José De Gregorio: Autonomy of the Central Bank of Chile, 20 years on

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, at the commemoration of the 20 years of autonomy of the Central Bank of Chile, organised by ICARE, Santiago, 29 October 2009.

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The autonomy of the Central Bank of Chile is enshrined in the Constitution, specifically in the Basic Constitutional Act of the Central Bank of Chile enacted in October 1989 that constituted a fundamental change for the functioning of the Chilean economy.

The Law stipulates that the Central Bank is an autonomous entity, of a technical nature, created in accordance with constitutional provisions, with full legal capacity, the full owner of its assets and of indefinite duration. Its third article states that "the Bank shall have as its purposes to look after the stability of the currency and the normal functioning of internal and external payments." It then adds that "the authority of the Bank, for these purposes, shall include regulating the amount of currency and credit in circulation, the performance of credit transactions and foreign exchange, as well as the issuance of regulatory provisions regarding monetary, credit, financing and foreign exchange matters."

In addition, it establishes that "no public expenditure or credit of any nature may be financed either directly or indirectly with loans granted by the Bank." Finally, article six states that "when passing its resolutions, the Board shall consider the general orientation of the Government's economic policies."

This is a clear mandate for the Central Bank of Chile, by which it establishes instruments and mechanisms for the designation and removal of Board members, as well as vehicles for coordination with the Executive.

In addition, its autonomy is further reinforced and legitimated through the achievement of said objectives and by the Bank's communication and transparency policy, whose effects go far beyond the provisions in the law regarding the obligation to inform about its decisions.

In this presentation I will address some of the main elements concerning the autonomy of central banks, as well as an evaluation of the principal accomplishments of the past twenty years.

The reasons for pursuing autonomy

High inflation is costly for society because it is associated with higher price volatility, which distorts resource allocation. Erroneous price signals lead to mistaken investment decisions, that is, to a less efficient use of resources, which reduces the economy's productive capacity and, ultimately, its growth.

There is abundant evidence of the harmful effects of inflation on long-term growth (Barro, 1995; De Gregorio, 1995).

But, why does inflation tend to be higher when the central bank is not autonomous?

To begin with, there is a need for public expenditure financing. There are various reasons why there is always pressure to increase public spending. Many of them are well-known and it is beyond the purpose of this presentation to discuss them. The truth that this tendency to raise public spending combined with the fact that the inflation tax is easy to collect, creates a natural pressure towards higher inflation.

Numerous episodes where fiscal objectives have dominated price stability goals have resulted in significant inflationary spirals, which are very costly for society. This fact is well-known in Chile and in the rest of our region.

A second element behind the inflationary bias has to do with the so-called dynamic inconsistency problem. In parallel with the tendency of the government to increase public spending comes the incentive to boost economic activity above sustainable levels. There are several reasons for this to occur. Potential market failures may result in a less than socially optimal output level, or political cycle motives can lead the central bank to try to boost economic activity beyond the level believed to be sustainable in the medium term. How can the government (the central bank) generate a higher output level? By surprising economic agents with a higher than expected inflation rate. The inflationary surprise increases aggregate demand and output.

However the public fully understands this situation, so the final result will be higher inflation and output at the same level as it would have reached without the inflationary surprise. Inflation cannot generate permanent increases in output. In other words, more inflation is created but not more activity, which reduces welfare.

Granting autonomy to the monetary authority has been a way to establish a credible commitment with price stability while, at the same time, allowing it to implement a monetary policy that helps to smooth the business cycle.

To the extent that the central bank is independent of the government's financing needs, the inflationary bias that is attributable to financing a recurring public deficit will be eliminated.

In addition, increasing the horizon of a central bank, which is related to greater independence, reduces the dynamic inconsistency problem because its interaction with economic agents is repeated over time. Within this context, the central bank's reputation acts as a self-regulating mechanism for its behavior. Therefore, the longer the planning horizon of the central bank, the greater the probability of it implementing efficient policies. This significantly strengthens the capacity of the central bank to deal with external shocks.

For an open economy like Chile, the credibility of its central bank can have important effects on competitiveness. A credible central bank, where inflation expectations are anchored, will experience a smaller pass-through coefficient from the exchange rate to inflation. This allows the central bank to respond with more flexibility to shocks requiring a real exchange rate depreciation.

To summarize, if there is confidence in the central bank's anti-inflationary commitment, the central bank can react more flexibly to various shocks and, in this way, minimize deviations of output from its potential level.

The central bank can smooth the business cycle while preserving price stability. The key element in this strategy is the credibility of the central bank's commitment to price stability, for which communication and transparency are crucial.

Autonomy and transparency

Autonomy means that the State delegates to the central bank the administration of monetary policy, such that it be applied using technical criteria and with a medium-term horizon. Here is the first reason why central banks must be transparent: to preserve the legitimacy that an autonomous institution must have in a democratic regime, particularly one whose decisions have important implications on the nation's well-being. Autonomous institutions must properly inform the country of their actions.

In Chile, the delivery of information is determined in the Basic Constitutional Act, which establishes that, once a year, the Bank must inform the President of the Republic and the Senate about the general policies and regulations it dictates in exercising its mandate. This is done every September, when the Board of the Central Bank presents its *Monetary Policy Report* (IPoM) before the full Senate. Nonetheless, the Bank has substantially enlarged its information disclosure function, taking important steps forward during this year. First, since March, the background minutes prepared by the Research Department are published on our website the day before the monetary policy meeting. This way, the public has the same background information as the Board does when making its monthly monetary policy decisions. Also, the Board announced that, as of next December, it will increase the frequency of the IPoM from three to four issues per year.

Additionally, the Bank publishes the *Financial Stability Report* twice a year, in December and June, and publishes its yearly account on the administration of international reserves once a year as part of its Annual Report.

But this is not enough. Legitimacy is strengthened through direct, open, and non-exclusive communication with the general public and, for that reason, the aforementioned documents are uploaded onto our website at the same time as they are being presented. In addition, the Bank issues other reports, communiqués, minutes, specialized studies and statistical publications, all of which are available to the public. These are complemented by presentations by Board members or staff, which are also uploaded to the website.

The times when central banks' operations were complex and indecipherable are being left behind. It is our objective – although it is difficult to accomplish – that the community understands our work, which is to provide the public good of stability that allows the country to progress, and is not an operation carried out by technocrats with incomprehensible criteria.

There is another important reason why central banks need to be transparent: the efficacy of monetary policy. In the past few years, advances have been made towards consensus that a more predictable monetary policy is better, without itself being a source of noise and instability. To that end, it is necessary to properly communicate our vision of the way the economy works and how monetary policy decisions affect inflation.

Results

During the 1990s there was a substantial increase in the number of autonomous central banks; many countries enacted legal reforms favoring central bank independence (table 1).

The evidence shows that the increase in central bank independence has been associated with a reduction in inflation (Figure 1). This is valid for both developing and advanced economies, and confirms the findings of a large body of research that includes more rigorous statistical analysis to verify the robustness of the partial correlations. Also, higher degrees of independence have helped to reduce inflation volatility. Therefore, autonomy is the adequate strategy to correct the inflationary bias. In summary, the evidence indicates that higher degrees of independence are associated with lower, more stable inflation and, hence, with increased growth.

In Chile, over the twenty years of central bank autonomy, inflation has averaged 7.5% per year. In the last decade, where inflation has been 3.2% on average, output volatility has dropped markedly with respect to previous decades (Figure 2). These results suggest that the conduct of monetary policy by an autonomous central bank has had a first-order effect on our macroeconomic performance.

As for the inflationary process, the research findings are encouraging. The greater credibility of the Central Bank regarding its inflationary objective, which is confirmed directly in the market's inflationary expectations two years ahead, has reduced the well-known tradeoff between inflation and growth.

The evidence shows that today inflation is better anchored in future inflation expectations. Inflation looks less to the past and more to the target. This means that when shocks hit the economy, the adjustments entail a smaller stabilization cost and, therefore, more output stability, without jeopardizing the inflationary objective (Céspedes and Soto, 2007).

Proof of the importance of the central bank's autonomy and the associated gain in credibility has to do with the capacity to implement countercyclical policies.

The stabilizing actions of an autonomous central bank allow it to confront negative shocks without sacrificing credibility. A good example is the recent Chilean experience. The substantial injection of liquidity and the subsequent sharp cut in interest rates as a response to the international financial crisis of September 2008 occurred within a context where inflation expectations over the policy horizon remained in line with the inflation target.

The empirical literature on the Chilean case provides evidence of a negative correlation between the pass-through coefficient of nominal depreciations to inflation and the credibility of the Central Bank. Said credibility is fundamental to allowing the real exchange rate to contribute in the adjustments of the economy.

As for recent developments, the evidence shows that more autonomous central banks have implemented more aggressive monetary expansions (Figure 3).

Conclusions

Twenty years into the era of autonomy of the Central Bank of Chile, we can say that it has succeeded and it is consolidated.

There remain challenges ahead. The evolution of the economy in the past few years has raised issues that need to be further analyzed to improve the policy framework.

An objective look at reality – acknowledging the personal conflicts of interests I have in acting as an independent referee – shows that our country's current monetary policy has succeeded as never before.

The business cycle has been smoothed and low inflation has been consolidated. Inflationary expectations have stabilized and it is possible to implement a truly countercyclical monetary policy. Of great support has been the accountable and predictable fiscal policy.

The successes in the conduct of monetary policy owe to the work of many people. Many from outside the Bank have stressed the importance of its autonomy and its macroeconomic achievements, and have also made strong contributions to improving the conduct of monetary policy. This enables the consolidation of the institution.

Many from within the Central Bank have contributed decisively as well. Former Governors, former and current Board members, as well as a great contingent of excellent economists and professionals have contributed to the design of monetary policy, a better understanding of our economy, and to administering an institution to which the country has entrusted great responsibility and to which we have an enormous obligation of excellence.

Thank you very much.

Table 1
Evolution of the central banks' autonomy index and inflation (*)

I. Late 1980s

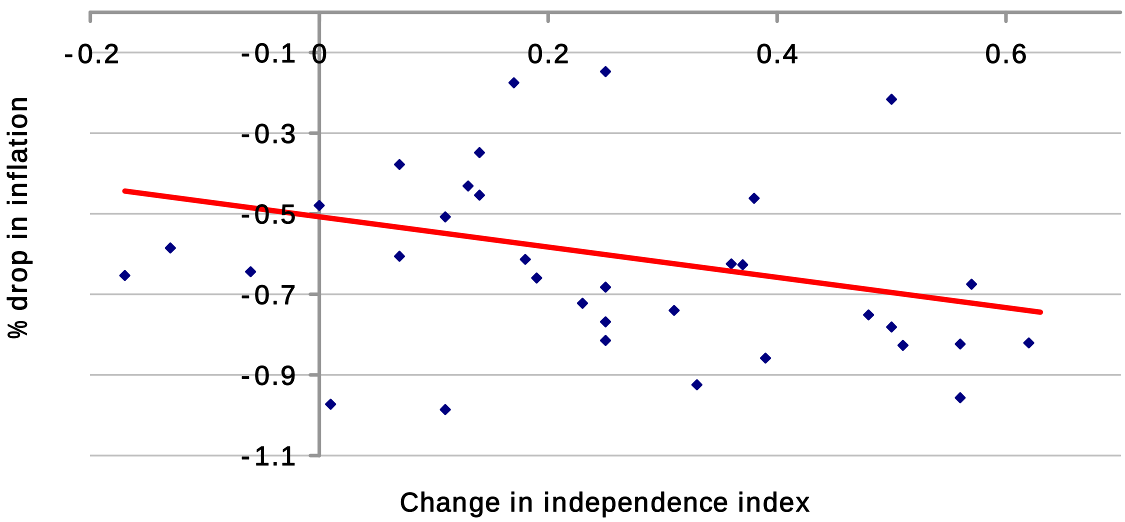
Economies	Average inflation (1989)	Autonomy index Political	Economic	Total
Advanced	5.3%	0.39	0.59	0.48
Emerging	18.6%	0.27	0.38	0.32
Developing	22.5%	0.27	0.45	0.35

II. 2003

Economies	Average inflation (1989)	Autonomy index Political	Economic	Total
Advanced	2.1%	0.74	0.81	0.77
Emerging	7.0%	0.47	0.75	0.61
Developing	8.4%	0.29	0.67	0.48

(*) Countries with annual inflation above 100% were deleted from the sample.
Sources: Arnone *et al.* (2007) and IMF.

Figure 1
Drop in inflation and change in the autonomy of the central banks*



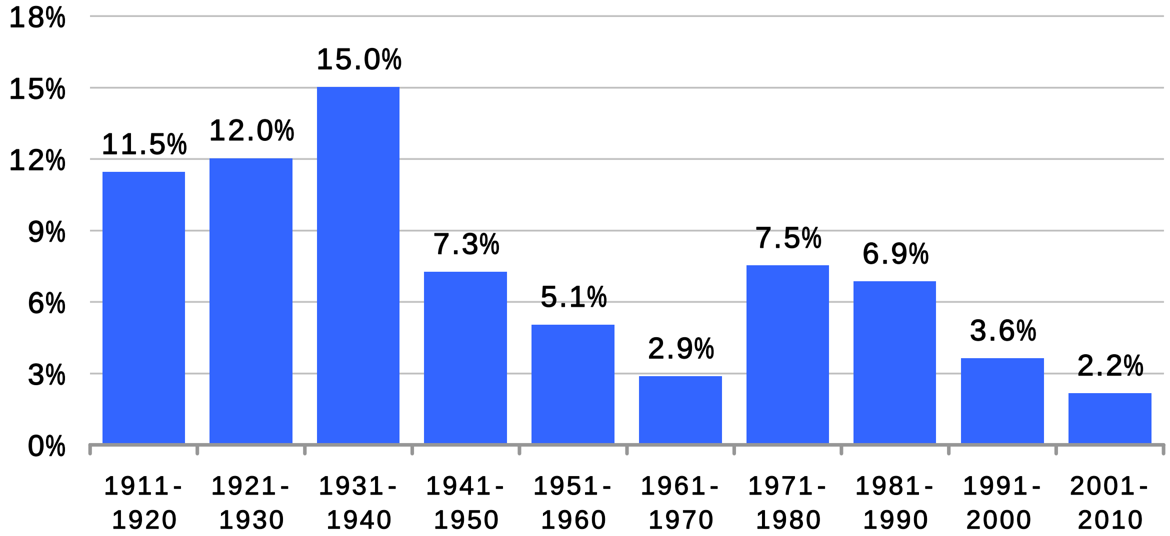
(*) Drop in inflation corresponds to the percent variation of average inflation between periods 1980-1989 and 2000-2008. Change in the independence index corresponds to the change in Arnone *et al.* (2007)'s autonomy index between the late 1980s and 2003.

Sources: IMF and Arnone *et al.* (2007)

Figure 2

Growth volatility in Chile, 1911-2010 (*)

(Standard deviation of the growth rate)

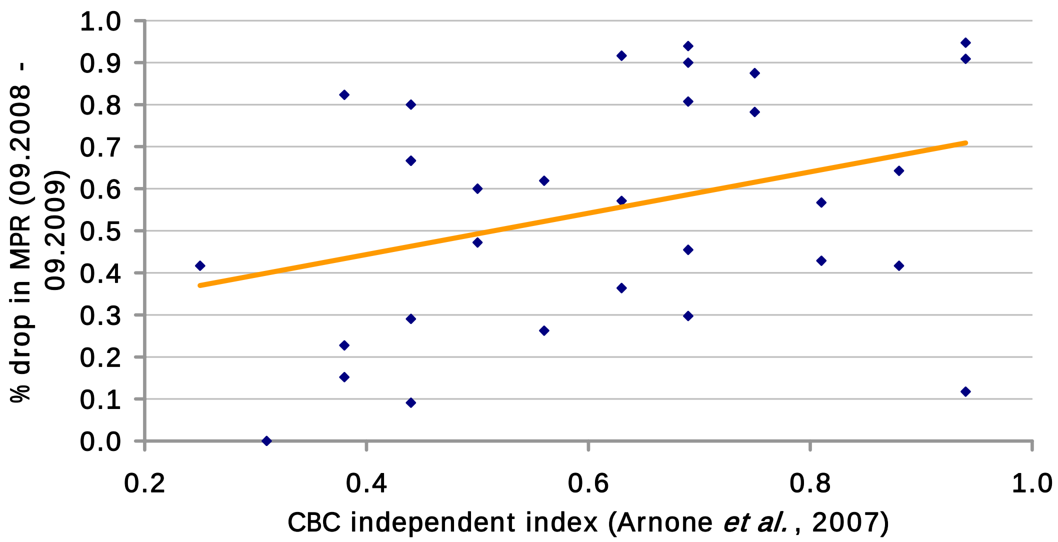


(*) 2009-2010 based on the IPoM of September 2009.

Source: Central Bank of Chile.

Figure 3

Percentage drop in the MPR between September 2008 and September 2009 and Central Bank independence



Sources: Arnone *et al.* (2007) and Bloomberg.

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