ECO 407
Competing Views in Macroeconomic Theory and Policy

Lecture 9
Should Central Banks Be Independent?

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The Bank of Canada

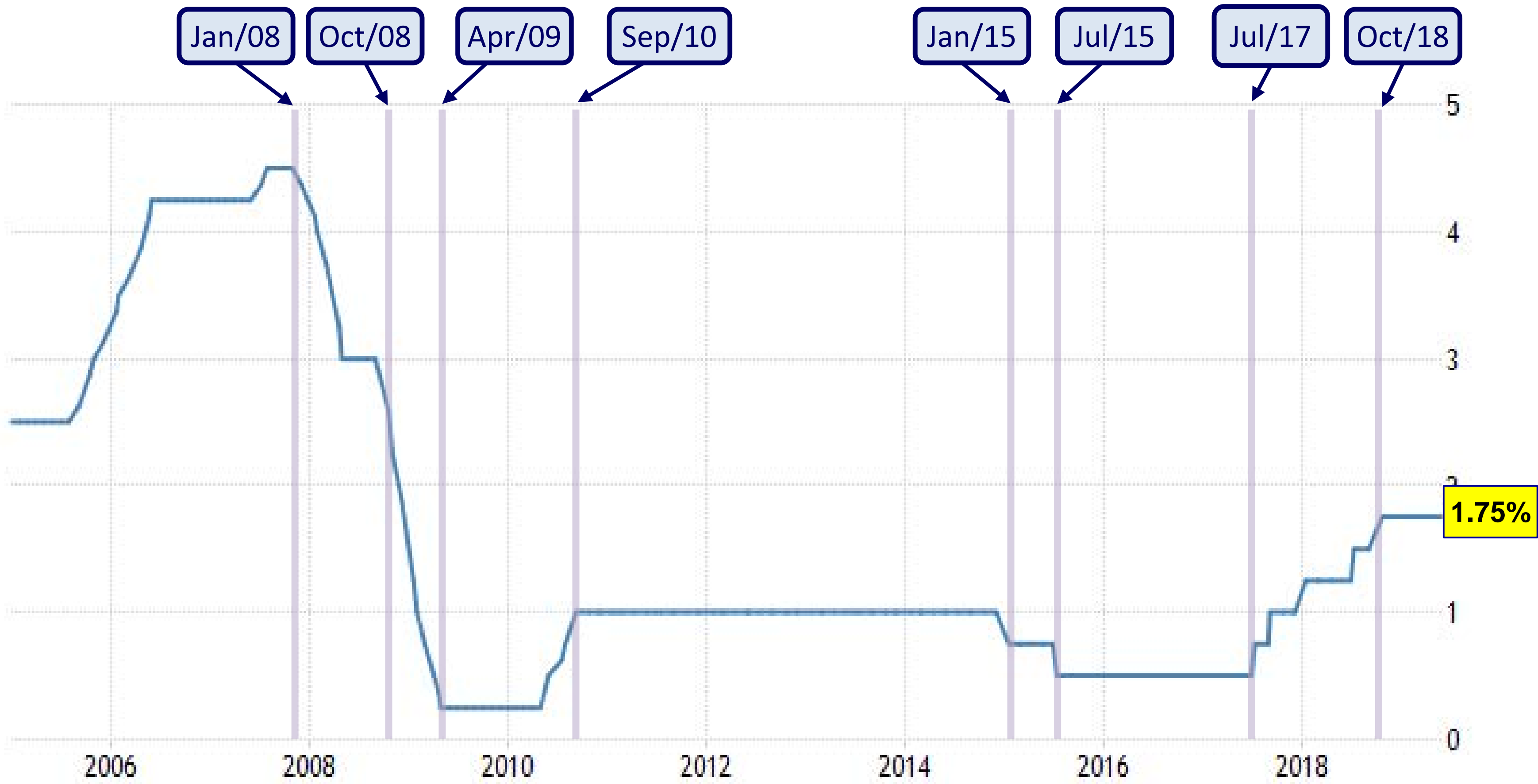
- The ***Bank of Canada*** was established in order to:
  - regulate credit and currency;
  - control and protect the external value of the currency;
  - mitigate fluctuations in the general level of production, trade, ***prices*** and ***employment***; and generally
  - promote the ***economic and financial welfare of Canada.***

- The Bank of Canada is managed by a Board of Directors composed of a ***Governor***, a Deputy Governor and twelve ***independent*** directors (plus the ***Deputy Minister of Finance***)

- The ***Minister of Finance*** and the ***Governor*** should "consult regularly on ***monetary policy*** and on its relation to ***general economic policy***"

Canada: Overnight Rate of Interest

January 2005 to October 2019



Source: Trading Economics / Bank of Canada.

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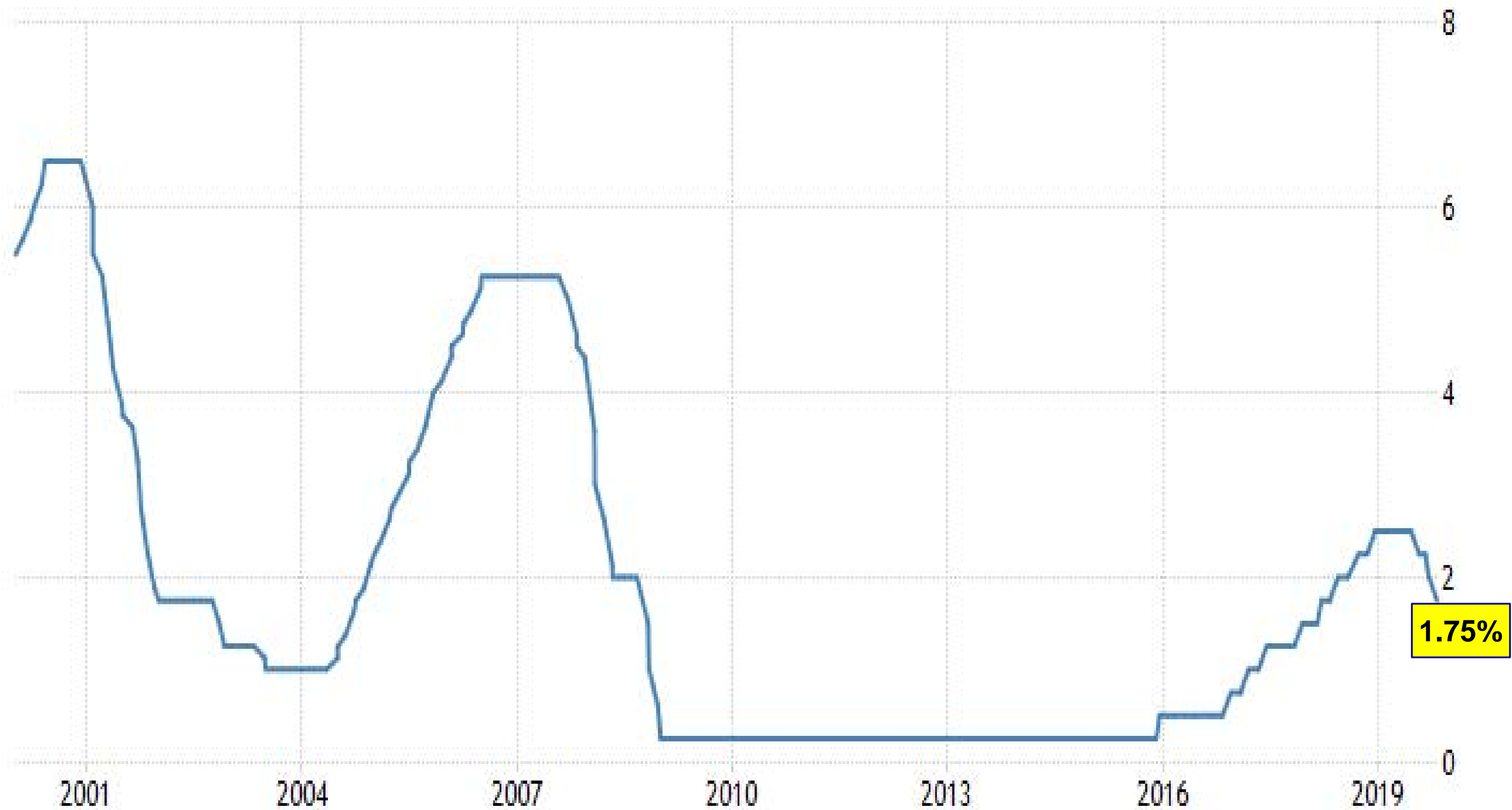
The U.S. Federal Fund Rate

January 2000 to October 2019



Source: Trading Economics / Federal Reserve.

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Independent Central Bank?

- The central bank is ***instructed*** by the government to conduct ***monetary policy***
  - ➢ Therefore, there is no ***absolute*** independence of the central bank

- The government states some specific macroeconomic ***objective*** such as ***inflation targeting***, but it is up to the bank how to achieve this objective
  - ➢ Therefore, there is ***instrumental*** independence of the central bank

- The central bank can decide on its own when to change the ***rate of interest*** as a matter of ***monetary policy***
  - ➢ The central bank is free to carry ***open market operations*** and set the target for ***overnight rate***

Weak Arguments in Support of Independent Central Banks

- There is a ***lag*** as long as two years for the full impact of changes in monetary policy to take effect
  - The central bank can look at the ***longer run*** and not at the next election
- Given the significant lag, the ***sooner*** a policy decision is made the ***better***
- It leads to greater ***public confidence*** in dealing with the financial market
- The central bank can make decision which would be ***politically unpopular***
  - Price stability as an ***at all times*** main objective could be politically unpopular

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Worrisome Arguments in Support of Independent Central Banks

- ***"The democratic voting process is not appropriate for deciding at any point in time whether, and by how much, monetary conditions should be altered"*** (J.A. Galbraith)
  - Why not?
  - What about fiscal policy?

- ***"This is a technical matter that must be entrusted to managers who can be held accountable"*** (J.A. Galbraith)
  - Accountable to whom?
  - Aren't elected officials accountable to the public?
  - Isn't this the way democracies work?

Does a *"Post-Democratic"* Era Beget a *"Post-Truth"* Era?

- ***Post-democratic*** era (***Democratic deficit***)
  - Important ***policy decisions*** made on the basis of ***expert opinion***
  - Institutional arrangements put ***executive power*** in the hands of ***experts***
  - ***Democratic deficit*** further compounded by the capture of policy-making institutions by ***vested interests***
- ***Post-truth*** era
  - ***Truth*** is popularly regarded as ***irrelevant***
  - ***Assertions*** accepted as ***valid*** if they challenge the ***elite*** and its ***vested interests***

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The Origin of the Argument

- The origin of the argument about the independence of central banks can be found in the ***rule vs. discretion*** debate of 1970s
  - Keynesian economists favoured ***discretionary*** monetary policy while monetarists advocated policy ***rules***
- ***Keynesians*** see ***monetary policy*** as one component of economic policy to be used to achieve ***price stability***, ***full employment***, ***balanced trade***, and ***growth***
  - The central bank enforces monetary policy as the outcome of a ***discretionary*** government policy decision
- ***Monetarists*** incorporates the neoclassical ***general equilibrium theory*** of markets determined by "***natural laws***"
  - Money is believed to have no influence on this equilibrium in the long run

The Theory of Credibility

- The "***credibility***" issue belongs to "new" classical economics (NCE) developed in the 1980s
  - NCE accepts the monetarist framework but introduces short-term ***unanticipated inflation*** resulting from government's discretionary policy

- Monetarists believe that if the growth of the quantity of money is consistent with the long-term potential growth of output, this will prevent ***core inflation***

- To prevent short-term ***unanticipated inflation***, policy needs to be ***credible***
  - To ensure ***credibility***, monetary policy must be entrusted to an ***independent*** central bank

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Credibility Theory and Independence of Central Banks

- The ***theory of credibility*** assumes politicians use monetary policy to increase their chances of being re-elected
  - Policy-makers seek trade-off between inflation and unemployment for their ***own political gain***

- ***Time inconsistency*** of economic policies leads to an ***inflationary bias***
  - Since households and firms are rational, they modify their ***expectations***
  - Inflation ***expectations*** explain ***current*** inflation

- ***Credibility*** of central bank depends on its ability to enforce a ***rule*** for fighting inflation trend
  - ***Credibility*** should act on inflation ***expectations***

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Critical Appraisal of the Theory of Credibility

- Highly questionable ***assumptions*** of the mainstream theory of credibility
  - Why do ***rational*** agents vote for policies they know are wrong?
  - Why do ***rent-seeking*** politicians accept independence of central banks?

- Independence implies a ***democratic deficit***
  - Central banks suffer from a problem of ***transparency*** and a lack of ***democratic legitimacy***
  - It implies separation of ***fiscal*** and ***monetary*** policies

- ***Uncertainty*** is the fundamental problem of monetary policy
  - ***Flexibility*** is more important than ***credibility***

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Credibility vs. Confidence Debate

- The ***theory of credibility*** was criticized by "new" Keynesian economists (NKE)
  - They shifted the argument to the question of ***confidence***
  - There is uncertainty regarding the "true" model of the economy
  - There are unforeseen economic shocks, and thus it's impossible to apply an inviolable rule

- NKE does not reject central bank ***independence*** completely
  - It proposes to develop a mode of governance that would reconcile the central bank with the political authorities

- We move to the question of ***credibility*** to the question of ***confidence*** among agents

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The Theory of Confidence

- ***"Credibility is literally defined as the ability to have one's statements accepted as factual or one's motives as the true ones"*** (Otmar Issing, former chief economist of the ECB))
  - Follow the same ***rule*** according to the ***"true" model***

- Critics of credibility show that it's better to develop a ***confidence strategy***, which requires:
  - ***Good governance*** rather than independence
  - ***Accountability*** for government objectives rather than responsibility for inflation
  - Common understanding of ***expectations*** of different agents rather than the common knowledge of the "true" model
  - ***Openness*** of central bank rather than full independence

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