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A Note on the Independence and Governance of Asia-Pacific Central Banks

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Majority of central banks have embarked on establishing their autonomy from national governments, as well as improving their own governance mechanisms to meet the price stability objective. Central banks became independent a few years after the publication of the paper explaining the dynamic inconsistency in macroeconomic policy by Kydland and Prescott (1977), which called for long-term commitment from the central bank, with the conduct of monetary policy devoid of any form of influence from governments. Consequently, the spate of financial bubbles and crises in the past two decades prompted not only private companies, but also government agencies, to become more transparent and accountable in their transactions.

Central bank independence is important for monetary authorities, and this independence was further emphasized as a crucial ingredient for inflation targeting (IT) economies. Ever since New Zealand's adoption of IT as its monetary policy framework,[2] a number of industrial and emerging economies have joined the bandwagon. The goal of price stability had become a permanent fixture in most countries, with an independent monetary authority as the well-established feature of the contemporary monetary order (Cukierman, 2006). In this regime, other goals, such as sustained economic growth and low unemployment rate, are being considered as "by-products" or subsequent outcomes of an IT framework (Allen, Baumgartner, and Rajan, 2006).

However, historical accounts beg to differ. In many advanced economies, as well as in a number of emerging economies in the post-Second World War period, economic development was seen as a crucial part of the central bank's responsibilities. Gerald Epstein (2007) suggested that there should be a return to the historical norm of central bank policy: wherein goals such as employment creation and rapid economic growth should join the goals of attaining price and financial market stability. The return of the central bank as an active institution in economic development had been further echoed by Dr. Joseph Stiglitz, who advocated that inflation targeting should be "abandoned".[3] The current rate of price increases in oil and food, and inflation in developing nations are imported from the United States and other oil-producing countries, would render an inflation targeting central bank as "not credible" and "powerless" in reducing domestic inflation at stable levels.

A number of studies appear to support the notion that a higher level of central bank independence leads to lower and benign inflation (Bade and Parkin, 1988; Grilli, Mascianandaro, and Tabellini, 1991; Cukierman, 1992; Arnone, Laurens, Segalotto and Sommer, 2007). Interestingly, though, Cornwall and Cornwall (1998), as well as Fuhrer (1997) and Kilponen (1999) found that a higher level of central bank independence could also lead to a higher unemployment

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[2] Under section 8 of the Reserve Bank of New Zealand Act of 1989, the bank should formulate and implement monetary policy *with the intention of achieving price stability* by the year ending December 1992. It is executed under the policy targets agreement between the finance minister and the governor.

[3] Posted on the web on 8 May 2008, as opinion page for Business Day (Johannesburg, South Africa). Dr. Stiglitz was a professor of economics at Columbia University, and was the 2001 Nobel Laureate in Economics.
http://allafrica.com/stories/200805080438.html

rate. These two separate findings suggest that the Phillips curve principle postulated by Mankiw (2007) was valid in that society faces a short-run trade-off between inflation and unemployment. Thus, this note seeks to determine whether a central bank should exclusively focus its energies on pursuing price stability, or if it should include employment generation as a complementary policy objective for central banks in the Asia-Pacific region.

Central Bank Independence

The concept of central bank independence could be attributed to the 1977 seminal paper made by 2004 Nobel Laureates Finn Kydland and Edward Prescott pertaining to the dynamic inconsistency of economic policy. This refers to the difference between the optimal policies that a central bank would announce if it were considered credible by the public, and the policies it would carry out after the public had made decisions on the basis of its expectations. In reality however, the public can discount the announcements of the central bank, and the resulting inflation rate will be higher than it needs to be. As a result, output may or may not rise above the full employment rate, depending on the wage rigidities present in the system that prevents complete wage and price adjustments. The incentive of policymakers to promote surprise inflation is constrained by the behavior of rational agents, creating an economy with inflationary bias (Halcon and De Leon, 2004). Thus, an important aspect of any reform is to make it credible over a longer time horizon, emphasizing the need for time consistency in both fiscal and monetary policies.

The degree of central bank independence refers to the bank's capability to formulate and implement its monetary policy in pursuit of a given mandate or primary objective (Abenoja, 1995). It is viewed in consensus as separating the monetary authority from the affairs of the national government mainly to avoid *seigniorage* – or net government revenues as a direct result of government instructing the central bank to finance its deficits via the printing of money (Abel and Bernanke, 2005). Thus, a relationship is formed between the central bank and its two agents: the national government and the general public. Central bank independence is a multi-faceted concept (Amtenbrink, 2004) as it has various dimensions:

- *Institutional independence* – monetary policy setting is the sole prerogative of the central bank. Thus, it does not enter into directives by the national government nor other agents or entities.

- *Legal independence* – a personality which allows it to exercise its powers and functions with full flexibility and accountability.

- *Personal independence* – fixed and secured terms of office for its decision makers. While they may be relieved from office by any competent national authority on the basis of civil service guidelines and stipulations, they are protected from summary dismissal.

- *Functional and operational independence* – the role of the monetary authority is controlling the monetary base through utilization of instruments at its disposal. It also extends to the absence of fiscal dominance that unduly compromises the conduct of monetary policy.

- *Financial and organizational independence* – full budgetary autonomy in carrying out central banking tasks and functions. This includes setting up own staffing and profit distribution mechanisms.

Arnone, Laurens, Segalotto and Sommer (2007) provided a global consensus of views on the principles of central banking autonomy as follows: (1) set price stability as the primary objective of monetary policy; (2) curtail direct lending to national governments; (3) ensure full autonomy for setting the policy rate; and (4) ensure no government involvement in policy formulation. The sequencing of central bank reforms were also illustrated as follows: Step 1 – clarifying the objectives and establishing basic instrument autonomy; Step 2 – further strengthening instrument autonomy; and Step 3 – further strengthening political autonomy.

Central Bank Governance

Amtenbrink (2004) indicated that the three pillars of central bank governance rely upon its independence, accountability and transparency. Analyzing for the principles of good governance, he concluded that due to the various legal complexities and varying degrees of these pillars among nations, a "guidebook" similar to the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies is the best option rather than what William Poole visualized as an "optimal central bank law". Moreover, Hall (2003) stressed that there is no "one size fits all" best practice governance framework after analyzing the governance structures of Australia and New Zealand – central banks who are under inflation targeting, as well as Hong Kong and Singapore – monetary authorities which place a major emphasis on exchange rate stability. Thus, central banks should continue aiming for monetary policy excellence and corporate governance on their own. In a recent working paper, Crowe and Meade (2008) stressed that more independent central banks tend to be highly transparent, while transparency is also positively correlated with measures of national institutional quality. Also, enhanced transparency practices are associated with the private sector making greater use of information provided by the central bank.

Tuladhar (2005) emphasized that under the governance structure of an inflation-targeting central bank, high transparency and public accountability are deemed crucial since they are used for anchoring public expectations of the inflation process. To maintain accountability, target breaches need to be publicly examined in accordance with the terms set out when determining the inflation target. Also, Van der Cruijsen and Eijffinger (2007) observed the tendency that more substantial research are being devoted to improving central bank transparency and communication to the business sectors, the national government and the general public as a whole. Evidence shows that improved transparency and communication provides the ability to move financial markets, as well as the potential to help the central bank attain overall macroeconomic stability. Indeed, central bank communication as a governance component had gradually developed into a vital instrument in a central banker's toolbox in managing market expectations.

Inflation and Unemployment

Unemployment and inflation – sometimes referred to as the "twin evils" of the macroeconomy – are among the most difficult and politically sensitive economic issues that policymakers face. High rates of unemployment and inflation generate intense public concern since their implications are direct and visible. Almost everyone is affected by rising prices, and few workers can be confident that they will never lose their jobs. The Phillips curve illustrates that based on United States data, a negative or an inverse relationship exists between inflation and unemployment (Abel and Bernanke, 2005).

The trend of inflation and unemployment rates, as well as the current status of inflation targeting countries under the Asia-pacific region, can be illustrated in Table 1. Countries such as New Zealand and Australia saw their inflation rates increase, but their unemployment rates declined considerably. In contrast, a number of emerging market economies in the Asia-pacific region had seen their inflation rates decline, but their unemployment rates increased. These trends appear to support the notion of a possible short-run trade-off between inflation and unemployment as represented in the Phillips curve (Mankiw, 2007).

Table 1. Movement towards Inflation Targeting (I.T.), with Inflation and Unemployment Trends

Asia-Pacific Country	Start / Plans	Inflation Trends		Unemployment Trends	
		1991-2000	2001-2005	1991-2000	2001-2005
Industrialized Nations					
Australia	1993	2.22	3.03	8.55	5.90
Japan	Not I.T.	0.83	-0.44	3.31	4.96
New Zealand	1990	1.76	2.48	7.75	4.56
Emerging Markets					
Indonesia	2005	14.67	8.92	4.73	9.57
Korea, South	2001	5.11	3.34	3.44	3.66
Philippines	2002	7.85	5.37	9.74	11.47
Thailand	2000	4.55	2.26	2.81	2.37
Azerbaijan *	3-5 yrs.	3.22	4.48	0.76	1.39
Kyrgyzstan *	3-5 yrs.	167.98	4.10	5.72	8.58
Pakistan *	3-5 yrs.	9.71	4.98	5.82	7.95
China **	> 5 yrs.	7.49	1.36	2.83	4.06
Sri Lanka **	> 5 yrs.	9.72	9.10	11.65	8.20
Vietnam **	> 5 yrs.	3.88	4.81	3.75	2.37
Bangladesh	Not I.T.	5.72	4.28	3.25	4.30
Cambodia	Not I.T.	41.59	2.87	2.14	0.91
Fiji Islands	Not I.T.	3.29	2.87	6.48	7.40
Hong Kong	Not I.T.	5.48	-1.35	3.17	6.54
India	Not I.T.	9.05	3.98	2.62	3.13
Kazakhstan	Not I.T.	303.47	6.81	11.97	9.01
Laos	Not I.T.	34.40	10.32	3.63	5.03
Mongolia	Not I.T.	76.73	6.96	6.55	3.68
Malaysia	Not I.T.	3.55	1.76	3.18	3.54
Taiwan	Not I.T.	2.59	0.69	2.18	4.66
Tajikistan	Not I.T.	25.15	15.00	2.03	2.25
Uzbekistan	Not I.T.	36.94	15.08	0.30	0.36

Source: Batini, et. al. (2006) and IMF (2006) "Inflation Targeting and the IMF", Tables 1 and 2

Notes: Selected Asia-Pacific countries. Average Inflation and Unemployment calculations by researcher.

* Countries which sought Technical Assistance from the IMF.

** Countries which did not sought Technical Assistance from the IMF.

Results from the Pooled Least Squares Regression

Relating CBIG indices with inflation variables, three observations can be drawn: (1) the accountability/ transparency component was negative and significant on all regressions using the three inflation variables; (2) the foreign exchange policy component was positive and significant; and (3) inflation results were mixed, consistent with past studies that the consensus on the inverse relationship between CBIG indices and inflation is still subject to further evaluation (See Table 2).

Relating CBIG indices with unemployment variables, two interesting observations were drawn: (1) the accountability/transparency component has a negative relationship with unemployment; and (2) the price stability component was negatively related in all the three unemployment variables. This result validated the Epstein (2007) argument: that the unemployment rate could be a complement for inflation rates under increased CBIG indices. The negative relationships on the price stability objective and the accountability / transparency components of CBIG on both inflation and unemployment variables show that Phelps' claim (2006) was correct: that the inflation and

unemployment relationship is also a matter of institutions and governance mechanisms which formulate structural policies. The positive relationship with the legal, political, exchange rate and monetary policy components only goes to show that an increase in these CBIG components could possibly increase the rate of unemployment. It should be cautioned however that the econometric exercise focused more on the "direction" of the beta coefficients, and not necessarily putting much emphasis on the individual and overall statistical significance of these coefficients.

Table 2. Econometric Results - Pooled Regression (Multivariate - Without Control Variables) Using Eviews 4.0

Variables	INFLATION			UNEMPLOYMENT		
	STDEV	TRANS	RATE	STDEV	NAT LOG	RATE
C (Common Constant)	2.905061**	6.076697**	3.944316**	4.249179**	4.761170**	4.493118**
CBIG (Legal)	-0.466004	-1.008895	1.042980	0.592902	1.198540	1.495216
CBIG (Political)	1.253457	-1.111469	0.472968	0.553147	0.383850	1.991535*
CBIG (Accnt / Transp)	-2.277121*	-1.186730	-1.844560	-0.246115	-1.010762	-1.665544
CBIG (Price Stability)	-1.738754	0.443389	-1.196727	-2.482373*	-2.049659*	-2.993300**
CBIG (Exchange Rate)	1.191726	3.101427**	3.252305**	1.207989	2.385572*	5.833630**
CBIG (Mon. / Def Fin)	1.690252	-1.838634	1.036894	1.294230	3.783518**	5.187946**
Total Panel (unbalanced) observations	316	323	323	273[a]	291	291
R-Squared	0.042185	0.058944	0.025538	0.041180	0.086422	0.232388
Prob. (F-Statistic)	2.268186*	3.298839**	1.380249	1.904070	4.477600**	14.32973**

Notes: ** .01 level, * .05 level of significance. Values are in t-statistics. Method: Pooled Least Squares.

Period: 1991-2005 / Cross-Sections: 25 / White Heteroskedasticity-Consistent Standard Errors and Covariance

[a] Under STDEV unemployment, there are only 22 cross-sections / 3 were dropped due to insufficient number of observations

Implications for Inflation Targeting Central Banks

Amidst the clarion call of Dr. Stiglitz to abandon inflation targeting, Asia-pacific central banks under the inflation targeting framework should not worry too much for two reasons: First, central bank independence was already established as an institutional requirement not only for successful inflation targeting but also for creating a credible monetary authority insulated away from national government affairs; and second, the inflation targeting framework uses a comprehensive set of information to accurately calibrate adjustments in policy interest rates – wherein part of the comprehensive set is the fluctuations in the rate of unemployment, as well as on the adjustments in labor wages. Along with central bank independence, there is now also a widespread acceptance of the idea that having good governance of institutions, as well as having incentive structures, is becoming an important precursor for growth and development (North, 1990). Also, even if monetary policy actions cannot directly handle the unemployment situation, central banks keep a constant and close watch on any unusual or sudden increase in the unemployment rates (Tetangco, 2005).

In the end, economic stability is anchored on price stability, which ensures that a currency preserves its purchasing power and retains public trust. It also includes a stable financial system with a considerably vibrant capital market. This is the responsibility of central banks – for their monetary policy actions ensures control of the price level over the medium and long term (Papademos, 2007).

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