On Central Bank Independence and the Effects of Monetary Policy*

José De Gregorio
Central Bank of Chile
October 2005

* Presented at the roundtable on Latin American Central Banks, 10th LACEA Meeting, Paris.

Outline

1. Measuring independence: from legal to de facto.

2. Independence, credibility and monetary policy effectiveness.

3. Central bank objectives and the policy horizon.

4. Latin America current economic developments.

1. Measuring Independence

- Early evidence (e.g., Cukierman, 1992) shows that legal independence correlated with inflation. In developing countries *de facto* independence (turnover) looks as a better proxy. However, recent research by Cukierman et al (2002) and Jacome and Vazquez (2005) show that legal CBI is negatively correlated with inflation in Eastern Europe y Latin America.
- In developing countries, specially those with poor inflation record, legal independence may be a pre-requisite to gain credibility and to act effectively in an independent way. This may help to explain the previous finding.

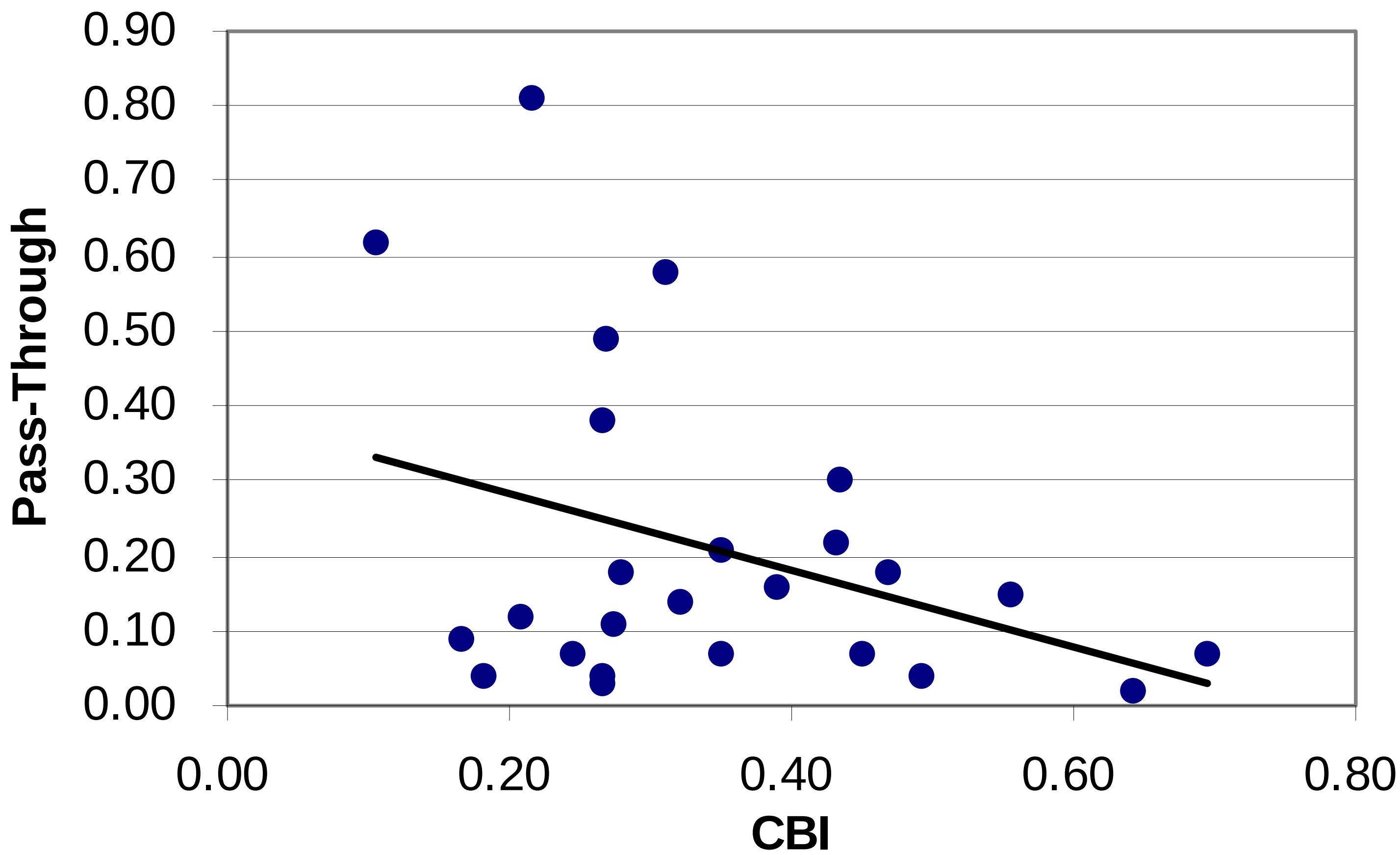
1. Measuring Independence

- Independence is mainly based on appointments and removal of central bankers. The former is more important to insure competence and the latter for independence.
- The Chilean experience: legal independence is the same since 1989, but certainly de facto independence has increased significantly overtime. This has happened together with much greater degrees of transparency and accountability.

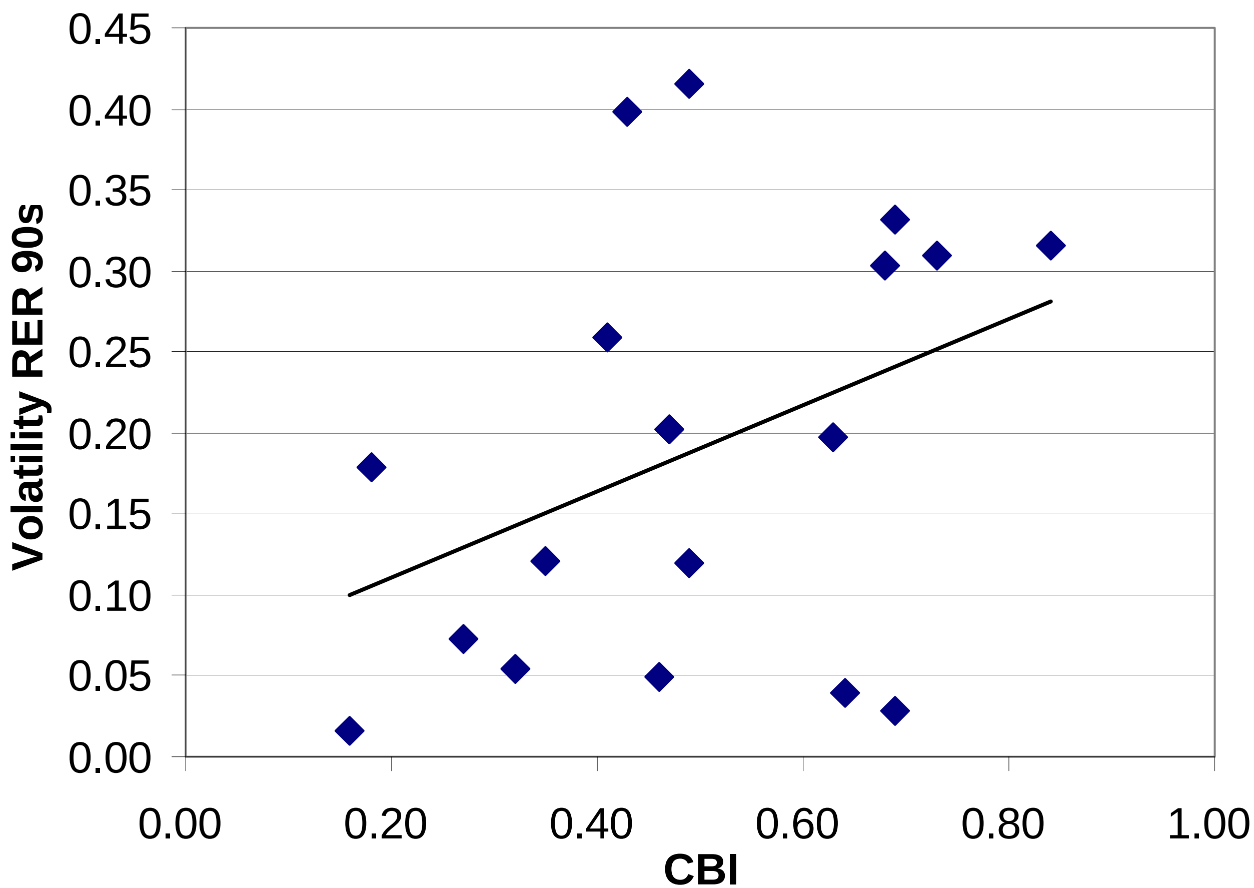
2. Monetary policy effectiveness

- Declining passtrough of exchange rate to prices linked to CBI (Céspedes and Valdés, 2005). Greater incentives to local currency pricing and implementation of flexible exchange rates. However lower passthrough may require larger fluctuations of the exchange rate for external adjustment, which is achieved with flexible exchange rates.
- Lower inflation and repercussion effects of cost shocks: oil. The effect of oil prices on inflation have been declining. Lower oil dependence, tax effects, but also more credibility and limited second round effects.

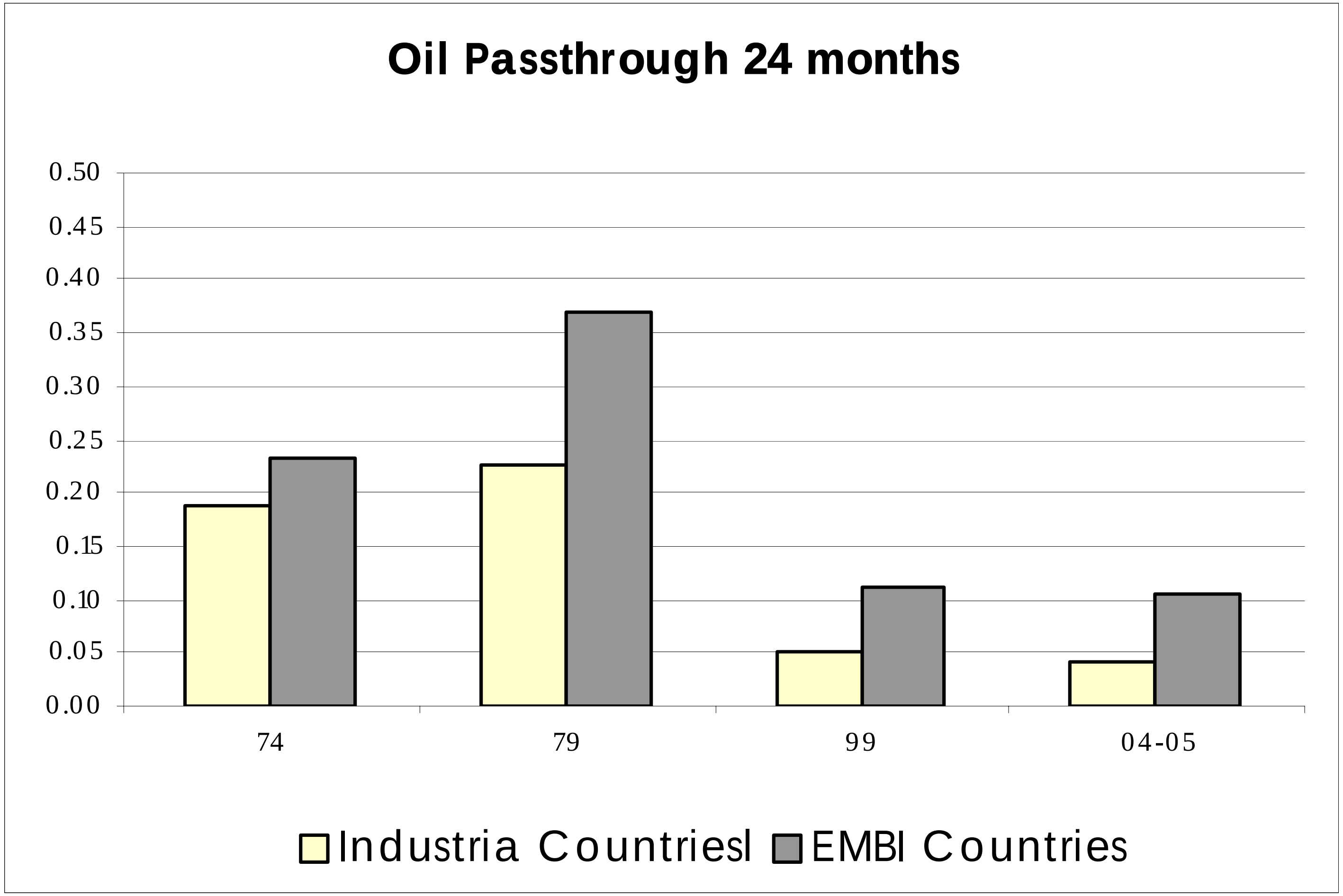
2. Central Bank Independence and Pass-Through exchange rate-inflation



2. Central Bank Independence and Real Exchange Rate Volatility



2. Passthrough Oil prices -inflation



3. Central Bank Objectives

On the implementation of inflation targeting:

- Headline versus core inflation: in industrialized nations more tendency to core inflation, but most countries use headline inflation and those that innovate are returning to headline. Credibility versus transmission of second round effects when focusing on a subset of prices. The advantage is that reduces the reaction to transitory shocks.
- Policy horizon: a form to overcome problems of using headline inflation by allowing transitory shocks to dissipate before taking action. Short horizon and exchange rate pressures.
- Transparency: to improve workings of monetary policy and for accountability. Transparency is irreversible.
- Transparency and credibility: Which come first?

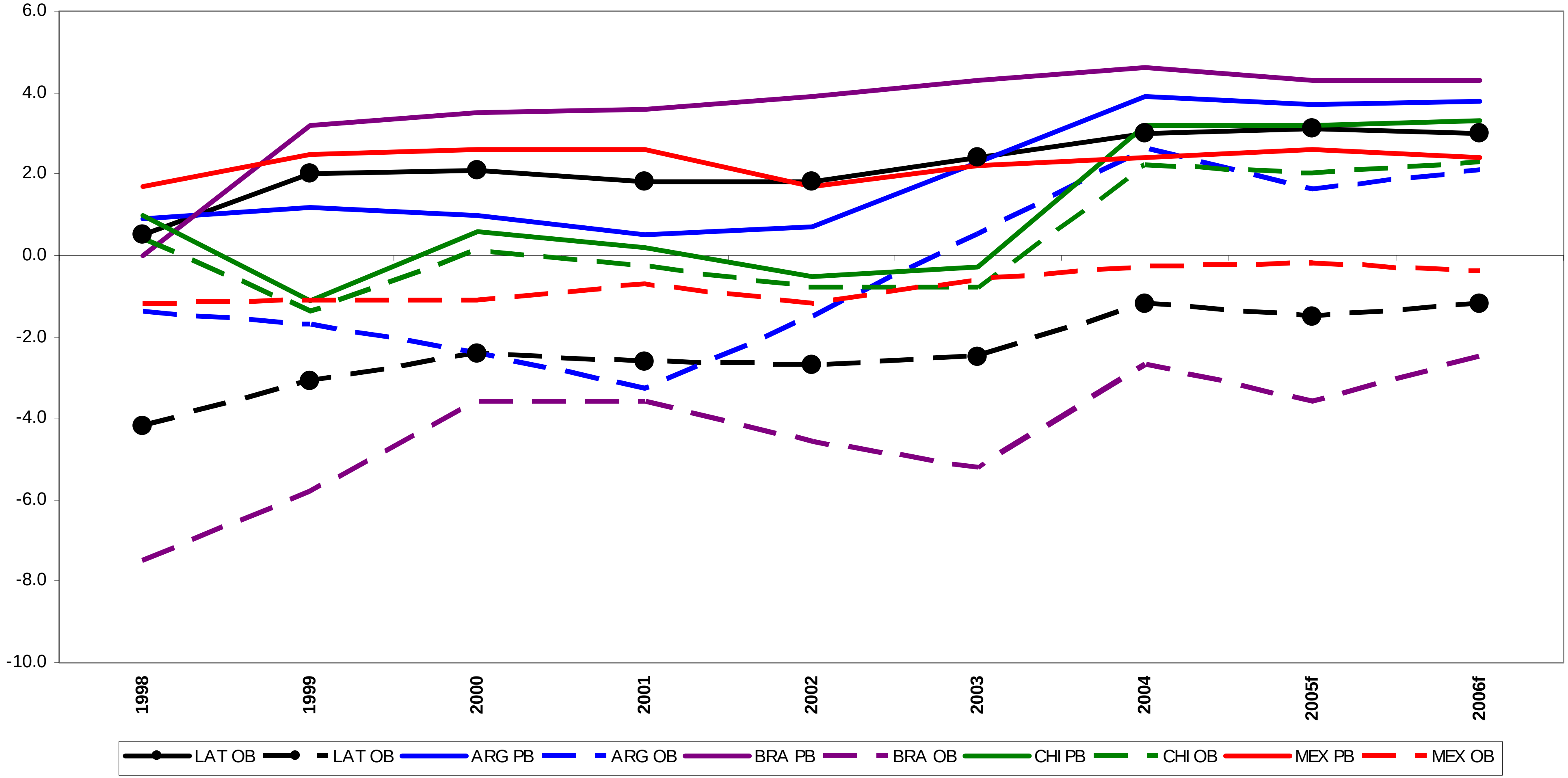
4. Latin America: Macroeconomic Performance

	GDP Growth (%)				Inflation (%)				Current Account (% GDP)			
	1993-2002	02-06(f)	2005(f)	2006(f)	1993-2002	02-06(f)	2005(f)	2006(f)	1993-2002	02-06(f)	2005(f)	2006(f)
World	**3.5**	**4.1**	**4.3**	**4.3**	**11.4**	**3.7**	**3.9**	**3.7**				
Argentina	0.7	3.7	7.5	4.2	4.2	12.7	9.5	10.4	-2.2	3.5	1.3	0.1
Bolivia	3.5	3.0	3.9	2.5	6.1	3.5	5.5	3.2	-5.4	1.0	2.6	2.9
Brazil	3.0	2.8	3.3	3.5	412.3	8.2	6.8	4.6	-2.9	0.7	1.7	0.7
Chile	5.0	4.7	5.9	5.8	6.4	2.5	2.9	3.3	-2.7	-0.3	0.3	-0.7
Colombia	2.4	3.6	4.0	4.0	15.9	5.9	5.2	4.8	-2.9	-1.5	-1.8	-1.5
Ecuador	2.2	3.7	2.7	2.8	38.4	5.4	2.0	2.0	-2.4	-0.8	0.2	2.4
El Salvador	3.9	1.9	2.0	2.0	6.4	3.7	4.0	4.0	-1.6	-4.3	-4.7	-5.5
Guatemala	3.7	2.7	3.2	3.2	8.8	6.8	7.6	5.3	-5.0	-4.7	-4.7	-4.5
Mexico	2.8	2.6	3.0	3.5	16.0	4.4	4.3	3.6	-3.1	-1.3	-1.1	-0.8
Peru	4.4	4.7	5.5	4.5	12.0	2.1	1.8	2.6	-5.0	-0.6	0.3	0.3
Uruguay	0.5	2.7	6.0	4.0	22.9	10.9	5.2	6.5	-1.5	-1.2	-2.8	-5.3
Venezuela	0.1	2.7	7.8	4.5	41.9	22.0	16.6	18.0	3.8	13.1	15.9	14.9
Average	**2.7**	**3.3**	**4.6**	**3.7**	**49.3**	**7.3**	**6.0**	**5.7**	**-2.6**	**0.3**	**0.6**	**0.3**

(f): Forecast.

Source: World Economic Outlook, September 2005.

4. Latin America: Improved Fiscal Balance



Source: UBS