Interpreting Central Bank Independence in Mexico

"Mounting political pressure on the central bank to ease monetary policy may eventually cause faster money growth."

In May, Mexican President Carlos Salinas de Gortari proposed to his congress a constitutional amendment granting independence to the nation's central bank, Banco de México. Although much of the media took little notice of the proposal, it represents a milestone in the trend toward greater central bank independence.[1]

The proposed amendment would give Banco de México autonomy in managing the nation's money supply and credit policy and require staggered terms for members of the bank's governing body, so as to prevent selection of a majority during the term of any one Mexican president.

Central Bank Independence and Long-Term Growth

Independence means that, as in the cases of Germany's Bundesbank and the United States' Federal Reserve, a central bank does not have to obey the government when ordered to print money to pay for federal deficits. Instead, an independent central bank can follow a noninflationary monetary policy and leave the government to borrow to pay its deficits rather than use inflation to shrink the value the nation's money.

Independence also means that a central bank can pay less attention when politicians, including those in the executive branch, call for expansionary monetary policies to counter cyclical downturns in the economy. Politicians are sensitive to short-term economic downturns because such events can hurt their chances for reelection (or their parties'). Accordingly, to win elections, politicians sometimes try to pressure their nation's central bank to inflate its way out of a downturn. They are correct in guessing that the central bank can do this.

Inflationary policies can sometimes spur higher output in the short run. But when they do, they run the risk of lowering long-run output. The reason is, inflation typically involves not only rising prices but also more volatile prices. In a period of inflation, all prices do not increase at the same rate. It becomes difficult for businesspersons to know if they can pass their cost increases on to their customers. Businesspersons respond by cutting back on investment. Investment, however, is essential to long-run growth.

Mexico and Inertial Inflation

In recent years, Mexico has pursued a stable monetary policy even though the central bank has not been independent. Inflation rates have fallen drastically from the high levels of the mid-1980s. But considering how rapidly Mexico put its fiscal house in order, the fall in inflation has been slow. This persistence of inflation despite full fiscal adjustment is a phenomenon economists call *inertial inflation.*

One reason inflation may persist is that when a central bank announces it will hold down inflation, the policy may lack credibility. If the central bank is constitutionally subservient to the treasury, businesses and households may expect that future increases in government deficits will be financed through the central bank—that is, financed by printing money—despite the frequency and vehemence of anti-inflation statements by central bankers. Accordingly, when businesses contract to buy goods and services, some of them accept sellers' price increases, betting that an inflationary surge will cause overall price increases even greater than what the buyer had contracted to pay. In this case, if the central bank tries to fight inflation by tightening the monetary policy, the ongoing increase in prices will cause a severe recession. Mounting political pressure on the central bank to ease monetary policy may eventually cause faster money growth. The high inflation expectations thus become a self-fulfilling prophesy.

The establishment of independence for a central bank sends a signal that surprise inflationary money stock increases are less likely. If the business community takes this signal seriously, buyers will be more reluctant to accept sellers' efforts to push up prices. This time, the self-fulfilling prophecy will help, rather than hurt, the economy.

Numerous studies offer evidence that central bank independence and low inflation are closely linked.[2] Across the board, the higher the degree of independence enjoyed by a country's central bank, the lower the country's inflation.

Greater central bank independence also has been linked to higher real growth rates—probably because inflation discourages investment and stifles long-term growth. And over the long run, monetary policies that respond to political pressures neither restrain the cyclical variability of output nor lead to lower rates of unemployment.[3]

In sum, central bank independence helps to place monetary policy outside politics. Firms and households become less likely to act as if the government is trying to trick them into believing inflation will be low, and then print too much money. An independent Banco de México would help ensure the longevity of the recent successful economic liberalization and inflation stabilization in that country. Its independence enhances the credibility of its commitment to stable inflation and exchange rates and ultimately fosters economic growth.

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[1] For example, Chile made its central bank fully independent in 1989. For details, see Banco Central de Chile, "Ley Orgánica Constitucional del Banco Central de Chile," Banco Central de Chile *Boletín Mensual*, no. 745, March 1990, pp. 529–54.

[2] See, for example, Alberto Alesina, "Macroeconomics and Politics," in Stanley Fischer (ed.), *NBER Macroeconomics Annual 1988* (Cambridge: MIT Press, 1988), pp. 17–52; Ben Bernanke and Frederick Mishkin, "Central Bank Behavior and the Strategy of Monetary Policy: Observations from Six Industrialized Countries," in Olivier Jean Blanchard and Stanley Fischer (eds.), *NBER Macroeconomics Annual 1992* (Cambridge: MIT Press, 1992), pp. 183–238; W. Michael Cox, "Two Types of Paper: The Case for Federal Reserve Independence," Federal Reserve Bank of Dallas *1990 Annual Report*; Alex Cukierman, Steven B. Webb, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effects on Policy Outcomes," *The World Bank Economic Review*, vol. 6, no. 3, 1992, pp. 353–98; Vittorio Grilli, Donato Masciandaro and Guido Tabellini, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries," *Economic Policy*, no. 13, October 1991, pp. 342–92.

[3] Bradford De Long and Lawrence H. Summers discuss the link between central bank independence and real growth rates, and the long-term effects of monetary policies influenced by political pressure, in "Macroeconomic Policy and Long Run Growth," Federal Reserve Bank of Kansas City *Economic Review*, Fourth Quarter, 1992, pp. 5–29. Mark A. Wynne discusses the relationship between inflation and long-term growth in "Price Stability and Economic Growth," Federal Reserve Bank of Dallas Southwest Economy, May/June, 1993.