Central Bank Design

If there are nominal wage contracts or the government has an outstanding stock of debt, central banks face a temptation to create inflation. By lowering real wages and the real value of the outstanding stock of government debt, unanticipated price increases lower unemployment and improve the government's fiscal situation. But, in the long run the public understands the central bank's incentives and the inflation is anticipated. Inflationary expectations are built into wages and interest rates.

Because the central bank is unable to systematically fool the public, its incentive to bolster short-run employment and lower government outlays leads to a permanent inflation bias without any social gain. This does not provide an outcome which is conducive to growth and it is unfair. High and variable inflation leads to an inefficient allocation of resources, makes planning difficult for households and firms, and leads to an undesirable reallocation of income.

A nation's ability to control inflation depends on the structure of its central bank and the relationship between the central bank and the government. Central banks around the world vary widely in their structure and in their effectiveness at maintaining price stability.

Central bank goals and independence

Perhaps the best way to shield an economy from inflation is to make the central bank independent and to give it a legally binding mandate to achieve price stability. (It appears that, to policy makers, "price stability" is inflation in the range of zero to two or three percent.) Central bank independence protects the nation from opportunistic politicians desirous of extracting short-run gains from price increases. Empirical research suggests that more independent central banks produce lower inflation. A legal directive reflecting the long-run goals of society would reduce a central bank's own inflation bias. A combination of a clearly stated goal and the freedom to achieve it without government interference might be referred to as operational independence.

The first country to formally introduce inflation targeting was New Zealand. The Reserve Bank of New Zealand Act of 1989 statutorily binds the Bank to price stability. The exact target is the result of negotiations between the central bank head and the finance minister. To give the Act clout, the head of the central bank can be fired if he misses his target. The central bank has had some success in meeting its ambitious target.

A number of other countries have recently introduced legislation aimed at increasing their central bank's operational independence. In June 1997, the Bank of England was given an inflation target and independence to carry it out (although the government may overrule the Bank in exceptional circumstances.) This was formalised in the Bank of England Act of 1998.

June 1997 also saw the enactment of the Bank of Japan Law. This gave the Bank of Japan greater independence and ordered it to pursue low inflation. As a result, government officials no longer sit on the Bank's monetary policy committee and cannot instruct the Bank. No explicit inflation targets were set, however.

Eleven European countries, including Germany, France and Italy, have formed a monetary union. A common currency, called the "euro" has been adopted. Euro notes will be introduced in January 2002 and national currencies will lose their legal tender status in July of that year. A common monetary policy is now made by a new central bank, the European Central Bank (ECB). The Maastricht treaty and its annexed protocols describe the institutional structure and policy of common central bank.

The treaty makes the central bank highly independent, but is more ambiguous about its policy prescription than is the Bank of England Act. It proscribes the ECB from both asking or receiving advice from member countries' governments. It calls for price stability to be the ECB's main objective, but does not set an inflation target. Instead, the Bank has adopted its own.

In contrast, although the Federal Reserve is relatively independent, the US government does not require price stability. The Fed is not given and does not set inflation targets.

Openness and Accountability

For new institutional arrangements to have teeth, central banks must detail their procedures and assumptions to the public and the government. They must be held accountable for their actions. In addition, central bankers are not elected. For this to be palatable to a democratic society, their actions and goals must be transparent.

Among the most open central banks are those of the United Kingdom and Japan. Both central banks publish detailed minutes, the Bank of England with a two-week lag and the Bank of Japan with a two-month lag. The Bank of England publishes a detailed inflation report and both banks detail their assumptions. Individual votes of monetary policy committee members are published and in Japan, the dissenters provide their rationale.

If the Bank of England misses its inflation target by more than one part point in either direction, it must explain to the UK Parliament why this happened and what steps are being taken to correct matters. Parliament may freely question members of the Bank's Monetary Policy Committee. The Bank of Japan must explain its actions to the Japanese Diet every six months.

At the other extreme, the ECB has opted for opaqueness and has little accountability. Although its actions are to be explained to the public, it has no plans to publish either its forecasts or its minutes. It appears that individual votes are to be published only with a 16-year lag.

The ECB justifies not revealing votes by arguing that monetary policy committee members will be subject to pressure from their home governments. Not publishing the votes protects them. Of course home governments will apply pressure and, whether or not they are published, leaks are likely to ensure home governments know the votes. It inherits its closed-door policy from the German central bank, the Bundesbank. It is not clear that it also inherits the Bundesbank's reputation for price stability. Openness may be more desirable for the ECB than it was for the Bundesbank. In addition, it is difficult to believe that the European Union is going to find such clubbish monetary policy politically attractive.

The European Parliament has the right to question the six ECB Executive Board Members, but not the 11 central bank heads which make up the remainder of the ECB monetary policy committee. However, not *officially* knowing how members voted limits the usefulness of an inquiry.

Relative to other central banks, the Federal Reserve is accountable, but far less open than the Bank of England or the Bank of Japan. The Humphrey-Hawkins Act requires the Board of Governors to submit a report on the economy and monetary policy twice a year. The Chairman must testify before both the House and Senate. The votes of individual members are recorded, but details of the forecasts and assumptions are not.

Unfortunately, making the central bank accountable may not be enough. The government must be prepared to punish a central bank which does not achieve its target. If the government would benefit from higher short-run inflation, then it may not have an incentive to punish a central bank which does not meet its target. Italy, for example, had inflation targets which were regularly violated in the 1980s and early 1990s. In this case one must rely on the potential embarrassment to central bankers for appearing incompetent or to the government for going back on its word

Efficiency

Even with operational independence, openness and accountability, price stability is unlikely to be attained unless committee members are competent. An ability and willingness to hold serious discussions with a frank interchange of ideas improves the outcome. For this reason, the makeup of the committee, the amount of privacy that is available for exchange, and the size of the committee are all important.

The members of the monetary policy committee

It is frequently argued in the press that monetary policy committee members should include representatives from different parts of society. Appointments could include minorities, women, and small businessmen and farmers.

If a central bank has operational independence, then making monetary policy is a technician's job. It should be done by people trained in economic analysis. Most central banks make monetary policy by choosing a short-run interest rate and members need to have some idea about what interest rate translates into what level of future inflation. In addition, a goal of central bank design is to guard society from having policy being made by people who might an incentive to generate inflation to create short-term gains for a particular segment of society.

Populating a central bank's policy making body with representatives from special interest groups, rather than economists, makes as much sense as putting people who are not judges on the Supreme Court. This is of course why central bankers, as well as judges, are appointed rather than elected.

The United States' Federal Open Market Committee is required to have regional representation and, before its recent reforms, the Bank of Japan's monetary policy committee was required to include representatives from banking, industry and farming. However, it is not surprising that technical expertise, rather than diversity, is now used to populate the decision making groups of most of the world's major central banks.

Publishing transcripts

Openness requires the publication of minutes, but not of transcripts. A proper exchange of ideas requires that central bankers discuss different possibilities and possibly play the devil's advocate. The idea of such exchanges appearing in print is likely to deter policy makers from speaking freely. Most central banks do not publish transcripts. The Bank of England does not and the ECB does not plan to. Exceptions are the Bank of Japan, which intends to, and the US Federal Reserve which does.

The publication of minutes by the Fed has the anticipated result. Federal Open Market Committee members come with prepared speeches. The real discussion takes place elsewhere, where it cannot be monitored.

Size of the monetary policy committee

A serious conversation about monetary policy requires a manageable group size. In this area the Bank of England and the Bank of Japan fare relatively well; their monetary policy committees have only nine members. The US Federal Open Market Committee is too big, with its twelve members as is the ECB with its five Executive Board members and 11 national central bank heads.

I have advocated a three-pronged approach to achieving price stability. First, central banks should be given operational independence. That is, they should be given an inflation target and the freedom to achieve that target without government interference. Second, their procedures should be open and they should be accountable if they fail to meet their goals. Third, they must be given an efficient institutional structure for making policy.

It is too soon to tell how the Bank of Japan, the Bank of England, and the ECB will fare with their new institutional arrangements. The US Federal Reserve Board has enjoyed recent success, despite a lack of a mandate to pursue price stability, no inflation target and little openness. However, this is may be due to the personalities of its two most recent chairmen, rather than the structure of the organisation.