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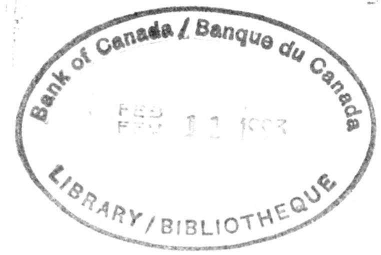


# Monetary policy, and the responsibilities and accountability of central banks

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The Gerhard de Kock Memorial Lecture

by John W. Crow
Governor of the Bank of Canada

at the

University of Pretoria
Pretoria, South Africa
10 February 1993

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## Monetary Policy, and the Responsibilities and Accountability of Central Banks

It is a pleasure and a privilege to address you on this special occasion.

Chris Stals and I go back a long way together -- to when we were both deputy governors and would share notes on the kinds of things deputy governors, who are in some ways the meat in the sandwich, have to do. I am glad to have the chance to visit with him.

We both have been fortunate to work with great governors. And Gerhard de Kock stood out around the world as a monetary statesman in a field full of major leaguers. It was a pleasure to deal with him in more recent years as Governor to Governor, and I am honoured to have the chance to deliver this lecture in his memory.

Monetary policy is not made in splendid isolation. It is not handed down from rarefied heights by simple fiat. Central bankers try to get a job done day to day, year to year, in the real world, with all its challenges, complications and changes.

At the same time, the practice of monetary policy does involve principles grounded in its very nature. With the best will in the world, it cannot be all things to all people. And given the importance of the institution of money in the modern market economy, the question of what monetary policy is and what it can really hope to contribute to the economy needs to be faced squarely. It is because monetary policy matters that questions related to the responsibility and accountability of a central bank in the public policy framework also matter. These are the issues I want to talk about.

I know I am chewing off a lot here. And I should quickly add that my remarks will not be that long. What they will reflect is the trend of thinking on these issues at the Bank

of Canada, in light of the heightened interest and concern in recent years in Canada and elsewhere. I should add that the goals of monetary policy, and the mandate, accountability and governance of the Bank of Canada, have in recent years been a matter of considerable discussion and review -- through academic studies and legislative committees, and as part of Canada's recent constitutional debate.

(To mitigate any suspense, I will note that the outcome has been, for a range of reasons that could themselves be the subject of a lecture, that the arrangements for the Bank of Canada will be left where they were in the first place.)

I want to start by discussing quite generally what economic analysis can tell us about monetary policy and how it might contribute to the economy. This sets the stage for the review of institutional matters -- central banks, their roles and responsibilities, and the nature of their accountability in a democratic society -- that takes up most of these remarks.

**The objective(s) of monetary policy**

The debate that has gone on in recent years in many countries about the objective, or objectives, of monetary policy, might seem to casual observers to be virtually on a question of grammar: Should monetary policy be viewed in the singular, with an "objective," or should it be viewed in the plural, as having a multiplicity of goals i.e. "objectives?" Be that as it may, to my mind at the heart of the debate has been the following question: Is it important for monetary policy to aim at preserving the value of money, at price stability, as its fundamental contribution to good economic performance; or would it be more effective in promoting such performance by being aimed at a range of different economic targets?

Since monetary policy involves the use of a single tool, providing liquidity to the financial system, one might well ask how monetary policy could be expected to achieve more than one economic objective.

A traditional answer can be found in the view of the economy that was dominant for the early part of the post-war period. In this view, there was a lasting trade-off between unemployment and inflation: bringing down inflation involved a permanent increase in unemployment. The policy maker's job was to hit the right trade-off between unemployment and inflation.

There is another aspect of the conventional wisdom of the period that is relevant. This is that the policy maker had at hand a whole range of different policy tools that could be

calibrated, and mixed, to achieve a best combination of a range of macro-economic goals. Hence, it was not monetary policy alone that was to achieve the variety of goals but all public policies jointly.

Indeed, it is no accident that this was also the age of the rise of the computer-based economy-wide model. Those models appeared to many to show quite precisely how the policy maker could continually adjust the various policy instruments for optimum effect. They also seemed to suggest that the short-run optimum led straight to the long-run best result. In other words, expectations among savers and investors were assumed to be quite static relative to what policy was doing.

Over the past two decades there has been a clear shift in thinking away from this paradigm. Even setting aside the theoretical shortcomings, it did not fit the facts of the late 1960s and 1970s -- a world of rising inflation and rising unemployment. The unemployment-inflation trade-off had gone out the window. The simple Phillips curve, purporting to explain the stable relationship between unemployment and inflation, when plotted for that period took some funny turns.

The broader views of economic and financial relationships that made ground during this period, with their greater appreciation of the monetary character of inflation, were better able to explain why inflation broke out and stayed high. This appreciation, together with a greater understanding of the role of expectations and how they are formed, showed that monetary policy simply could not avoid dealing with inflation.

There was also increased awareness that monetary policy has its effects with long and variable lags. Combined with the experience of inaccurate forecasts and unsuccessful attempts to offset short-term cycles in the economy, this indicated that effective fine tuning, even with the benefit of all kinds of econometric models, was beyond the capacity of the monetary authorities.

The persistence of inflation provided further useful, if disagreeable, experience. Not only was there no employment benefit to be gained in choosing to live with higher inflation, but there were also economic costs in tolerating inflation. Over time, our understanding of the harmful effects of inflation on the economic fabric has deepened.

The costs of inflation include the substantially greater difficulty for savers and investors in making good decisions in an inflationary environment, the resources expended in coping with inflation, and the distributional inequities

brought about by inflation. Indeed, stability in the value of money began to be seen as a kind of structural contribution to an effective market economy.

In other words, monetary, or price, stability began to be seen as an investment that would, so far as the institution of money and monetary exchange could, promote a range of objectives, such as high employment and rising living standards, that go under the head of economic progress.

The goal of price stability does not mean monetary policy actions should be taken without regard to the demand situation in the economy. Moreover, the goal of price stability is typically interpreted as keeping the price level stable on average over time, and not each and every quarter, for example. Let us say, perhaps, taking one year with another.

However, the first challenge facing monetary policy makers has been to bring inflation down. This also means unwinding the expectations of persistent inflation that have for so long weighed upon the behaviour of businesses and households. What can be done to improve those expectations? Can one do better than simply issue announcements that monetary policy will be geared to bringing down inflation and promoting price stability? Setting out a decelerating path for a monetary aggregate had important and obvious attractions for central banks. And in most major industrial countries, monetary growth targets were established during the 1970s.

But the use of monetary aggregate targets was often a disappointment, in large part because of successive waves of financial innovation. Attention shifted from setting intermediate targets (without necessarily abandoning them entirely) to focussing on how the objective of monetary policy, price stability, could be made more influential in changing inflation expectations.

It was in this general context that the institutional role of central banks in delivering good monetary policy came under more searching scrutiny. Given the divergence in macroeconomic performance among the major industrialized countries, most notably the greater success of Germany and Japan, attention began to focus on the extent to which a factor such as a firm commitment to an anti-inflationary monetary policy could explain any success, and, indeed, on what might reasonably be meant by "a firm commitment." So the importance of establishing a clear mandate in this direction for monetary policy came to the fore.

Let me turn to this area.

**A Mandate for the Conduct of Monetary Policy**

Where, in the industrial countries, there is legislation governing monetary policy, it roughly falls into two groups. In one, e.g. Germany, New Zealand, the legislation sets out a clear, specific objective for the monetary authority. In the other, e.g. the United States, the legislative mandate sets out multiple objectives.

In Canada, the preamble to the Bank of Canada Act does suggest a lot of different economic goals. But, as in Switzerland, the practical focus is unambiguously on price stability as the means by which those goals can best be achieved through what we have got to work with -- namely, our central bank balance sheet, nothing less and nothing more.

As regards the mandate, the growing perception that countries with price stability mandates have been helped in their economic performance was buttressed by further developments in economic analysis, in particular the time inconsistency literature. This type of analysis emphasized the practical policy value of a clear long-run goal, to which monetary policy really would stick.

Having the objective of price stability clearly expressed in the mandate of the monetary authority establishes a goal for monetary policy that is understandable and that will be consistent over time. But it has other advantages as well. It underscores basic support for price stability as the appropriate goal of monetary policy. It also provides a solid basis on which to judge the performance of the monetary authority and thus to improve its accountability. I will return to this aspect later.

Although I believe that identifying price stability in legislation as the underlying target for monetary policy would improve monetary policy credibility, I would not argue that such legislation would, by itself, deliver all the goods at once. Actions matter as well as words, and actual progress towards price stability is essential.

Nor would I argue that without legislative identification of price stability the necessary monetary policy credibility cannot be built up. What is essential, however, is that the monetary authorities make as clear as they can that monetary policy _is_ being conducted to achieve price stability, and that as policy actions are taken they _are_ seen as contributing unambiguously to that goal.

But anything that helps to clarify the goal also helps.

In Canada, in early 1991 specific targets for the reduction of inflation were jointly announced by the central bank and the Government. Those targets set out a path for declines in the rate of inflation, leading to price stability. In this way the commitment to achieving price stability has become increasingly recognized. This recognition may well have contributed to the improvement in inflation expectations and behaviour that we have seen in Canada in the recent period. In other words, it pays to advertise.

**Institutional Arrangements for the Conduct of Monetary Policy**

Now let me turn to institutional arrangements. In virtually all industrialized countries the central bank has a position somewhat apart from government -- that is, it is not simply a department of government. Why?

The traditional answer has been that the power to spend money should in some way be separate from the power to create money. Since raising taxes or limiting spending is almost invariably politically costly, governments might be tempted to look to the printing press for relief -- an apparently painless way of paying bills. I say "apparently painless" because, of course, the effects on the economy of the resulting inflation will be far from pleasant, even though one might well suppose that these effects will be heavily discounted in some quarters.

Today's justification for a measure of separateness of decisions to spend money from decisions to print it would go further. It would also emphasize the need for monetary policy to take a medium-term to longer-term view for greater effectiveness.

As noted earlier, monetary policy operates with long lags. Its economic effects, which begin in financial markets and spread to aggregate demand in the economy and finally to inflation, may as we judge it be distributed over more than two years. And expectations about inflation are also bound to take a good deal of time to adjust as all those operating in the economy and using its money look for some assurance of continuity in monetary policy if they are to change their outlook. Having the central bank somewhat separate from the political process enables the bank to take the medium-term to longer-term perspective that is needed if monetary policy is to work.

Now, if this general line of analysis is accepted, and it does indeed seem to be quite widely accepted these days, two issues require careful consideration. First, what should be the relative responsibilities of a central bank, and those of the government, within the general framework of public policy? In some countries, the central bank is a principal in formulating as

well as in implementing monetary policy. In others the central bank basically acts as an advisor to government on monetary policy, with its responsibility limited to implementing that policy. Second issue: Through what kinds of mechanisms is the central bank to be accountable to some elected body or person and to the general public for carrying out its responsibilities? Let me underline here that these questions of division of responsibility and mechanisms of accountability are linked. The greater is the responsibility assigned to the central bank, obviously the more important it is to have sound arrangements for accountability.

You may note that I have not used the popular term "independence" in setting out the issues relating to institutional arrangements. This is because I do not find the concept of independence a terribly helpful starting point in discussing such issues. If the notion of independence is not set carefully in context, it can leave the impression that a central bank can, or should, operate without institutional constraints. That, of course, cannot be the case. Simply put, in a democratic society a central bank has to be accountable in some way to the elected representatives of the people -- the government and/or parliament -- for some reasonably clear responsibilities.

For this reason I find it more useful to start any such discussion by first focussing on the kinds of responsibilities one might appropriately assign to the central bank for the conduct of policy, and then proceed to consider how the bank is to be held to account for its success or failure in carrying out its responsibilities. If these are indeed the substantive issues, then zeroing in on the matter of whether a central bank is or is not "independent" is likely to obscure more than it will explain, and that is not helpful -- at least, not to a central bank.

**a) Division of responsibility for monetary policy**

The recent resurgence of interest in how much policy responsibility a central bank should have -- in particular, whether it has enough -- comes from recognizing that there may be a link between the extent of central bank policy responsibility and the bank's success in generating confidence in money. Germany is often cited in this context. But more broadly, a number of studies have found an inverse relationship between measures of the degree of central bank responsibility for monetary policy (or extent of "independence" in the usual jargon) and the rate of inflation. Although quantifying this responsibility is difficult, those studies do seem to have touched on an underlying reality.

In this light, the framework most likely to result in good economic outcomes would give the central bank considerable responsibility for formulating, as well as implementing, monetary policy. I have already noted that the ability to take a medium-term perspective is essential if monetary policy is to be conducted effectively, and a central bank answerable for policy is more capable of taking such a perspective. Furthermore, giving responsibility for the conduct of monetary policy to an institution for which it is the primary responsibility, and an institution which is somewhat apart from government, is more likely to generate the necessary credibility than would leaving monetary policy as one of many competing responsibilities of government. The facts seem clear on this matter.

Let me now move on to the related issues of accountability.

**b) Accountability**

These issues seem to me to have received less attention than they deserve. The difficulty in generating general discussion about them may stem from the fact that in any country the accountability links devised will depend a lot on the national traditions and the specific nature of institutional relationships. In any event, good accountability arrangements are in general difficult to develop because there is a "tension" between the mechanisms needed to ensure the accountability of the central bank to government or parliament, and the ability of the central bank to carry out its policy responsibility as an institution apart from government. Where, exactly, does one draw the line?

In this context it is worth underlining, even at the risk of repetition, that the clearer and more precise the purposes of monetary policy, the more readily can responsibility for conducting policy be assumed by the central bank, because the more readily can the central bank be held accountable in a credible way.

In the broadest sense, government must always bear ultimate responsibility because government retains the option of having the law governing the central bank amended. However, this type of procedure is very clumsy, to say the least. Hence the legislation in some countries explicitly incorporates arrangements to specify the relative responsibilities of central bank and government, and the process for resolving any important disagreements.

Finding a mechanism that recognizes the government's ultimate responsibility in case of fundamental, irreconcilable

differences, while leaving the conduct of monetary policy in the hands of the central bank in all other circumstances, is a delicate task indeed. Obviously, the mechanism for government intervention should be structured in such a way that it would be resorted to only in exceptional circumstances. Since such circumstances would arise only when government and the central bank disagree over basic policy, the government should expect to explain why its proposed policy is preferable.

The mechanism developed in Canada some thirty years ago requires, firstly, that the Governor and the Minister of Finance "consult regularly on monetary policy and on its relation to general economic policy." Therefore, there is no danger of ships passing in the night, of unnecessary surprises. Secondly, and more weightily, the Act provides an explicit directive power through which the Minister of Finance can override the Bank's monetary policy decisions. The directive must be in writing, in specific terms, and applicable for a specified period. Furthermore, it must be made public as soon as it is issued. The directive power makes absolutely clear that the government must take ultimate responsibility for monetary policy and that the Bank must accept immediate responsibility so long as a directive is not in effect. No directive has ever been issued, but it has been recognized from the time the mechanism was put in place that if one were issued, a likely outcome would, naturally, be the resignation of the Governor. I say "naturally" because of the Bank's policy responsibility. If the Governor could in good conscience agree to the course of action advocated by the Minister, no directive would be necessary.

As regards accountability through communication, I doubt if anyone would disagree that a body with public policy responsibilities should be as clear as possible regarding the basis for its actions. And this must be true whether the institution has a clear objective in legislation or not. Let me just emphasize, however, that when the mandate is less than clear, transparency through communication is an absolutely vital part of the accountability framework. Without a clear legislative objective, the central bank obviously must go to great pains to set out as clearly as it possibly can the basis on which policy _is_ being made. Only by doing this can it provide the public and government with the wherewithal for properly assessing its performance.

Reporting mechanisms can vary a lot. They can range from annual reports explaining and commenting on policy, to periodic reports on the achievement of the target or target path with explanations of any failure to achieve the goal (as in New Zealand), to regular appearances before a legislative body (as in the United States under the Humphrey-Hawkins legislation). The

Bank of England has recently emphasized that it will be publishing regular inflation reports. Such procedures, along with the more standard means of public communication (including, I might add, lectures), give the central bank the opportunity to explain how its actions are contributing to the objective that has been established for monetary policy.

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By way of conclusion, let me summarize my main message. Recent trends in both industrialized and developing countries have been in the direction of giving the central bank increased responsibility in monetary policy. Those trends recognize the effectiveness of such an arrangement in generating and maintaining confidence in the future value of money. As a result, developing mechanisms for accountability and for resolving differences between the government and the central bank has become all the more important. The challenge is to devise appropriate structures. These structures need to reconcile the requirement for accountability with the need for a central bank endowed with the institutional strength and vision to pursue a clearly articulated and consistent monetary policy purpose that, furthermore, must have a medium- to long-term focus if it is to be pursued successfully.