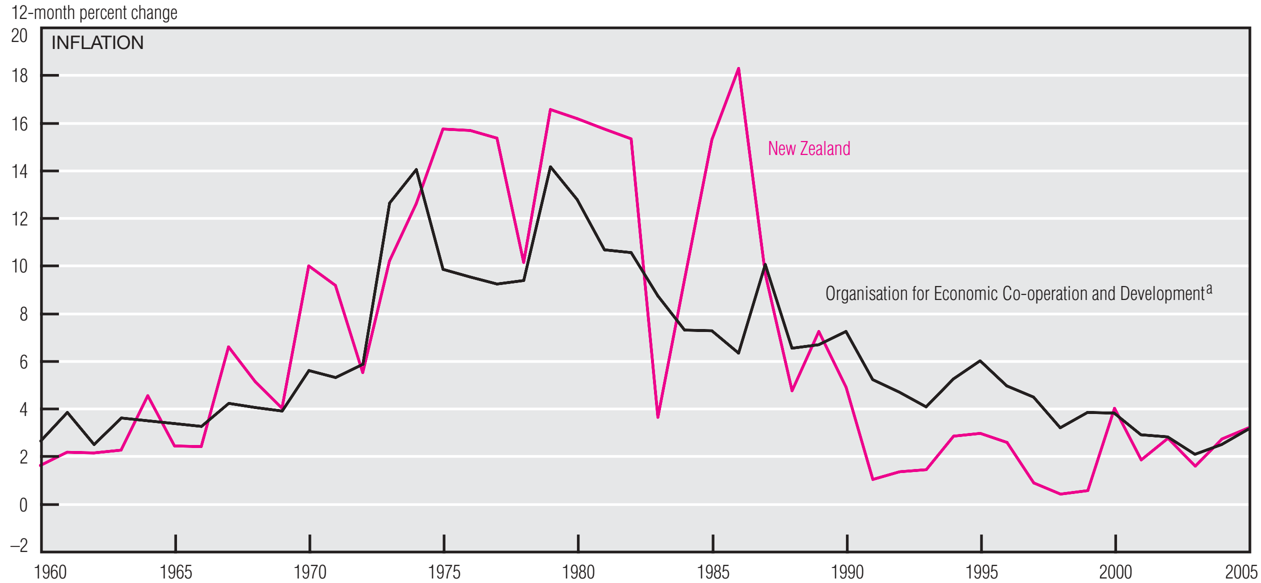
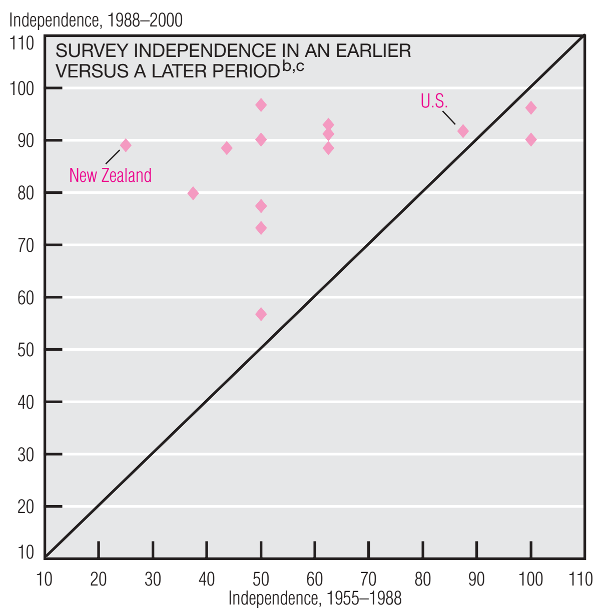
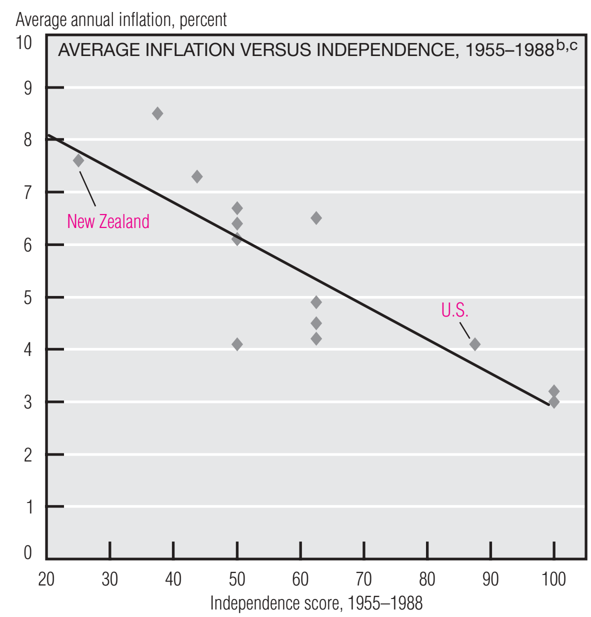
Central Bank Independence







a. All OECD countries except Turkey.
b. For New Zealand, Spain, Italy, Belgium, France, Norway, Australia, Sweden, U.K., Denmark, Japan, Netherlands, Canada, U.S., Germany, and Switzerland.
c. Independence data for 1955–88 are based on A. Alesina, and L. Summers (1993), "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit and Banking*, vol. 25, pp. 151–62. Independence data for 1988–2000 are from L. Mahadeva, and G. Sterne (eds.), *Monetary Policy Frameworks in a Global Context*. London: Routledge, 2000.
SOURCES: International Labor Organization; Organisation for Economic Co-operation and Development; and Bloomberg Financial Information Services.

New Zealand has succeeded dramatically in lowering inflation. Its annual average inflation rate over the 1955–88 period was 7.6%, but from 1989 to 2000, it averaged 2.7%. Once higher than other industrialized nations, it is now among the lowest. The critical development that made this change possible was the passage of the 1989 Reserve Bank of New Zealand Act, which instituted inflation targeting; perhaps more importantly, it granted the central bank more independence. Formerly considered the least independent, New Zealand's central bank now ranks among the more independent ones. Other nations have also made their central banks more independent.

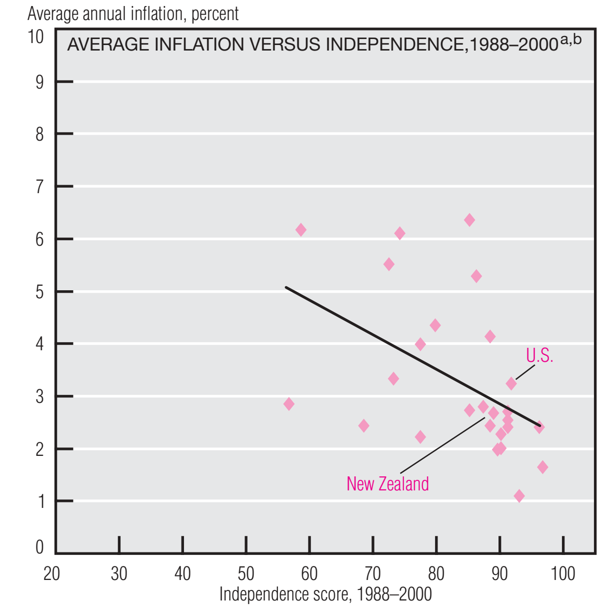
Central bank independence is very important in keeping inflation low over long periods. The idea is to limit the fiscal authority's ability to influence monetary policy because it may have more incentive than an independent central bank to inflate in order to achieve, say, a lower exchange rate, a higher output level, or a lower level of inflation-adjusted debt.

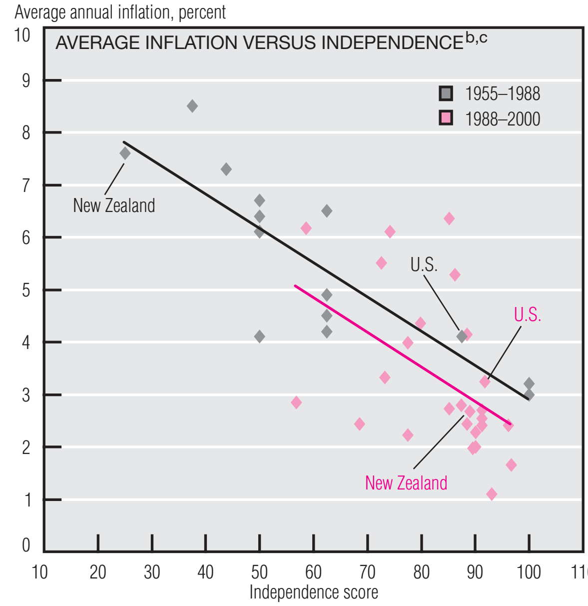
The data suggest that countries with more independent central banks do have lower inflation rates. From 1955 to 1988, when New Zealand had one of the least independent central banks, it had one of the highest inflation rates. At the other extreme, Switzerland, with one of the most independent central banks, enjoyed a 3.2% inflation rate, one of the lowest.

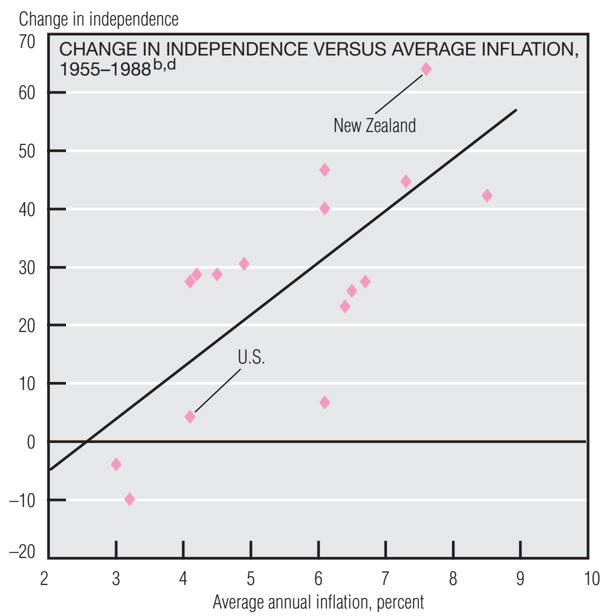
The same relationship is apparent from 1988 to 2000. Iceland, one of the least independent central banks, has had the highest inflation rate (6.2%). Japan's central bank is considered among the most independent, and its

(continued on next page)

Central Bank Independence *(cont.)*







Independence and Inflation[b]

	1955–88		1988–2000		Change, 1955–88 to 1988–2000[f]	
	Ind.	Infl.	Ind.	Infl.	Ind.	Infl.
New Zealand	25.0	7.6	89.0	2.7	64.0	–4.9
U.S.	87.5	4.1	91.8	3.3	4.3	–0.9
Average for (inflation) targeters[e]	45.8	6.6	84.6	3.1	38.8	–3.6
Average for non-targeters[e]	66.9	5.0	86.4	2.5	19.5	–2.4
Average for both groups	60.0	5.6	85.7	2.7	26.7	–2.9

a. For New Zealand, Spain, Italy, Belgium, France, Norway, Australia, Sweden, U.K., Denmark, Japan, Netherlands, Canada, U.S., Germany, Switzerland, Austria, Greece, Hong Kong, Iceland, Ireland, Korea, Portugal, Singapore, Taiwan, and Finland.
b. See footnote c, page 6.
c. Data for 1988–2000 are based on the countries listed in footnote a. Data for 1955–88 are based on the countries in footnote b, page 6.
d. For 1955–88 countries from footnote c.
e. The targeting nations are New Zealand, Spain, Australia, Sweden, U.K., and Canada. The non-targeters are Italy, Belgium, France, Norway, Denmark, Japan, Netherlands, U.S., Germany, and Switzerland.
f. Some numbers do not add up due to rounding errors.
SOURCES: International Labor Organization; Organisation for Economic Co-operation and Development; and Bloomberg Financial Information Services.

inflation rate has been the lowest. Clearly, other factors contribute to Japan's low (some would say too low) inflation rate.

The impact of independence on inflation seems pretty stable across time. We can use linear relationships to deduce how much New Zealand's dramatic improvement in independence would be expected to have lowered its inflation. Holding everything else constant, its inflation rate would be expected to have improved by 4.2 percentage points; in fact, it improved by 4.9 percentage points. The evidence also suggests that increased independence is responsible for a decline of nearly 2 percentage points in inflation rates for the industrialized countries as a whole.

Inflation targeting has had a much smaller degree of success. During the 1990s, inflation-targeting nations had an average inflation rate of 2.5%, versus 2.9% for those with no explicit target. But we should be careful about inferring causality from correlations. The nations that adopted inflation targeting and had the biggest gains in independence also had the highest inflation rates in the earlier period. This suggests that inflation targeting could be made more effective in lowering inflation than the data suggest. Similarly, the strong relationship between changes in independence and inflation suggests that independence may be even more effective than the data show.