World Economic Outlook

Forrest Capie, Geoffrey Wood, and Juan Castaneda

Central Bank Independence in Small Open Economies

Discussion by
Thomas Helbling
Research Department, IMF

Overview

- Issues and hypotheses
- Approach
- Summary of results
- Discussion
  - Has central bank independence been compromised?
  - Definition of central bank independence.
    - Lender of last resort function.
    - Monetary policy at the zero lower bound and after the crisis
  - Other aspects of the small open vs. big economies dichotomy

Hypotheses

- Paper explores whether crises also compromise central bank independence in small open economies, not only in big economies (Capie and Wood, 2014).
- Why should small open economies be different?
  - More detailed central bank laws make it more likely that laws have to be adjusted after crises because they do not cover all contingencies. Opens the door for independence to be compromised.
  - In high trust societies, laws are more likely to be less detailed, hence lower likelihood of compromised independence.
  - Small open economies are high trust societies.

Approach

- Definition of central bank independence
- Analyze inflation in small open economies in 4 eras.
  - Gold standard
  - Interwar period
  - Bretton Woods
  - Era of flexible exchange rates
- Analyze the evolution of independence in the 4 eras.
- Case studies of evolution in central bank laws in 4 countries using New Zealand’s law as a benchmark

Main results

- Small open economies with independent central banks have slightly below average inflation.
  - Inflation is relatively as absolutely low; a stronger finding than that of Romer (1994).
- Some evidence that central banks in small open economies do better in terms of retaining their independence.
- Central bank independence is much more likely to be durable in small open economies than in large economies.
- CB contracts depend on the circumstances in which they came about.

Discussion

- Timely paper.
  - Clear change in tone after celebration of the great moderation.
  - Central bank policies have been questioned much more since the crisis.
  - Political criticism of central banks has intensified (e.g., in the United States).
  - Success/relevance of inflation targeting is being questioned.

Discussion (continued)

- Some methodological issues.
  - Small sample of industrial countries. How representative are the countries in the sample? High trust seems to be very much a Nordic phenomenon.
  - Endogeneity and omitted factors. No banking crises in 2008/09 in New Zealand, Australia, and Norway. Neutrality in World War I.
  - How relevant is the Spain in the modern era (independence as precondition for monetary union; no difference with larger EMU applicants).
  - More complete presentation of results (e.g., big vs. small economies).
  - 4 eras vs. cross-section of responses to crises. How relevant is the Bretton Woods era (few crises)?

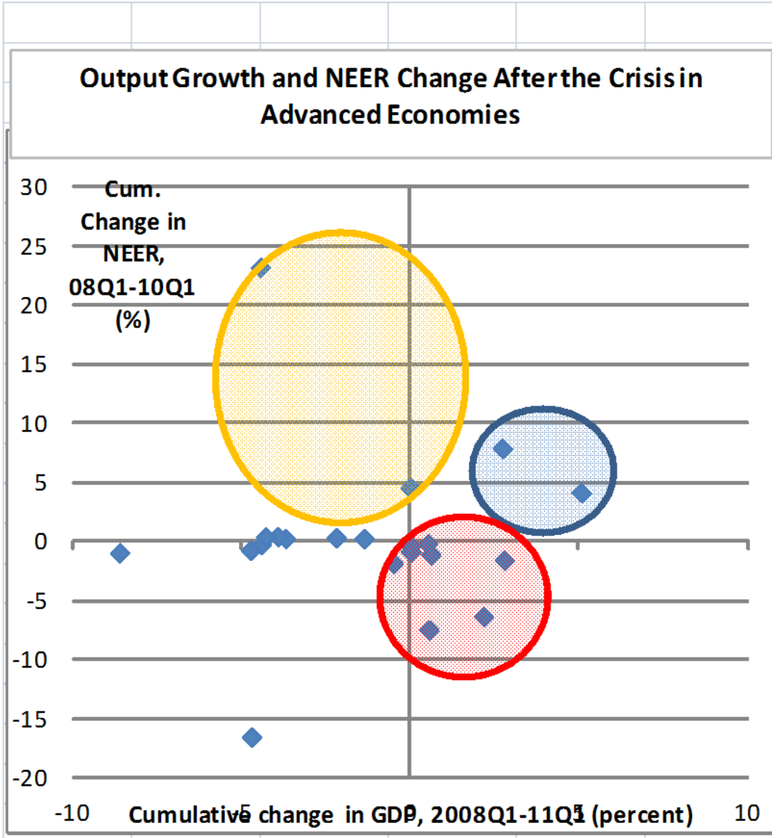
Definition of CB Independence

- Definition of CB independence. Matters for the overall picture. Has CBI really been compromised?
  - Analysis in the tradition of the recent literature of measuring CB independence (de jure/de facto) (e.g., Cukierman et a., 1992; Crowe and Meade 2007) suggests that there has been no damage to CBI from the crisis (e.g., Dincer and Eichengreen, 2013).
  - Inflation targeting, broadly speaking, by CBs with a clear inflation/price stability mandate and operational independence remains the monetary policy paradigm.
  - Recent improvements. Fed now has an inflation target. BoJ and Abenomics.

Definition of CB Independence

- Definition of CB independence. Matters for the overall picture. Has CBI really been compromised?
  - CWC seem to base their assessment of independence on inflation outcomes and policy choices (e.g., QE vs. conventional monetary policy; banking sector support).
  - But is QE driven by ZLB or plain government finance motives? If it were the latter, one could frame it in the de jure vs. de facto dichotomy and what it means for measuring CBI (e.g., Cargill and O'Driscoll, 2013).
  - Recent studies study confirm the negative correlation between inflation outcomes and CBI (e.g., Posso and Towadros, 2013). Not clear that country size or openness matter.

The economics of small open economies in the GFC: did IT work because of exchange rate adjustment?



- Possible alternative to high trust explanation
- Exchange rate adjustment during the early stages of the crisis helped small open economies with IT (monetary policy autonomy).
- Situation was different in bigger (open) economies
- Positive QE spillovers to small open economies through long-term interest rates?