FRBSF Weekly Letter

Number 95-16, April 21, 1995

Central Bank Independence and Inflation

The following is adapted from a speech delivered by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, before the College of Business Administration at the University of Iowa on March 29, 1995.

My remarks today focus on the link between central bank independence and the pursuit of low-inflation policies. This is a timely issue, because a number of countries—in Western Europe, Central Europe, and even China—have been considering changes to their central banks' structures.

I think central bank independence is an especially interesting issue because a lot of the research on it revolves around an age-old human problem—temptation. The temptation in this case isn't like the one Eve faced in the Garden of Eden, when the snake offered her fruit from the Tree of Knowledge. The temptation instead is to allow a high-inflation environment to develop in the economy.

You might think the comparison of Eve's temptation and the temptation to inflate is ridiculous. After all, her punishment was mortality and eternal banishment from Eden. But according to Dante's *Inferno,* the punishment for people who debase the currency could be pretty rough, too —the tenth pit of the eighth circle of Hell, to be exact.

As a conservative central banker, I can easily think of a number of reasons to justify Dante's harsh treatment of inflators. To begin with, a higher level of inflation is generally associated with higher uncertainty about inflation. And higher uncertainty about inflation means more difficult planning and contracting by business and labor. It also means higher risk premia in long-term interest rates, which depress capital formation and productivity.

In fact, 600 years after Dante, Lenin said the best way to destroy the capitalist system was to debauch the currency. And according to Keynes, Lenin was right.

Temptation and central bank independence

I'd like to start by describing how temptation plays a role in justifying central bank independence. Basically it has to do with the difference between monetary policy's effects in the short run and the long run. In the short run—say, six to nine months—an "easy" monetary policy can stimulate the economy to grow faster and to lower the unemployment rate. But *persistently* stimulating the economy to get gains in output and employment is an exercise in futility. The reason is that, in the long run, output and unemployment depend mainly on *real* factors—such as population growth and improvements in technology and productivity. So eventually the monetary effects on the real economy dissipate, and rather than long-run gains in output and unemployment, all we end up with is persistently high and volatile inflation. And that in itself takes a toll on economic growth.

Furthermore, as we learned from the early 1980s, once inflation gets going, it's costly to bring it under control. Back in 1980, CPI inflation was running at over 12 percent a year, and 30-year fixed-rate mortgages were as high as 16 percent. By 1982, the annual inflation rate was down to 3.8 percent. But to get there we went through a double-dip recession with over 10 million in the ranks of the unemployed.

Temptation enters the picture because it's natural to let near-term concerns obscure considerations about long-term consequences. In the standard story involving monetary policy, it's elected officials who could be tempted to be short-sighted in their efforts to expand the economy. With elections on the near horizon, they'd be tempted to try to ensure their return to office by pushing the central bank to follow an "easy" policy, figuring they can deal with the resulting inflation when it shows up later on.

The more political pressure on the central bank, the more likely this short-sighted strategy will be followed. As I said, in the long run, this strategy doesn't lead to any gains in employment or output, it just leads to higher, more volatile inflation.

But that's not all. It also leads people to *expect* higher inflation. Because the public believes that if politicians can pressure the central bank into an "easy" policy once, they can do it again.

Under these circumstances, a central bank would have a hard time convincing anybody that it was serious about maintaining low inflation. In other words, the public wouldn't think that the central bank's commitment to a low-inflation policy was credible. For a central banker, this is the worst of all possible worlds. Without a credible low-inflation policy, the only way the central bank can slow inflation down is to step on the economic brakes *hard*. And the result can be a deep recession with many jobs lost.

The Federal Reserve's structural independence

One way to insulate monetary policy from day-to-day political pressures is to give the central bank a more independent structure. In this respect, the Fed ranks toward the top among the world's central banks. So I'll draw from the Fed to describe some of the elements of an independent structure.

First, the Governors on the Board are appointed to 14-year terms—not as long as Supreme Court Justices, but much longer than congressional or presidential terms. Although they're political appointees—in that the U.S. President nominates them and the Senate confirms them—their terms aren't tied to an election cycle. Second, the Reserve Bank presidents—like me—aren't appointed by *any* politician. Instead, we're selected by our Reserve Bank's Board of Directors and approved by the Board of Governors. This provides further insulation from partisan politics. Third, the Fed covers its own operating expenses, so it isn't dependent on Congressional appropriations.

I want to stress that independence does *not* mean that the Fed is free of *accountability* to the government. For example, the Fed—like virtually all central banks—has its goals set by the government. In the case of the U.S., the goals are laid out in the Humphrey-Hawkins Act. In addition, the Chairman, the Governors, and the Reserve Bank Presidents give testimony before Congress on a number of issues. Furthermore, the Fed meets regularly with senior Administration officials to discuss one another's respective economic programs. In fact, the phrase usually used to describe the Fed is "independent *within* government."

Independence, goals, and credibility

There *is* a way beyond such structural means to make monetary policy even more independent of political pressure to inflate. And that way is for the Congress to give us a clear statement that low inflation is our goal. The Humphrey-Hawkins Act actually does this, by calling for an inflation rate in the range of 0 to 3 percent.

But it also calls for unemployment in the range of 3 to 4 percent. Just about any economist you talk to will tell you that, in today's economy, you can't achieve both goals at once—and furthermore, it's virtually impossible to achieve the unemployment goal at all! This combination of goals sends the Fed mixed signals, where almost any policy approach—from "easy" to "tight"—is technically consistent with the instructions from Congress.

In this session of Congress, Senator Connie Mack (R) of Florida actually has proposed legislating low inflation as the Fed's only goal. Such a change would not only reduce the Fed's exposure to pressures to inflate, but some economists also have argued that it may add credibility to the Fed's low-inflation policy.

In fact, on just those grounds a number of other countries recently gave their central banks specific low-inflation goals. So now let me take a look at how their experiences with independence, goals, and credibility have worked out.

Since 1990, the governments of New Zealand, Canada, and the United Kingdom have worked with their respective central banks to adopt specific low-inflation targets. And, so far, all three countries have achieved their inflation objectives.

But the evidence also suggests that the low-inflation regimes in these countries aren't fully credible (Ammer and Freeman 1994). For example, surveys show that the public's expectation of inflation remains somewhat above actual inflation, although expectations have come down since the introduction of the targets. That probably means that it takes more than inflation targets and a few years of success to establish full credibility.

The example of Japan drives home the point. The Bank of Japan has neither political independence nor formal inflation mandates. Yet because inflation in Japan has averaged only around 2 percent for the last 10 years, the Bank of Japan is among the world's most credible central banks.

But that's not to say that an explicit low-inflation mandate or target from Congress wouldn't help —and help significantly—in the U.S. I personally support proposals that make low inflation the central bank's primary goal. In fact, when former Representative Stephen Neal (D) of North Carolina held hearings on a similar plan a few years ago, I testified in favor of it. I think such a goal would help in a number of ways: It would help us avoid the pressures for higher inflation, it would add to the Fed's accountability to the Congress and the public, and it would help us solidify and extend the significant gains against inflation that the Fed has made in the last decade and a half.

Conclusion

In closing, let me restate what I believe are the most important issues in discussions of central bank independence: First, the temptation to focus on the short run rather that the long run can thwart the best efforts to maintain low and stable inflation. Second, some approaches—namely, structural independence and low-inflation goals —can help fend off those temptations. Finally, although the Fed has made considerable progress against inflation over the last 15 years, we still have our work cut out for us, and we can't afford to relax our vigilance.

To return to Dante, I urge continued vigilance *not* because I think the alternative is spending eternity in the eighth circle of Hell. I urge it because achieving and maintaining low and stable inflation is the best way the Fed—or any other central bank—can contribute to long-run, sustainable growth in the economy.

Robert T. Parry
President and Chief Executive Officer

Reference

Ammer, John, and Richard T. Freeman. 1994. "Inflation Targeting in the 1990s: The Experiences of New Zealand, Canada, and the United Kingdom." *International Finance Discussion Paper* Number 473. Federal Reserve Board (June).

Research Department

Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120

Printed on recycled paper
with soybean inks.

Index to Recent Issues of *FRBSF Weekly Letter*

The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.