Federal Reserve Bank of Cleveland

Three Myths about Central Banks

by Geoffrey P. Miller

Do central banks control the business cycle? Should price stability be their only monetary policy goal? Do politicians give up a degree of power and gain nothing personally when they grant central banks independence? This *Commentary* argues that none of these widely held notions is true. The *Commentary* is based on a speech presented to participants at the conference on the Origins and Evolution of Central Banking, sponsored by the Central Bank Institute of the Federal Reserve Bank of Cleveland, in May 2001.

Over the past decade, central banks have emerged from relative obscurity to global recognition as one of the most powerful institutions in the world—powerful not only economically, but also politically, socially, and as forces for cultural and historical change. Associated with this new image are several ideas about central banks that, while often not clearly expressed, are nevertheless widely held. These ideas circulate in a sort of folklore or oral tradition. They exercise a significant influence on how central banks are perceived.

Central Bank Omnipotence

The first of these ideas is that of central bank omnipotence. There seems to be a general public perception that a central bank is responsible for controlling the business cycle and for ensuring an endless stream of prosperity. This isn't a view that is held by central bankers themselves, although they benefit to some extent if the public holds them in a sort of awed semiadulation.

We see this idea at play today. In the United States, for example, the Federal Reserve System is credited for the period of economic expansion and price stability that we have enjoyed for many of the past years. The Fed is also blamed for the recent economic slowdown; if only the central bank had loosened credit earlier, we hear, we would not have faced the layoffs, lack of consumer confidence, deteriorating corporate profits, and so on that were grist for business news over the past few years. But is the Fed really so powerful?

We can't easily determine the degree of central bank influence. No controlled experiments are available. However, there's reason to believe that central bank powers, although very large, are still significantly limited.

One object lesson on this is the role of the Bank of Japan (BOJ) over the past 15 years. Many have criticized the BOJ for contributing to, even creating, the bubble economy of 1987–1990, whose collapse was followed by more than a decade of economic stagnation in that country. A governor of the BOJ even accepted blame for the failure.

Yet my research suggests the Bank was not nearly as responsible as many think (see "The Role of a Central Bank in a Bubble Economy," by Geoffrey P. Miller, in the *Cardozo Law Review*, 1996). It was highly constrained in its ability to act against the bubble economy, for several reasons. It wasn't clear, at least in the early years, that Japan *was*, in fact, in the midst of a speculative bubble; many argued that the upsurge in Japanese equity and real estate prices was due to economic fundamentals. The bubble economy didn't show up in the wholesale or retail price indexes, so the Bank could not easily justify intervention as an inflation-control measure.

Tools of monetary policy were too broad in scope to deal effectively with sectoral phenomena; the Bank's intervention was going to affect the economy as a whole rather than the limited areas of stock market and real estate prices. The Bank also had to take foreign relations into account, especially relations with the United States. BOJ credit tightening would have been seen by the United States as inconsistent with commitments the Japanese government had made to stimulate domestic spending in order to increase demand for U.S. goods. The United States was also very concerned that Japan not do anything to destabilize its stock market, given the perception after October 1987 that U.S. equity markets were fragile.

Finally, the BOJ had to deal with powerful figures inside Japan who were profiting enormously from the bubble economy. Anyone who owned land in Tokyo, and later throughout the country, saw his paper wealth skyrocket during this period. Investors got rich on stock market profits. People in industries such as construction, real estate development, securities brokerage, and so on earned fabulous sums and were quite liberal with campaign contributions. Some politicians also earned large amounts in the stock market. And nearly everyone felt buoyed by the enthusiasm that accompanied the climb in the Nikkei.

Faced with these conditions, the BOJ, I think, was not really in a position to take strong action against the bubble economy. While the experience of the BOJ does not translate directly to

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lessons for the Fed, the two central banks do play a largely similar role in their respective economies. I would guess, however, that the Fed's powers, if not as constrained as the BOJ's during the Japanese bubble economy, are considerably more limited than might appear at first glance. Central banks are indeed powerful, but they are not omnipotent, and the popular belief that attributes excessive powers to them is not supported by the evidence.

The Talisman of Price-Level Control

A second popularly held belief about central banks is that their only function with respect to monetary policy should be maintaining price stability. The belief rests on the observation that there are essentially no benefits to inflation, and from this observation it is surmised that a central bank should be charged with a nondiscretionary responsibility to keep the price level steady or within a narrow range.

If we take this idea of rule-based price stability to its extreme, we can engage in the following thought experiment: In place of the central bank, we build a supercomputer, program it to achieve price stability in all circumstances without exception, and then throw away the password. We even install an internal nuclear power supply so we can't pull the plug. We have an absolute, rule-based commitment to price stability.

But I don't think a country would, or should, adopt this strategy, even if it were technologically feasible. Price stability is a very important goal, but not necessarily the only goal. There may be emergency political or social conditions in which this goal should give way to overriding objectives. The government may urgently need to raise funds quickly to accomplish these objectives. In such cases, an inflation tax, although not desirable under ordinary conditions, might be a useful tool.

An obvious example of such an emergency condition is a threat to national security. If a country faces a sudden, extreme threat from outside, it may have good reason to elect to fund the necessary response through inflation rather than through the slower, although otherwise more desirable, means of the explicit tax system. For another example, we might look to the Bundesbank's approach to German reunification. Even though the German central bank was perhaps the world's most famous inflation hawk, its leaders perceived that reunification was a priority important to the nation's essential identity. The very large costs of unification, which involved huge subsidies for the East, were in part funded by inflation.

The problem, as a matter of institutional design, is how to know when rules should give way to discretion, and how to ensure that short-term temptations do not erode the value of a rule-based system. This is a matter to which law can contribute—although we have always to remember that laws are just pieces of paper, and what counts is what people actually do.

For an example of a legal response to the design problem, we can look at how U.S. law deals with the problem of regulatory forbearance, that is, when the government permits an economically failed bank to remain open because it is "too big to fail" or permits the FDIC to extend de facto guarantees to uninsured depositors and nondeposit creditors during the resolution of a closed bank. It might be tempting for government officials to offer this kind of assistance, both to cover themselves against criticism and to cater to powerful constituents.

The 1991 Federal Deposit Insurance Corporation Improvement Act created a filter—the systemic risk exemption—to ensure that forbearance is extended only when really needed. The FDIC can rescue uninsured depositors and creditors of a closed bank or allow an insolvent bank deemed "too big to fail" to remain open only if the following conditions are met. The board of directors of the FDIC and the Board of Governors of the Federal Reserve System must each pass by two-thirds vote a resolution recommending the rescue. And the secretary of the treasury, in consultation with the president of the United States, must determine that not rescuing the institution "would have serious adverse effects on economic conditions or financial stability" and that the planned assistance "would avoid or mitigate such adverse effects" (12 U.S.C. Sec. 1823(c)(4)(G)). Moreover, any FDIC losses must be expeditiously recovered out of a special assessment, and any rescue must be investigated by the General Accounting Office.

Whether a similar approach should be used for central bank monetary policy responsibilities is another interesting question of institutional design (some countries, such as the United Kingdom and New Zealand, already direct their central banks to meet specific price-level targets). In the event of a crisis or other compelling need, the central bank would be allowed to deviate from these targets, but usually only after consultation with, and ultimately with the approval of, specified other government officials or agencies. How to best design such a system would depend on the constitutional and legal structure of the particular country.

Why an Independent Central Bank?

My final example of central bank folklore is that central bank independence is simply a matter of good government. There are persuasive theoretical reasons to believe that independent central banks represent a desirable social policy. When we look at the fact that central bank independence has been upgraded in country after country around the world, we might conclude that leaders are persuaded by the theory and are implementing the recommendations out of a sense of social responsibility.

Undoubtedly, political leaders are often motivated to improve the welfare of citizens, and this incentive plays a significant role in the establishment of independent central banks. But it would be simplistic to say that public-spirited motivations fully explain the phenomenon. Good government is undoubtedly desirable, but it is not a hallmark of all political systems. Independent central banks are created by *politicians*, not political scientists or economists, and they operate within a political regime.

When we focus on politicians, the issue of central bank independence becomes puzzling. Control over price levels is one of the most important powers of government, and, historically, the source of unlegislated revenue to the state. Politicians usually want and desire power. Why, then, do politicians vote in favor of central bank independence, an act that seems to give away a hugely important amount of authority?

There are a number of answers to this conundrum. Countries vie for prestige, and having an independent central bank has become a mark of status. For developing countries, the International Monetary Fund and the World Bank support enhanced central bank independence; desire for funding from these and other international agencies can provide an incentive to enhance legal independence.

But what about the developed world? Why have so many developed countries moved toward establishing independent central banks during the past several decades? I'll offer a speculation in this regard, based on political and institutional data that lawyers see in our professional role and consistent with how economists have modeled interactions between the government and the public.

Politicians want and need support from interest groups. Interest groups typically want the politicians to enact legislation that benefits their members economically. But politicians know that once the law is passed, the interest group is satisfied, and the campaign contributions and other support dry up. In this context, inflation can work to the advantage of politicians in a manner that has not been fully recognized in the literature to date.

The interest group deals that get enacted are often tied, implicitly or explicitly, to price levels. Where deals are tied to price levels, the politician, by creating unanticipated inflation, can effectively *undo* the deal previously negotiated. A $100 per ton subsidy for a commodity is worth only $50 if price levels double. The producers of that commodity are going to come back to the politician for a new deal, and the politician can extract more campaign contributions.

Taken by itself, this suggests that politicians would not want an independent central bank. Rather, they would want to keep control over price levels so they can renew their sources of campaign contributions. However, we have to take expectations into account, just as economists have learned to do in analyzing monetary and fiscal policy. If the interest groups suspect that politicians have power over price levels, they are likely to reduce the contributions they will give to obtain the deal in the first place. They discount the present value of the deal they are getting by the probability that inflation will undo it.

The politician, however, has a short-term time horizon. He or she wants to get as much as possible in the way of campaign contributions now, not in the future. Politicians recognize the value of offering a credible commitment to not give in to the temptation to undo political deals by creating inflation. This way, the politician can offer durable deals and thereby maximize campaign contributions in the short run. The upshot of this analysis is that politicians actually have an incentive of self-interest to create independent central banks. By doing so, they offer a credible commitment that the deals they are offering will be durable, in the sense that they will not be threatened by inflation.

This interest group theory of central bank independence has some plausibility, but it has also to explain why politicians cannot accomplish the same objective through other commitment devices such as indexing. It could be the case that different interest groups demand different forms of commitment; Social Security payments in the United States, for example, are indexed. Also, standing alone, the interest group theory doesn't provide a full explanation for the rather remarkable trend toward enhanced central bank independence we have seen around the world in recent years. Still, it's a useful idea to keep in mind when we try to understand the incentives operating on a central bank within a nation's political and economic system.

As I indicated at the outset, central banks are now commonly regarded as being among the most powerful institutions in the world, capable of fostering economic, political, and cultural change. At the same time, research into the design and functioning of central banks has not been studied as much as the significance of the institution would suggest is worthwhile. I hope my remarks indicate that I regard this line of inquiry to be fruitful for legal scholars and social scientists alike.

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