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UA36I/29 Gary Ransdell - Federal Reserve Board - Central Bank Independence, Transparency & Accountability

St. Louis Federal Reserve Board

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From: Mary.H.Karr@stls.frb.org [mailto:Mary.H.Karr@stls.frb.org]
Sent: Wednesday, May 26, 2010 1:05 PM
Subject: FedDigest, May 25, 2010: Chairman Bernanke's Speech on Central Bank Independence, Transparency, and Accountability

To: FedDigest recipients -- the latest from the Board

At the 2010 Institute for Monetary and Economic Studies Conference

This document is not an official transcript. The text is selectively drawn from the original and summarized. Full text: http://www.federalreserve.gov/newsevents/speech/bernanke20100525a.htm

Central banks around the world are working with their governments to prevent future crises by strengthening frameworks for financial regulation and supervision.

In undertaking financial reforms, it is important that we maintain and protect the aspects of central banking that proved to be strengths during the crisis and that will remain essential to the future stability and prosperity of the global economy. Chief among these aspects has been the ability of central banks to make monetary policy decisions based on what is good for the economy in the longer run, independent of short-term political considerations. (B)oth theory and experience strongly support the proposition that insulating monetary policy from short-term political pressures helps foster desirable macroeconomic outcomes and financial stability.

The Case for Central Bank Independence

A broad consensus has emerged among informed observers around the world that the goals of monetary policy should be established by the political authorities, but that the conduct of monetary policy in pursuit of those goals should be free from political control. This conclusion is a consequence of the time frames over which monetary policy has its effects. To achieve both price stability and maximum sustainable employment, monetary policymakers must attempt to guide the economy over time toward a growth rate consistent with the expansion in its underlying productive capacity. Because monetary policy works with lags that can be substantial, achieving this objective requires that monetary policymakers take a longer-term perspective when making their decisions. Policymakers in an independent central bank, with a mandate to achieve the best possible economic outcomes in the longer term, are best able to take such a perspective.

In contrast, policymakers in a central bank subject to short-term political influence may face pressures to overstimulate the economy to achieve short-term output and employment gains that exceed the economy's underlying potential. Such gains may be popular at first, and thus helpful in an election campaign, but they are not sustainable and soon evaporate, leaving behind only inflationary pressures that worsen the economy's longer-term prospects. Thus, political interference in monetary policy can generate undesirable boom-bust cycles that ultimately lead to both a less stable economy and higher inflation.

Undue political influence on monetary policy decisions can also impair the inflation-fighting credibility of the central bank, resulting in higher average inflation and, consequently, a less-productive economy. Central banks regularly commit to maintain low inflation in the longer term; if such a promise is viewed as credible by the public, then it will tend to be self-fulfilling, as inflation expectations will be low and households and firms will temper their demands for higher wages and prices. However, a central bank subject to short-term political influences would likely not be credible when it promised low inflation, as

the public would recognize the risk that monetary policymakers could be pressured to pursue short-run expansionary policies that would be inconsistent with long-run price stability. When the central bank is not credible, the public will expect high inflation and, accordingly, demand more-rapid increases in nominal wages and in prices. Thus, lack of independence of the central bank can lead to higher inflation and inflation expectations in the longer run, with no offsetting benefits in terms of greater output or employment.

Additionally, in some situations, a government that controls the central bank may face a strong temptation to abuse the central bank's money-printing powers to help finance its budget deficit. Abuse by the government of the power to issue money as a means of financing its spending inevitably leads to high inflation and interest rates and a volatile economy.

These concerns about the effects of political interference on monetary policy (have) been validated by the experiences of central banks around the world and throughout history. In particular, careful empirical studies support the view that more-independent central banks tend to deliver better inflation outcomes than less-independent central banks, without compromising economic growth. In light of all these considerations, it is no mystery why so many observers have come to see central bank independence as a critical component of a sound macroeconomic framework.

I am by no means advocating unconditional independence for central banks. First, for its policy independence to be democratically legitimate, the central bank must be accountable to the public for its actions. As I have already mentioned, the goals of policy should be set by the government, not by the central bank itself; and the central bank must regularly demonstrate that it is appropriately pursuing its mandated goals. Demonstrating its fidelity to its mandate in turn requires that the central bank be transparent about its economic outlook and policy strategy…. Second, the independence afforded central banks for the making of monetary policy should not be presumed to extend without qualification to its nonmonetary functions. There should be no "spillover" from monetary policy independence to independence in other spheres of activity.

The case for independence also requires clarity about the range of central bank activities deemed to fall under the heading of monetary policy. Conventional monetary policy, which involves setting targets for short-term interest rates or the growth rates of monetary aggregates, clearly qualifies. I would also include the central bank's discount-window and lender-of-last-resort activities. These activities involve the provision of short-term, fully collateralized loans to the financial system as a means of meeting temporary liquidity needs, reducing market dysfunctions, or calming financial panics. As has been demonstrated during financial panics for literally hundreds of years, the ability of central banks to independently undertake such lending allows for a more rapid and effective response in a crisis. On the other hand, as fiscal decisions are the province of the executive and the legislature, the case for independent lender-of-last-resort authority is strongest when the associated fiscal risks are minimal. Requiring that central bank lending be fully secured, as is the case in the United States, helps to limit its fiscal implications. Looking forward, the Federal Reserve supports measures that help further clarify the dividing line between monetary and fiscal responsibilities. Notably, the development of a new statutory framework for the resolution of failing, systemically important firms is not only highly desirable as a means of reducing systemic risk, but it will also be useful in establishing the appropriate roles of the Federal Reserve and other agencies in such resolutions.

The issue of the fiscal-monetary distinction may also arise in the case of the nonconventional policy

known as quantitative easing, in which the central bank provides additional support for the economy and the financial system by expanding the monetary base, for example, through the purchase of long-term securities. Central banks in a number of advanced economies have undertaken variants of quantitative easing in recent years as conventional policies have reached their limits.

Although quantitative easing, like conventional monetary policy, works by affecting broad financial conditions, it can have fiscal side effects: increased income, or seigniorage, for the government when longer-term securities are purchased, and possible capital gains or losses when securities are sold. Nevertheless, I think there is a good case for granting the central bank independence in making quantitative easing decisions, just as with other monetary policies. Because the effects of quantitative easing on growth and inflation are qualitatively similar to those of more conventional monetary policies, the same concerns about the potentially adverse effects of short-term political influence on these decisions apply. Indeed, the costs of undue government influence on the central bank's quantitative easing decisions could be especially large, since such influence might be tantamount to giving the government the ability to demand the monetization of its debt, an outcome that should be avoided at all costs.

The Historical Evolution of Central Bank Independence

Support for the idea of central bank independence has evolved over time. In the United States and many other countries, the historically high and volatile inflation rates in the 1970s and early 1980s prompted a reexamination of monetary policies and central bank practices. Since that time, we have observed the confluence of two global trends: the widespread adoption of improved monetary policy practices and the virtual elimination of high inflation rates. The improved policy practices prominently include a broad strengthening of central bank independence, increased transparency on the part of monetary policy committees, and the affirmation of price stability as a mandated goal for monetary policy.

In recent years, the number of central banks with a relatively high degree of independence has steadily increased, and the experience of some major central banks testifies to the importance of that independence.

Although the Federal Reserve was established as an independent central bank in 1913, its effective degree of independence has gradually increased over time. Initially, the Secretary of the Treasury and the Comptroller of the Currency sat on the Board; they were removed when the current structure of the Federal Open Market Committee (FOMC) was introduced with the Banking Act of 1935. The act also extended the terms of Board members from 10 years to 14 years; the long, staggered terms of Board members have also served as a brake on political influence.

During World War II, the Federal Reserve agreed to peg Treasury yields at low levels to reduce the cost of financing wartime deficits. After the war, the Fed sought to resume an independent monetary policy, fearing the inflationary consequences of continued political control, but the Treasury was still intent on containing the cost of servicing the debt. The conflict was resolved in 1951 through the negotiation of the Treasury-Federal Reserve Accord, as it came to be known. The accord reestablished the Federal Reserve's ability to freely set interest rates, but with active consultation between the Fed and Treasury. It was only by the amendment of the Federal Reserve Act in 1977 that the Fed's current objectives of maximum employment and stable prices were specified by the Congress. A clear mandate of this kind is a key pillar of central bank independence.

Over the years, a consensus developed among U.S. political leaders that the Federal Reserve's

independence in making monetary policy is critical to the nation's prosperity and economic stability. In 1978, the Congress formally recognized this principle by approving a provision that exempts monetary policy, discount window operations, and the Fed's interactions with other central banks from Government Accountability Office policy reviews. In 1979, President Carter appointed Paul Volcker chairman of the Federal Reserve with the expectation that Volcker would strengthen the central bank's inflation-fighting credibility.... Subsequently, President Reagan's support for Volcker's politically unpopular disinflationary policies and for the principle of Federal Reserve independence proved crucial to the ultimate victory over inflation, a victory that set the stage for sustained growth. Presidents and other U.S. political leaders have since then regularly testified to the benefits of an independent Federal Reserve.

Transparency and Accountability

Central bank independence is essential, but, it cannot be unconditional. Democratic principles demand that, as an agent of the government, a central bank must be accountable in the pursuit of its mandated goals, responsive to the public and its elected representatives, and transparent in its policies. Transparency regarding monetary policy in particular not only helps make central banks more accountable, it also increases the effectiveness of policy. Clarity about the aims of future policy and about how the central bank likely would react under various economic circumstances reduces uncertainty and--by helping households and firms anticipate central bank actions--amplifies the effect of monetary policy on longer-term interest rates. The greater clarity and reduced uncertainty, in turn, increase the ability of policymakers to influence economic growth and inflation.

Over the years, the Federal Reserve...has taken significant steps to improve its transparency and accountability. Policymakers give frequent speeches and testimonies before the Congress on the economic situation and on the prospects for policy, and the Federal Reserve submits an extensive report to the Congress twice each year on the economy and monetary policy. The FOMC releases a statement after each of its meetings that explains the Committee's policy decision and reports the vote on that decision. The FOMC also publishes the minutes of each meeting just three weeks after the meeting occurs and provides, with a lag, full meeting transcripts. In addition, the FOMC has begun providing the public a quarterly summary of Committee participants' forecasts of key economic variables and, more recently, their assessments of the longer-run values to which these variables would be expected to converge over time.

The Federal Reserve's response to the financial crisis has involved a range of new policy measures, about which the Fed has provided extensive information. For example, the Board has regularly published detailed information about the Federal Reserve's balance sheet and the special liquidity facilities that were introduced. We created a section on our website devoted to these issues and initiated a regular monthly report as well. And we are committed to exploring new ways to enhance the Federal Reserve's transparency without compromising our mandated monetary policy and financial stability objectives.

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