



Central bank independence and financial stability: A tale of perfect harmony?



Wolfram Berger^{a,b,*}, Friedrich Kißmer^c

^a Cottbus University of Technology, Chair of Macroeconomics, Erich-Weinert-Str. 1, 03046 Cottbus, Germany

^b GATE Lyon/St. Etienne (CNRS UMR 5824), 93, Chemin des Mouilles, B.P.167 69131, Ecully Cedex, France

^c University of Hagen, Universitätsstr. 11 (TGZ), 58084 Hagen, Germany

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ABSTRACT

In this paper we show that the degree of central bank independence influences the optimal choice of monetary policy strategy during potentially unsustainable asset price booms. We assume that central bankers have to choose between a policy that preemptively raises short-term real interest rates in the boom phase to prevent the build-up of a financial market crisis scenario and the cleaning-up strategy that ignores its impact on the likelihood of a future crisis. We find that the more independent central bankers are, the more likely it is that they refrain from implementing preemptive monetary tightening to maintain financial stability. These results stand in sharp contrast with the seemingly predominant view that central bank independence fosters financial stability. The intuition underlying these results is that a preemptive interest rate hike gives rise to, among other things, a lower inflation rate in the boom period. Whether this disinflation creates additional costs or benefits depends on the degree of central bank independence. It can benefit dependent central bankers who otherwise would suffer from a higher inflation bias; however, for independent central bankers, this disinflation leads to an undesirable undershooting of their inflation target.

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1. Introduction

The two decades prior to the most recent global financial crisis saw the emergence of a new consensus about monetary policy that highlighted, among other things, the importance of central bank independence (hereafter, CBI) and the affirmation of price stability as a mandated goal for monetary policy. This consensus view is not only well documented in mountains of academic literature but also corresponds to the remarkable changes in monetary policy practices that took place in many countries during that time. Since the late 1980s, many central banks have achieved more independent status, and the related revisions of the central bank laws generally have led to a greater emphasis on price stability.

Economic theory suggests that CBI, coupled with an explicit mandate for maintaining price stability, offers an institutional device for realizing the social benefits associated with low and stable inflation rates. In addition, a large body of empirical studies provides evidence that these benefits of CBI come about without apparent costs, such as a deterioration of real macroeconomic performance (e.g., increased output volatility, reduced economic growth). Moreover, it has even been claimed that CBI does not only help assure price stability but also fosters financial stability (e.g., Bernanke, 2010a; Arnone et al., 2009). Former conventional wisdom (i.e. prior to the recent global financial crisis) stressed that at least in the long run, no trade-off between price stability and financial stability existed. At first glance then, it might seem reasonable to expect a double dividend: those institutional changes that have helped achieve low and stable inflation rates seem conducive to a stable financial system as well.

* Corresponding author at: Cottbus University of Technology, Chair of Macroeconomics, Erich-Weinert-Str. 1, 03046 Cottbus, Germany. Tel.: +49 355 69 3956; fax: +49 355 69 3924.

E-mail address: bergerw@tu-cottbus.de (W. Berger).

In sharp contrast to the voluminous literature on the relationships between CBI and inflation, a still scarce, albeit burgeoning, research stream attends to the impact of CBI on financial stability.¹ Čihák (2010) argues that insulating monetary policy from political pressures implies that central bankers are less constrained from acting preemptively to prevent financial crises. He also presents some preliminary empirical findings that support the view that CBI fosters financial stability. Using a sample of yearly data for 79 countries between 1970 and 1999, García Herrero and Del Río (2003) provide evidence that higher values of CBI indicators are associated with a lower likelihood of a banking crisis. Relying on a broader set of financial instability indicators and a sample of 80 countries between 1985 and 2005 Klomp and de Haan (2009) also find a negative relation between CBI and financial instability.

However, such tentative findings regarding the link between CBI and financial stability should surprise those observers who recognize that both the recent global financial crisis and the Wall Street crash at the end of the 1920s, which led to the Great Depression, occurred during periods in which CBI had been comparatively high for an extended time. Thus in an analysis of historical experiences, Bordo (2010) cannot arrive at a clear-cut conclusion. However, he emphasizes that the U.S. Federal Reserve Bank's policy during the interwar period indicates that CBI can be harmful for financial stability if monetary policy is based on a flawed policy doctrine. Furthermore, insofar as CBI contributes to a high degree of monetary policy credibility and thus the existence of a low inflation environment, it may create the so-called paradox of credibility. According to Borio and Lowe (2002), a credible low inflation policy reduces the probability that investors and financial institutions assign to the occurrence of a future economic downturn and encourage them to engage in further borrowing and lending, respectively, thus driving up asset prices and private indebtedness. A credible monetary policy could therefore render the financial system, paradoxically, more vulnerable to adverse economic shocks.²

In this paper we analyze the nexus between CBI and financial stability and ask how the policy chosen in the run-up to an asset price bust depends on the degree of central bank independence. To do that we modify an otherwise standard New Keynesian model by integrating the degree of CBI – in dependence on political pressure – and the possibility of a financial crisis. To the best of our knowledge, this work belongs to the first attempts to model the impact of CBI on financial stability. We show that policymakers' optimal choice between a policy that preemptively raises short-term real interest rates in the boom phase to prevent the build-up of a financial market crisis scenario and the cleaning-up strategy that ignores its impact on the likelihood of a future crisis *inter alia* depends on the degree of CBI. In particular, our model results stand in sharp contrast to the view that CBI fosters financial stability. The intuition underlying this result is that safeguarding financial stability through a preemptive interest rate hike not only leads to output gap losses but also gives rise to lower inflation rates in the boom period. This can be beneficial for politically dependent central bankers, who must follow less hawkish anti-inflation policies than actually warranted by their own policy objectives. For independent central bankers the decrease in inflation only gives rise to additional costs because inflation gets driven away from its target. Therefore, the more independent central bankers are, the lesser their willingness is to prevent the occurrence of a future financial crisis.

We further show that if the cleaning-up strategy is chosen, it does not imply that central bankers should stay passive and view a potential detrimental asset price boom with benign neglect, as was apparently favored until the recent crisis by politicians and academics alike (e.g., Greenspan, 2002; Posen, 2006). As also suggested by Berger and Křížmer (2008) and Gruen et al. (2005) in a different set-up the optimal cleaning-up approach involves a preemptive loosening of monetary policy when central bankers confront a looming asset price bust in an attempt to accommodate the progressive deterioration of expectations before the crisis or overcome time lags in monetary policy transmission, respectively. Hence, our model suggests another important policy conclusion: Central bankers' willingness to adopt a leaning-with-the-wind strategy during asset price booms is higher when the degree of CBI is greater.

Our approach relates to the literature that deals with the hotly debated question of the extent to which, and how, monetary policymakers should adjust interest rates when they observe rapidly rising asset prices. Prior to the recent financial crisis, the conventional wisdom regarded interest rate policy as an overly blunt tool to deal effectively with asset price boom-and-bust cycles. The best monetary policy could do instead was to mitigate the adverse effects on inflation and the output gap after the bubbles burst ("clean-up").³ Recently, sparked at least partially by the global financial crisis and its severe economic repercussions, this consensus has started to falter (White, 2009). Studies such as Berger et al. (2007), Bordo and Jeanne (2002), Gruen et al. (2005) and Woodford (2012) stress that under certain circumstances monetary policymakers should be ready to act preemptively to prevent future financial crises.⁴ Similar to our paper these studies show that the optimal policy response to an asset price boom depends in a complex way on various economic determinants, such as the probability of a bust-induced credit

¹ Since the outburst of the recent financial crisis, intensive debate has also raged about the reverse causality, namely, how financial instability affects or should affect the (optimal) degree of CBI (e.g., Blinder, 2010; Bordo, 2010; Cukierman, 2011a, 2011b; Goodhart, 2010). Alesina and Stella (2011) point out that the crisis has shaken the foundations of economists' knowledge about monetary policy so profoundly that many questions about the conduct and institutional design of monetary policy, which once were regarded as consensual, are back on the agenda. Raising the normative question of how the optimal degree of CBI is determined has a long tradition in the literature since the seminal work by Rogoff (1985). However, doing this in a financial crisis context is beyond the scope of this paper.

² Bean et al. (2010) provide some evidence that the reduction in macroeconomic volatility has been an important factor for explaining real credit growth, as well as real house price growth in the United States and United Kingdom during the period (2002–2005) prior to the outburst of the recent financial crisis. They support the view that a more credible monetary policy contributed to the "Great Moderation" and potentially added to an unsustainable asset price boom through this indirect channel.

³ See, e.g., Bernanke and Gertler (1999,2001), Greenspan (2002) and Posen (2006).

⁴ In contrast with prior studies, these contributions model the build-up of a financial crisis scenario as an endogenous process that partly depends on monetary policy.

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