

SOME OBSERVATIONS ON CENTRAL BANK ACCOUNTABILITY

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It is not unusual to hear complaints about the performance of the Federal Reserve System. Not surprisingly, sometimes these complaints reflect the System's performance. In the 1970s the Federal Reserve mistakenly and regrettably paid too little attention to inflation, a mistake that culminated in the enactment of the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins), with provisions for reporting to Congress about economic conditions and monetary targeting.

Today, even though inflation has hovered in the 4 percent range for the past six years, the complaint is apt to be that the Federal Reserve 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 the financial problems in the banking and thrift industries have recently generated criticism of the System's discount window operations.

Today, I would like to discuss these issues with you, and to do so we must step back a bit and construct a framework for the discussion. We must ask ourselves several questions about central banks: What are their costs and benefits? Why should we have them at all? Why do they need realistic and compatible goals? And how can they be held accountable for achieving these goals without imposing other offsetting costs upon society?

The Rationale for a Government-Sponsored Central Bank

What is the justification for a central bank? Can some configuration of private institutions in a so-called "free banking" environment better perform the functions of a government-sponsored monetary authority? Are central banks even necessary?

A classic statement of the economic rationale for the existence of central banks was provided by Milton Friedman 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 (e.g., gold). 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 -- resulted in the active participation of government. We have come to know this active participation as central banking.

These rationales have not gone unchallenged, not even by Professor Friedman himself. Disruptions in payments can be costly, but so are the instabilities and 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 to alternative market arrangements. For example, some of the financial backstop functions performed by central banks and banking regulators may have weakened if private market incentives to control and protect against risk.

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 it did in eighteenth-century Scotland. 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 and interference. This line of debate fails to consider whether any political equilibrium exists that would support a market-oriented 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 already 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," but a money which was, and would remain, fully convertible into gold until 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 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 our 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. I will argue that if the benefits of a fiat currency are to be achieved without large offsetting costs, the gradual demise of our convertible monetary standard has brought us to a point that requires a basic change to 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 this: How can nations 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, and independence and accountability for achieving these objectives. 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 -- to have independence within government. Along with that independence, central banks should be clearly accountable for attaining their objectives.

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. 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 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 paid 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, CPI inflation 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 ten 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.

Fortunately, if this analytical framework is accurate, the outcome of such a contest between monetary and fiscal policymakers has not yet proven to be detrimental to the U.S. economy. The Federal Reserve's ability to resist monetizing the 1980s federal debt buildup 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 progress has been made rests on a fragile commitment to preserving it. We should not ignore the fact that inflation in the past year was about as high as in 1971, when President Nixon imposed wage and price controls 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 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 current 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 decade of unfortunate economic performance would not have been possible with clear and realistic objectives and priorities for the Federal Reserve. The Federal Reserve 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 tradeoff between inflation and output or employment which may be exploited by the actions of the central bank. We learned from the experience in the 1970s that such a tradeoff 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. Neither were national or international capital markets very well developed. 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. By enabling the FDIC to keep an insolvent bank open, the Federal Reserve makes it easier for the regulators to avoid prompt closure of insolvent banks, thereby both adding to the tendency for banks to take on risk and increasing the ultimate cost of bank failures to the taxpayer.

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 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 object of the Federal Reserve or any central bank: To promote the stability and the 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 monetary policy, the Federal Reserve, on these occasions, risked both its credibility and loss to its own portfolio by participating with the Treasury in foreign currency purchases and sales.

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 do not compromise the integrity of the Federal Reserve's price level objective precisely because they are sterilized or offset.

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.

Summary

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, recent 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, one that releases the latter from responsibility for supporting the former's exchange-rate policies.

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. To do otherwise can seriously undermine the discipline provided by market mechanisms, and in so doing hamper the Federal Reserve's stewardship of those very markets.

The precise features of changes to the Federal Reserve System can and should be debated. Unfortunately, much of the current discussion over Federal Reserve independence, by focussing on the process of selecting System officials, falls wide of the mark. Holding the institution accountable for an explicit objective lessens 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. Attaining price stability is essential for the economy to achieve its maximum long-run growth.

Experience around the world and through time repeatedly demonstrate 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.