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Central bank accountability and independence: Are they inconsistent?

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ABSTRACT

The language of discretion offers little information about monetary policy beyond the assurance that policymakers always "do the right thing at the right time". This language renders problematic the reconciliation of central bank independence with accountability. Monetary policymakers should articulate an analytical framework using the language of economics that allows them to respond to the question, "What variables does the central bank control and how does it exercise that control".

1. Introduction

Using the provocative title "Has the Fed Been a Failure?", Selgin and White (2012) criticized the long-run performance of the Federal Reserve System. I prefer the criticism that from colonial times through the present monetary arrangements have periodically created instability. The latter statement directs attention away from the individuals who have run the Fed and toward the difficulty of creating the institutional arrangements that can prevent money creation from being a source of instability. The hypothesis advanced here is that the ongoing competition for control over money creation has prevented an evolutionary development of monetary arrangements conducive to economic stability. The reason is that this competition causes policymakers to package their policy actions as the optimal discretionary response to external shocks. While this packaging builds in a defense against political attacks, it also limits the ability to learn from historical experience. Bad outcomes are always a consequence of bad shocks, never bad policy.

At the same time, arrangements that would eliminate competition for control over the monetary system would remove oversight and ultimate control of the political system over the Fed. Even if possible in principle through a constitutional change that would make the Fed into a fourth branch of government, absolute independence of the central bank would be incompatible with democratic institutions. The issue is how to create institutional arrangements that improve the accountability of monetary policy while limiting political pressures to use monetary policy to aid in achievement of a political agenda.

There is a need to require monetary policymakers to move beyond ritualistic repetition of the "price stability" and "maximum employment" phrases of the 1946 Full Employment Act by requiring them to be explicit about the nature of the monetary standard they have created. That explicitness requires communication with the language of economics. In that way, the United States would move toward an "economist standard". (The phrase is from Marvin Goodfriend.) Use of the language of economics for communication with the academic community would allow an ongoing dialogue and informed monitoring that would act as a check on episodes of monetary disorder.

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A dialogue using the language of economics would answer the question, "What have policymakers learned since the Fed's creation?" The analytical framework of economics explains causation through models, policy rules, and shocks. At present, because policymakers do not use this framework to communicate, there is no way to answer the question of what they understand and have learned about the monetary standard they have created. The argument here is that this void in public knowledge derives from the latent competition for control over the monetary system. That competition leads to the language of discretion rather than that of economics, which disentangles the simultaneity in causation between the behavior of policymakers and the behavior of the economy.[2]

2. Independence and accountability are siamese twins

Accountability requires that policymakers answer the question: "What macroeconomic variables does the Fed control and how does it exercise that control?" Because the question concerns causation, in responding to it, there is no way to avoid the analytical framework of economics. Congress delegated its authority to determine the monetary regime to the Fed. Although *The Federal Reserve Act* states the ideals of "maximum employment, stable prices, and moderate long-term interest rates", those ideals do not determine the monetary regime. With the independence to choose this regime, the Fed should articulate the nature of the regime that it has created.[3]

Oversight of the Fed necessitates an answer to the question above formulated within an explicit analytical framework. At least contemporaneously, with only unusual exceptions, Fed policymakers have assigned responsibility for inflation and recession to real (nonmonetary) shocks. A conceptual framework would allow for an evaluation of monetary policy ex post under alternative assumptions about whether shocks were real or monetary. Policymakers then would have to argue that real rather than monetary shocks yield implications more consistent with experience.

Macroeconomists advocate different models with conflicting assumptions about basic behavioral relationships, especially, about the nature of trade-offs, if any, between inflation and unemployment (the Phillips curve). Despite this lack of consensus, policymakers have no choice but to make decisions based on their beliefs about those behavioral relationships. It follows that they have a responsibility to be explicit about their understanding of them. That explicitness does not require choosing a particular numerical forecasting model. It does mean choosing among alternative classes of models as a way of explaining how they as policymakers work backward from a choice of macroeconomic objectives to their choice of policy actions.

Accountability also entails a dialogue between policymakers and academic economists. One way to advance this dialogue would be for FOMC participants to hold quarterly give-and-take forums with economists. The regional Fed Bank presidents could engage with economists from their district while members of the Board of Governors could engage with nationally-recognized experts in monetary economics. FOMC participants would explain the policy actions they have recommended in the context of the model they choose to discipline their policy actions.[4] As background for these forums, FOMC participants could maintain a blog of the policy actions they have espoused explained in the context of their chosen model.

3. The fed genesis in competition for control

In two respects, understanding the political and intellectual environment that spawned the Fed is essential for understanding the evolution of monetary policy since the Fed's inception in 1913. First, from the perspective of political economy, the Fed emerged out of a competition for the control of the banking system and money creation. Second, from the perspective of monetary policy, the Fed emerged without any recognition of its responsibility for the behavior of the price level.

The end of the 19th and beginning of the 20th centuries witnessed an intense struggle for control over the monetary system. Proponents of the gold standard saw themselves as protecting property rights. Proponents of a silver standard saw themselves as wresting control of money away from an Eastern financial establishment that exploited farmers and working people. In his "Cross of Gold Speech" at the 1896 Democratic National Convention, William Jennings Bryan said, "I stand with Jefferson...that the issue of money is a function of government, and that the banks ought to go out of the governing business".

As a Progressive, President Woodrow Wilson made government control of the monetary system a priority. While governor of New Jersey, Wilson had denounced the "money trust" and declaimed that "the greatest monopoly in the country is the money monopoly. So long as it exists our old variety of freedom and individual energy of development are out of the ques-

[2] Nothing here offers ideas for how to change the current political equilibrium. Under the Constitution, Congress is responsible for the monetary standard. Congress, which focuses on the politics of the distribution of income, cannot itself conduct monetary policy or even assess it. Because Congress is unwilling to abandon its constitutional prerogative, it will not surrender control of the monetary standard to the Treasury. It has necessarily delegated that control to an independent government sponsored enterprise (GSE), that is, the Fed. It has done so using language with no substantive content while reserving the power to change the terms of that delegation of authority. To protect against political attack, monetary policymakers package communication about monetary policy using a language that avoids reference to trade-offs and causal relationships.

[3] An early proposal in the spirit of the one offered here is in Benjamin Friedman (1978).

[4] While the Minutes of FOMC meetings are useful for learning the diversity of views expressed in those meetings, they are limited. They do not associate individuals with the particular views summarized. Also, there is no way of understanding how members reach consensus over particular policy actions or of understanding the strategy that gives coherence to those actions.