

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Some Observations on Central Bank Accountability

by W. Lee Hoskins

We often hear complaints about the performance of the Federal Reserve System. A cogent example is the decade of the 1970s, when the Federal Reserve mistakenly and regrettably paid too little attention to inflation. This mistake culminated in the enactment of the Federal Reserve Reform Act of 1977, which set out provisions for reporting to Congress about economic conditions and monetary targeting.

Even though the Fed has since had greater success in controlling inflation, with the rate of price increase hovering in the 4 percent range for the past six years, the complaint most likely to be heard now is that the System is not sufficiently sensitive to the administration's economic priorities. Moreover, grumblings from some quarters about the System's foreign exchange market operations in partnership with the Treasury, and about the financial problems in the banking and thrift industries, have recently generated criticism of the System's discount window operations.

In order to examine these issues, we must step back a bit and construct a framework for the discussion. We must ask ourselves several questions: What is the justification for central banks? Why should we have them at all? What are their costs and benefits, and why do they need realistic and compatible goals? Finally, how can they be held

accountable for achieving these goals without imposing other offsetting costs on society?

■ The Rationale for a Government-Sponsored Central Bank

Milton Friedman presented a classic statement of the economic rationale for the existence of central banks in his 1959 Millar Lectures at Fordham University, subsequently published as *A Program for Monetary Stability*.

Professor Friedman's argument appealed fundamentally to the costs inherent in a pure commodity-standard system, such as the gold standard. These costs arise both from pure resource costs and, perhaps more significantly, from substantial short-run price variability resulting from inertia in the adjustment of commodity-money supply to changes in demand. The inefficiencies represented by these costs are a significant disadvantage of commodity-money exchange systems.

As a consequence there is a natural tendency, borne out by history, for pure commodity standards to be superseded by fiat money. But particular aspects of fiat money systems—such as fraudulent banking practices, "natural" monopoly characteristics, and tendencies for localized banking failures to spread to the financial system as a whole—have resulted in the active participation of government. We have come to know this active participation as central banking.

The independence of the Federal Reserve System within government ensures that monetary policy is insulated from fiscal policy. Yet, calls for the central bank to fine-tune the money supply in response to economic woes continue to be heard. If the Federal Reserve were given a clear legislative mandate to achieve price-level stability and financial market efficiency—along with the independence and accountability necessary to realize these goals—maximum economic growth would be the result. These objectives apply to the System's role in discount window lending and to its relationship with the Treasury in the realm of exchange-rate policy.

These rationales have not gone unchallenged, not even by Professor Friedman himself.¹ Disruptions in payments can be costly, but so are the inefficiencies caused by the lack of an effective anchor for the price level in fiat money systems. Moreover, theoretical discoveries in the area of finance and monetary economics, closer attention to the lessons of historical banking arrangements, and advances in information and financial technologies have contributed to a healthy skepticism about the superiority of central banks and government regulation over alternative market arrangements. For example, some of the financial backstop functions performed by central banks and banking regulators may have weakened private market incentives to control and protect against risk.²

Still, those who would argue for alternative monetary structures must at least recognize that their case rests on untested propositions. Yes, it would be foolish to accept unthinkingly our current central banking setup as the best solution to problems posed by the creation and maintenance of monetary systems in advanced economies. But it would also be foolish to claim that the current practice of central banking does not reflect progress in society's groping for solutions to those problems.

It is not sufficient to argue that market-oriented alternatives to our current central banking structures functioned better in other times and places; for example, as they did during the private banking period in eighteenth-century Scotland.³ This begs the question of why such a system did not prove to be sustainable. Nor is it sufficient to argue that this system would have prevailed if not for government intervention. This line of debate fails to consider whether any political equilibrium exists that would support a market-driven monetary system in a modern economy.

It is premature to claim that some hypothetical monetary system can, or should, come to dominate institutional arrangements that have evolved from extended political and economic experience. I believe that the prudent first course is to seriously consider the advantages of improving the performance of the Federal Reserve System. The benefits of a properly managed fiat currency are considerable, and the issue today is, or should be, how to provide the Federal Reserve System with a proper charter.

■ The Federal Reserve and Its Charter

Before the creation of the Federal Reserve, the country prospered without a central bank. Broadly speaking, the historical impulse for the Federal Reserve's creation in 1913 was a series of banking panics. These panics led to contractions in money and credit in various regions of the country, often with serious consequences for economic activity. The nation wanted to improve the functioning of its banking system by establishing a means for providing an "elastic money" in the context of a monetary standard based on full convertibility into gold. The gold link was broken considerably by the Gold Reserve Act of 1934.

The Federal Reserve was born out of a compromise between those who would have kept the banking system entirely private and those who wanted government to assume a prominent role in a rapidly growing economy. Other nations have grappled with the same problems and have created similar institutions. Today, the Soviet Union and several Eastern European nations are facing these same issues. We now have a world monetary system in which governments monopolize the supply and management of inconvertible fiat monies. Often using central banks as their agents, governments also regulate banking activities.

The displacement of the commodity standard that prevailed at the time our central bank was founded has exposed problems not otherwise envisioned in 1913. For example, we have no anchor for the price level except for that provided by the Federal Reserve. The quadrupling of our price level since 1950 suggests that the essential mandate of the Federal Reserve—to ensure the viability of our monetary exchange system by the maintenance of price stability—is neither as explicit nor as strong as would be desirable for the management of a fiat currency. If the benefits of a fiat currency are to be achieved without large offsetting costs, the gradual demise of our convertible monetary standard will require a basic change in the framework within which the Federal Reserve System functions.

The evolution of the global monetary system reflects a common, even if unstated, acknowledgment that the benefits of a fiat monetary standard are substantial. Wise administration of that standard requires a central bank in some capacity. In this context, the essential issue is how nations can achieve the benefits of a fiat money standard and simultaneously constrain the exercise of that power to the service of the public good. To put it another way, how can a nation prevent its central bank from debasing the monetary standard it is charged to protect, or from undermining the efficient functioning of the financial system it is charged with strengthening?

The answers to these questions can be found by giving the central bank clear objectives as well as independence and accountability for achieving them. The problems that emanate from multiple and often incompatible objectives are well known. To contribute to maximum economic growth over time, central banks must achieve price-level stability and financial market efficiency. Achieving these goals requires central banks to be free from political expediencies.

The objectives of the central bank are substantially determined by its legal structure. For example, a clear legislative responsibility to achieve price-level goals above all others would all but eliminate potential conflict with other objectives. The vexing question of whether, and to what extent, a central bank should compromise the objective of price stability in order to pursue auxiliary goals, such as smoothing real output fluctuations or stabilizing exchange rates, should be resolved in the legislative charter.

■ Independence and Accountability: The Case of Fiscal Dominance

The consequences of concentrating power in a central bank were appreciated, and much debated, at the time of the Fed's creation in 1913. Checks and balances were woven deliberately and carefully into the fabric of the Federal Reserve System. A "fire wall" was constructed between Congress and the executive branch on one side and the monetary authority on the other, in order to diminish both the motive and means to debase the value of the nation's money. The fire wall was Federal Reserve accountability for monetary (rather than fiscal) policy objectives. It was reinforced by the Treasury-Federal Reserve Accord of 1951, which served as a clear statement that the Fed would not be responsible for solving the federal government's debt management problems. The institutional structure was designed to ensure enough Federal Reserve independence within the government to carry out this mandate without interference.

What, then, is the source of tension between monetary and fiscal authorities? Because the creation of fiat money involves an implicit tax on money balances, the monetary authority is one source of government revenues (last year the Federal Reserve System returned nearly \$25 billion to the Treasury). For the most part, the long-run viability of the government's fiscal operations requires that its real current debt burden plus the present value of its expenditures equal the present value of revenues. Thus, if the path of debt plus expenditures diverges from the path of

explicit tax revenues, fiscal viability requires that the discrepancy be satisfied by seigniorage from monetary growth. This scenario is typically referred to as "fiscal dominance" over the monetary authority.

The dramatic increases in federal deficits in the early and mid-1980s prompted fiscal dominance believers to predict the impossibility of achieving and maintaining inflation rates below the disastrous levels of the decade's start. So far, this prediction has not come to pass. In 1983, the federal deficit was 3.8 percent of GNP, a level far above the post-World War II average and nearly equal to the postwar peak realized in 1975. In the same year, inflation as measured by the Consumer Price Index fell to 3.2 percent, a 16-year low. As the decade proceeded, the deficit relative to GNP rose, fell, and rose again. The inflation rate was impervious to these patterns.

Astute observers might question the relevance of this period to the fiscal dominance proposition, because deficits—as they are conventionally measured—do not necessarily reflect the government's long-run fiscal operations. To name just a few of the problems, the value of long-run government net liabilities is inherently ambiguous, the path of future revenues is uncertain, and the appropriate method of discounting future tax and expenditure flows is problematic. Although sympathetic to this view, I am still left with the very strong suspicion that if any period in our recent history was ripe for the emergence of fiscal dominance, it was the last 10 years.

Indeed, as the decade progressed and the predictions of the fiscal dominance theory failed to materialize, more sophisticated variants of the relationship between fiscal and monetary policy began to find their way into economic research. The fiscal authority's reign over the subservient monetary authority was replaced by a more subtle and complicated institutional structure, a world in which fiscal and monetary authorities engaged in a "chicken"

game whose outcome left both parties less than fully satisfied.⁴

Fortunately, if this analytical framework is accurate, the outcome of such a contest between monetary and fiscal policymakers has not yet proven detrimental to the U.S. economy. The Federal Reserve's ability to resist monetizing the federal debt buildup of the 1980s has resulted in both lower inflation and, to some extent, the fiscal reforms that started with the Gramm-Rudman-Hollings legislation and continued through last year's budget agreement.

I am not suggesting that we should be satisfied by the present situation. Inflation is still too high, and whatever headway has been made rests on a fragile commitment to preserving our progress. We should not forget that inflation in the past year was about as high as in 1971, when President Nixon imposed wage and price controls in a misguided attempt to force the rate down. Reform of the process for setting fiscal priorities is still evolving and has been largely untested. Considering recent budget outcomes and projections, it is not easy to find signs of success. But important lessons were learned in the 1980s: Lower inflation means better economic performance, and better inflation results can be achieved almost regardless of fiscal policy. There is every reason to believe that the Treasury-Federal Reserve Accord of 1951 was a prerequisite for this outcome.

■ Clear Objectives and Where We Lack Them

The fiscal dominance case provides an important lesson about the need for clear objectives, accountability, and independence if our central bank is to be successful at achieving price stability and maintaining the integrity of our financial system.

Currently, there is some measure of support for reducing inflation from its present level. But what can explain a period such as the 1970s, when inflation spun out of control? The story of that period is one of mistakes and wishful thinking by economists and

policymakers alike, acting on the view that the Federal Reserve could manipulate the nonfinancial economy in predictable ways to soften or offset the oil price shocks and to control the business cycle. This unfortunate economic performance would have been avoided with clear and realistic objectives for the Federal Reserve. The Fed was not held sufficiently accountable for achieving price stability.

Some of the current discussions about monetary policy and the Federal Reserve suggest that the lessons of the 1970s may be fading from our memories. Calls for lower interest rates or more rapid money growth are not at all unusual. More often than not, those suggestions seem impelled by desires for more growth, or to offset the problems of particular sectors of the economy. They seem based on the notion that there is a trade-off between inflation and output or employment that may be exploited by the actions of the central bank. We learned from the experience in the 1970s that such a trade-off does not exist. Instead, higher inflation only added to uncertainty, distorted resource allocation, and reduced economic performance below the maximum sustainable level possible with price stability.

The System's mandate for financial stability is also vague, raising some questions about the role played by discount window lending in recent bank failures. The original intent of discount window lending, as I interpret history, was a mechanism by which the Federal Reserve served as the lender of last resort. Such lending was understood to apply to solvent institutions in temporary need of liquidity. Recall that at the time of the System's founding, there was not much of an interbank market for banks to tap when liquidity problems arose. National or international capital markets were also not very prevalent. Today, by comparison, open market operations in well-developed national capital

markets have much greater capability than in 1913 for providing adequate financial market liquidity.

As the role of the Fed in the economic policy arena evolved, so did the use of the discount window. Until recently, discount window lending primarily functioned for so-called "adjustment assistance," a technical operation associated with satisfying required reserve positions. The recent use of discount window lending in conjunction with FDIC-directed operations at failing institutions is more troubling. Both houses of Congress are concerned about the Federal Reserve's use of discount window loans to undercapitalized, insured banks. Congress seeks assurance that such loans do not provide an opportunity for uninsured depositors to withdraw their funds and thus to increase the loss to the receiver should the bank fail.

Use of the discount window for temporary support of insolvent banks has resulted in a situation that, at least in retrospect, appears outside the scope of the Federal Reserve's intended responsibility. The impulse for these activities has almost certainly been the belief that they were necessary to avoid systemic banking failures. It also makes sense to me that, if both the FDIC and the Treasury seek the Federal Reserve's help, then there are incentives to be a "team player."

The irony is that, lacking a clear set of rules and objectives, the Federal Reserve's discount window activities can interfere with its mandate to protect the efficient and safe functioning of the payments system. Findings in academic research, supplemented by some bitter real-world experience, have brought into focus the perverse incentives created by regulatory policies that shift risk from individual depositors to the public at large. By focusing on the fortunes of individual institutions rather than on the liquidity of the financial system as a whole, the lender of last resort process may very well have become distorted in a way that undermines what I believe is the appropriate

objective of the Federal Reserve or of any central bank: to promote the stability and efficiency of financial markets.

Another area in which accountability and clear objectives remain disturbingly absent is the relationship between the Federal Reserve and the Treasury in the realm of exchange-rate policy. Three of the past five administrations have, at various times, chosen extensive direct intervention in foreign exchange markets to influence the value of the dollar. Because direct intervention cannot be effective without basic changes in economic policy, I believe that the Federal Reserve has, on these occasions, risked confusing the financial markets about its monetary policy intentions. Moreover, although the System's participation with the Treasury in foreign currency purchases and sales has not yet resulted in large profits or losses, its exposure to loss rises with the size of its foreign securities holdings. During the past several years, there have been periods when the System's holdings expanded considerably.⁵

The Federal Reserve almost always "sterilizes" its exchange-rate interventions through offsetting domestic open market operations that leave the net money supply unchanged. These foreign exchange transactions thus do not compromise the integrity of the Federal Reserve's price-level objective.

Unsterilized interventions are nothing more than open market operations conducted through the foreign exchange market rather than through the U.S. government securities market. Unsterilized interventions in support of the Treasury's exchange-rate objective could work at cross-purposes to the pursuit of the System's price stability objective. Subordinating the goal of price stability to the Treasury's desired exchange-rate policy is unlikely to improve economic welfare. But in the absence of a clear statement of priority for monetary policy objectives, the possibility of such a sacrifice cannot be dismissed.

■ Conclusion

As I have argued, the institutional design of the Fed has served the useful purpose of insulating monetary policy from the federal government's debt policy. Recent studies suggest that greater degrees of central bank independence from the political process lead to better inflation performance. In this regard, legislative attempts to strengthen the role of the Treasury in the formulation of monetary policy seem to me to work in the wrong direction.

The fire wall between monetary and fiscal policy, capped in 1951 by the Treasury-Federal Reserve Accord, should be strengthened by releasing the System from responsibility for supporting the Treasury's exchange-rate policies. We need a Treasury-Federal Reserve Accord amendment for the twenty-first century.

Finally, preservation of the Federal Reserve's role in maintaining financial market stability requires that we develop clearer guidelines for discount window activity. Discount window lending must be confined to solvent institutions for the purpose of forestalling systemic, rather than bank-specific, risk. Recent congressional attention to this matter has already resulted in cooperation between the Federal Reserve and the House Banking Committee to clarify appropriate use of the discount window when undercapitalized institutions seek loans. The System and Congress can also agree on the need to close undercapitalized banks promptly, before they pose undue risk to the FDIC. To do otherwise could seriously undermine the discipline provided by market mechanisms, and in so doing could hamper the Federal Reserve's stewardship of the financial markets.

The precise features of changes to the Federal Reserve System can and should be debated. Unfortunately, much of the current discussion about Federal Reserve independence, by focusing on the process of selecting System officials, falls wide of the mark. Holding the institution accountable for an explicit objective dilutes the importance of how system officials are selected. For a nation to capture the advantages proffered by central bank management of fiat money, the central bank must be held accountable for achieving price stability. The Neal Resolution, which mandates that price stability should be the highest priority of the Federal Reserve and sets forth a specific time frame for achieving that goal, is a good approach.⁶ Attaining price stability is essential for the economy to achieve its maximum long-run growth.

Experience around the world and through time repeatedly demonstrates that central banks require independence from day-to-day political life to perform their price stability role. If legal and cultural conditions could be created that truly fixed a central bank with accountability for anchoring the price level, the structure of the central bank itself would become a less important issue. Those circumstances would be a joy to behold, but I am afraid they will be some time in coming.

■ Footnotes

1. See Milton Friedman and Anna J. Schwartz, "Has Government Any Role in Money?" *Journal of Monetary Economics*, vol. 17, no. 1 (January 1986), pp. 37-62.
2. See, for example, the discussion in Charles Goodhart, *The Evolution of Central Banks*. Cambridge, Mass.: MIT Press, 1988.
3. For a discussion of the free banking era in Great Britain, see Lawrence H. White, *Free Banking in Britain: Theory, Experience, and Debate, 1800-1845*. New York: Cambridge University Press, 1984.
4. See Thomas J. Sargent, "Reagonomics' and Credibility," in Albert Ando et al., eds., *Monetary Policy in Our Times: Proceedings of the First International Conference Held by the Institute for Monetary and Economic Studies of the Bank of Japan*. Cambridge, Mass.: MIT Press, 1985, pp. 235-52.
5. For a review of recent studies on this subject, see Owen F. Humpage, "Central Bank Intervention: Recent Literature, Continuing Controversy," *Federal Reserve Bank of Cleveland, Economic Review*, vol. 27, no. 2 (Quarter 2 1991), pp. 12-26.
6. I present my arguments in support of this resolution in "The Case for Price Stability," *Federal Reserve Bank of Cleveland, Economic Commentary*, March 15, 1990.

W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary is based on a speech he presented to the Center for the Study of Market Processes at George Mason University, Fairfax, Virginia, on September 10, 1991.

W. Lee Hoskins has served as president of the Federal Reserve Bank of Cleveland since 1987. In November, he will leave this position to become president and chief executive officer of Huntington National Bank and vice chairman of Huntington Bancshares Incorporated, based in Columbus.

As a tribute to his four years of distinguished service at the Cleveland Fed, we present a compendium of the *Economic Commentary* issues he has authored, which highlight his advocacy of such topics as zero inflation, deposit insurance reform, and market-based global policy coordination. Copies of any of the titles listed below are available free of charge through the Public Affairs and Bank Relations Department, 216/579-2157.

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