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Central Banking in a Democracy:  
Balancing Independence and Accountability

Remarks by

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It is my pleasure to be here this afternoon to address this distinguished group. I can think of no better sponsor for our discussions than the University of Chicago. The distinguished academic tradition of that institution and its role as a bastion in the intellectual defense of liberty is world renown.

That tradition is honored here today by the presence of so many of my central banking colleagues from Eastern Europe. The remarkable developments in their nations in recent years and the tremendous undertaking they now face represent the practical challenge to the cause of liberty in which we all believe.

Central banks are one of the key institutions for the proper functioning of a liberal political and economic regime. Yet the precise position of a central bank in such a regime is ambiguous. The demands of democratic governance argue for accountability of the central bank to the desires of the electorate. At the same time, the importance of a stable and dependable medium of exchange to the smooth functioning of a market economy cannot be underestimated. This latter requirement may necessitate some capacity for the central bank to resist short term political demands.

The tension between political democracy and economic liberty exists in many forms in our societies. Yet few of us would freely choose to dispense with either democracy or economic

liberty. We must therefore view this tension as an inevitable one, and do our best to harness it in a healthy way which produces sound public policy. The focus of my remarks today will be on the practical realities of maintaining central bank independence in a political democracy where accountability is indispensable.

An appropriate place to begin is to briefly review the theoretical and empirical case for central bank independence. I will defer to the many distinguished academics and practitioners on the various panels for their detailed analyses of central bank operation and performance. But, a brief review of opinion in this area will help set the stage for my remarks.

The *raison d'être* of central bank independence centers on the issue of inflation and its effects on both short term and long term economic performance. While economists are prone to disagree on the details of the interaction of inflation and the real economy, I believe that a consensus now exists on this subject. In the short term, it is quite likely that temporarily higher levels of output and employment can be obtained by money creation. But, in the longer term there is no tradeoff between inflation and output. Indeed, the price of temporarily lower unemployment is often likely to be permanently higher inflation.

The tension between short term and long term economic developments sets the stage for the first of two arguments in favor of maintaining central bank independence from the political process. While much economic theory is premised on the

existence of omniscient planners interested only in social welfare maximization, elected governments are in fact comprised of ordinary human beings with their own individual interests. The desire to be reelected is quite a normal part of their individual preference functions. It is therefore only natural that their willingness to trade off short term costs for long term benefits may vary with the period until the next election.

In economic modelling terms, we might characterize this behavior as a variable rate of discount on policy decisions. As election time nears, the rate of discount rises sharply. Short term benefits become quite attractive, even at the price of high longer term costs. Similarly, short term pain for the electorate rises sharply in cost, in spite of potential longer term benefits. Thus, the attractiveness of purchasing temporarily higher growth even at the price of permanently higher longer term inflation greatly increases as election time nears.

Alternatively, after a government receives a mandate, its rate of discount on policy decisions falls markedly. The objective is the next election which may be four or five years distant. Being able to run as a government which reduced inflation may well have some political benefits. A rational politician therefore might well choose to tighten monetary reins just after an election, thus reducing inflation, while planning to stimulate the economy in the runup to an election. Elections therefore would tend to dictate the timing of the business cycle with rapid periods of expansion preceding and during election

years and periods of slower growth following elections. Indeed, in America there is a long literature on the so-called "political business cycle", which began with work by Nordhaus (1975) and MacRae (1977) in the mid 1970s.

Such behavior would be harmless political sport if there were no costs associated with economic cyclicity. But at minimum, cyclicity involves an uneven distribution of sacrifice by individuals. And, while some theories suggest that some degree of business cyclicity is inevitable, even beneficial, an excess of cyclicity -- particularly cyclicity which is artificially induced -- will tend to lower the long term output of an economy. Output is foregone during downturns and is inefficiently produced at times of excess capacity. From the perspective of maximizing economic efficiency and long term output, limits on the ability of a government to time economic circumstances may prove beneficial to the long term level of societal well being.

The second argument for maintaining central bank independence is that a democratic government may permanently choose a rate of inflation in excess of the socially optimal level. The reasoning here centers on the assumption that inflation represents a means of transferring wealth from creditors to debtors. While the theoretical existence of perfectly rational expectations would make an actual transfer of wealth impossible, the mere presence of an assumption that such a transfer would take place may be sufficient for an electoral bias

toward inflation.

The political case for inflation is most clearly seen in a democratic society in which debtors outnumber creditors. The reality, or even the widespread assumption, that a wealth transfer is taking place would make inflation popular among the majority of the electorate. Further, the existence of economically irrational views such as "money illusion" makes the constituency for inflation potentially even bigger. As a central bank governor, I am particularly struck by the number of retirees who yearn for a return to the high-inflation, high-interest rate days of the late 1970s. Although the real returns to saving are essentially unchanged, and the real after-tax returns are higher in the present low inflation environment, these individuals felt most comfortable consuming the cash flow generated from the inflation driven depreciation of their stock of wealth.

The political imperative for inflation becomes particularly challenging when the government is the largest debtor in the society. Here, some form of "political illusion" may be involved. Inflationary finance may prove attractive to the government of the moment when it is viewed as less painful politically than either tax increases or spending cuts. This incentive may be particularly strong around election time due to the high rate of discount applied to policy decisions, as discussed above. In its most extreme form, governments may be tempted to monetize their outstanding debt rather than ask current taxpayers to bear the interest burden of political

decisions of past office holders.

These two arguments might be termed the "cyclical" and "secular" incentives for democratic governments to pursue inflationary policies. Together, they lead to the conclusion that a central bank which is independent from the political process would be more likely to pursue more stable monetary policies. While international comparisons must be treated with care, this link between central bank independence and inflation has been empirically tested. The pathbreaking study by Alesina and Summers (1993) showed higher average inflation rates to be correlated with low degrees of central bank independence. Therefore, as an empirical matter, independent central banks do in practice face the challenge of checking a likely political desire for higher inflation.

Let me stress that the responsibility for resisting political pressures is not an easy task for a central bank or any other institution in a democratic society. The case for doing so at all is based on the assumption that there is a failure in the political marketplace which a central bank must correct. More precisely, we must assume that the socially optimal rate of inflation is lower than that which may be chosen by the political process at any given time.

The cyclical problem described above indicates a market failure because of what economists might term an agency problem - the true social rate of discount on policy decisions tends to be constant while that of our democratically elected policy

agents, the government, will vary with the election cycle. The secular problem that inflation rates in excess of their economically optimal rate may be preferred by a majority of voters presupposes that there are real resource costs lost to society as a whole from high inflation. The real or perceived transfer payments from creditors to debtors associated with inflation, on the other hand, involves no increase in aggregate social welfare.

Even though these market failures may give us some theoretical comfort that we are doing the right thing when we resist political pressure to inflate, caution is always appropriate when a policy maker assumes that his or her perception of the social optimum differs from majority will. Therefore, the first practical condition for central bank independence must be popular support for the concept of an independent central bank. In essence, the advantages of independence must be sufficiently manifest to the body politic that they or their agents must approve legislation for an independent central bank, and continued political support must be sufficient for that independence to be sustained.

The American experience with central banking involved two failed attempts in the early years of the Republic before a permanent structure was established in 1913. Indeed, the early political battles over central bank independence have left a permanent scar on our Nation's capital, which those of you who have visited Washington may have seen. Pierre L'Enfant, the

architect who designed Washington D.C., intended Pennsylvania Avenue to be a broad boulevard running directly from Capitol Hill, where Congress meets, to the White House, where the President resides. In the late 1830s when the battle over the second Bank of the United States was at its height, President Andrew Jackson -- an opponent of the Bank -- is reported to have stormed out of the White House and planted his cane in the middle of Pennsylvania Avenue. He insisted that the Treasury Department building, just being constructed at the time, have a cornerstone where he planted his cane. History tells us that his publicly stated reason for building the Treasury at that place was to physically block his view of the Capitol where supporters of the Bank were having their way. The result of this debate is a permanent bend in Pennsylvania Avenue, around the Department of Treasury, which blocks L'Enfant's plan for an unobstructed vista between the headquarters of our legislative and executive branches.

The Federal Reserve is a creature of the Congress which established it. At any time legislation could be enacted which abolishes us or alters our status. Indeed, legislation to make such changes is frequently introduced, though it rarely moves far in the legislative process. The ultimate reason for this is a widely held perception that whatever the quality of American monetary policy by the Federal Reserve, direct or even increased political control would not enhance the situation.

Practical political support, I believe, rests principally

on the central bank carrying out its mission in a reasonably successful manner. It is therefore vital that the central bank strive to maintain the public appearance of independence, as well as its statutory and practical reality. If it were perceived that the Central Bank were in fact merely bending to the will of the directly elected agents of the public, there would be no case against monetary authority being vested in those political agents.

The public is always skeptical about the Federal Reserve's independence of action. I believe that this is a natural outgrowth of a healthy skepticism about government in general. Last week I was addressing students at one of our midwestern universities and was asked for a reason why they should believe that my actions were independent of what the President wanted me to do. Taken aback by the frankness of the question, I resorted to a standard economic model of behavior: self interest.

I asked the students what the President could do for me if I did his bidding. First they said -- reappointment. I informed them that a single fourteen year term was more than enough for my tastes, particularly because I value my marriage. Desperate to find some reason for me to do the President's bidding, the students resorted to the potential value of being able to see the White House tennis court. I responded that I had, in fact, seen it and it looked like any other tennis court. I think the class left convinced.

In addition to acting independently, I believe that central

bankers have a responsibility to explain to the public what they are doing and why. There is a widespread perception that we are monks who are secluded in our cloister. I think that perception is belied by our travel schedule and our regular interaction with groups from different parts of the country and the world. Regular interaction with the public not only informs the central banker about what is actually happening in the economy, it reassures the public that public policy is being made in a rational way which has the national interest as its goal. I believe that genuine two-way communication between the public and central bankers is vital to both central bank performance and central bank independence.

A final part of maintaining public support for central bank independence involves public education regarding economic principles -- particularly regarding the harmful effects of inflation. If a key reason for being independent is to resist pressures for inflation, it is important for the central bank to explain and remind the public that inflation has pernicious consequences and few benefits. Of great importance in today's economy is a continual reminder that the alleged redistributive benefits of inflation are, in fact, illusory. Such redistributions rely on either a lack of information or a lack of anticipation of policy changes. But modern financial markets' rapid flow and dissemination of information mean that changes in inflationary expectations are rapidly built into the cost of money. Unanticipated inflation changes are therefore much less

likely. Debtors therefore tend to pay creditors up front for inflationary finance.

Another practical condition for central bank independence is respect for the independence and integrity of the other institutions of government. It is unlikely, indeed almost unthinkable, that a truly independent central bank could exist in a society in which other aspects of political and economic power were centralized in one place. Machiavelli commended his Prince, an autocrat, to be sure to "control the currency and the courts". No sensible autocrat would do otherwise. Thus, the existence of checks and balances within the government, and within society, are key to the independence of the central bank.

Private sector institutions, such as a fairly decentralized and independent commercial banking system, are a natural bulwark to central bank independence. It is hard to imagine meaningful central bank independence when the commercial banking system is controlled by the political process. The Federal Reserve is fortunate to have substantial private sector underpinnings in its regional Reserve Bank network. The Boards of Directors of the Reserve Banks are independent of the political process and represent the banking, business, and community interests of their regions since they are either elected by local bankers or selected by the Federal Reserve Board of Governors.

Central bank independence also requires independence from other economic institutions, particularly those involved in commercial activities. Credit allocation by the central bank can

result in the abrogation of its independence. If the central bank must direct its monetary policy based on the commercial needs of enterprises over which it has no direct control, then the stated objective of checking inflationary tendencies in the political process must take second priority. Thus, central banks will be turning their primary mission over to the individuals who head the nation's commercial enterprises.

But respect for the political, as well as the economic, institutions of our society is also vital. The Congress has a responsibility to oversee our activities. Members of the Federal Reserve Board and senior staff frequently testify before congressional committees and answer written inquiries about the conduct of monetary and regulatory policy. The General Accounting Office audits the non-monetary policy functions of the Federal Reserve. We also have frequent formal and informal contacts with members of the Administration and with both federal and state regulatory bodies. The views of these officials, both elected and appointed are valuable to the Federal Reserve Board. One should never view independence as being so vital as to permit ignoring the views of others with different responsibilities. Respect for the views and independence of these other institutions of government is a key part of our maintaining our own independence.

In the end, the tension between accountability and independence is one which cannot be escaped. As a rule, we tend to view accountability and independence as polar opposites. But

in a democracy, this is not entirely the case. A central bank which stresses only its independence and ignores its ultimate accountability to the body politic may soon find its independence at risk. It will have lost touch with its ultimate mission -- serving the public at large. The basis of our independence is the role we can play in correcting some imperfections in the normal democratic process. But our independence is granted democratically by that process. Maintaining our independence is what we will be held accountable for and remembering that we are accountable is the key to our independence.