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Is There a Cost to Having an Independent Central Bank?

In recent years, many economists have argued that average inflation can be kept low if central banks are insulated from political pressures. Politically independent central banks, it is argued, will be less likely to give in to pressures to adopt expansionary monetary policies for political purposes, and, therefore, will be able to deliver lower average inflation. Indeed, using a variety of measures of independence, a number of researchers have documented empirically the association between greater central bank independence and lower average inflation (for a survey, see Cukierman 1992).

But are there costs associated with keeping inflation down? This *Weekly Letter* examines recent evidence on the relationship between measures of real economic performance, such as output growth, and measures of central bank independence. The evidence suggests that central bank independence, while associated with low inflation, is not associated with either slower of more volatile economic growth. Moreover, given that low inflation helps to reduce arbitrary wealth transfers and economic uncertainty, an independent central bank is likely to enhance economic welfare.

Independence and the conduct of monetary policy

The usual reason cited to explain the correlation between independent central banks and lower average inflation is that independent central banks are often viewed as more concerned with achieving and maintaining low inflation than politicians are. Thus, independent central banks are similar to other systems of "checks and balances" in a democratic society: An independent central bank would tend to offset a bias towards excessive inflation that is commonly thought to characterize monetary policy that is not guided by a specific mandate or rule on inflation. While society benefits from lower average inflation as a result, it also gets a less activist monetary policy. By placing greater weight on its inflation goals, the central bank might be willing to tolerate greater fluctuations in real economic activity and unemployment.

A recent study of 16 major industrial economies by Alesina and Summers (1993) attempts to determine if central bank independence is associated with either slower real growth or greater economic fluctuations. Perhaps somewhat surprisingly, they find that the degree of central bank independence is not related to average real GDP growth or average unemployment, nor to measures of the volatility of economic growth or unemployment, nor to the average level of real interest rates. These are important findings, since they would seem to indicate that central bank independence yields lower and less volatile inflation at no cost in terms of slower average real growth, higher average unemployment, or increased economic fluctuations.

Before drawing very strong policy conclusions from this work, however, it is important to determine whether these findings hold for a larger set of countries. And since economists have disagreed over how to measure central bank independence, it is also of interest to determine if these results still hold when using different indexes to measure central bank independence.

What is central bank independence?

Most research has focused on two dimensions of central bank independence. One, usually called political independence, represents the degree to which a country's central bank has policy objectives that are insulated from political pressures to expand aggregate demand rapidly. Political independence is influenced by institutional structure, such as the process for appointing the bank's policymaking board, and the existence of explicit policy goals, such as price stability. For example, a central bank with government representatives and political appointees with short terms of office on its policymaking committee would be classified as having a low degree of independence.

The second dimension of independence, called economic independence, is the degree to which the central bank is free to use its policy instruments to pursue its objectives. In some countries, the central bank must finance government deficits; such a central bank lacks economic independence,

since it cannot control the extent to which government deficits are monetized.

Alesina and Summers employ as their measure of central bank independence an index that is an average of measures of political and economic independence. Among the 16 countries examined, Germany and Switzerland are ranked as having the most independent central banks, with New Zealand having the least (prior to the 1989 reform of the Reserve Bank of New Zealand). The U.S. is ranked just below Germany and Switzerland.

Formal institutional independence may bear no relationship to the actual degree of independence enjoyed by a central bank. For example, Cukierman, Webb, and Neypati (1992) constructed a measure of independence based on the legal description of the bank's structure and a measure based on surveys of experts in each country who were asked to assess the independence the central bank had *in practice*. The analysis covered 24 countries and found no correlation. That is, a central bank ranked as highly independent by one measure was no more likely to be highly ranked than lowly ranked on the other index (see Walsh 1993).

The Bank of Japan (BOJ) provides an interesting case in point. The BOJ is legally subordinate to the Ministry of Finance. For this reason, Cukierman, Webb, and Neypati (CWN) rank it as having little formal independence. In fact, they rank it below even the pre-reform Reserve Bank of New Zealand, the Bank of Italy and the Bank of Spain. In contrast, Alesina and Summers rank the BOJ as having a degree of independence slightly above the average in their sample, because, over the past 20 years, it has operated much like the most independent central banks in keeping inflation at low levels. Part of the explanation may lie in the connection found by Cukierman, Edwards, and Tabellini (1992) between inflation and political instability. Countries with unstable political cultures, with frequent changes in office by competing political parties, are more likely to generate pressures on the central bank to follow inflationary policies. Until the elections of 1993, Japan had been governed by a single party for nearly 40 years. Cargill and Hutchison (1990) argue that, with the LDP party holding a monopoly on power, it was unnecessary to exploit the government's control over the Bank of Japan to engage in expansionary policies. It will be interesting to see if more competition for electoral control also leads to greater political pressure on the Bank of Japan.

Independence and economic activity

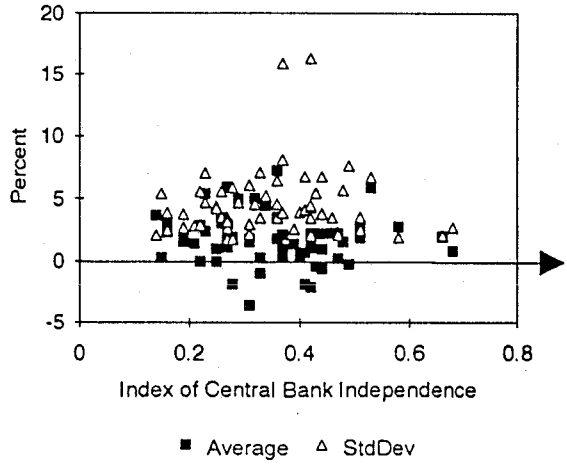
Converting a description of a central bank's institutional and policymaking structure into an index of independence of necessity involves judgment calls. Therefore it is useful to see if measures of central bank independence other than the one employed by Alesina and Summers display any relationship to average real growth or measures of economic fluctuations. To investigate this, I used the CWN index of legal independence which covers 68 countries, compared to the 16 analyzed by Alesina and Summers. Data on real per capita GDP were obtained from the Penn World Table (Summers and Heston 1991). Focusing on the period from 1971 to 1985 yielded a sample of 60 countries for which both the CWN index and real per capita GDP data were available.

To explore the effects of using an alternative measure of central bank independence the average growth rate of real per capita GDP and its standard deviation (a measure of its volatility) can be compared to the CWN index of independence for the same countries used by Alesina and Summers. Such an analysis shows a slight negative relationship between central bank independence and average GDP growth. However, this is the result of one data point—Japan—which had the highest average growth rate over this period and has the least independent central bank according to CWN. If Japan is dropped from the sample, or if the BOJ is reclassified according to Alesina and Summers' ranking, any relationship between growth and central bank independence disappears.

Using the CWN index of central bank independence in place of the Alesina-Summers measure, therefore, provides some further evidence in support of their finding that, for the industrialized countries, the degree of central bank independence is unrelated to average real economic growth or its fluctuations. This result, however, is based on a small group of countries. Since the CWN index is available for a large number of countries, one can examine the robustness of the finding when the number of countries in the sample is greatly expanded. Figure 1 shows the average growth rate of real per capita GDP and its standard deviation for 60 countries for 1971 to 1985.

Figure 1 shows no apparent relationship between central bank independence and either average income growth or its volatility. More formal statistical analysis is consistent with the absence of

Figure 1
GDP Growth and its Standard Deviation 1971–1985: CWN-Based Sample



any relationship. This holds even if the two outliers with extreme output fluctuations (Nicaragua and Uganda) are excluded.

Conclusions

Using an alternative measure of central bank independence and examining a larger sample of countries serves to confirm the findings of Alesina and Summers: There appears to be no association between a country's real economic performance, as measured by average growth or its volatility, and the degree of political and economic independence enjoyed by its central bank. Many researchers, however, have documented a negative association between average inflation and central bank independence. While both the degree of independence granted the central bank and the average inflation rate reflect fundamental attitudes of the population, countries that insulate their central banks from direct political pressure do not seem to suffer adverse effects on real incomes.

Inflation imposes significant costs on an economy, particularly by causing arbitrary wealth redistributions and heightened economic uncertainty. These costs clearly lower the level of real income and overall economic welfare, and there is some evidence that inflation may even lower long-term average real growth (see Motley 1993). Consequently, a policy of price stability is seen by many as the most important contribution monetary policy can make to ensuring desirable real economic performance. While there certainly may be important transitional costs to eliminating existing inflation, greater political control over the conduct of monetary policy seems to result in higher average rates of inflation with no apparent gain in average real economic performance.

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