policy regime. There exists evidence on the positive effects of high institutional quality reflected in political stability example democracy, rule of law on maintaining the independence of the central bank and fostering the necessary environment useful for successful and efficient implementation of its price stabilization objective (Hielscher and Markwardt, 2012). Klomp and De Haan (2010) establishes that in transparent governance systems, legal CBI is effective. Central banks’ reputation to be independent are enhanced by the quality of political institutions (Hielscher and Markwardt, 2012). This is because, generally, for people to have high confidence in governments’ sticking to their decisions and the law, the presence of high quality institutions to hold them accountable is paramount. The quality of institutions relate to the levels of political stability, the rule of law and respect for civil rights which are a reflection of government’s willingness and ability to respect the legal provisions made to ensure that central banks remain independent from government interference in the discharge of its duty towards maintaining low levels of inflation. In most democratic jurisdictions, where there is transparency in governance and institutions are left to work, where there is political stability and civil rights are respected, voters can freely express their like or dislike for a government who flouts the laws. This promotes accountability of government and policy-makers.

CBI alone, does not suffice!

Comparatively few attempts have been made to study the extent to which these two can enhance CBI’s impact on a country’s macroeconomic performance (Hielscher and Markwardt, 2012). This is relevant particularly in the context of most developing countries including sub-saharan Africa, where CBI studies have not empirically established a negative relationship between CBI and macroeconomic performance. The few that have done so have focused on 6, 11, and until recently, 21 African countries found no significant impact of CBI, except in some few cases when the turnover rate of governors are used as proxies for CBI (Presnak, 1996; Wessels, 2006; and Kasseeah et al., 2011). They didn’t consider how the effectiveness of CBI in leading to low inflation, can be enhanced by financial systems and institutional quality.

While there exists a wide gap between developed and developing (African) countries in terms of financial development and institutional quality, there have been significant efforts to develop banking, stock and bond markets, improve democracy, good governance, institutional quality and rule of law in Africa in the past two decades. In Fig. 2, we observe that financial development in Africa and developing countries, measured by the ratio of private credit to GDP from 1970 to 2016, is low relative to developed countries.

In Fig. 3, we also observe that developed countries have had higher levels of institutional quality, measured by the rescaled political rights score (from 0 for least ratings and 6 for highest rating) from Freedom House from 1970 to 2016. Africa has had the lowest levels of institutional quality.

So developed countries having high levels of financial development and institutional quality, do also have the lowest inflation rates. Whilst Africa and developing countries, with lower levels of financial development and institutional quality, have higher inflation rates. This could provide explanation for the inability of studies to identify a clear link of CBI on inflation in Africa, and an explanation as to why developed countries have lower inflation rates compared to Africa and developing countries. This study seeks to

Fig. 1. Inflation.
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