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# Central bank independence and monetary policymaking institutions — Past, present and future

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ABSTRACT

This is an extensive survey of worldwide developments in the area of monetary policymaking institutions during the second half of the twentieth century and beyond. In addition the last section discusses current open issues and future challenges. Section 2 reviews the changes that have occurred in the area of central bank independence (CBI) during the last twenty years, discusses reasons for those developments and provides an overview of accumulated empirical evidence on the relation between CBI and the performance of the economy. Section 3 discusses lessons from stabilization of inflation, reviews the evidence and implications of asymmetric central bank objectives and considers the issue of CBI within the broader context of choosing a nominal anchor. Section 4 reviews the impact of independence on economic performance in the presence of labor unions. Section 5 considers future challenges facing modern central banks. The discussion presumes that CBI and price stability are here to stay and focuses on issues relating to the conduct of monetary policy by independent central banks in an era of price stability, like the risks associated with flexible inflation targeting and the impact of central bank capital and finances on its independence.



## 1. Introduction

Twenty years ago and earlier, most central banks in the world functioned as departments of ministries of finance. They were expected, by law, custom or both, to utilize their policy instruments to achieve a myriad of objectives like high levels of growth and employment, provision of funds to government for the financing of public expenditures, and to address balance of payments problems.[1] They also were expected to maintain financial and price stability but the price stability objective was one among several other objectives in the charter of the bank and had no particular status. In some cases like Spain and Norway it did not even appear in the charter. Paralleling this state of affairs, economic theory did not attribute particular importance to central bank independence (CBI) and the concept of credibility of monetary policy was in early stages of development. Furthermore, a notable legacy of the Keynesian revolution was the belief that a certain amount of inflation is conducive to economic growth.

Although some banks had a reasonable amount of legal independence the level of actual independence, particularly in developing countries, was usually lower than the one indicated in the law. Except for a few cases central banks did not possess instrument independence and the responsibility for price stability was, at least implicitly, located in the ministry of finance and other economic branches of government. In a few developed economies (like the UK, Japan, the US and West Germany) with wide

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[1] In the case of many developing countries the central bank often functioned as a development bank that provided subsidized loans to various sectors of the economy.

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capital markets price stability was maintained mainly through the actions of relatively conservative treasury departments or because of de facto independent central banks.[2]

Most other countries that enjoyed reasonable levels of price stability achieved this result by pegging their currencies to the currency of a country with sufficiently conservative aggregate nominal policies. Under the Bretton Woods system most currencies were automatically pegged to the US $. Following the breakdown of this system in the seventies many countries adopted unilateral pegs and later on, bands. Countries without either of those three commitment devices endured prolonged episodes of high and variable inflation as exemplified by the cases of Argentina, Brazil, Israel, Mexico, Chile and other countries.

The contrast of this state of affairs with current practice and academic consensus with respect to CBI cannot be overemphasized. Most central banks in today's world enjoy substantially higher levels of both legal and actual independence than twenty years ago or earlier. CBI and accompanying institutional arrangements like inflation targeting have become widely accepted commitment devices. In spite of some contentious issues the following broad practical consensus backed by academic work has emerged. The primary responsibility of the central bank (CB) is to assure price stability and financial stability. Without prejudice to these objectives the CB should support the economic policies of government. To achieve its main objective the bank is given instrument independence.[3] Delegation of authority to a non-elected institution should be accompanied by accountability and transparency. It is noteworthy that those two buzz words of modern monetary institutions were hardly heard twenty years ago or earlier. In the absence of independence accountability was unnecessary and, as political entities, governments and ministries of finance had no incentives to raise questions about their own transparency in the conduct of monetary policy.[4]

This paper is a selective survey of the vast literature of the last twenty years on CBI.[5] Section 2 quickly reviews the institutional changes that have occurred in the area of central bank autonomy and related monetary policymaking institutions in the world during the last twenty years. It discusses some of the reasons for those developments and provides an overview of accumulated empirical evidence on the relation between CBI and the performance of the economy. Section 3 opens with a discussion of some of the lessons from stabilization of inflation and proceeds to consider the issue of CBI within the broader context of choice of nominal anchor. It also reviews recent evidence on asymmetric central bank objectives and its consequences. Section 4 briefly reviews recent literature which considers the impact of effective conservativeness or independence on economic performance in the presence of labor unions.[6] A main insight of this literature is that, in the presence of large wage setters, CBI affects real variables like the rate of unemployment, implying that conservativeness affects economic performance even in the long run.

Section 5 closes the paper by considering future challenges facing central banks. Price stability is now a permanent fixture of industrial economies and of many developing economies, and CBI is a well established feature of the contemporary monetary order. Starting from the presumption that those features are here to stay, the discussion in this part focuses on issues relating to the conduct of monetary policy by independent central banks in an era of price stability. In such times the bank is naturally expected to devote more attention to stabilization of the output gap. The section discusses the risks associated with such a flexible inflation targeting regime. In some instances a trade-off between democratic accountability and CBI may arise. This occurs, for example, when, due to its obligation to maintain financial stability, the CB engages in operations that lead to substantial losses. A closely related issue is the distribution of CB profits and losses between the CB and government and the optimal level of CB capital. The section reviews this hitherto relatively neglected issue.

## 2. The evolution of CBI over the last two decades: evidence, reasons and consequences

### *2.1. Evolution of CBI*

The most widely available indices of CBI refer to the level of independence as specified in the law. It is well known that actual independence may often deviate, quite substantially, from legal independence. Such deviations are more important in developing than in industrial economies. This is probably due to better enforcement of the law in the first group of economies.[7] Other, more

[2] Partly because of the US wide capital markets, the *de facto* independence of the Federal Reserve was higher than its legal independence. At the time the German Bundesbank was unique in that it enjoyed both *de jure* as well as *de facto* independence and generally used its independence to promote public support for price stability. In spite of this long term position the Bundesbank's policy occasionally responded to the electoral cycle. Vaubel (1997) shows that monetary expansion accelerated at the beginning of pre-election periods when the German government had a political majority at the Bundesbank council and that it decelerated when the reverse was true.

[3] In a few cases like the ECB and the Banco Central de Chile, the bank is even given some limited goal independence in the sense that it is free to determine its own inflation target.

[4] For reasons of space I do not discuss the fast expanding literature on those topics. The March 2007 issue of the *European Journal of Political Economy* is devoted to CB transparency and communications.

[5] Previous surveys appear in Eijffinger and de Haan (1996) and in Berger et al. (2001).

[6] Although related, independence and conservativeness are not quite the same. Independence refers to the ability of the bank to implement the policies it desires without political interferences. Conservativeness refers to the importance that the bank assigns to price stability in comparison to real objectives like high levels of economic activity and employment. Obviously, effective conservativeness, that determines policy choices, depends both on the bank's conservativeness, as well as on its independence. For the purposes of this survey there is no need to distinguish between those two concepts. I therefore use the terms conservativeness and independence interchangeably to mean "effective conservativeness." This is also the interpretation of conservativeness in Rogoff (1985) article in which this term was first introduced. However, there are contexts in which it is useful to keep conservativeness and independence apart (Eijffinger and Hoeberichts, 1998).

[7] Using data till the end of the eighties Cukierman (1992, ch. 19) documents a negative correlation between inflation and legal independence in developed economies but no significant relation between those two variables in developing countries. More recent evidence surveyed below suggests that the difference between actual and legal independence may also vary over time within a given country.