CENTRAL BANKING IN A DEMOCRATIC SOCIETY: IMPLICATIONS FOR TRANSITION COUNTRIES

by

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I.
Introduction

In recent years we have seen the emergence of two important trends: an increase in the number of countries operating on democratic principles, especially with the abandonment of communism in the transition countries, and an increase in the independence of central banks. Indeed, many of the transition countries have granted their central banks a higher degree of legal independence than is seen in many other countries. At a glance, the independence of central banks seems to be in conflict with the democratic principle that government policies should be controlled by elected officials, rather than by an elite group that is insulated from the political process. On the other hand, there is a strong case for independence of central banks in order to ensure that they take a long-run view and conduct monetary policy in an effective manner. This apparent conflict between these two views immediately raises the question of what the role of a central bank should be in the emerging democracies of the transition countries. What form should central bank independence take? Can central bank independence and democratic principles be reconciled? How can the central bank be made sufficiently accountable in a democratic society? Answering these questions is not only of importance in countries that have been democratic for a substantial period, but is especially relevant in the transition countries of Eastern Europe which are now in the process of designing their political and governmental frameworks.

This paper seeks answers to the above questions by first discussing what principles should guide the conduct of monetary policy. Using these principles, it goes on to discuss what form the independence of central banks should take and then how independent central banks can be made accountable to the democratic process. Then it examines different monetary policy regimes in different countries and evaluates where these regimes stand in terms of central bank independence and accountability. Finally, it looks at issues of independence and accountability for the European Central Bank that is coming into existence in 1999 and ends with some implications for transition countries.

II.
Basic Principles for Monetary Policy

Recent theorizing in monetary economics suggests five basic principles that can serve as useful guides to the successful conduct of monetary policy: 1) monetary policy should focus on promoting price stability. 2) monetary policy should avoid the time-inconsistency problem; 3) monetary policy should be forward looking; 4) policymakers should be accountable; and 5) fiscal policy should be aligned with monetary policy. We look at each of these principles in turn.

1. Price Stability In recent years a growing consensus has emerged that price stability -- a low and stable inflation rate -- provides substantial benefits to the economy. Price stability prevents overinvestment in the financial sector, which in a high inflation environment expand to profitably act as a middleman to help individuals and businesses escape some of the costs of inflation.[1] Price stability lowers the uncertainty about relative prices and the future price level, making it easier for firms and individuals to make appropriate decisions, thereby increasing economic efficiency.[2] Price stability also lowers the distortions from the interaction of the tax system and inflation.[3]

All of these benefits of price stability suggest that low and stable inflation can increase the level of resources productively employed in the economy, and might even help increase the rate of economic growth. While time-series studies of individual countries and cross-national comparisons of growth rates are not in total agreement, there is a consensus that inflation is detrimental to economic growth, particularly when inflation is at high levels.[4] Therefore, both theory and evidence suggest that monetary policy should focus on promoting price stability.

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[1]For example, see English (1996).

[2]E.g., see Briault (1995).

[3]E.g., see Fischer (1994) and Feldstein (1997).

[4]See the survey in Anderson and Gruen (1995).

2. Avoiding Time Inconsistency One of the key problems facing monetary policymakers is the time-inconsistency problem described by Calvo (1978), Kydland and Prescott (1978) and Barro and Gordon (1983). The time-inconsistency problem arises because there are incentives for a policymaker to try to exploit the short-run tradeoff between employment and inflation to pursue short-run employment objectives, even though the result is poor long-run outcomes. Expansionary monetary policy will produce higher growth and employment in the short-run and so policymakers will be tempted to pursue this policy even though it will not produce higher growth and employment in the long-run because economic agents adjust their wage and price expectations upward to reflect the expansionary policy. Unfortunately, however, expansionary monetary policy will lead to higher inflation in the long-run, with its negative consequences for the economy.

McCallum (1995) points out that the time-inconsistency problem by itself does not imply that a central bank will pursue expansionary monetary policy which leads to inflation. Simply by recognizing the problem that forward-looking expectations in the wage- and price-setting process creates for a strategy of pursuing expansionary monetary policy, central banks can decide not to play that game. From my first-hand experience as a central banker, I can testify that central bankers are very aware of the time-inconsistency problem and are indeed extremely adverse to falling into a time-inconsistency trap. However, even if central bankers recognize the problem, there still will be pressures on the central bank to pursue overly expansionary monetary policy by politicians. Thus overly expansionary monetary policy and inflation may result, so that the time-inconsistency problem remains. The time-inconsistency problem is just shifted back one step; its source is not in the central bank, but rather resides in the political process.

The time-inconsistency literature points out both why there will be pressures on central banks to pursue overly expansionary monetary policy and why central banks whose commitment to price stability is in doubt are more likely to experience higher inflation. In order to prevent high inflation and the pursuit of a suboptimal monetary policy, monetary policy institutions need to be designed in order to avoid the time-inconsistency trap.

3. Alignment of Fiscal Policy with Monetary Policy One lesson from the "unpleasant monetarist arithmetic" discussed in Sargent and Wallace (1981) and the recent literature on fiscal

theories of the price level (Woodford, 1994 and 1995) is that irresponsible fiscal policy may make it more difficult for the monetary authorities to pursue price stability. Large government deficits may put pressure on the monetary authorities to monetize the debt, thereby producing rapid money growth and inflation. Restraining the fiscal authorities from engaging in excessive deficit financing thus aligns fiscal policy with monetary policy and makes it easier for the monetary authorities to keep inflation under control.

4. Forward-Looking Policy The existence of long lags from monetary policy actions to their intended effects on output and inflation suggests that monetary policy should be forward looking. If policymakers wait until undesirable outcomes on inflation and output fluctuations actually arise, their policy actions are likely to be counterproductive. For example, by waiting until inflation has already appeared before tightening monetary policy, the monetary authorities will be too late; inflation expectations will already be embedded into the wage and price-setting process, creating an inflation momentum that will be hard to contain. Once the inflation process has gotten rolling, the process of stopping it will be slower and costlier. Similarly, by waiting until the economy is already in recession, expansionary policy may kick in well after the economy has recovered, thus promoting unnecessary output fluctuations and possible inflation.

To avoid these problems, monetary authorities must behave in a forward-looking fashion and act preemptively. For example, if it takes two years for monetary policy to have a significant effect on inflation, then even if inflation is quiescent currently, but with an unchanged stance of monetary policy policymakers forecast inflation to rise in two years time, then they must act today to head off the inflationary surge.

5. Accountability A basic principle of democracy is that public should have the right to control the actions of the government: in other and more famous words, "the government should be of the people, by the people and for the people." Thus the public in a democracy must have the capability to "throw the bums out" or punish incompetent policymakers through other methods in order to control their actions. If policymakers cannot be removed from office or punished in some other

way, this basic principle of democracy is violated. In a democracy, government policymakers need to be held accountable to the public.

A second reason why accountability of policymakers is important is that it helps to promote efficiency in government. Making policymakers subject to dismissal from office makes it more likely that incompetent policymakers will be replaced by competent policymakers. In addition, making policymakers subject to dismissal or subject to other punishments creates better incentives for policymakers to do their jobs well. Knowing that they are subject to punishment when performance is poor, policymakers will strive to get policy right. If policymakers are able to avoid accountability, then their incentives to do a good job drop appreciably, making poor policy outcomes more likely.

Armed with these five principles of monetary policy, we can now go on to look at two key issues of the design of monetary policy institutions: the degree of independence of the central bank and how central banks might be held accountable.

III.
Central Bank Independence

Together, the first three principles for monetary policy outlined above suggest that the overriding, long-run goal of monetary policy should be price stability. A goal of price stability immediately follows from the benefits of low and stable inflation, while an institutional commitment to price stability is one way to make time-inconsistency of monetary policy less likely. An institutional commitment to the price stability goal provides a counter to time-inconsistency because it makes it clear that the central bank must focus on the long-run and thus resist the temptation to pursue short-run expansionary policies that are inconsistent with the long-run, price stability goal.

The third principle that fiscal policy should be aligned with monetary policy provides another reason why price stability should be the overriding, long-run goal of monetary policy. As McCallum (19xx) has emphasized, "unpleasant monetarist arithmetic" only arises if the fiscal

authorities are the first mover. In other words if the fiscal authorities are the dominant player and so can move first, thus setting fiscal policy exogenously knowing that the monetary authorities will be forced to accommodate their policies to maintain the long-run government budget constraint, then fiscal policy will determine the inflation rate. Indeed, this is the essence of the fiscal theory of the price level. On the other hand, as McCallum (19xx) points out, if the monetary authorities are the dominant player and move first, then it will be fiscal policy that will accommodate in order to satisfy the long-run government budget constraint, and monetary policy will determine the inflation rate. An institutional commitment to price stability as the overriding, long-run goal, is just one way to ensure that monetary policy moves first and dominates, forcing fiscal policy to align with monetary policy.

Although there is a strong rationale for the price stability goal, who should make the institutional commitment? Should the central bank independently announce its commitment to the price stability goal or would it be better to have this commitment be mandated by legislation?

Here the distinction between goal independence and instrument independence made by Debelle and Fischer (1994) and Fischer (1994) is quite useful. Goal independence is the ability of the central bank to set its own goals for monetary policy, while instrument independence is the ability of the central bank to independently set the instruments of monetary policy to achieve the goals. The basic principle of democracy that the public must be able to exercise control over government actions strongly suggests that the goals of monetary policy should be set by the elected government. In other words, a central bank should not be goal independent. The corollary of this view is that the institutional commitment to price stability should come from the government in the form of an explicit, legislated mandate for the central bank to pursue price stability as its overriding, long-run goal.

Not only is a legislated mandate and goal dependence of the central bank consistent with basic principles of democracy, but it has the further advantage that it makes time-inconsistency less likely, while making alignment of fiscal policy with monetary policy more likely. As we discussed above, the source of the time-inconsistency problem is more likely to be embedded in the political process than it is in the central bank. Once politicians commit to the price stability goal by passing central bank legislation with a price stability mandate, it becomes harder for them to put pressure on

the central bank to pursue short-run expansionary policies that are inconsistent with the price stability goal. Furthermore, a government commitment to price stability is also a commitment to making monetary policy dominant over fiscal policy, ensuring a better alignment of fiscal policy with monetary policy.

An alternative way to solve time-inconsistency problems has been suggested by Rogoff (1985): grant both goal and instrument independence to a central bank and then appoint conservative central bankers to run it who put more weight on controlling inflation relative to output than does the general public. The result will be low inflation, but at the cost of higher output variability than the public desires. There are two problems with this solution. First, having "conservative" central bankers impose different preferences than the public on the conduct of monetary policy is inherently undemocratic. Basic democratic principles indicate that the preferences of policymaking should be aligned with those of the society at large. Second, in the long run a central bank cannot operate without the support of the public. If the central bank is seen to be pursuing goals that are not what the public wants, support for central bank independence is likely to erode. Thus appointment of "conservative" central bankers may not be stable in the long run and will not provide a permanent solution to the time-inconsistency problem.

Although an institutional commitment to price stability helps solve time-inconsistency and fiscal alignment problems, it does not go far enough because price stability is not a clearly defined concept. The definition of price stability has many elements in common with the commonly used legal definition of pornography in the United States -- you know it when you see it. Constraints on fiscal policy and discretionary monetary policy to avoid inflation might thus end up being quite weak because not everyone will agree on what price stability means in practice, providing both monetary policymakers and politicians a loophole to avoid making tough decisions to keep inflation under control. A solution to this problem is to have the government and central bank adopt an explicit nominal anchor that ties down exactly what the commitment to price stability means.

There are several forms that an explicit nominal anchor can take. One is a commitment to a fixed exchange rate. For example, in 1990, Argentina established a currency board that required the central bank to exchange U.S. dollars for new pesos at a fixed exchange rate of one to one. A second nominal anchor is for the central bank to have a money-growth target, as in Germany. A third

nominal anchor is for there to be an explicit numerical inflation goal as in inflation targeting countries such as New Zealand, Canada and the United Kingdom, among others. All these forms of explicit nominal anchors can help reduce the time-inconsistency problem, as the success of countries using them in lowering and controlling inflation demonstrates (Mishkin, 1998a) These nominal anchors also help restrain fiscal policy and are also seen as an important benefit of inflation targeting in countries such as New Zealand and Canada (Mishkin and Posen, 1997, and Bernanke, Laubach, Mishkin and Posen, 1998).

The same principles that suggest that the central bank should be goal dependent, with the commitment to the price stability goal mandated by the government, also suggest that the commitment to an explicit nominal anchor should be made by the government. In the case of an exchange rate target, the government should set the target, as in Argentina, or in the case of an inflation target, the government should set the numerical inflation goal. The fact that the government sets these targets so that the central bank is goal dependent does not mean that the central bank should be cut out of the decision making process. Because the central bank has both prestige and expertise in the conduct of monetary policy, governments will almost always be better served by setting these targets in consultation with the central bank.

Although the arguments above suggest that central banks should be goal dependent, the principles for monetary policy in the previous section provide a strong case that central banks should be instrument independent. Allowing central banks to control the setting of monetary policy instruments provides additional insulation from political pressures to exploit short-run tradeoffs between employment and inflation. Instrument independence means that the central bank is better able to avoid the pursuit of time-inconsistent policies.

The important principle that monetary policy needs to be forward looking in order to take account of the long lags in the effect of monetary policy on inflation provides another rationale for instrument independence. Instrument independence insulates the central bank from the myopia that is frequently a feature of the political process arising from politicians' concerns about getting elected in the near future. Instrument independence thus makes it more likely that the central bank will be forward looking and adequately allow for the long lags from monetary policy actions to inflation in setting their policy instruments.

Recent evidence seems to support the conjecture that macroeconomic performance is improved when central banks are more independent. When central banks in industrialized countries are ranked from least legally independent to most legally independent, the inflation performance is found to be the best for countries with the most independent central banks (see Alesina and Summers, 1993, Cukierman, 1992, and Fischer, 1994, among others.) However, there is some question whether causality runs from central bank independence to low inflation, or rather, whether a third factor is involved, such as the general public's preferences for low inflation that create both central bank independence and low inflation (Posen, 1995).

The bottom line is that basic principles for monetary policy and democracy suggest that central banks should have instrument but not goal independence. This degree of independence for central banks is analogous to the relationship between the U.S. military and the government during the successfully prosecuted Gulf War in 1991. The military had instrument independence: it had complete control over the prosecution of the war with little interference from the government (in contrast to the less successfully waged Vietnam War). On the other hand, the military did not have goal independence: it was the Commander in Chief, George Bush, who made the decisions as to what the objectives and goals of the war would be.

IV.
Central Bank Accountability

The basic principle that policymakers should be accountable indicates that the central bank should be subject to government and public scrutiny. One way of ensuring accountability is to make the independence of the central bank subject to legislative change by allowing the act that created the central bank to be modified by legislation at any time. Another way is to mandate periodic reporting requirements to the government, for example as was done in the Humphrey-Hawkins legislation which requires the Chairman of the Federal Reserve to testify to Congress twice a year. Stronger accountability can be enforced by making the central bank governor subject to dismissal if he or she breaches the goals set by the government, as is the case in New Zealand.

Increased transparency of monetary policymaking is another important way to increase

central bank accountability. Central banks need to communicate clearly their monetary policy strategy to explain their objectives and how they plan to achieve them. Each time they change their policy instruments, such as the interbank interest rate, they also need to clearly state the decision and then explain the rationale for it. Furthermore, they need to pursue many outreach vehicles to communicate with the public. These include the continual making of speeches to all elements of society, more openness with the press and media, and the development of brochures and reports that are accessible to the public. Particularly noteworthy in this regard are the "Inflation Report" type documents initially developed by the Bank of England, but now emulated by many other central banks. These documents depart from the usual, dull-looking, formal reports of central banks to take on the best elements of textbook writing (fancy graphics, use of boxes) in order to better communicate with the public.

Increasing transparency and accountability not only helps to align central banks with democratic principles, and is thus worthy of its own right, but it also has benefits for the ability of central banks to conduct monetary policy successfully. Transparency reduces the uncertainty about monetary policy, interest rates and inflation, thus making private-sector planning easier. Transparency and communication also promotes a better public understanding of what central banks can do -- promote price stability which has the potential to enhance economic growth in the long run -- and what central banks can't do -- create permanent increases in output and employment through expansionary policy. Better public understanding of what central banks can and cannot do is then likely to generate more public support for monetary policy which is focused on price stability as the long-run, overriding goal.

Although central bankers find their life to be a more comfortable one when they are not accountable and can avoid intense public scrutiny, increased transparency and accountability have important benefits for central bankers. Because transparency and accountability can increase the public support for the price stability goal, they can reduce political pressures on the central bank to pursue inflationary monetary policy. In addition, transparency and accountability can increase support for independence of the central bank. An instructive example is provided by the granting of instrument independence to the Bank of England in May 1997. Prior to this date, monetary-policy decisions in the United Kingdom were made by the government (the Chancellor of the Exchequer)

rather than by the Bank of England. When, on May 6, 1997, the Chancellor of the Exchequer, Gordon Brown, announced the granting of instrument independence to the Bank of England, giving it the power to set the overnight interest rate, he made it particularly clear at the press conference that, in his view, the action had been made possible by the increased transparency and accountability of policy under the recently adopted, inflation-targeting regime.

V.
Different Monetary Policy Regimes

There are four basic types of policy regimes that are used in the conduct of monetary policy: 1) exchange-rate targeting, 2) monetary targeting, 3) inflation targeting, and 4) preemptive monetary policy without an explicit nominal anchor. It is well beyond this paper to discuss the relative merits of these regimes, and so the interested reader is referred to Mishkin (1998a) or our forthcoming book, Bernanke, Laubach, Mishkin and Posen (1998). Here we will focus on how well these different regimes stack up in terms of central bank independence and accountability.

Exchange-Rate Targeting

In exchange-rate targeting regimes, whether it is an fixed exchange rate or a crawling peg regime, the target is typically set by the government, with the central bank in charge of setting policy instruments in order to achieve the target. In this type of set up, the central bank has instrument, but not goal independence, which is in line with the basic monetary-policy and democratic principles outlined earlier.

At first glance, exchange-rate targeting makes the central bank quite accountable because it has a clear cut goal, an exchange rate target that is easily monitored by the public. However, an exchange-rate target can actually weaken accountability of the central bank, particularly in emerging market countries, because it eliminates an important signal that can help keep monetary policy from becoming too expansionary.

In industrialized countries, and particularly in the United States, the bond market provides

an important signal about the stance of monetary policy. Overly expansionary monetary policy or strong political pressure to engage in overly expansionary monetary policy produces an inflation scare of the type described by Goodfriend (1993) in which long-term bond prices tank and long-term rates spike upwards. In many countries, particularly emerging market countries, the long-term bond market is essentially nonexistent. In these countries, the daily fluctuations of the exchange rate can, like the bond market in the United States, provide an early warning signal that monetary policy is overly expansionary. Thus, like the bond market, the foreign exchange market can constrain policy from being too expansionary. Just as the fear of a visible inflation scare constrains central bankers from pursuing overly expansionary monetary policy and also constrains politicians from putting pressure on the central bank to engage in overly expansionary monetary policy, fear of exchange rate depreciations can make overly expansionary monetary policy less likely.

An exchange-rate target has the important disadvantage that it removes the signal that the foreign exchange market provides about the stance of monetary policy on a daily basis. Under an exchange-rate-target regime, central banks often pursue overly expansionary policies that are not discovered until too late, when a successful speculative attack has gotten underway. The problem of lack of accountability of the central bank under an exchange-rate-target regime is particularly acute in emerging market countries where the balance sheets of the central banks are not as transparent as in developed countries, thus making it harder to ascertain the central bank's policy actions.

One exchange-rate targeting regime that does not suffer from this problem of lack of transparency and accountability is the currency board arrangement like the one adopted in Argentina. The currency board in Argentina clearly is one in which the goals are not set by the central bank, but rather by the Convertibility law passed in 1990 which fixed the exchange rate of new pesos to the U.S. dollar of one to one. The currency board is an especially strong and transparent commitment to an exchange-rate target because it requires the note-issuing authority, whether the central bank or the government, to stand ready to exchange the domestic currency for foreign currency at the specified fixed exchange rate whenever the public requests it. Although the central bank in theory has instrument independence, in practice it does not because its requirement to exchange the domestic currency for foreign currency at the fixed rate means that it is the demand for domestic relative to the foreign currency it is pegged to (and the interest rates in that foreign

country) that determines interest rates, not the central bank. This loss of control of monetary policy is not a problem with the currency board arrangement when independent domestic monetary policy in the past has been irresponsible and thus it is felt that it is the only way to break a country's inflationary psychology and alter the political process so that it no longer leads to continuing bouts of inflation.

Despite some of the advantages of a currency board in terms of its transparency, accountability and consistency with democratic principles, it does suffer from some severe problems. Shock such as the tequila crisis of 1995 can result in the public pulling their money out of banks and exchanging them for the foreign currency, thus causing a dramatic decline in the money supply and with it a sharp contraction in economic activity, as happened in Argentina in 1995. These and other problems with currency boards are discussed more extensively in Mishkin (1998b).

Monetary Targeting

The second monetary policy regime, monetary targeting, is currently pursued seriously by only two countries: Germany and Switzerland. In both countries, the central banks are both goal and instrument independent. Although legislation has mandated price stability as the primary goal for the Bundesbank, this is not the case for the Swiss National Bank. However, in both countries the central bank, on its own, determines the numerical inflation goal, as well as the money growth targets, and also has complete control over its monetary policy instruments. Thus by our criteria that central banks should be only instrument but not goal independent, the Bundesbank and the Swiss National Bank appear to be too independent. However, it must be noted that both central banks are well aware that central bank legislation can be modified at any time and that without the support of the public they will not retain their independence. Indeed, as documented in Mishkin and Posen (1997) and Bernanke, Laubach, Mishkin and Posen (1998), both banks have demonstrated a very strong commitment to the communication of their monetary policy strategies to the general public, going well beyond what is required of them by law.

One potential advantage of monetary targeting is that information on whether the central bank is achieving its target is known almost immediately -- announced figures for monetary

aggregates are typically reported periodically with very short time lags, i.e., within a couple of weeks. Thus monetary targets can provide almost immediate accountability of the central bank. However, this advantage of monetary targeting depends on a big *if*, that there is a strong and reliable relationship between the goal variable such as inflation and the targeted aggregate. If there is velocity instability so that the link between the goal variable and the monetary aggregate is weak, then the aggregate will no longer provide an adequate signal about the stance of monetary policy. This has not only been a problem in countries like the United States,[5] but it also has been a problem in both Switzerland and possibly even Germany.[6]

The problems with monetary aggregates suggest an important reason why even the most avid monetary targeters, the Bundesbank and the Swiss National Bank, do not rigidly hold to their target ranges, but rather allow undershoots and overshoots for extended periods of time. The Bundesbank, for example, misses its target ranges on the order of fifty percent of the time (e.g., see Von Hagen, 1995, Neumann, 1996, Bernanke and Mihov, 1996, Clarida and Gertler, 1997, Mishkin and Posen, 1997, and Bernanke, Laubach, Mishkin and Posen, 1998.) The unreliable relationship between monetary aggregates and goal variables also calls into question the ability of monetary targeting to serve as a communications device that both increases the transparency of monetary policy and makes the central bank accountable to the public.

Thus despite its potential advantages, monetary targeting may not enhance central bank accountability. Indeed, Bernanke, Laubach, Mishkin and Posen (1998) argue that the monetary targeting strategy of he Bundesbank and the Swiss National Bank has only worked because of the clarity of the explanations emanating from the Bundesbank and the Swiss National Bank, and by the fact that the policy framework for these central banks includes an explicit long-run inflation goal and regular evaluations of the progress made toward that goal.

Inflation Targeting

[5]See Stock and Watson (1989) Friedman (1995), Friedman and Kuttner (1993, 1996) and Estrella and Mishkin (1997).

[6]Estrella and Mishkin (1997) and Bernanke, Laubach, Mishkin and Posen (1998.

Inflation targeting has been adopted by New Zealand, Canada, the United Kingdom, Sweden, Finland, Spain, Australia and Israel and involves several elements: 1) public announcement of medium-term numerical targets for inflation; 2) an institutional commitment to price stability as the primary, long-run goal of monetary policy and to achievement of the inflation goal; 3) an information inclusive strategy, with a reduced role for intermediate targets such as money growth; 4) increased transparency of the monetary policy strategy through communication with the public and the markets about the plans and objectives of monetary policymakers; and 5) increased accountability of the central bank for attaining its inflation objectives.[7]

In all inflation targeting regimes to date, the inflation goal is set by the government, in consultation with the central bank. Except in the case of the United Kingdom before May 1997, in all inflation-targeting regimes, the central bank sets the monetary policy instruments. Thus inflation-targeting regimes satisfy the criteria from monetary-policy and democratic principles that the central bank should focus on price stability and be instrument, but not goal independent.

Inflation-targeting regimes also put great stress on making policy transparent -- policy that is clear, simple, and understandable -- and on regular communication with the public. Inflation targeting, like exchange-rate targeting, has the key advantage that it is readily understood by the public. Monetary targets are less likely to be easily understood by the public than inflation targets, and as mentioned above, if the relationship between monetary aggregates and the inflation goal variable is subject to large unpredictable shifts, as has occurred in many countries including a long-standing monetary targeter such as Switzerland, then monetary targets lose their transparency because they are no longer able to accurately signal the stance of monetary policy. However, inflation targeting does have some important disadvantages in terms of accountability: In contrast to exchange rates and monetary aggregates, inflation is not easily controlled by the monetary authorities. Furthermore, because of the long lags of the effects of monetary policy, inflation outcomes are revealed only after a substantial lag. Thus, an inflation target is unable to send

[7]Detailed analyses of experiences with inflation targeting can be found in Goodhart and Vinals (1994), Leiderman and Svensson (1995), Haldane (1995), McCallum (1996), Mishkin and Posen (1997) and Bernanke, Laubach, Mishkin and Posen (1998).

immediate signals to both the public, politicians and markets about the stance of monetary policy.

The central banks engaging in inflation targeting have frequent communications with the government, some mandated by law and some in response to informal inquiries, and their officials take every opportunity to make public speeches on their monetary policy strategy. These channels are also commonly used in countries that have not adopted inflation targeting, Germany, Switzerland and the United States being prominent examples, but inflation-targeting central banks have taken public outreach a step further: not only have they engaged in extended public information campaigns, even engaging in the distribution of glossy brochures, but they have engaged in publication of "Inflation Report" type documents (originated by the Bank of England) described earlier.

Another key feature of inflation-targeting regimes is the tendency toward increased accountability of the central bank. Indeed, transparency and communication go hand in hand with increased accountability. The strongest case of accountability of a central bank in an inflation-targeting regime is in New Zealand, where the government has the right to dismiss the Reserve Bank's governor if the inflation targets are breached, even for one quarter. In other inflation-targeting countries, the central bank's accountability is less formalized. Nevertheless, the transparency of policy associated with inflation targeting has tended to make the central bank highly accountable to both the public and the government. Sustained success in the conduct of monetary policy as measured against a pre-announced and well-defined inflation target can be instrumental in building public support for a central bank's independence and for its policies. As Bernanke, Laubach, Mishkin and Posen (1998) find, this building of public support and accountability occurs even in the absence of a rigidly defined and legalistic standard of performance evaluation and punishment.

Inflation targeting stands up well on both the principles of monetary policy outlined earlier, but especially on the democratic principle that policymakers should be accountable to the political process. Under inflation targeting, the central bank is highly accountable to the public and elected officials, who in turn typically have primary responsibility for setting the goals for monetary policy and then monitoring the economic outcomes. At the same time, the inflation-targeting framework ensures that the objectives set by the government are feasible, and that they are considered within

the appropriate long-run perspective.[8] In terms of independence and accountability, inflation-targeting central banks seem to have it just about right.

Just Do It: Preemptive Monetary Policy without Explicit Targets

In recent years, the United States has achieved excellent macroeconomic performance without using an explicit nominal anchor such as a target for the exchange rate, a monetary aggregate target, or inflation. Although in the U.S. case, no explicit strategy has been articulated, a coherent strategy for the conduct of monetary policy exists nonetheless. This strategy consists of careful monitoring for signs of future inflation, coupled with periodic "preemptive strikes" by monetary policy against the threat of inflation.

This preemptive monetary policy strategy is clearly also a feature of inflation-targeting regimes because monetary policy instruments must be adjusted to take account of the long lags in their effects in order to hit future inflation targets. However, the policy regime in the United States, which does not have a nominal anchor and so might best be described as a "just do it" policy regime, differs from inflation targeting in that it does not officially have a nominal anchor and is much less transparent in its monetary policy strategy.

The "just do it" strategy in the United States is one where the goals of monetary policy are not clearly defined by the government, with potentially conflicting goals a feature of the central bank mandate. Thus the central bank retains a fair degree of goal independence, while it also has complete control over the setting of policy instruments. The substantial goal independence of the Federal Reserve creates a fair amount of tension in a democratic society because it allows an elite group to set the goals of monetary policy. Indeed, recent criticism of the Federal Reserve may have been prompted by the impression that the Federal Reserve, and particularly its Chairman, has become

[8]Nominal GDP targeting has many features of inflation targeting and is closely related to it. It is not discussed in this paper because no country has to date adopted this monetary policy framework. For a discussion of nominal GDP targeting, see Taylor (1985), Hall and Mankiw (1994), Mishkin (1998a) and Bernanke, Laubach, Mishkin and Posen (1998).

too powerful. Although the Fed is currently riding high because of the recent successes of its monetary policy, a political backlash against a "highhanded" Federal Reserve could have adverse consequences on its independence and ability to successfully conduct monetary policy in the future.

Another important disadvantage of the "just do it" strategy is a lack of transparency. The opacity of its policymaking is hardly conducive to making the Federal Reserve accountable to Congress and the general public, because there are no predetermined criteria for judging its performance. In addition, the lack of clarity of the Fed's monetary policy strategy results in a public debate which puts pressure on the Fed to focus more on the short-run creation of jobs and growth, rather than the long-run goal of producing a healthy economy through price stability. The Fed currently has a very positive working relationship with the executive branch of the government. However, in a different economic or political environment, the Fed could be more susceptible to the time-inconsistency problem, whereby it could be pressured into pursuing short-term objectives at the expense of long-term ones.

Thus although the "just do it" regime has worked quite well for the United States in recent years, there is no guarantee that it will continue to do so in the future. In the past, after a successful period of low inflation, the Federal Reserve has reverted to inflationary monetary policy -- the 1970s are one example -- and without an explicit nominal anchor, this could certainly happen again in the future. In addition, the lack of accountability of the "just do it" framework could cause increased attacks on the independence of the Federal Reserve. We have already discussed how inflation targeting can increase the likelihood that time-inconsistent policies will be pursued and can protect the independence of the central bank. Thus, although many commentators take the attitude that if it ain't broke, why fix it, as argued in more detail in Bernanke and Mishkin (1997), Mishkin (1998a) and Bernanke, Laubach, Mishkin and Posen (1998), there are strong reasons for a switch in the United States from the "just do it" monetary policy regime to a regime of inflation targeting.

VI.

Issues for the European Central Bank

In 1999, we will see the birth of a new central bank for the European Monetary Union. As it is currently designed, how does this new institution, the European Central Bank, compare to other existing central banks with regard to its independence and accountability.

A key feature of the European Central Bank (ECB) is that its statutes cannot be changed by legislation, but only by alterations to the Maastricht Treaty. Furthermore, the Maastricht Treaty specifies that the overriding, long-run goal of the ECB is price stability, but does not specify exactly what this means. Thus the European Central Bank not only has instrument independence, but goal independence as well. Indeed, the ECB will be the most independent central bank in the world since its statutes are specified in a treaty and are thus far harder to change than statutes that are embedded in legislation. Moreover, it is not clear to whom the European Central Bank would be accountable. Although the President of the ECB is required to testify once a year to the European Parliament, this requirement may not guarantee sufficient oversight of ECB policies. Since the European Parliament is currently significantly less powerful than the national parliaments of the countries that make up the Monetary Union, scrutiny by that organization would not influence ECB behavior as strongly as would oversight by a more powerful body, such as a consortium of national parliaments, or the individual parliaments themselves.

The European Central Bank will thus an inherently undemocratic organization and this could be highly problematic in the future. Indeed, recent fights over whether there needs to be additional oversight of the ECB and over who should be the first President, suggest that these tensions will be serious ones in the future.

The European Monetary Institute, the precursor to the European Central Bank, is currently debating whether the European Central Bank should adopt one of two possible monetary policy strategies: monetary or inflation targeting. As we have seen, both strategies involve specifying an explicit numerical inflation goal and there is an important question of who should decide on this goal. Although the Maastricht Treaty gives the ECB the authority to specify the numerical goals, some mechanism for consultation between the ECB and the constituent governments should be developed.

Enabling the national governments to participate in the setting of inflation goals would yield several benefits. First it would keep the European Central Bank from being viewed as a non-democratic institution indifferent to the concerns of the public, helping to preserve its independence in the long run. Second, having the governments in the Monetary Union participate in setting inflation goals would help focus the political debate on monetary policy on long-run issues, such as price stability, rather than on the need for short-run monetary stimulus to create jobs. Third, allowing the governments to take part in the setting of inflation goals would tend to sensitize them to the fact that large increases in public sector wages or unduly expansionary fiscal policies might interfere with these goals.

Because the accountability of the European Central Bank under the Maastricht Treaty seems insufficient, the ECB should be required or voluntarily agree to justify its policy actions though periodic testimony not only in the European Parliament but in the national parliaments of the EMU countries as well. Besides increasing the Bank's accountability, such testimony would demonstrate to the public in each EMU country that the ECB is accountable to them, as well as to EMU as a whole, which should help increase popular support for the Bank's independence. This testimony would also provide the European Central Bank with an additional public forum in which to explain its policy and to emphasize the need for central bankers to adopt a long-run perspective when making policy decisions. In taking up the mantle of the Bundesbank, the ECB should make a concerted effort to communicate regularly and comprehensively with the public as the Bundesbank has done. Production of an "Inflation Report" type document, as well as the ECB taking every opportunity to explain its policy actions and monetary policy strategy in public forums, should be important elements of this process.

VII.
Implications for Transition Countries

This paper has argued that the institutional design of a central bank most consistent with its role in a democratic society and with basic monetary-policy principles is one in which the central bank is instrument, but not goal independent. In addition, central banks should be highly accountable in a democratic society. Making sure that the central bank performs a role in the society that is perceived by the public as consistent with democratic principles is particularly important in transition countries. Because their institutional framework is in some sense starting from scratch, having a central bank that is perceived as undemocratic may undermine support for this institution that may prevent it from carrying out its job properly in the future. Thus, the degree of independence of the Bundesbank, which has an element of goal independence, but especially of the new European Central Bank, which I have argued is far too independent, may be inappropriate for the transition countries.

An evaluation of the four basic monetary policy regimes in terms of central bank accountability and independence leads to the following conclusions for transition countries. The "just do it" strategy of preemptive monetary policy without explicit targets is highly problematic even for the United States, but is clearly inappropriate for transition countries. Given the newness of the independence of central banks in these countries, their central banks do not yet have a high degree of credibilty. Thus the "just do it" strategy is unlikely to be effective because it requires a high degree of credibility in order to produce good economic outcomes. Furthermore, because it allows too much goal independence for the central bank, the "just do it" strategy is not fully consistent with democratic principles and thus could create tension in a transition country that would ultimately lead to a weakening of support for the central bank.

Because monetary targeting has been associated with goal independence for the central bank and because monetary aggregates may provide poor signals about the stance of monetary policy if the relationship between the aggregate and the inflation goal is weak, monetary targeting may result in a central bank that is too independent and not sufficiently accountable for its actions. The problem of instability of the relationship between monetary aggregates and inflation is likely to be severe in transition countries because the institutional changes they are undergoing is substantial. Thus, monetary targeting is unlikely to be an effective strategy for transition countries and may not

lead to sufficient accountability of the central bank.

Exchange-rate targeting, which has been a basic monetary policy strategy for many transition countries, can be consistent with both monetary policy and democratic principles, but only if the commitment mechanism is both strong and transparent. However, exchange rate targets can weaken the accountability of the central bank because it removes the signal that the foreign exchange market provides about the stance of monetary policy on a daily basis. Also, for the reasons described in Mishkin (1998b), exchange rate targeting can be dangerous for emerging market and transition countries because it can promote financial fragility and lead to foreign exchange crises that can lead to full-fledged financial crises with disastrous consequences for the economy.

Inflation targeting, with instrument, but not goal independence and its high accountability, meets the criteria set by both democratic and monetary-policy principles. Indeed inflation targeting regimes are likely to strengthen the independence of the central bank because it provides an appropriate role for a central bank in a democratic society. Inflation targeting is not without its problems, however. In contrast to exchange-rate and monetary targeting, inflation is not easily controlled by the monetary authorities. This can be a particularly severe problem for a transition country that is trying to bring down inflation from a previously high level and so is more likely to experience large inflation forecast errors. In addition, inflation targets may not provide a sufficient nominal anchor until a central bank in a transition country has established credibility by showing some ability to reduce inflation to reasonable levels. These problems suggest that hard targets from inflation might be worth phasing in only after there has been some successful disinflation. This is exactly the strategy followed by Chile (see Morande and Schmidt-Hebbel, 1997) which adopted a weak form of inflation targeting in September 1990. Initially, inflation targets were announced and interpreted as official inflation projections, rather than as hard targets. However, over time as inflation fell, this procedure was changed and inflation targets came to be viewed by the central bank and the markets as hard targets. Waiting to harden targets until after some success has already been achieved on the inflation front, is also consistent with what inflation-targeting industrialized countries have done: in every case, inflation targeting was not implemented until after substantial disinflation has previously been achieved (see Mishkin and Posen, 1997, and Bernanke, Laubach, Mishkin and Posen, 1998). The discussion above therefore suggests that transition countries should

seriously consider inflation targeting as a monetary strategy, but may need to choose an alternative monetary policy strategy initially, such as exchange-rate targeting, in order to obtain the requisite amount of credibility to make inflation targeting a success.

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