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"Central Banks: Independence, Mandates and Accountability"

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Central Banks: Independence, Mandates and Accountability

We all operate in economies where money and monetary exchange is a vital component. So how money is managed is everywhere a lively and important subject. And very appropriately, the subject gathers interest and concern well beyond the cares of central banks -- even though they have of course very relevant experience to bring to bear.

In recent years, such interest and concern has been apparent in many parts of the world. In particular, exactly what the role of the central bank, which is by definition the statutory creator of national money, should be in regard to how the nation's money is actually managed has been a subject of debate and reappraisal.

Change is very evident in Europe, as economic structures to help the process of European union are developed. There, on the monetary front, the strong record of the Bundesbank has been the central point of reference. But the process has been far from limited to Europe and the particular institutional concerns of European union. It is evident in the Antipodes and of course in the Americas. Clear central banking change has taken place in a number of countries in Latin America.

North of Mexico there's been a fair amount of discussion, but no significant shift. That is, of course, not the same as saying that everyone has been satisfied that the structures of monetary management in Canada or the United States are not also capable of improvement.

Now admittedly, the political environment and immediate motivation for re-examination and change may vary quite a bit across regions and across countries. However, the underlying economic argument for change, or at least for reappraisal in this area of central bank independence, mandate and accountability, is essentially everywhere the same.

And indeed, in my remarks I plan to be quite general. I will focus mainly upon the economics of the matter, without, I trust, having you forget that the territory is one that belongs squarely in the camp of political economy.

In reviewing the issues, I want to begin by suggesting how the various concepts tossed around in this area are most sensibly ordered. A number of ideas are important, but in my book some ideas definitely come first. After that broad exercise, I want to look particularly at the relationship between what central banks should do and how they should be set up to do it from the viewpoint of the open economy.

This is only being realistic. All our economies are open and are becoming increasingly exposed internationally. And while the general question of exchange rates and exchange rate regimes can well be a subject all in itself, this matter has such intimate links to what central banks might do in the real world that I cannot afford to ignore it.

Now to the matters at hand.

From the title of my remarks, one would readily infer that the main issue was the matter of central bank independence. Indeed, if there is one term that has become associated with this general territory of central bank polity, it is "independence" -- the wisdom of it for the central bank, or how the central bank should be given it.

Certainly, "central bank independence" has through custom and repetition become a useful way of identifying the kind of terrain to be covered. But if not put carefully in its context, the term can prove an obstacle to understanding what is really involved for monetary policy, and in particular for the central bank.

As the rest of my title -- "mandates and accountability" -- is meant to suggest, it is important to move

behind the essentially political concept of "independence". In particular, it is important to address what it is that would constitute an appropriate mandate, or purpose, for a central bank. To put it another way, I want to approach these matters by first posing the question: Independence (or "autonomy" if one finds that term less jarring) for what? The answer is to be found not in politics but in economics.

In the first place, it is now more widely accepted that inflation, rather than being part of the package for a good economic outcome, as used to be commonly believed, actually is a hindrance. It doesn't create jobs, not in the end. And by eroding the monetary underpinnings of economic exchange it can actually inhibit them. Both economic theory and economic experience have shown why and how this is so. Essentially, this demonstration involved the discrediting and demise of the view that there is a durable trade-off between inflation and jobs -- that is, that more inflation generates more jobs, for example.

An additional development that reinforces the case for improving confidence in the future value of a nation's money has been the shift in so many countries around the world to a more decentralized, market-based, economy. Such a shift means that the role of market finance and of investors' and savers' expectations become progressively more significant. There is

less reliance on command, more reliance on price signals and incentives. Expectations and price signals obviously work better in a climate of monetary stability. So does the tax system, by the way, if it is broad economic welfare we are concerned with as opposed to exploiting the inflation tax.

Now, considerations of this nature certainly suggest why national governments will, in the national interest, likely wish to follow less inflationary policies than used to seem acceptable. But this is only part of the answer to my question. It does not in itself show why a particular policy role in safeguarding the national currency should be entrusted to the central bank. As I already noted, the central bank is by definition the institution through which national money is ultimately created, but it does not directly follow that this institution should also decide how much money should be created. In fact, it doesn't even follow that there should be a separate central bank at all -- as opposed, for example, to a government department for primary liquidity creation.

The other part of the answer also stems from economic experience. It derives from the fact that while governments may wish in principle to engage in sufficient monetary restraint to deliver a non-inflationary outcome, in practice they tend to

compromise that principle under the pressure of other objectives that are likely shorter run in nature.

However, the problem with inflationary surprises, whatever their short-run attractions -- a good case in point is the political business cycle, or taxation through inflation -- is that people are bound to learn, or fear, that they are coming. The result then, to be very practical about it, is a trend of higher interest rates than the country need experience -- higher in real terms (accounting for risk premia) as well as in nominal terms. This of course is damaging to growth. So something needs to be done about the monetary policy decision-making process also.

The answer to this consistency, or credibility, problem is to establish a policy framework where the need to generate confidence in the future value of money is given explicit importance. That framework, to be robust, involves political precommitment. It involves ensuring that the institution statutorily charged with the creation of the nation's money be given the mandate and the tools to limit such money creation to a rhythm consistent with maintaining confidence in money's future value.

This is the essence of what is meant in institutional terms by monetary, or price, stability. And that is what I think must be behind the idea of an "independent" central bank.

I might add, and contrary to what often seems to be assumed, that such a mandate does not rule out monetary actions that help stabilize economic activity in the near term. What such a mandate does do is help ensure that such actions respect the longer term objective of maintaining trust in money. And this also is fundamentally stabilizing. Nor, and for similar reasons, does it stand in the way of the contributions the central bank can make to the stability of the domestic financial system through its lending of last resort.

Let me also add very briefly, in case it does not go without saying, that central bank "independence" does presuppose sound domestic fiscal management. To be very direct, the central bank cannot be viewed as creator of finance for government. To be sure, the bank will acquire government debt. But it will only buy such debt as required to fulfill its basic monetary responsibilities for the economy as a whole.

Now let me move on to discussing the matter of the central bank's accountability.

I will begin by emphasizing that a clear mandate is a vital requirement for proper accountability -- whether generally at the bar of public opinion, or specifically before the political authorities.

From my experience, a lot of the discussion on central bank accountability that takes place gives inadequate attention to this point -- the need for a mandate for the central bank that is clear, and which it can achieve. Rather, the discussion often tends to focus one rung down -- on the specific accountability mechanisms that might be used. These would be, for example, how and to which bodies central banks should report for monetary policy actions, and in which way the executive or the legislature might intervene in the monetary policy process. Such mechanisms need careful examination of course. But even more important -- indeed the essential starting point for proper accountability -- is the need to think hard about and to set out what it is that the central bank is supposed to be answerable for. What is needed is a monetary policy mandate that is clear and rooted in what monetary policy can achieve with the tools at its disposal. Without this, with the best will in the world it is difficult to see how the accountability mechanism can be truly effective. As the baseball player said, if you don't know where you're going, you may finish up somewhere else.

In Canada, the central bank and the Government are required to consult regularly on monetary policy. This means at least no surprises. And in the event of serious disagreement over the policy, the legislation provides that a directive on monetary policy can given to the Bank of Canada by the Government. Such a directive has never been issued. Still, this provision has been seen, quite understandably, as helping to clarify the accountability structure for the Bank. Furthermore, since the directive has to be made public, it adds valuable transparency that in a sense secures the Government's accountability in this particular regard as well as the Bank of Canada's.

All the same, in Canada the central bank's monetary policy mandate, contained in the preamble to its statutes, is demonstrably less than clear. Therefore, in the absence of a clear mandate, this directive provision might be seen more as giving the government the power of override rather than as being an instrument of accountability in the fuller, and better, sense of the term.

One potential area of economic override, perhaps in all countries, would be in relation to major shocks hitting the economy. I am thinking in particular of major shocks to supply and to prices through drastic economic changes -- in the supply

of energy, or through natural disasters, for example. One would trust, however, that a better formula could be found for dealing with such rare events than dropping the monetary stability framework itself.

It is of course possible, as in New Zealand, to create formal mechanisms for dealing with contingencies of this nature. But what needs to be stressed here is that a path back to monetary stability really must be seen as integral to the adjustment. Indeed, it is worth underlining that in the case of the Reserve Bank of New Zealand, and, I might add, in the case of the Bank of Mexico under the recent legislation providing it with autonomy, the law itself spells out that achieving price stability is indeed the institution's primary monetary policy objective. In other words, this objective, or monetary stability contribution, doesn't change unless the basic law governing the central bank is changed.

Thus far, I have sketched out some important features for a robust and constructive monetary policy role for a central bank. This sketch has highlighted the desirability of a central bank with a clear responsibility, and therefore powers, for safeguarding the purchasing value of the national currency -- thereby making a monetary contribution to good national economic performance overall.

I could now perhaps contend that there is little to add at this broad level and possibly embark on some more detailed examination of particular instances. If, for example, the discussion were being limited to the situation for the United States, there would be a lot of sense in going in this direction. For instance, one could discuss the adequacy of the Federal Reserve's mandate in terms of what monetary policy can really be expected to achieve and the extent to which it provides a basis for accountability. One could also review the particular accountability mechanisms that apply to the Federal Reserve, especially via the U.S. Congress, for example. Attention could also be given to the role played by the regional reserve banks in the whole constellation of policy independence, accountability, and political legitimacy.

However, for virtually all other countries, certainly all other countries in the Americas, this would leave out a broad consideration that logically precedes any review of particular central banking institutional arrangements. That consideration is the matter of the exchange rate regime.

The United States is a true exception in the matter of regime choices for exchange rates. It is an exception because of its economic size and the correspondingly dominant international role of the U.S. dollar. This means that aside from really

exceptional situations (such as those in 1971 surrounding the collapse of the gold exchange standard and the subsequent, and short-lived, Smithsonian Agreement on exchange rates; and again, perhaps, those surrounding the Plaza Agreement of 1985) the United States does not have the same kinds of possibilities as are in principle available to others in deciding upon an exchange rate relationship. In particular, the United States never really faces the classic polar choice of whether to peg or to float. One simple reason is that there is no other currency (or basket of currencies even) it could realistically fix to.

But for other countries of course, the question of the exchange rate relationship is a real-world decision point with real-world implications for monetary arrangements. It is therefore also a very important matter in regard to what the relevant central bank should be expected to do.

Judging from the conference program, exchange rate regimes will get quite a bit of discussion. And while it is a topic on which I have thought quite a bit, particularly in the context of Canadian choices, I will focus here on its relationship to the immediate matter at hand -- the particular role of central banks.

Clearly, arrangements such as common currencies, monetary unions, currency boards even, rule out a lot of what I have been discussing -- except, perhaps, as filtered through U.S. monetary policy choices. And no doubt such arrangements, centering on the U.S. dollar and therefore on U.S. monetary policy, might have a lot to commend them if the realistic alternative for the national partner concerned is a poor performance for its money when managed domestically.

Let me be clear, however, that I do not take it at all for granted that the common currency, or monetary union, route is the one that is in the cards. I would tend to agree with anyone who argues that merely deciding to fix the exchange rate without proceeding to a stronger form of link is likely not to be enough -- or even, to use Sir Alan Walters' famous phrase, that such a decision will be "half-baked". But I believe there are persuasive reasons why the fixed exchange rate loaf does not need to be put in the oven in the first place.

The reason I suggest that this route cannot at all be taken for granted is precisely because of the role that well-conceived national monetary policies, that is, with "independent" central banks along the lines I have sketched earlier, can play. They not only help sustain good domestic economic performance through the monetary route. They also help to promote a solid

financial and economic relationship across trading partners -- themselves in distinctive real economic circumstances.

The basic economic point in this regard is a non-monetary one. It is that the differences among many economies are large in regard to structure, and therefore in regard to how their economies are behaving at any given time. Therefore, variation in real exchange rates provides a valuable margin of adjustment and stabilization.

Clearly, if this is accepted as a valid approach then, realistically, nominal exchange rates can be expected to move around. And this movement will be part of the mechanism through which real exchange rates adjust in an economically appropriate manner.

What does this mean for domestic monetary policy?

What it means is that the reality of the open economy only reinforces the arguments made earlier from a purely domestic viewpoint. The "independent" central bank provides the domestic nominal anchor -- domestic monetary stability. In so doing it generates a stable monetary platform for nominal and real exchange rate movements that can be broadly supportive of coherent economic adjustments. Conversely of course, if monetary

policy does <u>not</u> provide a solid domestic anchor, the adverse effects from domestic financial uncertainty are more likely to make the exchange rate an additional source of instability. National monetary policy, and the exchange rate that goes with it, will then hardly do anything that is useful for the national economy as a whole.

This point should be taken further still. Such a central bank, acting in the way suggested, and in a way that is beginning to be realized around the world, would be promoting a profoundly consistent basis for economic adjustment across all nations. Furthermore, its actions would promote stability of the more lasting kind in exchange rates. This is because these actions would be based on national monetary policies rooted in sound and internationally consistent principles.

By way of conclusion, let me re-emphasize that any discussion about central bank "independence" should be viewed as a discussion about what it takes to generate a good monetary policy -- one that is purposeful and accountable. Such a policy is public good. Moreover, it not only pays off within national borders. It also provides a robust framework for good monetary linkages <u>across</u> such borders.