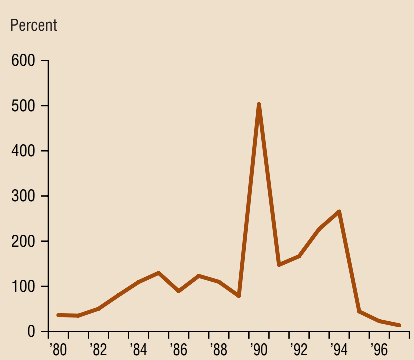
Latin American Central Banking: Does Independence Make a Difference?

SINCE THE 1980s, many countries in Latin America have undergone fundamental changes to their political and economic structures. Democracies are beginning to take hold where authoritarian regimes were common; large state-run enterprises are being dismantled or sold; and economic growth, which eluded the region for most of the previous decade, is slowly returning.

Accompanying these political and economic shifts have been fundamental reforms to central banking. Central banks have become more independent, and policy has grown more transparent. Countries such as Chile, Mexico and Peru have all taken steps to create more independent central banks. The aim of these changes has been to create a more credible anti-inflation program, and recent inflation rates in the region seem to indicate that the reforms are working. As Chart 1 shows, after experiencing damaging price instability over the past two decades, inflation in Latin American countries has declined from over 500 percent in 1990 to just under 14 percent last year.

CHART 1
LATIN AMERICAN INFLATION



SOURCE: International Monetary Fund, *International Financial Statistics.*

But how much of Latin America's recent success in fighting inflation is due to more independent central banks, and how much is due to other fundamental economic and political changes? Although institutional changes to central banks can make a return to high inflation more difficult and costly, the bottom line is that there is no shortcut to achieving a credible anti-inflation program through such changes. Credibility can only be achieved over time with a demonstrated broad-based commitment to keep inflation low.

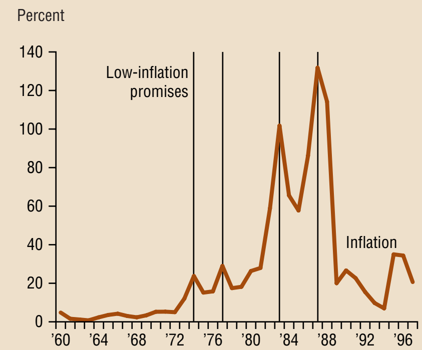
The Argument for Central Bank Independence

Why should the institutional framework of central banks make a difference in determining inflation? Presumably, if a government wants lower inflation, all it has to do is restrict fiscal spending and slow the growth of the money supply.

The problem is, however, that a government's promise to reduce inflation is often not believable. People understand that elected governments have an incentive to create higher-than-expected inflation for temporary employment gains and political support. If expectations of future inflation remain high, people will not accept wage adjustments of less than the rate of expected inflation, so any attempt to reduce inflation will be costly in terms of increased unemployment and higher interest rates.

Central bank independence may make a difference by reducing the elected government's influence on monetary policy. By handing over monetary policy decisions to an independent central bank with a clear mandate to keep inflation low, a government may create a more credible anti-inflation policy. The idea is that an independent central bank does not have the same political incentive to inflate as do elected members of government.

CHART 2
MEXICAN INFLATION RATE



SOURCE: International Monetary Fund, *International Financial Statistics.*

Prior to the 1990s, Latin America exemplified the difficulties associated with creating a credible anti-inflation policy. Mexico, for instance, suffered increasing bursts of inflation after several failed inflation-fighting programs. As Chart 2 shows, during the 1970s and 1980s, anti-inflation programs that were implemented at inflation peaks were ultimately abandoned, and inflation subsequently accelerated to new highs. As inflation programs failed, the credibility of the government's inflation-fighting promises diminished, and, as a result, citizens raised their inflation expectations. Each subsequent anti-inflation program was less effective and more costly (in terms of reduced output) to implement. Consequently, the government accommodated higher inflation expectations with an increasing rate of money supply growth. Inflation eventually peaked in 1987 at an average annual rate of over 130 percent.

A similar scenario occurred in Argentina over roughly the same period when the government's credibility fell after each subsequent inflation burst. Argentina's inflation eventually peaked at more than 3,000 percent in 1990.

Central Bank Independence

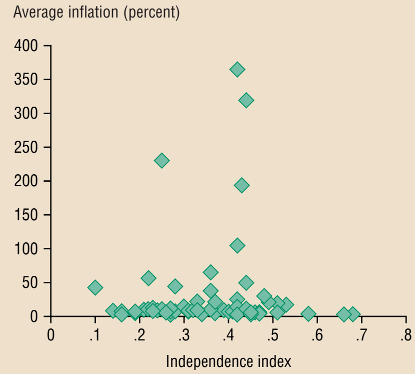
The expected benefit of an independent central bank is that it is removed from political control, and, as a result, policy reversal is made more difficult. A government that wants to boost the money supply to increase output and employment temporarily may find it more difficult to do so because it would involve changing laws and the operational structure of the central bank.

But the factors that characterize independence are not precise, and they vary quite a bit across countries. Actual, as opposed to formal, central bank independence depends not only on the degree of independence conferred on the bank by law, but also on many other factors, such as informal arrangements between the bank and other parts of government, the quality of the bank's research department, and the personalities of key individuals in the bank and other economic policy-making departments like the treasury. Obviously, it's hard to quantify independence in a completely objective manner.

There are, however, some elements of independence that are more relevant and easier to observe than others. Alex Cukierman of the University of Tel Aviv has put together a measure of central bank independence that depends on four factors: (1) the method by which independence is achieved, (2) how the head of the central bank is appointed and the length of the appointment, (3) the central bank's policy mandate and (4) restrictions on government borrowing from the central bank.[1] Given these measures, is there evidence that central bank independence is associated with lower inflation?

Evidence on Central Bank Independence and Inflation. Although central bank independence may make an anti-inflation program more credible, in general a relationship between legal independence and inflation does not hold. Chart 3 shows average inflation rates for 68 countries mapped against an index of central bank independence based on the four factors mentioned above. There does not appear to be even a weak relationship between measured central bank independence and inflation.

Chart 3
Inflation versus Central Bank Independence, 1980–89



SOURCE: Cukierman (1992).

Why isn't measured independence necessarily associated with lower inflation? First, as mentioned above, a legal definition of independence does not always mean that a bank is independent in practice, nor does it mean that a bank without legal independence is run completely by the elected government. Consequently, the degree of central bank independence is sometimes difficult to measure and can be subject to varying degrees of political pressure. Moreover, fiscal spending is important. Countries with large public sectors and huge budget deficits are likely to exert tremendous pressure on the monetary authorities to print money to pay down existing debt. With enough political pressure, even constitutions can be changed. And in countries with less stable governments and shorter histories of price stability, legally declaring a central bank independent may not mean much.

Even with the best institutions, there appears to be no quick and easy way to gain a credible anti-inflation program. Credibility can only be gained over time with a demonstrated commitment to price stability. However, in addition to other reforms, central bank independence may help. It can send a powerful signal to individuals that the elected government is serious about reducing inflation by making policy reversal more difficult. If central bank independence is pursued along with other policies such as more transparent operating polices and a reduction in general fiscal spending, a low-inflation program is that much more credible.

After years of costly high and variable inflation, polls in many Latin American countries indicate overwhelming support for fiscal and monetary restraint, despite periods of high unemployment. Recent sustained declines in inflation in the region are consistent with this support. Consequently, much of Latin America's recent central banking reform reflects a general desire to keep inflation low. Legal central bank independence is a key but not the sole determinant of low inflation.

—David M. Gould
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Note

[1] Alex Cukierman, *Central Bank Strategy, Credibility, and Independence* (Cambridge, Mass.: The MIT Press, 1992).