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Central Bank Independence and Macroeconomic Performance: A Cross Country Analysis

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Central Bank independence and macroeconomic performance: a cross country analysis

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Abstract

The issue of implementing an independent central bank has evolved in recent years. Many arguments believe that by becoming more independent, the central bank can transform into a stronger institution that more efficient and more capable fulfill its functions. Although the importance of central bank independence has long been recognized in the academic literature, in this particular case, independence cannot contribute a significant impact to macroeconomics performance. Many moral hazards were caused by lack of transparency. therefore, increasing widespread transparency of central bank become more importance factor in practicing central bank independence. Transparency has become a new feature of monetary process in term of the decision making process. A central bank that is transparent does a good job of communicating its intentions to the public and thereby reducing the public's uncertainty about what it is trying to achieve. Thus, by providing information to the public,the central bank can control and forecast what the public expecation is. In other side, the public can also offer valuable feedback to the monetary performance. In this paper, we will give panel data in order to show how much the role of transparency in order to support central bank performance. i compare this data with macroeconomic variables and analyze by using the cross-section method. Therefore, this paperr aim to show us how important the relationship between central bank and public in achieving good macroeconomic performance.

Keywords: central bank independence, central bank transparency, macroeconomic perfomance

This thesis has been presented in front of the examiners in the Thesis Examination and successfully passed the Thesis Examination on Mei 12th, 2010.

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CHAPTER I

INTRODUCTION

1.1 Background

Among the many factors causing or contributing to some banking crisis, there are some problem areas that seem to be accepted as the major problems facing the national economies in the region. Such as the weak of banking systems, unsustainable corporate debts in foreign currencies and another factor that can disturb financial mechanism. Straightly to the center of issues related to these problems is the absence of a robust financial infrastructure, including the lack of independence in central banking. This condition occurs due to high intervention from executive board lead to central bank can't fulfill its function and duty in order to response monetary crisis.

An independent central bank is definitely an important issue for the well functioning of banking systems, and not just an article of faith that central banks should be independent in their role as monetary authorities. Independence of central banking has been considered as part of the requirement for improved corporate governance and transparency in the conduct of business of national economies that have increasingly integrated into a borderless economy. Beside that, Central bank independent is a base theory that using to overcome higher of inflation rate and also to separate monetary system from political interest.

In both economic research and policy making, the issue of central bank independence has been widely investigated and discussed during the last decade. More recent studies test the robustness of the statistical relationship between the distribution of inflation, growth and CB autonomy. These studies have used different measures of autonomy, different time and cross-country samples, and additional determinants. Some explanations that are described by each researcher also support the results of their studies. To a large extent, the interest of that study is motivated by the success of the Deutsche Bundesbank (central bank of German) in keeping the rate of inflation stable at a low level for several decades. Based on that study, suggests that countries having an independent central bank can achieve low inflation rates because politicians cannot so easily influence monetary policy. This is good because politicians face a time inconsistency problem when they try to implement their preferred policies and this leads to inferior outcomes. The time-inconsistency problem can be mitigated by delegating monetary policy to an independent central bank that is more conservative than the government in the sense that it cares more about inflation.

A great deal of emphasis has been placed on the necessity of an independent central bank. The reason given for this necessity is that there is a fundamental difference between governments and central banks governments pursue both political and economic objectives while central banks generally pursue only economic objectives. For example, a government is responsible for the national defense while a central bank is not. If a central bank is not independent of a politically motivated government and government intervention is allowed, the central bank cannot optimize economic social welfare. This heterogeneity in objectives between the government and the central bank makes an independent central bank necessary. Hence, the essential reason for the

CHAPTER VI

CONCLUSION AND RECOMMENDATION

6.1 Conclusion

One of most significant trends in international politics and economics during the last decades is the dramatic increase in CBI. The underlying idea behind this policy development is that CBI-reforms are believed to solve the time inconsistency problem of monetary policy (Kydland and Prescott, 1977, Barro and Gordon, 1983), and thereby contribute to lower inflation rates. A number of previous empirical studies (Alesina, 1988, GMT. 1991, Cukierman., 1992, Alesina and Summers, 1993) have supported this hypothesis such as CBI have negative relationship with inflation rate and no significant impact to economic growth. Moreover, investigations about CBI develop to the factor that support implementation of CBI such as transparency, accountability and credibility. So, we can said that implementation of CBI have become main considerable for policy maker in order to improve its economic performance.

In this study, we analyze the impact of implementation of CBI on two macroeconomic variables, there are inflation rate and economic growth. We utilize OLS method in order to exam the relationship between variable of CBI index, dummy variable and transparency index to on inflation variable and economic growth variable. Thus, by investigating the relationship among all variables above, we can get description of effectiveness of CBI regime.

From that statistical result we can see that expectation of implementation CBI cannot be always achieved even thought degree of central bank independence improves over time. The existences of gap between theory and real

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