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The trade-off between central bank independence and conservatism in a New Keynesian framework☆

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ABSTRACT

The purpose of this paper is to discuss the issue of Treaty reform and its consequences for monetary policy. Inter alia, the changes include that the institutional set-up will be subtly changed and the European Central Bank (ECB) will be grouped in the first part of the Treaty as one of the “other institutions and advisory bodies”. Possibly more importantly, the euro area as such will be in the position to act legally as itself within the European Union (EU) legal structures. The Eurogroup also will be officially recognized (“Euro-Ecofin-Council”). President Jean-Claude Trichet's concern about the status of the ECB under the new Treaty and fear that by including the bank in a list of EU institutions implies a risk that EU member states could formulate policy recommendations to the ECB, but may also lead to more central bank conservatism with the ECB as explained in our analysis. In this paper we analyze the trade-off between central bank independence and conservatism with New Keynesian framework following Woodford [Woodford, M., 2003. Interest and prices: foundations of a theory of monetary policy. Princeton University Press, Princeton.] and others. Our conclusion is that the trade-off between central bank independence and conservatism still holds within the New Keynesian framework. Politicians should therefore realize that their attempts to downgrade ECB's independence legally and verbally will only *increase* its conservatism in order to maintain the *same* inflationary bias and limit the ECB's degrees of freedom with respect to its interest rate policy.

1. Introduction

The purpose of this paper is to discuss the issue of Treaty reform and its consequences for monetary policy. Inter alia, the changes include that the institutional set-up will be subtly changed and the European Central Bank (ECB) will be grouped in the first part of the Treaty as one of the “other institutions and advisory bodies”. Possibly more importantly, the euro area as such will be in the position to act legally as itself within the European Union (EU) legal structures. The *Eurogroup* also will be officially recognized (“Euro-Ecofin-Council”). The rules for enhanced cooperation have also been further facilitated from the Treaty of Nice, also applying for the area of economic governance (e.g. euro area coordination, tax policy, exchange rates).

In essence, the content of the new proposed reform treaty is very similar to that of the Treaty establishing a Constitution for Europe. It has just been modified and rephrased, as many heads of the different EU governments have already confirmed. In July 2007, an Inter Governmental Conference (IGC) has been held to discuss the “new” Treaty and to seek political support for all the amendments to the original treaties that are in the reform of the Treaty. The major proposed changes include the removal of the

☆ Views expressed are those of the individual authors and do not necessarily reflect official positions of De Nederlandsche Bank.

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three-pillar structure of the EU, more democracy, change of the institutional setup of the Union, improvement of the solidarity and security within the Union and enhancement of the position of the EU on the global stage (European Commission, July 10, 2007). The three-pillar structure will be abolished, as to simplify the structure of the EU. The structure will be reorganized, with more emphasis on foreign and security policy and justice and home affairs. More democracy is realized by giving national parliaments and the European Parliament (EP) a bigger say, while the power of the European Commission (EC) will decrease. The EP will be on equal footing with the Council of Ministers in many areas in terms of decision making. Also, a withdrawal option will be included, as to state that member states are part of the EU by their own choosing. The change in the institutional set-up of the ECB will be most important for the working of monetary policy and the status of the ECB. The latter effects will be singled out later in the text and treated in more detail. Furthermore, decision making will be made more swiftly and more commonly supported by the system of *qualified majority voting*, which will be introduced in more than forty new areas. This is also going to apply to economic governance. These measures include the giving up of veto power in many areas (including the ECB's powers over financial regulation), the appointment of a permanent President of the European Council, and a reinforcement of the Commission's authority. Also, as will be clear later on, it is easier to amend the treaty in the new form, by means of co-decision and qualified majority voting, so that a new IGC will not be necessary.

Although Article 108 of the Treaty still states that “neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions or bodies, from any government of a Member State or from any other body”, the fact that the ECB will be grouped with institutions such as the EC and the EP makes that its special status may or will be affected. This may have consequences for the functioning of the ECB in conducting effective monetary policy. The grouping of the ECB with other EU institutions will affect its independence and must be considered as an extremely dangerous development.

In this paper we will argue that a *Thomas Becket effect* is likely to occur after a reduction of central bank independence.[1] Once appointed as a central banker, officials learn to behave like an independent central banker. Faced with the reduction in their independence, they develop a more conservative attitude and become like Wim Duisenberg's “whipped cream”: the more politicians stir them, the stiffer they become.[2] We argue that it is optimal for society to select central bankers that have the right degree of conservatism (given the present level of independence) and have the “whipped cream” property that makes them more conservative, if and when the level of independence is reduced. Both the Thomas Becket effect and the “whipped cream” characteristic are perceptible with the (newly) appointed members of the Governing Council of the ECB and perhaps most remarkable with President Trichet after the discussion of Treaty reform including the change of the institutional set-up and the grouping of the ECB in the first part of the Treaty as one of the “other institutions and advisory bodies” (Trichet, 2007). President Trichet's concern about the status of the ECB under the new Treaty and fear that by including the central bank in a list of EU institutions implies a risk that EU member states could formulate policy recommendations to the ECB, but may also lead to more central bank conservatism with the ECB as will be explained by our analysis.

Section 2 discusses briefly the time inconsistency problem and the rationale for central bank independence based on Rogoff (1985) and others. In Section 3 we analyze whether there exists a trade-off between independence and conservatism within a New Keynesian framework following Woodford (2003) and others. Section 4 draws some conclusions.

2. The rationale for central bank independence

The Maastricht Treaty has made the ECB very independent. Nowadays is it widely believed that a high level of central bank independence and an explicit mandate for the bank to deliver a low and stable rate of inflation are important institutional devices to assure price stability. It is thought that an independent central bank can give full priority to low levels of inflation. In countries with a more dependent central bank other considerations (notably, re-election perspectives of politicians and a low level of unemployment) may interfere with the objective of price stability. In that context the German central bank is often mentioned as an example. The Deutsche Bundesbank was relatively autonomous; at the same time, Germany had one of the best post-Second World War inflation records among the OECD countries (Eijffinger and Schaling, 1993). Indeed, the statutes of the ECB are largely modeled after the law governing the Bundesbank. Why would central bank independence, ceteris paribus, yield lower rates of inflation? The theoretical reasoning in this field stresses the *time inconsistency problem* (see Kydland and Prescott, 1977; Barro and Gordon, 1983). The basic idea behind the time-inconsistency problem can be explained as follows. Suppose, the policy maker announces a certain inflation rate that (s)he considers optimal. If private sector agents take this announced inflation rate into account in their behavior, it becomes at that time optimal for the government to renege and to create a higher than announced inflation rate. The reason for this is that a burst of unexpected inflation yields certain benefits. For instance, unexpected inflation reduces real wages, thereby increasing employment. Of course, this is only part of the story. The next step is to add rational expectations. Under rational expectations economic agents know government's incentive to create unexpected inflation and take this into account in forming their expectations. Government has no other choice than to vindicate these. It is clear that the inflation rate will be higher than under the situation in which government would stick to its promise. No matter which factors exactly cause the dynamic inconsistency problem, in all cases the resulting rate of inflation is sub-optimal. So in the literature devices have been

[1] The Thomas Becket effect was coined by the first and former Chief Economist of the ECB, Otmar Issing, and expresses the fact that it takes time for a central banker to learn to behave independently from politics.

[2] This comparison was introduced by the first and former President of the ECB, Wim Duisenberg, who stated (in Dutch): “Centrale bankiers zijn als slagroom: hoe meer je in ze roert, hoe stijver ze worden”.