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Finance, Financial Analysis

Supervised by: Prof. John Adams | Central Bank Independence and Inflation | Monetary and Fiscal Theory and Policy | | `Prepared by: Noha Gamal | ID: 110326 | Central Bank independence either Political or Functional being essential in the control of inflation is an issue of argument and there are different views on it supported by Evidence. This Paper will focus on considering these different point of views starting by describing Central bank independence, what central banks do, and who controls them which makes us reach the aim of the argument as to whether the independence help control inflation or not, or in other words, is it necessary or of any effect on inflation | Outline 1- Introduction * What are central banks and what do they do? * Who control central banks? * Independence of the Central bank and effect on Inflation 2- Literature Review * Review of the literature on the effect of Central bank independency on inflation and the aspects the Central bank must follow in dealing with inflation 3- Central Bank Independence * Who control Central banks and The aim of the CB * CB independence both politically and Functionally 4- Empirical Analysis * The Croatian Central Bank (CNB) and its independence 5- Conclusion * CB and their role * Literature outcomes * Alternatives to CBI * Recommendations for further research T Central Bank Independence and Inflation he Banking System, with all the transactions, the pumping of money in the banking system (Monetary Policies) and the Governmental taxation and Purchases (Fiscal Policies) are affected by the environmental conditions of an economy and therefore economic indicators like Inflation and Price stability are bound to be altered in the process. As a start, describing the central bank and its role is of high importance. The Irving Fisher Equation " MV= PT" is the main instrument of explaining the monetary policy (changing the Money Supply " M") on the Price " P" and transactions " T" with noticing the importance of the velocity of circulation " V" and its effect of making the change in M of no effect in some cases. This depends on the transmission mechanism (Heakal, 2010) Mentioned that the CB is referred to as " Last Resort Lender"; meaning that it is the supplier of funds when there is a shortage in the supply of funds within commercial banks. It can as well be explained as the backbone of the banking system which secures it from failing in the last minute. This role of the central bank was long ago available but increased more frequently with the shifting of the world currencies from the " Gold Standard" (GS), because of the increase in the problem of price stability, which was limited in the GS era. This is because gold was limited in amount and so there was no such thing as the problem of printing money (Quantitative Easing) available today by political decisions. Therefore, inflation was controlled at ease as opposed to today. The Central bank control varies across countries with differences in the political regime in control. For the stability of the prices and the currency, the Central bank has to be an authority that regulates the system. For this to happen there must be some sort of government control; not too much but at the same time not absent nor of a negligible effect. The debate on the effect of the independency of central banks on inflation and price stability began with the start of the First World War. This was because of the need of extra money, which increased the printing of money by the government, and so increases inflation. From here the Political independence of the Central bank arose. On the other hand, in the process to recover the economy after the WWI political dependence of the central bank was needed, but again, after the recovery, independence was back in play. This unstable requirement of independence was a factor that caused the debate of the Central Bank independency which persists till today. From what we reached so far, we can further discuss the different views on this debate and support it with empirical evidence in order to try to reach a point where we can have a better understanding of the pros and cons of the Independency debate and whether independency is required or not in achieving price stability Literature Review As mentioned earlier Central bank independency is an issue of debate present till today, with efforts in trying to realize its effect on inflation, and whether we should or shouldn't encourage it. Some studies where with, others were against, and some found it a tool of many alternatives. This argument is what we aim at taking a closer look on to it here. We first take a look at how (Hayo & Hefeker, 2001) critically examined the central bank independency issue and its effect on inflation and price stability. The argument here is against the hypothesis of CBI being a sufficient tool for achieving price stability. This is because independency is simply an instrument of monetary policy with several other alternatives used for the same purpose to achieve the same goal. The literature although specifies the drawbacks in the argument of CBI being the best instrument of monetary policy, yet concludes that CBI is considered the best way to deal with inflation. Again, (Hayo & Hefeker, 2001) argue this outcome stating the alternatives to CBI in achieving low inflation. These include the " fixed/constant exchange rate, inflation targets, and finally inflation contracts". An important notice here is that each one of these alternatives does have their own disadvantages which helps conclude that there is not a single instrument that can be considered optimal for achieving monetary and price stability and from this again we see that CBI is not considered a necessity for price stability. From the empirical perspective, (Hayo & Hefeker, 2001) again argues the outcome of literature which says that there is a positive correlation between CBI and low rates of inflation. They support their argument stating that there are two things to decide upon about the monetary policy " Two-step Procedure": 1) Importance of controlling inflation as an objective, which shows that independence is simply one instrument in achieving the price stability objective, 2) under a certain economic and political framework seeing if CBI constitute to be of good contribution, which shows CBI as a possible solution for some economies but not a necessity to every economy. In the end political conditions like costly procedures or difficulties in the political perspective in the legal changes can encourage enforcement of CBI opposed to other alternatives. " The Greater Political freedom the more CBI is chosen over other alternatives" (Hayo & Hefeker, 2001) This clearly shows the point against CBI or in specific against it being the only/ best solution to price stability. An article by (Diana & Sidiropoulos, 2003) discusses the empirical analysis of the relation between CBI, and Inflation persistence (disinflation speed). This paper was pro independence mentioning how it can positively affect the economy. The results of the study in this paper were a negative relation between independence and persistence of inflation. " Central bank reforms" in the EU were taking place due to the strong belief of CBI being an effective method to reaching price stability and low levels of inflation. (Diana & Sidiropoulos, 2003) Mentioned the outcomes of previous empirical studies and provided explanation for them. One of these outcomes was that " with high independence of central bank, the higher the disinflationary costs". They explained this outcome by the trade off between output and inflation (Phillips curve slope) saying that with CBI, there is less variation in inflation rates which results in an flatter/ inelastic Phillips curve in the short run (this is due to the reduced frequency of adjustments in wages and prices), therefore disinflationary costs are high. This concludes that the cost of disinflation is less when it is quick due to sharp adjustments of expectations by a quick shift in regime and so increasing credibility. Another outcome is regarding independence and its impact on the persistence of inflation. The study showed that with independence, persistence of inflation is low and therefore speed of disinflation is high. In another study by (Eijffinger & Hoeberichts, 1996), it was found that CBI or conservativeness is dependent on the " Natural rate of unemployment". This means, whether the society prefers stabilizing unemployment over stabilizing inflation is considered of importance for the level of independence or conservativeness. This is based on a previous study aiming to show the economic and political factors which affect how much of authority is given to CBs. The hypothesis or theoretical prediction was " independence is higher the more the inflationary bias is motivated towards stabilizing employment, the more unstable an economy is political wise, and the higher the governmental debt is". This was then rejected and other tests based on the same prediction continued reaching that of the (Eijffinger & Hoeberichts, 1996) contribution which shows that with higher rates of natural unemployment, the CBI and conservativeness is higher (that is with high rates of natural unemployment there is high credibility problem as rates of inflation become more time consistent). So we conclude that from the literature that, studies with CBI show how it affects the persistence of interest rates and the disinflation speed. Studies against it see it as just one like many monetary instrument that can be applicable in some countries and not in others which depends on the economic, legal and political system of each economy or country to be implementing or applying CBI as an instrument. Central bank independence In the analysis of central bank independence we focus on the European Central bank which is considered to be the best functional central bank around the world. A speech by (Smaghi, 2007) posted on the ECB website talks specifically about the central bank independence and explains the different forms of independence that can be present. As mentioned earlier the control of the central bank differs from an economy to another. CBI is measured by the degree of government control. The less the government control the more independent. The speech by (Smaghi, 2007) classifies independence into several categories. 1) Functional Independence It is when the central bank is able to freely set the policy instrument that it views as aiding to achieve the central bank's main objective. For it to be applicable the objective should be clarified in a legal form. So central banks has the power of setting the money market interest rate in the short run and any obstacle faced in doing so remarks a barrier to its independence. For example, an obligatory deficit finance by the central bank. 2) Personal Independence It is political independence; central banks decision making members and the governor nominated or removed by the political body. For it to be applicable there must be no conflicts in the interests of the governors and the decision makers of the CB. 3) Financial

Independence A proper mean of finance is required by the CB for a credible operation. For it to be applicable, the CB has to have the authority of determining their budget, and a clear statement of its financial liabilities. The more strongly the CB achieves each or some of these independence categories the more it is seen to be independent. It is important to note that although each country or economy is aware of these independence categories in theory when applying them the case varies Croatian CBI Croatia is a democratic republic in Europe. We will focus on the independency of its Croatian National Bank (CNB). It was reviewed by (Tomislav Ä†oriÄ‡, 2009) that CNB is stated in an Act to be independent in reaching its objectives. Considering its functional independence, CNB agrees to policies only if it does not negatively affect the main objective of price stability. It adjusted its laws to meet demands of the " Maastricht agreement". As for the institutional independence, the CNB doesn’t take instructions from the government representatives of the EU or from any third party. It may allow for cooperation with the government if it helps accomplishing its goals. Proposals and reports by the government reach the CNB for opinions prior to setting the rules. Regarding the personal independence, The CNB council consisting of only expertise of Croatian backgrounds for a fixed period of time, are restricted in representing the parliament, and not granted government membership, cannot work in the banking sector and their siblings cannot have shares in any institutions under supervision by the CNB. Finally, for the financial independence, the CNB is partially independent playing the role of a fiscal agency as a consultant and participant in procedures by the legislatures in the ministry of finance. Budgeting is in their hand but capital is in the hands of the government. Financing the government directly is prohibited but the CNB does indirectly finance the government by its purchase of government security Conclusion To conclude, the debate on CBI is and will still be an issue of thought by all economists. The literature proved Independence to be useful in some cases and of no use or of the same effect of alternatives in another case. The studies Pro CBI state that with independence, persistence of interest rate is low and so high disinflation rates; another point is that with CBI, variation in interest rates is less and so disinflationary costs are bound to be high so with a fast shift in regime, adjustments in expectations are quick and therefore disinflationary costs are less. The study against CBI viewed it as an instrument that does control price stability but not the only or the most essential monetary policy tool used. Even the alternatives do have their drawbacks therefore no single monetary tool can be said to be effective in all cases. This differs from an economy to another according to the economic, political and legal structures of the system. A point of importance for further study should be the fact that independence is not always a point of advantage in the economy. This leads us to introducing the business cycle when dealing with the Central bank policies. In times of recession political CBI is encouraged as printing money may occur and therefore inflation. Then in booms political CBI was not advocated till recovery takes place. After that point independence is then encouraged. So with political independence in recessions the CB can target the inflation into normal rates while in booms the economy is functioning in a good form so there is no much need for the independence at that stage. As a conclusion independence is found to be oscillating with changes in the business cycle.

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