

The Importance of Central Bank Independence for Monetary Policy Effectiveness

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Four Former Fed Chairs on CB Independence

“[A]n economy is strongest and functions best when the central bank acts independently of short-term political pressures and relies solely on sound economic principles and data. . . .

Even the perception that monetary policy decisions are politically motivated, or influenced by threats that policy makers won't be able to serve out their terms of office, can undermine public confidence that the central bank is acting in the best interest of the economy. That can lead to unstable financial markets and worse economic outcomes.”

(Paul Volcker, Alan Greenspan, Ben Bernanke and Janet Yellen.
Wall Street Journal, August 6, 2019)



Political interference and policy mistakes

- ▶ Political interference in the implementation of monetary policy inevitably leads to policy mistakes.
- ▶ Central Bank independence is critical to protect against such mistakes.
- ▶ However, over history, such mistakes have been observed even in central banks that appear independent.
- ▶ Example I: The Federal Reserve and the Great Inflation of the 1970s.
- ▶ Example II: The ECB and the “lowflation” of the 2010s.



Fed: Political foundations of the Great Inflation

“Mr. Martin, I submit that your agency—the Federal Reserve—has failed miserably, and is continuing to fail, in meeting its obligations to the economy in a wartime period. Outside of the Vietcong, I do not know of any institution that has done more damage to the American economy in the past few years.”

(Representative Wright Patman, Hearing of the Joint Economic Committee, February 14, 1968.)



ECB: Political foundations of “lowflation”

“The ECB’s actions have faced growing criticism in Germany, where the economy and labor market are in robust health, but ultralow rates have hurt savers setting money aside for retirement. . . .

Mr. Schauble also laid part of the blame for the rise of the populist Alternative for Germany at the ECB’s door. . . .

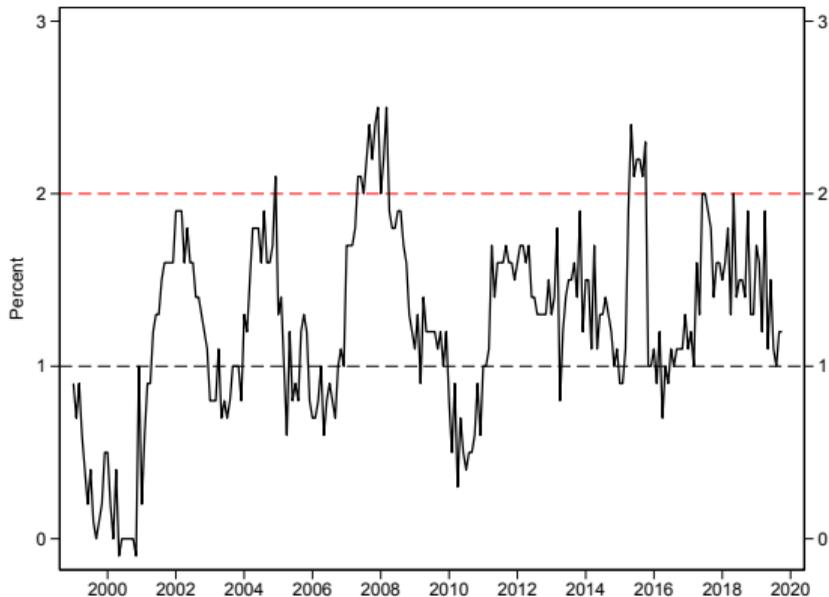
‘I said to Mario Draghi . . . be very proud: you can attribute 50% of the results of a party that seems to be new and successful in Germany to the design of this [monetary] policy,’ Mr. Schauble said.”

(Wall Street Journal, 9 April 2016)



Evaluating ECB policy: Core inflation in Germany vs Italy

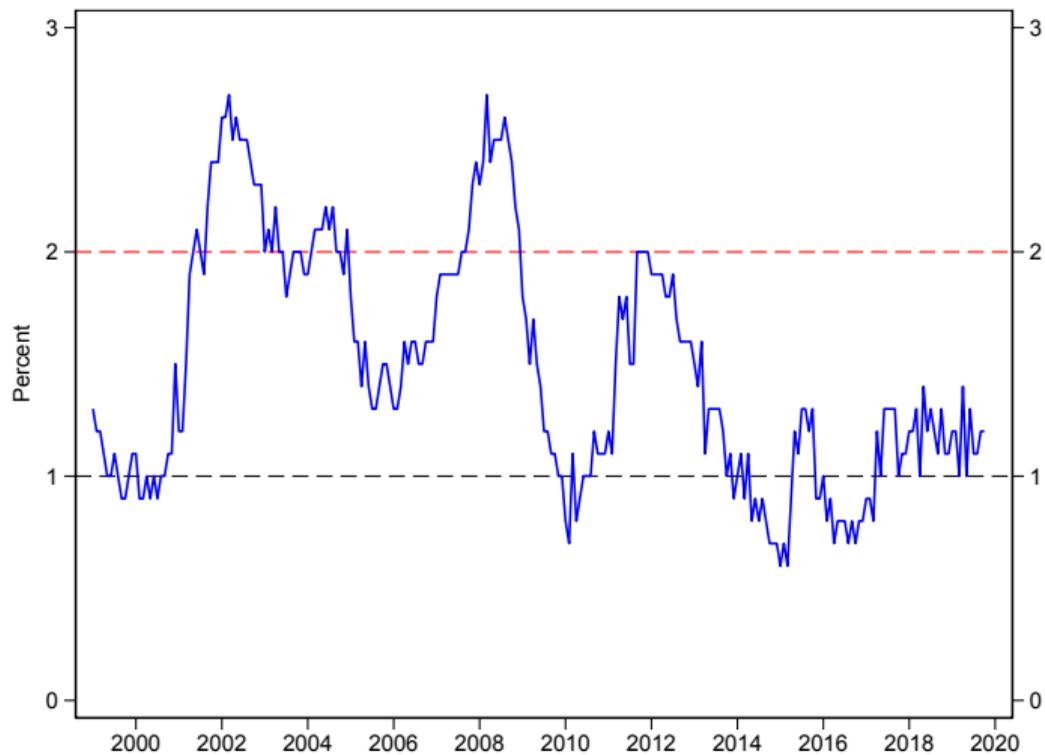
Germany



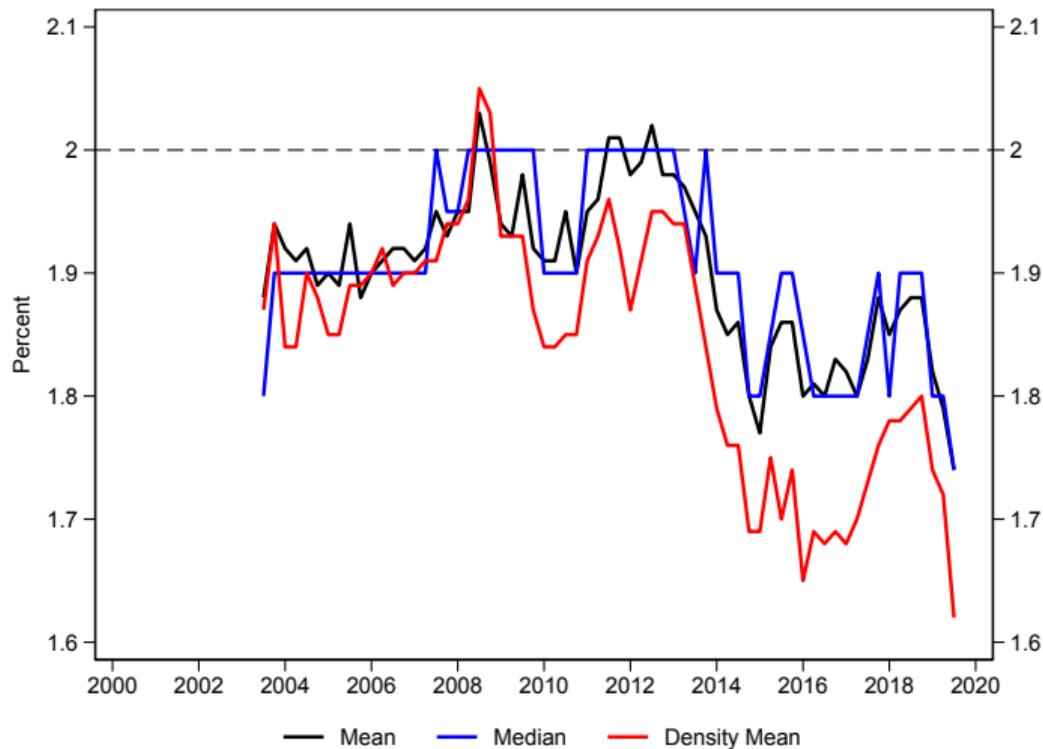
Italy



Evaluating ECB policy: Core inflation in euro area



Evaluating ECB policy: Long-term inflation expectations



ECP SPF. Five-year ahead survey forecasts.



Lessons from Fed and ECB mistakes

- ▶ Statutory CB independence is not enough to assure good policy.
- ▶ Absent a clear numerical definition of price stability, a politically influenced CB may let inflation drift up (1970s Fed) or drift down (2010s ECB), harming the economy.
- ▶ While CB independence is essential, to protect against policy mistakes, need to limit the harmful application of discretionary authority.



Elements of best practice

- ▶ Statutory independence.
- ▶ Clear numerical definition of price stability—a symmetric inflation target.
- ▶ Transparent policy strategy—a systematic policy response to shocks guiding inflation to target in the policy forecast horizon.
- ▶ Clear communication, including inflation forecasts and explanation of past forecast errors.
- ▶ Accountability.



Best policy practice in Mexico

- ▶ Political authorities in Mexico deserve credit for espousing the long-term benefits of an independent central bank over the past quarter century.
- ▶ Since Banco de Mexico was granted its independence a quarter century ago, its monetary policy has moved to the frontier of best practice.
- ▶ With the adoption of a numerical inflation target, a transparent policy strategy and clear communication, the Bank has maintained monetary stability in Mexico—a precondition for growth and prosperity.
- ▶ Similar adoption of best practices in other policy areas by political authorities would enhance welfare for all Mexicans.

