Comments on "Central Banks and Supreme Courts"

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This paper by Charles Goodhart and Ellen Meade accomplishes two things. It provides a fascinating commentary on the co-development of legal and monetary systems and it offers a provocative explanation for the different institutional designs of the US and UK central banks and highest courts; I will restrict my comments to the latter contribution.

1. The "democratic-deficit" concern

The authors theorise that democratic societies may want to delegate certain tasks to appointed bodies, either because of a time-inconsistency problem or because of the technical nature of the tasks. However, society dislikes unelected bodies holding political power. They term this aversion a "democratic-deficit concern". They argue that in designing their monetary authorities and highest courts, the United Kingdom and the United States have been motivated by the need to ensure sufficient independence for these bodies without compromising their democratic political systems. Different histories and different political and constitutional arrangements have caused the resulting institutions to vary across countries.

While liking very much the authors' arguments for the historical links between the evolution of legal institutions and monetary systems, I find their argument for the development of highest courts and monetary authorities to be less compelling. I am not convinced that the structure of either the supreme courts or the central banks in the Uniteds States and the United Kingdom are, or even should be, the result of a trading off of the need for institutional independence to satisfy efficiency concerns and the need to constrain the power of unelected bodies. Rather, I believe that the delegation of political power to a high court is a desirable check on the power of the elected government and there is no drawback to assigning monetary policy to an independent central bank as monetary policy should not be a political activity.

The notion that democratic governments are good and that delegating power to an appointed group is undesirable seems rather European. A perhaps more American view is that all governments – elected or not – have the potential to be dangerous and the primary task of designing a political system is to ensure that the citizenry is as protected as possible from abuse of power by the government. An unelected supreme court serves as a check on the power of the democratically elected legislature, helping to protect the rights of minorities from possible abuse by the majority.

The reasons that governments might delegate the operational aspects of monetary policy to an independent appointed body are different and lead me to provide a reason other than the one that the authors give for why the laws and conventions that govern monetary policy in the United Kingdom are so different than the ones that govern monetary policy in the United States.

2. Why are monetary policy institutions in the United Kingdom so different from monetary policy institutions in the United States?

In the 1960s it was believed that there existed a Philips curve relationship between inflation and employment and output. Society could increase employment and output if it was willing to tolerate higher inflation. The choice of where on the Philips curve to be entailed trading off the welfare of the primary beneficiaries of the higher real activity and the welfare of those who gained the most from low inflation. Thus, monetary policy was seen as involving redistribution and, thus, was viewed as a political activity. Evidence of this exists in the elaborate structuring of the Federal Reserve System, designed to ensure that different areas and sectors of society were represented in the decision-making process. (See Faust [2] for a description of this.)

By the end of the 1960s, this view was challenged; Friedman [3] and Phelps [6] argued that there is no long-run effect of money on output. In the 1970s the advent of rational expectations led to an amended view of society's tradeoff to one between *unexpected* inflation and output. Benevolent policy makers might attempt to increase output and employment by creating unexpected inflation, but in equilibrium the public's expectations are correct on average. The result is too high inflation, but on average no unexpected inflation and, hence, no employment or output gain; this is the time-inconsistency problem.

Given that the central bank cannot systematically produce unexpected inflation, the only positive function for monetary policy makers is to stabilise cyclical fluctuations if they have an informational advantage over the private sector. Even this role is questionable however. Friedman and the monetarist school argued that the long, variable and uncertain lags between the implementation of monetary policy and when its effects are realised render activist monetary policy to be of dubious value.

The beliefs that even benevolent policy makers have an incentive to inflate too much and that the stabilisation role of central banks is limited has led to the recent emergence of a view that the primary goal of monetary policy ought to be to target inflation. The task of the central bank is to project the paths of fundamental variables and to decide what interest rate will best achieve the inflation target, given the current and forecasted future values of the fundamental variables. This means that monetary policy can be viewed as a technical activity. Removing it from the influence of opportunistic governments solves the time-inconsistency problem; giving it to an independent body of technicians who are ordered to pursue an inflation target should cause no "democratic-defict" concern.

This change in thinking led to a revolution in central banking legislation in the United Kingdom and elsewhere. In June 1997 the Bank of England's Monetary Policy Committee (MPC) was given an inflation target and the operational independence to achieve it; this arrangement was formalised in the Bank of England Act of June 1998. The Reserve Bank of New Zealand Act of 1989 statutorily binds the Reserve Bank to price stability. The Bank of Japan Law of of 1997 orders the Bank of Japan to pursue low inflation and gives it greater independence to do so. The Maastricht Treaty and its annexed protocols make the ECB highly independent and mandate price stability as its primary goal.

This upheaval in central bank design passed the United States by. The Fed is relatively independent but US monetary arrangements do not give overriding importance to price stability. Instead, the Federal Reserve Act orders the Fed to, "... promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates." In this view, monetary policy is viewed as a political activity. Why is it that the institutional design is so different in the United States than in most of the rest of the industrialised world?

For a quarter of a century US monetary policy has been made by Paul Volcker and Alan Greenspan. Because of this historical accident, there has been little evidence of opportunistic monetary policy in the United States since the 1970s. The personalities of the policy makers compensated for the defectiveness of the Fed's design and as a result, in the United States there has been little to stimulate a public re-examination of the role of monetary policy or to motivate politicians to attempt to reform monetary institutions. As a consequence, in the United States – much more than in the United Kingdom – monetary policy is viewed as a political activity.

3. How do the different views of the nature of monetary policy shape monetary policy institutions?

The contrasting views of the nature of monetary policy – that it is largely a technical activity in the United Kingdom and primarily a political activity in the United States – have shaped the designs of UK and US monetary institutions. As examples, I focus on two features: how decisions are made and the size of the groups making the decisons.

3.1. The decision-making process. An economist modelling the decision-making process of a committee headed by a chairman who serves as agenda setter might proceed as follows. Assume that the choice is between the status quo and some other option. Then the chairman should select his most preferred option from the set of options that the median voter prefers to the status quo. Or, if the chairman prefers the status quo to any option in this set, he should offer an option that is less preferred by the median voter to the status quo. Members then vote for the alternative that they prefer. This model appears to fit the MPC fairly well. In his interesting paper on voting in committees, Seidmann [7] presents the following data for the 79 meetings between June 1997, when the MPC was given its independence and inflation target, until the end of Sir Edward George's tenure as Governor. The table presents the number of meetings at which different numbers of members voted against the Governor.[1]

$$\begin{array}{lccccc} \textit{Dissents} & 0 & 1 & 2 & 3 & 4 \\ \textit{Meetings} & 27 & 20 & 16 & 9 & 7 \end{array} \tag{1}$$

The above data is not obviously at odds with the theory; the chairman has never been in the minority but there is significant dissent.

In contrast, the following table (also from Seidmann [7]) gives the number of dissents from the chairman's proposal for the 12-member US Federal Open Market Committee (FOMC) for the period 1967 - Jan. 2002.

$$\begin{array}{lcccccc} \textit{Dissents} & 0 & 1 & 2 & 3 & 4 & 5 \\ \textit{Meetings} & 196 & 106 & 50 & 18 & 10 & 1 \end{array}. \tag{2}$$

At none of the meetings were there more than five dissents; the chairman never lost and he never cast the deciding vote. There is far less dissent in the FOMC than in the MPC; indeed the data does not appear consistent with a model where members are voting for their most preferred option.

Voting in the FOMC appears to be more consistent with what is predicted by the psychology and sociology literature. In this literature the median voter is mainly a mathematical curiosity, if it appears at all. (See for example Napier and Gershenfeld [4] and

[1] Except for a brief period at the start when it had seven members, the MPC has had nine members.

Parks and Sanna [5]. Scant attention is paid to majority rule, Napier and Gershenfeld [4], for example, dismiss it, saying, "A group should be willing to accept this approach only when the decision is of relatively little consequence and they need a quick response." Consistent with this view, former Federal Reserve Board Governor Alan Blinder [1] claims that the Fed makes decisions by consensus, not majority rule.

A consensus decision is defined as one that members are willing to go along with; it is not a decision that everyone necessarily agrees with. This fits what is evident from FOMC transcripts: many members vote for the chair's proposal although they are opposed to it.

Why does the FOMC make decisions by consensus when the MPC does not? Is it because of the perceived importance of the Fed chairman and the strength of his personality? The data in Seidmann [7] suggests that this is not the case. There was relatively little dissent under all of the FOMC's chairmen since 1967. It is likely instead that the perceived political nature of the FOMC's task means that consensus is perceived as more important there than it is in the MPC.[2] Goodhart and Meade comment that, "... frequent dissent may expose an institution to criticism and raise questions about its legitimacy."

3.2. The size of the monetary policy committee. An obvious difference between the UK MPC and the US FOMC is their sizes. The MPC is relatively small (although probably too big) with nine members; the FOMC has an unwieldy twelve. The smaller size of the MPC may be due to the technical nature of its task. The optimal number of people to have in a group charged with a technical activity is probably small. This is because information is a public good in a committee. The more effort an individual expends on being informed, the better informed is the committee as a whole and the better its performance. To see that increasing the size of the group can worsen performance, consider a simple example of how a one-person committee can have a better performance than a two-person committee.

Suppose that it costs a committee member c units to become informed. Group performance is F^2 if two members are informed, F^1 if one member is informed and 0 if no one is informed, where $0 < c < F^1 < F^2$. Assume that $F^2 - F^1 < c$.

Committee members like improved performance and dislike effort. If the committee consisted of one member he would become informed and the committee would have a performance of F^1. If the committee has two members, then their payoff matrix is

$$\begin{array}{cc} & \begin{array}{cc} Expend\ Effort & No\ Effort \end{array} \\ \begin{array}{c} Expend\ Effort \\ No\ Effort \end{array} & \begin{array}{cc} F^2 - c, F^2 - c & F^1 - c, F^1 \\ F^1, F^1 - c & 0, 0 \end{array} \end{array} . \tag{3}$$

The symmetric outcome to the above game of chicken is that each member becomes informed with probability $\pi = \left(F^1 - c\right) / \left(2F^1 - F^2\right)$. The committee's expected performance is

$$\pi^2 F^2 + 2\pi(1-\pi)F^1 < F^1. \tag{4}$$

Thus, the two-person committee is worse than a single policy maker.

Of course the result is specific to this particular example, but in general one would expect that the public good nature of information would cause the performance of the committee to be increasing and then decreasing in committee size. This is consistent with

[2] There may be other contributing factors. Longer terms of office for FOMC members may lead to greater identification with or socialisation by the group. The FOMC chair may have greater influence over members because they interact with him in other areas besides monetary policy.

a sizable sociology and psychology empirical literature that suggests that individuals may also put in less effort when they are part of a group. (See Parks and Sanna [5])

Why is the FOMC so large? Again, the answer must be the perecieved political nature of the monetary policy process in the United States. If monetary policy is seen as involving welfare tradeoffs, then many different regional and sectoral groups need to be involved.

References

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