MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

RESEARCH SUMMARY

THE MYTH OF CENTRAL BANK INDEPENDENCE

Conventional wisdom in monetary policy suggests that independent central banks can generate price stability better than their less independent counterparts. This idea has influenced the institutional design of central banks, which have been granted substantial de jure or legal independence from government in many cases.

A new study from the Mercatus Center at George Mason University investigates the empirical basis for this focus on central bank independence. After reviewing the historical and empirical backing for the conventional wisdom, the study finds that the statistical foundation for this conventional wisdom is flawed, with de jure central bank independence having little predictive power over price stability. Policymakers should instead focus on transparency and accountability.

To read the entire study and learn more about its author, University of Nevada Professor of Economics Thomas F. Cargill, please see "The Myth of Central Bank Independence."

BACKGROUND

The debate over central bank independence is rooted in the inherent conflict between the goal of price stability and the desire of governments to print money to accommodate deficit spending. Establishing de jure–independent central banks is viewed as the modern solution to this conflict, a solution that has enjoyed empirical support on the basis of the following methodology:

- *Measuring central bank independence*. Measurements of central bank independence are based on the de jure relationship between the central bank and the government as defined by the central bank's enabling legislation, with weight assigned to various characteristics of the relationship between bank and government.

- *Comparing independence to inflation*. The inflation rate in each country studied over long periods of time is compared with the de jure independence index, with some studies using statistical methods to account for other variables that may affect the inflation rate.

For more information, contact
Kate De Lanoy, 703-993-9677, kdelanoy@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

- *Drawing policy conclusions*. Researchers then use these results to draw conclusions about the institutional design of central banks. Results indicating that central bank independence leads to low inflation have been replicated dozens of times, but on closer inspection, the statistical foundation of the conventional wisdom appears flawed.

FINDINGS

The conventional wisdom is challenged by significant deviations that are difficult to explain without abandoning the idea that price stability relies on central bank independence:

- *Empirical studies overlook de facto independence*. Central banks are inherently political institutions established by governments, and empirical studies on this topic focus on the de jure relationships between central banks and governments instead of the de facto reality. The high degree of de jure independence assigned to the Federal Reserve overstates its de facto independence, while the pre-1998 Bank of Japan was de facto far more independent than was indicated by its low-measured de jure independence.

- *De jure independence is susceptible to measurement errors*. The inherent difficulty of measuring central bank independence has led some researchers to compensate by incorporating additional measurements into their analyses. However, these variables often reflect de facto, not de jure, independence, muddying the discussion of central bank independence.

- *Researchers have failed to adequately explain the "Japan problem."* Until the 1990s, Japan's central bank, considered one of the least de jure independent in the world, produced price stability. Attempts to explain this fact generally involve the incorporation of difficult-to-measure variables such as political and bureaucratic culture, reflecting the lack of information contained in any de jure measure of independence.

- *True determinants of price stability are more complex*. Price stability appears to rely on less tangible determinants such as the social priority assigned to price stability, which in turn can originate from a variety of economic and noneconomic factors. These noneconomic factors are complex and make it difficult to establish empirical relationships between central bank independence and price stability.

CONCLUSION

The concept of de jure central bank independence is confusing, and it has low predictive power for central bank policy outcomes. The concept of central bank independence is confusing because it conflates two separate elements, de jure and de facto independence. Furthermore, no central bank is politically independent of the influences that determine a country's preference for inflation.

Abandoning attempts to measure independence would improve the quality of the discussion about the proper role of central banks. Independence permits central banks to operate with discretion, and the record of monetary policy outcomes based on discretionary decisions is not encouraging. Instead, the focus should move to encouraging the accountability and transparency needed for central banks to achieve the best possible policy outcomes.