

Discussant Comments
by Cathy E. Minehan

on Franco Bruni:
Central Bank Independence in the European Union
Bank of Japan

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I want to thank the Bank of Japan for inviting me to this conference and for giving me the opportunity to comment on Franco Bruni's paper on central bank independence. Many of the issues raised by Professor Bruni with regard to the requirement that central banks of the countries of the European Union become fully "independent" before the start of the third phase of the economic and monetary union and the creation of the European Central Bank are on the table for U.S. central bankers as well. A bill currently under discussion in Congress would legislate price stability as the primary goal of the Fed, and would ask the Fed to announce numerical targets and a path over time for achieving price stability. So the questions of what constitutes central bank independence, how much of it should there be, and what are the proper goals for the monetary authority are just as relevant to the conduct of monetary policy in the United States as they are for the complex task of forming a European Central Bank.

Contributions of the Paper

Professor Bruni has provided a comprehensive summary of a large number of issues of concern in the convergence to European Monetary Union. He begins by noting the four aspects of the Central Bank Independence condition of the EMU agreement. Professor Bruni develops a numerical evaluation of convergence

toward central bank independence among the original 12 countries of the Union and notes that convergence has been greatest in the area of prohibiting lending to the government, and least in the area of statutorily setting price stability as the objective of the central bank.

Professor Bruni also discusses the relationship (and possible conflict) between the central bank's role as a monetary policy maker concerned with price stability, and its role as a supervisor of banks. A disproportionate concern by the central bank for the health of depository institutions might induce an inflationary bias into its monetary policy actions. On the other hand, the knowledge that the central bank gains from monitoring may be valuable in managing and stabilizing the payments system. Bruni makes five points here that emphasize his general discomfort with the appropriateness of joining monetary and prudential policy responsibility in the central bank, while recognizing it does not make sense to exclude the central bank totally from bank supervision.

Of interest is his notion that prudential policy setting needs independence and credibility as well. In that regard, he notes that a central bank in charge of the payment system may well have a fairly high sensitivity to the danger of systemic risk, and a fairly low sensitivity to the social costs of prudential controls and bailouts. He infers from this that it is better for the effectiveness and credibility of prudential policies and for the working of market discipline on banks that

the political responsibility for at least certain prudential decisions is located outside the central bank. He concludes that what is at issue is not whether central banks should be invested with prudential tasks, but how an optimal prudential framework can be designed with the recognition that such a framework increases the credibility and effectiveness of both monetary and prudential policies.

Finally, Bruni draws distinctions among four aspects of central bank independence: legal, actual, reputational, and the dimension provided by accountability. He suggests that the more imprecisely independence is defined by legislation, the more leeway there is for political pressure to weaken the defacto independence of the central bank, and that reputational independence, such as that enjoyed by both Germany and the U.S., may be more important for the credibility of monetary policy than measures of either de jure or defacto independence.

I found Bruni's paper useful in clarifying and distinguishing the sometimes murky and entangled issues surrounding central bank independence. His paper suggests four questions that I would like to raise and answer immediately, but discuss more fully in the rest of my comments. First, should a government legislate a goal of price stability for the central bank? I think the answer here is unequivocally yes. Second, should price stability be the sole goal of monetary policy, to the exclusion of financial stability? The answer here is no. Third, should the legislated goal include numerical targets that

define price stability? Again, the answer is no. Finally, should the central bank itself set numerical targets that it publicly communicates and is held accountable for? Maybe yes, maybe no. Now let me explain my positions more fully.

It is, of course, right and appropriate for a government to establish goals for a central bank. Certainly these exist for the Federal Reserve System, and have since its inception. It's also appropriate for such goals to change from time to time. A legislated mandate for price stability could serve as a wake-up call to the central bank, and give it a measure of authority it may not have had otherwise. Thus, I would view a legislated goal of price stability as clearly good, especially for countries with a history of high inflation.

Price stability as the sole goal of a central bank is more problematic. The ultimate objective of economic policy is to provide for continual improvement in standards of living. Price stability is a means to this end, but not an end in and of itself. To the extent that the single-minded pursuit of price stability precludes the central bank from, for example, any element of common sense in responding to cyclical or other shocks, I think it would be counter to achieving that ultimate objective.

Similarly, if setting price stability as the sole goal of monetary policy precludes the central bank from addressing issues of financial stability, it could also be harmful. In that regard, I am puzzled by the uncertainty in Bruni's paper and in

some of the literature about central bank involvement in bank regulation and supervision. A healthy banking system is key to financial stability and, far from being a distraction, financial stability is critical in practice to price stability. It may not be necessary for central banks to supervise all depository institutions to achieve some confidence that the state of bank health will not undermine monetary policy, but certainly an intimate knowledge of major banks, and the ability to intercede with them that comes only by being their regulator, seems to me to be key to maintaining financial stability.

On the third issue of numerical targets for price stability set by the legislature, I also have problems. Such targets are mentioned in some definitions of central bank independence. In some senses this is counter-intuitive since it seems to imply that a central bank can have little to say about what its goals and targets are, but still be considered "independent." More importantly, numerical targets set by legislatures can be revised by legislatures without assurance that this process will always result in the best outcome.

Finally, should central banks set their own numerical targets and time frames for achieving price stability and communicate them publicly? On the one hand, this could improve central bank accountability and if the choice is legislatively set targets or central bank set targets, I would always vote that the central bank set the targets. On the other hand, it's not clear whether targets achieve something for which the central

bank wants to be accountable. In theory, numerical targets ought to buy the credibility necessary to achieve lower inflation at a lower cost in terms of unemployment, or to wring inflation premiums out of long-term interest rates. To my knowledge, however, the available evidence does not indicate that countries with explicit inflation targets have lowered their sacrifice ratios or reduced inflation premiums. Moreover, publicly set targets have the added downside of focusing attention on adherence to the target rather than the progress toward sound economic growth and price stability over the long run. In the U.S., the good inflation performance since the early 1980s has been seen as a measure of central bank success. If explicit targets had been set, and perhaps exceeded, would the real progress be perceived in the same favorable light, with all that implies for credibility both with Congress and the general public? I think not, which makes me undecided on this issue.

Professor Bruni also comments on the payment system responsibilities of central banks. He apparently believes that these activities make central banks more willing to bail out depository institutions, and less attracted to market discipline. This seems to me to ignore the very real central bank dilemma of moral hazard. To the extent that a central bank always was willing to bail out, and depository institutions knew this, there would be little incentive to improve risk controls. Central banks would in effect be underwriting private sector risk taking in payment systems--something we do not want to do and worry

about a lot. The answer seems to lie in being involved in prudential policy setting which includes the establishment of standards related to risk control, and to be willing to intervene promptly to get the weak link out of the system (as is now required legislatively in the U.S.)--in short to be more involved in supervision and regulation rather than less because of payment system responsibilities.

My last point is an expansion on comments made by Bruni. He indicates he expects the existing central banks in the European Community to see their role diminish under the European Central Banking system. I think this has to happen if monetary union, and a single currency come to be, but I can understand that such a prospect may not warm the hearts of many European central bankers, perhaps some of whom are here in this room. Perhaps I can provide a ray of partial hope based on my own experience as a regional Reserve Bank president.

As you know, the Federal Reserve System was designed specifically with both central and regional aspects that at least initially were to balance each other. Regional Reserve Banks set their own discount rates at first, but over time the forces of capital market development, and the use of national open market operations as the main tool of monetary policy has pulled responsibility much more toward the center. However, regional Reserve Banks do continue to play a healthy role in the Federal Reserve System, as payments processors, as direct lenders to commercial banks using a single Discount Rate that is recommended

by the individual Banks, but approved at the national level, and also as providers of vital input to the deliberations of the FOMC. The Reserve Banks offer specific knowledge of economic developments in their region through their extensive ongoing contacts with local businesses and through information gained in the regulatory function.

A case in point is the New England experience in the 80s. I am told that Frank Morris, then president of the Boston Fed, was a voice in the wilderness regarding the problems inherent in the excessive real estate lending in the mid-80s. This fueled a sizeable economic boom in New England, but the recession that followed was much deeper as a result. The combination of a declining economy and a collapsing real estate market led to severe problems at the region's banks. As banks struggled to survive they cut back their lending which further exacerbated the regional recession. New England's problems were later echoed elsewhere; but because of New England's earlier experience, the FOMC was already sensitive to the contractionary effect of disruptions to the availability of credit.

The regional Reserve Banks also represent a variety of economic schools of thought, and bring many perspectives to the analysis of monetary policy. Because each bank has relative autonomy, each Bank's research department has developed a distinctive analytical character. I may be naive here, but I believe such a rich variety has contributed to the System's relative success over the past 15 years or so.

In sum, monetary union in the EC would not be easy, as Professor Bruni points out. I think the points he makes about autonomy for the ECB are right on the mark if unity is to happen at all. The individual national central banks cannot represent their national interests but must pursue the best for the entire union. If this does not happen, if the system does not evolve to something like the Federal Reserve, it is hard to see that it will work at all.