# On Monetary Policy and Central Bank Independence

*Kabir Hassan*[1]
*Shah Abdul Hannan*[2]

An independent Supreme Court Justice cannot be fired for rendering unpopular decisions. The rationale for having an independent Supreme Court is a belief that majority rule may sometimes produce undesirable outcomes. An independent Supreme Court limits the power of transient majorities to alter certain fundamental rights of a nation and thus contributes to its long–run stability. Alex de Tocqueville [1969] once said that an independent Supreme Court helped to protect against the "tyranny of the majority". Like an independent Supreme Court, should the central bank of a country be independent? What ought to be the goal of an independent central bank and how does the bank achieve this goal? What is the relationship between an independent central bank and price stability of the country?

John Maynard Keynes wrote in 1924 that "...the [Treasury and Bank of England] should adopt the stability of sterling prices as their primary objective". Across countries, there appears to be an inverse relation between average inflation and the degree of central bank independence. It is noted that most economists believe that monetary policy can have important effects on output and employment only in the short-run; in the longer–run, the central bank can affect inflation but not employment.

The history of money over the past two centuries shows nations groping for lasting institutional structures that provide incentives to limit their own governments' temptation to debase their currency in order to satisfy shortsighted political objectives. The approaches used in the past have stemmed directly from both the nature of money prevailing at the time and societies' views about the proper role of government. Nobel Prize winning economist Hayek put it this way: "History is largely a history of inflation, and usually of inflations engineered by governments and for the gain of governments." What remains uncertain is the mechanism that will

---

1 Associate Professor of Finance, Department of Economics and Finance, University of New Orleans, New Orleans, LA, USA.

2 Chairman, National Board of Revenue, the Government of Bangladesh. The views expressed in this paper are entirely those of the authors and do not represent the official views of the National Board of Revenue or of the Government of Bangladesh.

prevent such history from repeating itself. More directly, the challenge remains to devise a sustainable institutional monetary arrangements that can protect the public from debasement of the value of its money. The fiat monetary standards, that are not supported by convertibility into intrinsically valued commodities, such as gold or silver, have created a widespread recognition that national monetary authorities should not deliver price stability unless careful attention is given to the incentive structures under which they operate.

Consistent attempts to expand the economy beyond its potential for production will result in higher inflation while ultimately failing to produce lower average unemployment. In fact, extreme rates of inflation (or deflation) may so disrupt the role of the price system in directing resources in a market economy that the result could be slower average growth and higher average unemployment. Although economists continue to debate whether reducing inflation from moderate to low rates would significantly improve the long-run performance of the economy, most believe that there are no long-term gains from consistently pursuing expansionary policies.

Inflation might affect potential output in a number of ways. First, inflation may interfere with the efficiency of the price system and make it more difficult for households and firms to make correct decisions, in response to market signals. It is often argued that when most prices are rising, economic agents find it harder to distinguish between changes in relative prices that require them to reallocate resources and changes in the overall price level that require no such microeconomic response.

Second, inflation imposes various cost on the economy that would disappear if prices were stable. The search costs imposed on buyers and sellers when prices change often, and the costs of economising on holdings of non-interest bearing money are familiar examples of the costs of changing prices.

Inflation also has differing effects on individuals. For example, the incomes of wage and salaried workers generally are adjusted for inflation only annually, whereas self-employed workers can alter the prices of their services more frequently. Similarly, inflation—especially when it is unexpected—tends to benefit borrowers at the expense of lenders. In case of farmers, inflation benefits the net sellers while reduces the real incomes of the net byers and thereby increases income inequality. Finally, because some parts of the tax code are indexed for inflation whereas others are not, generalized increases in prices have differing effects on individual tax-payers. As a result of these considerations, inflation often is perceived as causing unfairness, since some households and firms benefit and others are harmed.

However, whether or not these differential effects of inflation are unfair, they do impose real costs on society at large. They frequently add to the uncertainties that households and firms face, which may be undersirable even for those that turn out to benefit. And many activities that seek to reduce the impact of inflation on individuals may hurt the overall economy but yield no corresponding overall benefits. In an inflationary economy, for example, talented persons may devote their energies to developing strategies to avoid the deleterious consequences of inflation for themselves rather than to inventing new products and processes that would raise overall living standards. Unfortunately many of these activites that aim to mitigate the effects of inflation are counted as additions to measured GDP, even though they may not add to welfare in any meaning sense.

Finally, inflation may affect investors' saving and investment decisions, reducing the proportion of GDP devoted to investment and causing the economy to accumulate less productive capital. For example, when inflation is high, it usually tends to be more variable and so harder to forecast. Uncertain inflation makes it more difficult to deduce the real returns on investments from available market information. As a result, savers and investors are less willing to enter into long-term nominal contracts or to invest in long-term projects. The reduced stock of productive capital the results from decreased investment will, in turn, imply lower levels of future GDP.

In practice, most central banks care about both inflation and measures of the short-run cyclical performance of the economy. However, pursuing multiple goals can create conflicts for policy; for example, the desire to mitigate short-run downturns raises the issue of whether this goal should take precedence over a low-inflation goal at any particular point in time. Thus, it is important to avoid allowing short-run, temporary successes in preventing employment losses during recessions from leading to longer-run failures in maintaining low inflation.