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Central Bank independence

Vasile DEDU
Bucharest Academy of Economic Studies
vdedu03@yahoo.com
Tiberiu STOICA
Bucharest Academy of Economic Studies

Abstract. *In this paper we present the key aspects regarding central bank's independence. Most economists consider that the factor which positively influences the efficiency of monetary policy measures is the high independence of the central bank. We determined that the National Bank of Romania (NBR) has a high degree of independence. NBR has both goal and instrument independence. We also consider that the hike of NBR's independence played an important role in the significant disinflation process, as headline inflation dropped inside the targeted band of 3% ± 1 percentage point recently.*

Keywords: central bank independence; monetary policy; Great Moderation; inflation; output.

JEL Codes: E50, E58, E59.
REL Code: 8J.

Introduction

Government control on the central bank generally reduces the efficiency of monetary policy measures. In 1970s, the industrialized countries faced high inflation and output volatility to a certain extent due to fiscal domination. Therefore, the authorities in the developed countries gradually increased central bank independence in order to increase the impact of monetary policy measures. Between the mid 1980s and 2006, inflation and output smoothened in many developed countries, determining specialists to name this period “The Great Moderation”. According to Bernanke (2004), “The Great Moderation” is the result of three important factors: 1) structural changes, 2) better macroeconomic policies and 3) good luck. Consequently, the changes of economic institutions, technology and business practices enhanced economies’ ability to deal with multiple shocks. As regarding macroeconomic policies, certain economists agree that the high inflation and output volatility in the 1970s was partly driven by inadequate monetary policies (Romer, Romer, 2002). After mid-1980s, higher central bank independence (CBI), as well as the increased ability of the monetary authority to better quantify the monetary policy transmission mechanism enhanced the efficiency of monetary policy measures. CBI is also an important institutional requirement for adopting inflation targeting (IT). In conclusion, we consider that increased central bank independence is compatible to modern monetary policy. In this paper, we present the main issues regarding central bank independence. We also calculate NBR independence considering certain factors presented in previous research papers.

1. Short history of central banks

The first central banks were created in Sweden and England and their main task was to finance the budget deficits. The frequent and severe financial crisis, as well as the lack of regulation of the banking system determined the authorities to extend central banks’ objectives in the developed countries. After the two World Wars, central banks dealt with high inflation and unemployment and low output especially in the countries severely affected by the military conflicts. Certain specialists realized that there could be trade offs between certain goals established for the central bank, as the monetary authority can not maintain price stability, high economic growths, low unemployment, external equilibrium and a stable exchange rate at the same time. In the 1960s, Friedman stated that the central banks can only influence in the long-run the inflation, the money supply and the exchange rate. Therefore, central banks focused on three main monetary policy strategies. In the last several decades, specialists realized that the institutional framework can also influence the efficiency of monetary policy measures.

2. Central bank independence

Central bank independence problem is not new in the academic literature, as in the early nineteenth century Ricardo emphasized the fact the central banks must not directly finance the public deficit. In 1913, Keynes stated the same thing in his speech at the inauguration of the Reserve Bank of India. Posen (1995) considers that the interests of the political parties determine the degree of the central bank independence, as it can affect the inflation in the long-run. Cukierman (1992) and Eijffinger and De Haan (1996) believe that central bank independence in the industrialized countries is inversely correlated with the annualized inflation rate. A higher degree of central bank independence reduces disinflation costs (Debelle, Fischer, 1994, Walsh, 1995, 2003). Cukierman, Webb and Neyapti (1992) quantify CBI considering the following factors: 1) the manner central bank governor is appointed, 2) the relation between the central bank and the government and 3) central bank goal. According to previous research papers, there are three types of central bank independence: 1) goal independence, 2) instrument independence, 3) both. In Canada and New Zeeland, the central bank governor and the ministry of public finance establish the long-term goals of the central bank, while NBR has total independence in implementing the necessary instruments in order to achieve the stated goals. Therefore, Bank of Canada and the Reserve Bank of New Zeeland have instrument independence but not goal independence while NBR has both goal and instrument independence as the governor establishes both the inflation target and the necessary instruments. Central bank independence is stipulated in special laws (in Romania, Law no. 312/2004). Despite special laws that guard CBI, in certain countries there are customs that prevail. An example is Argentina. Although the governors' mandate stipulated by the law is of four years, governors usually resign when a new minister of finance is appointed.

3. NBR's independence

In this paper, we determine NBR's degree of independence using a simple methodology. We construct an indicator that incorporates the following factors: 1) NBR governor, 2) NBR actions, 3) NBR Board. The factors are similar to the ones used by Cukierman (1992) in constructing the Legal Variables Aggregate

Unweighted (LVAU) indicator. We give a score for each criterion. The indicator is presented bellow.

0 – there is no central bank independence considering that criterion
1 – total central bank independence considering the criterion

I. NBR Governor				
1.	NBR's Governor mandate	1. over 8 years	1	0.50
		2. [6,8) years	0.75	
		3. 5 years	0.50	
		4. 4 years	0.25	
		5. <4 years	0	
2.	NBR Governor is appointed by			
	a. NBR Board		1	0.50
	b. NBR Board, Parliament and Government		0.75	
	c. Parliament		0.50	
	d. Government		0.25	
	e. Prime Minister/Ministry of Public Finance or both		0	
3.	The law permits NBR Governor to held other public positions			
	a. No		1	1
	b. Only if the Government approves		0.50	
	c. Yes		0	
4.	NBR Governor could be revoked			
	a. Only for reasons that are not political or he is unable to continue his work		1	0.60
	b. NBR Board		0.80	
	c. Parliament only for thorough reasons		0.60	
	d. Parliament		0.40	
	e. Government only for thorough reasons		0.20	
	f. Government		0	
II. NBR Actions				
5.	NBR can purchase government bonds or T-Bills from the primary market			
	a. The law does not allow		1	1
	b. The law allows		0	
6.	NBR is also a development bank for the public and private sectors			
	a. No		1	1
	b. To a certain extent		0.66	
	c. Yes		0.33	
	d. It is NBR's main task		0	
7.	NBR budget is established by			
	a. NBR		1	1
	b. NBR, Government and Parliament		0.50	
	c. Government and Parliament Commissions		0	
8.	NBR profit is distributed to			
	a. According to NBR Act		1	1
	b. NBR		0.5	
	c. Government		0	
9.	NBR loans have maturities of			
	a. 6 months and less		1	1
	b. One year		0.66	
	c. More than one year		0.33	
	d. It is not stipulated		0.25	
10.	NBR may grant short-term loans to the State Treasury. The maximum loan value is			
	a. A nominal value		1	0.66

	b. Established as a percentage of NBR's capital	0.66	
	c. Established as a percentage of total public revenues	0.33	
	d. Established as a percentage of total public expenses	0	
11.	NBR's interest rate for the short-term loans granted to the State Treasury is:		
	a. A market interest rate	1	1
	b. It is not allowed to be bellow a certain value	0.75	
	c. It is not allowed to be above a certain value	0.50	
	d. It is not stipulated	0.25	
	c. Zero	0	
12.	If there is a conflict between NBR and the Government		
	a. NBR decides	1	0.50
	b. The law does not stipulate	0.5	
	c. Government decides	0	
13.	The inflation target is established by		
	a. NBR	1	1
	b. NBR, Ministry of Public Finance or other institutions	0.5	
	c. Other institutions with the exception of NBR	0	
14.	The monetary policy rate is established only by NBR		
	a. Yes	1	1
	b. No	0	
15.	NBR can grant loans to other public institutions		
	a. No	1	1
	b. Yes	0	
	III. NBR Board		
16.	NBR Board members are appointed by		
	a. Parliament	1	1
	b. Government	0	
17.	The mandate of NBR's Board members is higher than Government mandate		
	a. Yes	1	1
	b. No	0	
18.	NBR Board members are allowed to have other public positions		
	a. No	1	1
	b. Yes	0	

Source: Authors' calculations.
The maximum degree of independence = 18
NBR's degree of independence = 15.76
NBR's index of independence = 15.76/18 = 0.8755 (87.55 %)

According to our indicator, NBR has a high degree of independence. We consider that the adoption of the Law no. 312/2004 regarding the Statute of the National Bank of Romania significantly increased the CBI. We also consider that the hike of NBR's independence played an important role in the disinflation process, as headline inflation dropped inside the targeted band of 3% ± 1 percentage point in the first part of 2012. NBR has both goal and instrument independence according to NBR's Statute. Further research should focus on comparing the degree of independence of the monetary authorities in Central and Eastern Europe (CEE).

The main disadvantage of the presented approach is that we attributed equal weights to each criterion introduced and this could negatively affect the final results. Determining optimal weights could be a very difficult task.

Another disadvantage is that the indicator offers a static view regarding the CBI and does not present how central bank independence changed in the past twenty years. We are aware of the fact that Law no. 312/2004 increased the CBI but we do not have figures indicating this process.

Conclusion

In this paper, we present the key aspects regarding central bank's independence. Most economists consider that the factor which positively influences the efficiency of monetary policy measures is the high independence of the central bank. We determined that NBR has a high degree of independence. According to our calculations, NBR has a degree of independence of 87.55 %. The Romanian monetary authority has both goal and instrument independence. We also consider that the hike of NBR's independence played an important role in the significant disinflation process, as headline inflation dropped inside the targeted band of 3 % +/- 1 percentage point in the first part of 2012.

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