Evidence, and 'evidence' on the benefits of central bank independence.
James Forder

The first problem: What is evidential support for independence?

- the absence of political business cycles in countries with independent central banks (Alesina, Cohen and Roubini (1992; Alesina and Roubini (1992): West Germany had PCB, most did not)
- superior performance where policy is rule governed: Friedman (1972))
- more credible policy where central banks are independent. Posen (1998) finds high sacrifice ratios in counties with independent central banks
- lower inflation where central banks are independent

The second problem: How to measure independence

- the statute reading methodology
    - Alesina (1988) drawing on Parkin and Bade (1978), Grilli, Masciandaro and Tabelini (1991), and most of Cukierman, Webb and Neyapti (1992)
    - Very influential, e.g. in the press (Forder (1998) p. 307
    - Are they serious? This is supposed to be *economics*. It is the incentives, not the rule book that matter. If we take the argument seriously, we take these things seriously too:
        - Statutory independence and actual independence
            - is policy set on the golf course?
        - Actual independence and the use of power
            - When the bank sets policy, maintaining is its independence may be one of its goals
        - The use of power to affect the non-monetary determinants of inflation (ssshh: to rig an election)

The third problem

- a variety of measures, 'all showing the same thing'
    - different approaches to measurement deliver different *measures*. What is the concept of 'independence' to which the 'test' relates?
    - To which definition do the newly 'independent' banks conform, and what is the basis for supposing the benefits are demonstrated?

The fourth problem

- implementation of the measures has left something to be desired
    - Emerson, Gros et al. (1992) amended their data without explanation, not that it was much good, having already been varied
    - Cukierman, Webb and Neyapti (1992) treat Greece and Portugal as 'developing'
    - Mangano (1998) tears the literature apart
    - Alesina (1988) considered 'political' and 'financial' independence and observed the first 'appeared more relevant', so he 'emphasised' it. (p. 41)

And Issing (1996) called the inflation-reducing power of independence an 'established finding of our discipline'!
Unconsidered matters

- The co-ordination of policy instruments
    - Fiscal policy (not quite unconsidered: e.g. Doyle and Weale (1994))

        - The American influence in theoretical thinking?
    - Government solvency (e.g. Sargent and Wallace (1981))
    - Trade policy
- Specifying the policy objective
    - Inflation targeting and asset prices
    - The crash and inflation targets
- The democracy issue
    - Careful now. What is the point of democracy?
    - Policy setting or leader selection? Schumpeter (1943), and in a modern setting: Forder (2011).

<u>Understanding the adoption of central bank independence</u>

Britain is an interesting case… pretty well the last

Policy targets and central bank independence

- the era of 'discretion'
    - fiscal management in the UK
    - occasional fiscal intervention in the US
- monetarism and monetary targeting
    - Restarted by Friedman (1956) – Keynesian or anti-Keynesian?
        - MV=PT
    - Stability of V, stability of T, direction of causation
        - All problematic
        - Money targeting failed in the 1980s. Well, it failed to meet the targets
- New Zealand CBI 1987
    - 'policy targets agreement'
- Britain and the European Monetary System, 1990-1992
- 'Independence' a condition of joining the euro 1993; the planned ECB was independent in a fanatically-designed way
    - it is hard for it not to be 'independent', but like *that*?
- 'Inflation targeting' as a replacement for EMS
- The Ken and Eddie Show before 1997 election
- Surprise move by Labour government 1997

What went wrong?

- plenty.
- An intellectual debacle of giant proportions. Go ahead and quote me.
    - The case for central bank independence as it was made in the academic economic literature was a professional disgrace
- The European Monetary Union ('nough said)
- Central bank independence and the crash
    - Complacency of 'the great moderation'
        - 'the most stable macroeconomic environment in recorded UK history' (Bank of England (2007), quoting Benati (2006) (a BoE working paper)
    - A kind of Lucas critique incorporating the 'Greenspan put'
            - Beware not-quite rational expectations

How did that happen?

- Cui bono? Well, who does benefit from central bank independence? Central bankers, perhaps politicians who can blame-shift, and, let's see … who wants a job on the MPC? If you can't work it out try Forder (2005).

Most of the arguments here drifted into my head while I was writing my DPhil and I wrote them up in Forder (1996), Forder (1998) and Forder (1999)

Alesina, A. (1988). "Macroeconomics and Politics." NBER Macroeconomics Annual: 13-52

Alesina, A., G. Cohen and N. Roubini (1992) Evidence on political business and monetary cycles *in* Political Economy, Growth and Business Cycles ed A. Cukierman, Z. Heskovitz and L. Leiderman Cambridge, MA MIT. SSL: HD75.CUK.

Alesina, A. and N. Roubini (1992). "Political Cycles in OECD Economies." Review of Economic Studies **59** (4): 663-689

Bank of England (2007). "Treasury Committee inquiry into the monetary policy committee of the Bank of England: Ten years on." http://www.bankofengland.co.uk/publications/other/treasurycommittee/mpc/tsc070219.pdf.

Benati, L. (2006). "UK monetary regimes and stylised macroeconomic facts." Bank of England working paper

Cukierman, A., S. B. Webb and B. Neyapti (1992). "Measuring the independence of central banks and its effect on policy outcomes." World Bank Economic Review **6**: 353-398

Doyle, C. and M. Weale (1994). "Do we really want an independent central bank?" Oxford Review of Economic Policy **10** (3): 61-77

Emerson, M., D. Gros, A. Italianer, J. Pisani-Ferry and H. Reichenbach (1992). One Market, One Money. Oxford, OUP.

Forder, J. (1996). "On the assessment and implementation of 'institutional' remedies." Oxford Economic Papers **48** (1): 39-51 http://www.jstor.org/stable/2663623

Forder, J. (1998). "The case for an independent European central bank: A reassessment of evidence and sources." European Journal of Political Economy **14** (1): 53-71 http://tinyurl.com/JF98ECB.

Forder, J. (1998). "Central bank independence - conceptual clarifications and interim assessment." Oxford Economic Papers **50** (3): 307-334 http://www.jstor.org/stable/3488575.

Forder, J. (1999). "Central bank independence - reassessing the measures." Journal of Economic Issues **XXXIII** (1): 23-40

Forder, J. (2005). "Why is central bank independence so widely approved?" Journal of Economic Issues **39** (4): 843-865 http://tinyurl.com/h7cz5ee.

Forder, J. (2011). The case against voting reform. Oxford, Oneworld Books.

Friedman, M. (1956) The Quantity Theory of Money - A Restatement *in* Studies in the Quantity Theory of Money ed M. Friedman Chicago University of Chicago 3-21. Bal:0775 c 037; Soc:HG201.STU.

Friedman, M. (1972). "Monetary policy." Proceedings of the American philosophical society **116** (3): 183-196

Grilli, V., D. Masciandaro and G. Tabelini (1991). "Political and monetary institutions and public financial policies in the industrial countries." Economic Policy **13** (13): 342-392

Issing, O. (1996) Comment on Charles Freedman 'What operating procedures should be adopted to maintain price stability?' *in* Achieving Price Stability: Symposium at the FRB of Kansas City, Aug 29-31, 1996 ed T. M. Hoenig Kansas City Federal Reserve Bank of Kansas City 287-296. http://www.kc.frb.org/PUBLICAT/SYMPOS/1996/Sym96prg.htm.

Mangano, G. (1998). "Measuring central bank independence: A tale of subjectivity and of its consequences." Oxford Economic Papers **50** (3): 468-492

Parkin, M. and R. Bade (1978) Central-bank laws and monetary policies: A preliminary investigation *in* The Australian monetary system in the 1970s ed M. G. Porter Clayton, Victoria Monash University.

Posen, A. (1998). "Central bank independence and disinflationary credibility: A missing link?" Oxford Economic Papers **50**: 335-359

Sargent, T. J. and N. Wallace (1981). "Some unpleasant monetarist arithmetic." Federal Reserve Bank of Minneapolis Review **5** (3): 1-17 http://minneapolisfed.org/research/qr/qr531.pdf.

Schumpeter, J. A. (1943). Capitalism, Socialism and Democracy. London, George Allen & Unwin. BAL: 0793 a 036; SSL: HX40.SCH (both 4rd ed); Saïd: HX86 SCH 1976; Union: 335 SCH (both 5th ed) eBook via Solo.