



JAMAICA:

IS AN INDEPENDENT CENTRAL BANK FEASIBLE?

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INTRODUCTION

We are more than a little bit surprised at the seeming reticence of the central bank's governor, Mr Derrick Latibeaudiere, to the idea of a monetary policy committee, being proposed by the private sector.

The suggestion forms part of the package of proposals of the so-called Partners for Progress group, who have been seeking a framework for sustained growth in the Jamaican economy.

This group has not only been talking. They have been prepared to back the strength of their convictions with substantial action.

Indeed, they have been attempting to convince domestic financial institutions to convert high-cost Jamaican dollar loans to other forms of debt instruments that would ease the short-term interest burden and provide an opportunity for the Government to begin to seriously address the public sector deficit.

Reasonably, those who are putting together this programme want to be assured that the administration establishes the environment in which concessions made by the private sector translate into real macro-economic value. One way to help ensure this is through transparency in policy formulation.

A monetary policy committee is but one instrument, so far as the partners are concerned, to add value to the idea.

Mr Latibeaudiere's reservation, it seems, rests on his argument that such committees usually operate in the context of independent central banks, which are removed from direct political control and which have control over monetary policy

formulation.

Perhaps!

Indeed, this newspaper supports the idea of an independent central bank, whose principal officers are removed from the whim of political control and have the authority, under law, to limit lending to the government.

This is an ideal for which we must strive - the sooner the better.

However, we do not see an independent central bank and a monetary policy committee in the context of the existing structure of the Bank of Jamaica as mutually exclusive.

The truth be told, senior officials who speak of the operation of the BOJ often hail its relative independence and the creative tension which usually exists between the central bank and the finance ministry. In fact, there is a healthy bit of chest-thumping at Nethersole Place.

In any event, we would have thought that in the absence of its independence, a monetary policy committee, involving key economic players, would be a development welcomed by the central bank and its top managers. Such a committee would, on the face of it, provide the central bank with some level of insulation from political controllers or politicised and over-reaching bureaucrats at the finance ministry.

Indeed, the timely publication of the minutes of the meeting on which the decisions of the committee were made would provide powerful moral authority against a Government that was intent on running roughshod over the wishes of the committee. We, for instance, would like to know the thinking, and technical

arguments, behind the decision in the first quarter of last year to push interest rates well beyond 30 per cent to defend the Jamaican dollar. It would be interesting to know what was the stance of the professional central bankers on offering investors such high levels of real return on their money.

The fundamental argument is that better decisions are likely to be made in an environment of openness and transparency and on the basis of access to other than a narrow slate of views.

Moreover, the kind of committee which is being proposed could well be a fundamental first step to an independent central bank.

Jamaica Observer Editorial, Sunday February 21, 2004

The government's ability to credibly commit to policy announcements is critical to the successful implementation of economic policies as diverse as capital taxation and utilities regulation. One frequently advocated means of signaling credible commitment is to delegate authority to an agency that will not have an incentive to opportunistically change policies once the private sector has taken such steps as signing wage contracts or making irreversible investments.....

Delegating authority is suggested as a government strategy particularly for monetary policy. And existing work on the independence of central banks generally assumes that government decisions to delegate are irrevocable. But delegation - in monetary policy as elsewhere - is inevitably a political choice, and can be reversed....

David Stasavage, Philip Keefer

Bureaucratic Delegation and Political Institutions: When Are Independent Central Banks Irrelevant?

Under the arrangements for the Euro, monetary policy will be controlled by the European Central Bank (ECB). Many of the objections to this arrangement are well-known and often rehearsed. However, one of the strongest arguments in favour of doing things this way is only rarely debated, and is almost never countered directly. This is the argument that the Euro is good because it means there will be a central bank which is totally outside political control, indeed so far outside political control that for all but one country it is not even located on national territory.

Whether the ECB will really be independent of political control is, of course, a contentious question. I shall not discuss it here. I want to assume that it is independent and to discuss whether that will be a good thing. Clearly this discussion will also have a bearing on whether arrangements like those of the Bundesbank or the Bank of England are a good idea. My argument will imply that they are not....

Andrew Lilico
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.....As monetary policy is handled by an independent authority, fiscal and wage/social protection policies remain an instrument in the hands of national governments. We find that so long as the two authorities pursue their goals independently of each other, a conflict arises which is exacerbated as preferences diverge. Further to that we find that the establishment of a conservative Central Bank encourages more left-wing preferences amongst the public (as reflected in

the governments they elect). And the election of more left-wing governments makes it more difficult for each authority to reach their own preferred objectives, unless they are able to cooperate...

Maria Demertzis and Andrew Hughes Hallett

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An Independent Central Bank Faced With Elected Governments

When Are Independent Central Banks Irrelevant¹?

The government's ability to credibly commit to policy announcements is critical to the successful implementation of economic policies as diverse as capital taxation and utilities regulation. (David Stasavage and Philip Keefer 2000).

One frequently advocated means of signaling credible commitment is to delegate authority to an agency that will not have an incentive to opportunistically change policies once the private sector has taken such steps as signing wage contracts or making irreversible investments.

¹ Keefer, Philip, Stasavage, David, Bureaucratic Delegation and Political Institutions, World Bank 2000

Delegating authority is suggested as a government strategy particularly for monetary policy. And existing work on the independence of central banks generally assumes that government decisions to delegate are irrevocable. But delegation - in monetary policy as elsewhere - is inevitably a political choice, and can be reversed, contend Keefer and Stasavage.

They develop a model of monetary policy that relaxes the assumption that monetary delegation is irreversible. Among the testable predictions of the model are these:

- The presence of an independent central bank should reduce inflation only in the presence of political checks and balances. This effect should be evident in both developing and industrial countries.
- Political actions to interfere with the central bank should be more apparent when there are few checks and balances.
- The effects of checks and balances should be more marked when political decision makers are more polarized.

The authors test these predictions and find extensive empirical evidence to support each of the observable implications of their model: Central banks are associated with better inflation outcomes in the presence of checks and balances. The turnover of central bank governors is reduced when governors have tenure protections supported by political checks and balances. And the effect of checks and balances is enhanced in more polarized political environments.

Should Financial Sector Regulators Be Independent²?

Should Financial Sector Regulators Be Independent?

In nearly every major financial crisis of the past decade—from East Asia to Russia, Turkey, and Latin America—political interference in financial sector regulation helped make a bad situation worse. Political pressures not only weakened financial regulation generally, they also hindered regulators and the supervisors who enforce the regulations from taking action against banks that ran into trouble. In so doing, they crippled the financial sector in the run-up to the crisis, delayed recognition of the severity of the crisis, slowed needed intervention, and raised the cost of the crisis to taxpayers.

Increasingly, both policymakers and policy analysts are recognizing the need to shield financial sector regulators from political pressure to improve the quality of regulation and supervision with the ultimate goal of preventing financial crises. Surprisingly, however, few analyses have systematically discussed why independence for the financial regulatory agency might be desirable and how it might best be achieved.

This document investigates why financial sector regulators and supervisors might need a substantial degree of independence—not only from the government but also from the financial services industry—to fulfill their mandate to achieve and preserve financial sector stability. It also looks at the need for keeping regulators accountable as they exercise the (often) far-reaching powers delegated to them by their government.

² Quintyn, Marc, Taylor, Michael W., Should Financial Sector Regulators Be Independent?, IMF 2004

Rationale for regulation

Regulators and supervisors in nations around the world are charged with managing the health of banks and other financial institutions and preserving the stability of the financial system. Governments regulate financial institutions for two main purposes. The first is consumer protection. This is much the same reason they regulate public utilities and telecommunications: to provide a framework of rules that can help prevent the excesses and failures of a market left entirely to its own devices. Second, regulation in the financial sector has the additional goal of maintaining financial stability, a clear public good that justifies a more elaborate framework of regulation and supervision.

Financial sector supervision, in particular, is more rigorous and intensive than supervision in other regulated sectors. Banking supervisors engage not only in off-site analysis of banks' performance but also in extensive on-site inspections, and they intensify their monitoring and may intervene when banks fail to meet minimum requirements designed to ensure their financial soundness. Supervisors can even, in extreme cases, take ownership rights away from the owners of failed or failing financial institutions.

Banking regulation developed out of the concern of central banks to ensure financial stability. In many parts of the world, the central bank is the agency responsible for regulating banks, while, in others, it is a separate agency. In the nonbank financial sector, such as securities markets, insurance, and pensions, regulation has usually been conducted either by a central government ministry or by a specialist agency answerable to a ministry. The need for independent regulatory agencies has not, however, featured very strongly in public debates. In recent years, this has begun to change, driven by two important reasons.

Lack of independence worsens financial crises

In many of the world's recent financial crises, policymakers in the countries affected have sought to intervene in the work of regulators—often with disastrous results. It is now increasingly recognized that political meddling has consistently caused or worsened financial instability.

In her account of the Venezuelan banking crisis of 1994, former central bank president Ruth de Krivoy cited ineffective regulation, weak supervision, and political interference as factors weakening the banks in the period leading up to the crisis. In her book, *Collapse*, published in 2000, de Krivoy emphasized the need for lawmakers to "make bank supervisors strong and independent, and give them enough political support to allow them to perform their duties."

In East Asia in 1997/98, political interference in the regulatory and supervisory process postponed recognition of the severity of the crisis, delayed action, and, ultimately, deepened the crisis. In Korea, for example, a lack of independence impeded supervision. While the country's commercial banks were under the authority of the central bank (the Bank of Korea) and the Office of Banking Supervision, Korea's specialized banks and nonbank financial institutions were regulated by the ministry of finance and economy. The ministry's weak supervision encouraged excessive risk taking by the nonbanks, which helped lead to the 1997 crisis. Korea subsequently reformed its supervisory system, both to give it more autonomy and to eliminate the regulatory and supervisory gaps.

In Indonesia, banking sector weaknesses stemmed from poorly enforced regulations and from supervisors' reluctance to take action against politically well connected banks, especially those linked to the Suharto family. When the crisis hit, central bank procedures for dispensing liquidity support to troubled banks were

overridden, it has been claimed, on the direct instructions of the president. Even after Suharto's fall, political interference continued in the bank restructuring effort. Indonesia's Financial Sector Action Committee, which was composed of several heads of economic ministries and chaired by the coordinating minister, intervened intrusively in the work of the Indonesian Bank Restructuring Agency and undermined the credibility of the agency's restructuring effort.

The lack of independence of financial supervisors in Japan's ministry of finance weakened the Japanese financial sector and contributed to prolonged banking sector problems. Although there was probably little direct political pressure on the ministry to allow weak banks to continue operating, the system lacked transparency, and implicit government guarantees of banking sector liabilities were understood to be widespread. Following a decline in the ministry's reputation in the late 1990s, the Japanese government created a new Financial Services Agency to oversee banking, insurance, and the securities markets, in part as an attempt to improve the independence of supervision.

The example of central bank independence

A second development that has encouraged interest in regulatory independence is the success achieved by independent central banks in fighting inflation. Since the late 1980s, more and more countries have freed their central banks from political control because evidence was growing that independent central banks had a successful record of achieving monetary stability—in other words, controlling inflation. Central bank independence is seen as essential to counter the natural preference of politicians for expansionary economic policies that promise short-term electoral gains at the risk of worsening inflation in the long run. Making

central banks independent frees them from political pressure and thus removes the inflationary bias that could otherwise unsettle monetary policy.

The incentives for politicians to rescue failing banks are similar to those for inaction in the face of inflation. The decision to close a failing bank is usually unpopular. Politicians eager to avoid a necessary closure may be tempted to pressure bank supervisors to organize a bailout or to excuse the failing bank from regulatory requirements, even at the risk of worsening the problem and increasing the long-term costs of resolving it. This similarity strengthens the case for regulatory and supervisory independence in the financial sector. Bank regulatory independence is to financial stability what central bank independence is to monetary stability, and the independence of the two agencies can be mutually reinforcing. Both agencies also provide a public good—financial stability—which sets them apart from other sector-specific regulatory agencies.

Still, banking supervisory authorities differ from central bank authorities in one important way. When banking supervisors revoke a failing bank's license, they are using the coercive power of the state against private citizens. When central banks conduct monetary policy, they have no such coercive power. However, the unique power enjoyed by financial regulators should not be used as an argument against granting them independence. Instead, governments should fully accept and take the implications of that power into account—both by establishing strong accountability mechanisms to prevent abuse and by recognizing the need to employ highly qualified supervisors of demonstrable integrity and to pay them adequately.

Potential problems with agency independence

Growing recognition of these factors, together with a growing trend toward the creation of "integrated" financial supervisory agencies that regulate banks,

securities markets, and insurance companies—which forces policymakers and legislators to rethink institutional arrangements—has focused attention on the case for agency independence. Increasingly, a consensus is forming that regulatory and supervisory agencies should be independent—that they should not be embedded in the executive hierarchy and thus subject to political pressure. In theory, independent regulators can decide on and conduct market interventions shielded from political interference and improve regulatory and supervisory transparency, stability, and expertise. And, indeed, growing evidence suggests that independent regulators have made regulation more effective, have led to smoother and more efficient operation of the market, and are a distinct improvement over regulatory functions located in government ministries.

But independent regulatory agencies have potential problems of their own. As the Nobel Prizewinning economist George J. Stigler pointed out in a seminal article in 1971, agencies tend to respond to the wishes of the best-organized interest groups. When regulators are free from political control, the risk of "regulatory capture" by other groups—in particular, the industry they regulate—grows. Agencies that suffer from such capture come to identify industry interests (or even the interests of individual firms) with the public interest. And industry capture can undermine the effectiveness of regulation just as political pressure can. Regulators may, for example, formulate rules so as to minimize industry costs rather than strike an appropriate balance between those costs and public benefits. They may also apply rules inconsistently and exempt individual firms from regulatory requirements.

Agency independence entails another important concern, namely, the need for accountability. An independent agency might pursue an agenda of its own, going against the wishes of the political majority. Some worried analysts have branded independent regulatory agencies the "fourth branch of government," implying that

they are outside the control of the traditional three branches that keep mature democratic systems in equilibrium through a system of checks and balances. Although such fears appear to be exaggerated, they nevertheless demonstrate the need for proper forms of accountability to balance the advantages of agency independence with the disadvantages.

Achieving both political independence and independence from the regulated industry, as well as accountability, is essential. Political independence, however, remains the prime concern from the point of view of financial stability, given the vested interests that many national governments still have in the banking system, and, therefore, in bank regulation and supervision, as well as the dismal track record of political interference in regulatory and supervisory arrangements.

Four dimensions of independence

In passing the laws that create regulatory agencies, politicians properly set and define regulatory and supervisory goals. But once those laws are in force, regulators must be free to determine how to achieve these goals—and should be held accountable if they fail to achieve them. Independence has four dimensions: regulatory, supervisory, institutional, and budgetary.

Regulatory independence in the financial sector means that regulators have wide autonomy in setting, at a minimum, prudential rules and regulations that follow from the special nature of financial intermediation. These rules and regulations concern the practices that financial institutions must adopt to maintain their safety and stability, including minimum capital adequacy ratios, exposure limits, and loan provisioning. Regulators who are able to set these rules independently are more likely to be motivated to enforce them. They are also able to adapt the rules

quickly and flexibly in response to changing conditions in the global marketplace without having to go through a lengthy, high-pressure political process.

In some countries, the laws governing financial institutions and the financial regulatory agency are so detailed as to leave little room for independent rule setting by the supervisory agency. In others, the laws merely brush a broad framework, leaving much greater scope for regulatory discretion. Regardless of a country's particular legal traditions, however, independent regulators should be given ample discretion to set and change regulations within the broad confines of the country's constitution and banking law.

Supervisory independence is crucial in the financial sector. It is also difficult to establish and guarantee. Supervisors work quite closely with financial institutions, not only inspecting and monitoring them but also enforcing sanctions and even revoking licenses. Much of their activity takes place outside direct public view, and interference with their work, either by politicians or by the industry, can be subtle and can take many forms. Steps to protect supervisors' integrity include offering legal protection (for example, repealing laws that, in some countries, allow supervisors to be sued personally for their work) and providing financial incentives that allow supervisory agencies to attract and keep competent staff and discourage bribery. Crafting a rules-based system of sanctions and interventions also lessens the scope for supervisory discretion—and thus for political and industry interference. To protect supervisors from political or industry intimidation during a lengthy court process, banking law should also limit the time allowed for appeals by institutions facing sanction. Independent supervisors, not a government agency or minister, should be given sole authority to grant and withdraw licenses because they best understand the financial sector's proper composition—and because the threat to revoke a license is a powerful supervisory tool.

Institutional independence, or the agency's status outside the executive and legislative branches of government, has three critical elements. First, senior personnel should enjoy security of tenure: clear rules, ideally involving two government bodies, must govern their appointment and, especially, dismissal. Second, the agency's governance structure should consist of multimember commissions composed of experts. And, third, decision making should be open and transparent to the extent consistent with commercial confidentiality, enabling both the public and the industry to scrutinize regulatory decisions.

Budgetary independence depends primarily on the role of the executive or the legislative branch in determining the agency's budget and how it is used. Supervisors should not be subjected to political pressure through the budget. Senior personnel should have the budgetary freedom to staff the agency as they see fit and to respond quickly to emerging agency needs. If funding must come from the government budget, the supervisory budget should be proposed and justified by the agency itself, following objective criteria related to developments in the market. Some supervisory agencies are funded through industry fees, a practice that minimizes political interference but risks increasing dependence on—and attracting interference from—the industry. Industry fees, if used, should be determined jointly by the agency and the government. Also, fee-based funding may leave the agency strapped for funds during a crisis, because that is precisely when the industry is most likely to have difficulty paying the fee. Agencies should therefore be allowed to build up reserve funds as insurance.

Conclusion

The case for regulatory independence in the financial sector can be based on analogies with two areas where the issue of regulatory independence has already

been largely settled: the regulation of public utilities and telecommunications, and the conduct of monetary policy by the central bank. Mounting evidence indicates that independent regulators have increased the efficiency and effectiveness of regulation and helped markets operate more smoothly and efficiently. And the concept of central bank independence has gained near-universal acceptance over the past two decades, as independent central banks have shown that they can successfully pursue monetary stability. Regulatory and supervisory independence in the financial sector complements central bank independence in achieving and preserving the twin goals of monetary and financial stability.

Even though independent regulatory agencies have proved themselves in practice, creating them and keeping them independent and accountable poses difficulties that cannot be ignored. An agency that is independent of political control may become subject instead to pressure from the industry it regulates. And freedom from political control can lead to serious deficiencies in political accountability. Making financial sector regulatory independence work requires attention to all four aspects of independence: regulatory, supervisory, institutional, and budgetary. The arguments for and against jump-starting independence by housing the agency in the central bank need to be considered and the best course decided upon. Whether the country's political institutions, especially its system of checks and balances, are adequately developed to safeguard the agency's independence must also be determined. Finally, the proposed arrangements must be tested against the seven essential criteria laid out above to ensure the proper balance between effective independence and political accountability.

Inflation, Growth, and Central Banks: Theory and Evidence³

Inflation limits economic growth by reducing the efficiency of investment rather than its level. An effective way of achieving low inflation is to establish an independent central bank.

De Gregorio reviews the theory and evidence on inflation and growth and provides additional empirical evidence for a large cross-section of countries.

The evidence, he reports, suggests a robust negative relationship between inflation and growth. He argues that inflation limits growth mainly by reducing the efficiency of investment rather than its level. But this finding is difficult to explain using traditional theories that rely on the effects of inflation on employment, which are not supported by the data. Explanations focusing on the effects of inflation on the allocation of talents and the functioning of financial markets may help in understanding better the long-run relationship between inflation and growth.

De Gregorio also reviews the theoretical and empirical literature on how central banks affect inflation and output growth. An independent central bank can be effective in reducing inflation if the public perceives that it is tough on inflation. But inflation persists because the cost of reducing it is high --- the most evident cost being the loss of output from disinflation.

De Gregorio concludes that although serious progress has been made in recent years in assessing empirically how central banks affect macroeconomic performance, the results are still inconclusive. The empirical evidence shows a

³ Gregorio, Jose de, *Inflation, Growth, and Central Banks: Theory and Evidence*, World Bank 1996

negative correlation between inflation and central bank independence, especially in OECD countries, but the effects on growth are less conclusive. It is fair to say that the bulk of the evidence suggests that central bank independence produces lower inflation at no real costs.

Central Bank encourages more left-wing preferences amongst the public.⁴

The literature argues that the benefits of an independent Central Bank accrue at no cost to the real side. In this paper, we argue that the lack of correlation between monetary autonomy and output variability is due to the proactive role of fiscal policy when faced with rigid monetary objectives. None of the attempts in the literature to measure these correlations allow for a changing fiscal role. As monetary policy is handled by an independent authority, fiscal and wage/social protection policies remain an instrument in the hands of national governments. We find that so long as the two authorities pursue their goals independently of each other, a conflict arises which is exacerbated as preferences diverge. Further to that we find that the establishment of a conservative Central Bank encourages more left-wing preferences amongst the public (as reflected in the governments they elect). **And the election of more left-wing governments makes it more difficult for each authority to reach their own preferred objectives, unless they are able to cooperate.**

⁴ Demertzis, Maria and Hughes Hallett, Andrew, An Independent Central Bank Faced With Elected Governments, CEPR, 1998

Central Bank Independence and Wage Bargaining Structure - Empirical Evidence.

This paper studies the relationship between central bank independence, wage bargaining structure and macroeconomic performance in OECD countries. A cross-sectional time-series (TSCS) model for inflation, nominal wage growth and unemployment for the period 1973-1996 is estimated using different and updated measures of central bank independence. The importance of the price stability objective in the central bank statute is used as a proxy for the degree of conservativeness of the central bank. A recently published data set on wage bargaining structure is used, and a distinction is made between coordination of wage bargaining and formal centralization. A new measure of union power is constructed, which combines formal centralization and union density. The implications of the large differences that can be seen between coverage and unionization rates in some countries are briefly discussed. Two important results emerge. First, the central bank's political independence and personnel independence contribute most importantly to a successful inflation policy. Second, a high level of coordination contributes to moderate inflation rates and unemployment, while union monopoly power tends to increase inflation.

Independence before Conservatism: Transparency, Politics and Central Bank Design⁵

The problem of monetary policy delegation is formulated as a two-stage game between the government and the central bank. In the first stage the government

⁵Andrew Hughes Hallett and Diana Weymark, Independence before Conservatism: Transparency, Politics and Central Bank Design, CEPR, 2002

chooses the institutional design of the central bank. Monetary and fiscal policy are implemented in the second stage. When fiscal policy is taken into account, there is a continuum of combinations of central bank independence and conservatism that produce optimal outcomes. This indeterminacy is resolved by appealing to practical considerations. In particular, it is argued that full central bank independence facilitates the greatest degree of policy transparency and political coherence.

Credibility vs. Flexibility⁶

The theoretical argument for central bank independence is based on the idea that even if the government represents people's preferences over inflation and output it has an incentive to renege from prearranged plans to gain a short run boost to output. This incentive leads to higher than desired inflation. One solution to this credibility problem is to give control of monetary policy to an independent central bank that is more averse to inflation than society. Central bank independence thus reduces society's credibility problem but this may be at the expense of less flexible counter cyclical monetary policy. The aim of this paper is to find the correct balance between credibility and flexibility, ie the optimal degree of central bank independence. The first part of the paper sets out an open economy model and identifies some macroeconomic factors that influence the optimal degree of independence. It finds that the optimal degree of independence increases when; 1) the NAIRU (Non-Accelerating Inflation Rate of Unemployment). is higher, 2) the benefits of unanticipated inflation are greater, 3) society is less inflation-averse, 4) productivity shocks have smaller variance, 5) the real exchange rate has less variability, 6) the economy is less open. The second part of the paper estimates the relationship between these six factors and measures of central bank independence

⁶ Sylvester Eijffinger, Optimal Commitment in an Open Economy, Bank of England,

for 19 industrial countries using a latent variables estimation technique. It finds that, in general, the actual degree of independence is related to these six factors and so the institutional arrangements in most countries are close to the optimum. The main exceptions are Germany and Switzerland - that seem to have an excessively high degree of independence - and Australia, Norway, Sweden and the UK - which have a lower than optimal degree of independence.

Unanticipated Inflation and Government Finance⁷

This paper discuss the merits of an independent "EuroFed" within the context of a tax/seigniorage smoothing model for a monetary union. There is an incentive to use a surprise inflation tax to wipe out the real value of government debt and wage contracts because this allows a cut in distortionary taxes and boost employment and private consumption. If dependent central banks can pre-commit, there is no case for an independent EuroFed as this leads to a sub-optimal government revenue mix. If only an independent EuroFed can guarantee sufficient discipline, however, a case can be made for it over and above a monetary union with a non-cooperative or cooperative central bank. This case is stronger when the aversion to inflation is high, when the outstanding stock of nominal government debt is high, when the underground economy is insignificant and when there is little indexation. Even if all contracts are indexed, there is an incentive to create unanticipated inflation if money demand depends on expected inflation. If private agents are rational in their forecasts of inflation, however, government spending is financed through temporary bouts of taxation and inflation, and given that all contracts are indexed, no case for an independent central bank can be made. Competition between central banks of a monetary union induces excessive inflation, because

⁷ Van der Ploeg, Frederick, Unanticipated Inflation and Government Finance: The Case for an Independent Common Central Bank, CEPR, 1991

each bank fails to internalize the externalities associated with appropriating too much seigniorage from the common central bank.

Central Bank Independence Promotes Budgetary Efficiency⁸

Research shows theoretically, inefficient public expenditure can be institutionally curtailed by an independent central bank. An advantage of our analysis is to employ a two-country model with cash-in-advance constraints. The model can deal with fiscal policy as well as monetary policy with considering international interdependence. Each government decides the levels of public goods provision and a lump-sum tax, and each central bank chooses the quantity of money supply, to maximize its own households' utility. When the central bank is not independent of the fiscal authority, that is, when fiscal policy is determined before monetary policy, the public good is oversupplied. When the central bank is independent (monetary policy is predetermined), however, the expenditure level is efficient. Because the government cannot decide the provision of public good in anticipation of seigniorage. Thus, an independent central bank can promote cuts of budgetary inefficiency.

Second Thoughts About Central Bank Independence⁹

The 2003 Institute for Fiscal Studies Lecture addressed two sets of issues relevant to current and prospective future EU members: the consequences of the Stability and Growth Pact for fiscal-financial sustainability and macroeconomic stability,

⁸ Doi, Takero, Central Bank Independence Promotes Budgetary Efficiency, Institute of Social Science, University Of Tokyo, 1998

⁹ Buiter, Willem H, Two Naked Emperors? Concerns about the Stability and Growth Pact and Second Thoughts About Central Bank Independence, CEPR 2003

and some risks associated with operational independence of the central bank. The relevance of the second issue is not restricted to EU members. Poor communication, cooperation and coordination between the fiscal and monetary authorities can be costly in two contingencies. The first of these occurs when the central bank's role as the lender of last resort needs to be backed up by the willingness of the Treasury to recapitalize the central bank, should the need arise. The second contingency occurs when unwanted deflation needs to be prevented or combated, but the central bank's conventional monetary arsenal is exhausted. Friedman's helicopter drop of money, a temporary tax cut or transfer payment increase financed through the issuance of base money will always stimulate demand provided it is not expected to be reversed, in present value terms, in the future. In most real-world institutional/legal settings the implementation of a helicopter drop of base money requires coordinated actions by the central bank and Treasury. Central bank independence is unlikely to survive if either or both of these contingencies occur, if there is an ineffective response by the fiscal and monetary authorities and if this is blamed on lack of communication, cooperation or coordination.

Policy Biases¹⁰

Central bank independence has contributed to achieve price stability and fiscal discipline for many countries. This is an accepted first-generation reform of fiscal and monetary policy. The question this paper asks is whether a second-generation reform consisting of institutional incentives for domestic policy coordination could be beneficial. The paper presents a game-theoretic model where the fiscal and

¹⁰ H. Bennett and N. Loayza, Policy Biases when the Monetary and Fiscal Authorities have Different Objectives, Central Bank of Chile, 2000.

monetary authorities interact to stabilize the economy. These authorities are different in that they have dissimilar preferences with respect to output and inflation gaps and control different policy instruments. Modeled as Nash or Stackelberg equilibria, the solution under lack of policy coordination implies that an increase in the preference divergence between the monetary and fiscal authorities leads to, *ceteris paribus*, larger public deficits (the fiscal authority's policy instrument) and higher interest rates (the central bank's instrument). The empirical section of the paper tests this conclusion on a pooled

sample of 19 industrial countries with annual information for the period 1970-94. Controlling for other shocks and economic conditions, the estimation results support the main conclusion of the theoretical section. The policy implication of the paper is that, without prejudice to the gains from central bank independence, institutional arrangements that allow for coordination both at the level of setting objectives and at the level of policy implementation can alleviate the biases that move the economy to sub-optimally higher fiscal deficits and real interest rates.

Conclusion

We have exposed you to numerous views for and against the case for an Independent Central Bank.

In summary, we draw the following conclusions:

There are two (2) strong arguments FOR an Independent Central Bank

- 1) That they imply lower inflation in theory;
- 2) And that countries with independent central banks have exhibited lower inflation in practice.

There are four (4) strong arguments AGAINST:

- 1) That independent central banks undermine the co-ordination, and hence the effectiveness of economic policy;
- 2) That if controlling inflation is left to monetary policy exercised by a central bank the government has an incentive to pursue inflationary policies in other areas;
- 3) That output-inflation tradeoffs are genuine political decisions, and should be under democratic control;
- 4) That central banks are intrinsically conservative, and that politicians might disagree with central bankers about appropriate monetary policy without wanting to increase inflation.

In my view the arguments against an independent central bank quite outweigh those in favour.