

Abstract

The purpose of this paper is to show the effect of central bank independence (CBI) on inflation in Mexico. We show that after suffering a period of high and volatile inflation during the 1970s and 1980s, inflation has been lower and more stable since the country's central bank (Banco de México, also known as BANXICO) was granted independence in 1994. We exhibit a simple theoretical framework which shows why CBI can lead to lower inflation and perform correlation and regression analyses to empirically understand CBI's effect (with data from Mexico and Chile). We were able to show that growth in the amount of money (as measured by M1 or M2) has indeed been strongly correlated to inflation, as one would expect in the monetarist framework. We could also show that CBI led to a significant reduction in inflation rates in Mexico. Finally, we were able to obtain indications in favour of the hypothesis that the central bank responded to recessions with increases in the supply of money prior to CBI (possibly with intentions to "stimulate" the economy) but that money supply and real GDP growth correlate positively during the post-CBI period (in line with the monetarist framework, this would imply that the central bank has been following a policy of price stability).