Central Banks, Governments and Markets: an Examination of Central Bank Independence and Power

Keith Bain, Philip Arestis, Peter Howells
University of East London

This paper raises a series of doubts regarding the widely accepted view that Central Banks should control monetary policy and should be independent of governments and the political process. It commences with an examination of the meaning of "independence" and of the notion of "sound money" at the basis of many of the arguments for independence. The paper contends that a goal of low inflation represents a very limited view of "sound money".

The paper goes on to analyse the source of central bank power and to raise the question of the extent to which central banks (independent or otherwise) have real power in a modern economy. It also points out the inconsistencies in many of the anti-politician arguments used to bolster the case for independent central banks. The paper concludes by examining the conflict between central bank independence and democratic control of economic policy.

Ce texte énonce de très sérieux doutes quant à la validité de la thèse que la Banque centrale devrait seule contrôler la politique monétaire et pour ce faire être indépendante du gouvernement et de tout le processus politique. Il s'agit alors d'examiner la signification du terme "independence" et celle de la notion de "monnaie saine", notions qui sont le fondement de beaucoup des arguments en faveur de l'indépendance. Il est prouvé que l'objectif d'inflation faible correspond à une interprétation très restreinte de la notion de "monnaie saine".

Ensuite, les auteurs analysent la source du pouvoir de la banque centrale et soulèvent la question cruciale : jusqu'à où les banques centrales (indépendantes ou non) peuvent contrôler réellement l'économie. Ce texte insiste sur les contradictions inhérentes à la thèse de
Attitudes towards the central bank and its role have changed over time and been different among countries. We have recently experienced a major change across many countries, as politicians and economists have shifted their stance in the direction of the "independence" of central banks, moving strongly towards the adoption of a theoretically pure version of the Bundesbank arrangements and procedures as the ideal central bank model. Most notably, this has been proposed as the basis of the European central bank system, in which both the European central bank itself and the national central banks of the members of EMU will be required to be independent of government. Other recent examples of a movement towards "independence" have been the Bank of France at the beginning of 1994 and the Bank of Spain in May, 1994. In the United Kingdom there has been much discussion of the issue as well as some small changes in procedures which leave power in the hands of the Chancellor of the Exchequer but which make more plain the views of the Bank of England regarding monetary policy and hence the extent to which monetary policy decisions diverge from the central bank's advice. Since the financial markets tend to favour the more cautious views of the Bank, this increases the pressure upon the Chancellor to conform to the Bank's wishes.

We must first note that the usual discussion of the role of the central bank in this context concentrates on one aspect only of the full set of responsibilities borne by central banks in many countries—namely, of the operation of monetary policy. Specifically, it omits consideration of the supervisory role of many central banks—i.e., the role of ensuring the financial probity and soundness of individual banks and the banking sector as a whole and hence the role of guardian of the degree of public confidence in the system which is essential for the operation of an advanced market economy. The separation of monetary policy from bank supervision is easy enough to accept at one level, particularly both because it is practised in several countries (notably in Germany where the responsibility for bank supervision rests not with the Bundesbank but with the Aufsichtsamts, the Federal Banking Supervisory Office) and because there are some clear arguments for it based principally upon moral hazard. Nonetheless, this separation leads to a compartmentalization of the elements of the idea of the "soundness of money" which is central to the needs of the market system. It also raises questions about the nature of the credibility of the central bank.

To see this, we must begin by looking at what is usually meant by "independence," and what central bank independence implies for monetary policy. Underlying this is the question of who is, in practice, in control of the international financial system and of global economic policy.

1 THE MEANING OF "INDEPENDENCE"

In the modern debate over the independence of central banks, "independence" has taken on the simple meaning of independence from the political institutions and processes of the country. This is nothing new. Politicians have always been under suspicion of having a "bias towards easy money" or "inflation" (Sylla, 1988) and two of the three elements of the requirements of independence when the US Federal Reserve System was set up in 1913 are covered by the modern interpretation—indeed, from:

a) duly constituted government authorities (executive and legislature); and

b) partisan political interests.

Modern political and economic theory has, however, gone well beyond a generalized suspicion of politicians and has formalized the arguments in favour of this form of independence in a number of ways. Thus, we have the theory of political cycles as a criticism of the short-run motivation of politicians; public choice theory as a criticism of the self-interest of both politicians and civil servants; arguments for the irrelevancy of demand-management policy based upon rational expectations; the notion of (time inconsistency developed by Kydland and Prescott (1977) and Barro and Gordon (1983); and attacks on the democratic system as producing instability, polarization and conflicts in policy-making (Galli et al., 1991). This is all supported by empirical evidence implying the absence of a long-run trade-off between inflation and unemployment and the apparent relative success in the control of inflation of countries with relatively independent (in the above sense) central banks.

Yet several issues are left in the way in which these various propositions are put together. Firstly, the goal of monetary policy has
come to be defined solely in terms of the rate of inflation. This derives from the belief in the absence of a long-run trade-off between inflation and unemployment mentioned above, allowing the possibility that welfare may be improved through a reduction in inflation at no long-run cost in terms of loss of output and higher unemployment. More broadly, the low (or zero) inflation target can be seen as a more technical definition of the old idea of "sound money" for which the money-issuing authority could reasonably be held to be responsible. However, a low inflation or zero inflation target represents an extremely limited view of "sound money."

There can be no doubt that rapid inflation, by reducing the real value of money, undermines public confidence in money as an asset and strikes at the basis of a modern monetary economy and hence an efficient market economy. Further, international distress of the currencies of high-inflation countries undermines the international value of the currency (damaging the country's terms of trade) or requires risk premia to be built into national interest rates (in turn keeping interest rates high with potentially damaging impacts on investment). In this sense, continued high inflation rates damage the "soundness" of money.

But the soundness of money may be damaged in other ways. Vitally, since a high proportion of the money stock consists of the liabilities of banks, the willingness of the public to hold money may be undermined by the possibility of bank failure. This may arise dramatically in the case of a too-soft monetary policy which forces banks into cash-flow problems and generates doubts in the public which may lead to runs on banks. Alternatively, it may arise as a result of the failure of individual banks due to unwise and/or unfortunate investment policies. If these are large banks, the great amount of interbank activity may cause problems for the system as a whole. Again, if the failure leads to a public suspicion that banks in general are not to be trusted and are inadequately supervised, problems may spread.

Thus, the difficulties in which international banks found themselves at the beginning of the "debate crisis" of the developing countries in the early 1980s were in part due to the behaviour of the banks themselves and in part due to the monetary policies of the developed countries. These difficulties raised serious doubts about the soundness of the international monetary system as a whole and hence about the soundness of the "product" of that system, international money. Again, such events as the failure of the British merchant bank, Barings, raise doubts about the effectiveness of bank supervision and the potential risks associated with speculation in complex derivative products. This too calls into question the soundness of money. It should be noted that none of these events were provoked by inflation.

At an international level, the soundness of different monies may only partially (and then only in the very long run) have anything to do with relative rates of inflation as we have seen in recent times in relation to the weakness of the US dollar. In a world of such complexity, it is surely simplistic to judge the soundness of money by the single measure of domestic inflation rates.

2 Even with domestic systems, inflation represents only one half of the problem since we should ask why the soundness of money is so vital for a market economy. The first answer of economists is likely to be in terms of resource allocation - the ability of the market system to combine the scarce resources of a country to produce high levels of economic welfare. Logically then, if the exchange mechanism is hampered by lack of confidence in money, the market system will not perform its economic tasks satisfactorily. But the market system also fails to carry out its resource allocation role effectively if there is lack of co-ordination in the system and a distribution of income which does not ensure that those who need and/or wish to spend have access to the income required to carry out their plans - the "soundness" of money is irrelevant to people who do not have wealth and for whom the decision as to how to allocate their portfolios consists entirely of dreaming what they will do if they win the lottery.

The soundness of money may be a necessary condition for the efficient operation of a market economy, but it is certainly not sufficient.

Indeed, it is arguable that the growth of domestic central banks in industrial countries was associated with bankers exercising control over monetary policy in an attempt to reduce the number and severity of slumps in the economy. That is, central banks arose out of a perceived need on the part of manufacturing and finance for greater stability and a fear of falling prices (Hicks, 1967).

The modern concentration on inflation, on the other hand, assumes that in all matters other than the issue of money itself, the market economy works effectively to co-ordinate decisions within the economy and to ensure that demand always matches supply in the long-run. Attempts to match demand more closely with supply in the short-run only interfere with incentives and cause problems for long-run supply. Free banking models, of course, assume that the market economy can also be trusted with the task of providing the economy's money. This has the virtue of both simplicity and logic. There seems to be no a priori argument for

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2 For a clear statement of this view see the Red Report (1993) p. 8

3 For a short outline of a free banking model see Selig (1994).
suggesting that an uncontrolled market system can cope with the coordination of the vast number and range of complex decisions required to convert scarce resources into output desired by consumers but cannot cope with the relatively simple task of providing the economy with a medium of exchange (something which has been achieved even within primitive societies with no productive capacity).

Thus, the argument which stresses the role of an independent central bank in preserving the soundness of money by ensuring a low rate of inflation seems both narrow and inconsistent. However, much of the argument for independent central banks derives from empirical evidence rather than from theoretical propositions. These studies seek to relate indices of central bank independence to the relative performance of countries in terms of rates and variability of inflation and of economic growth (see, for example, Alesina, 1994; Alesina and Summers, 1988; Cukierman, 1992, 1994; Cukierman et al., 1992; Pollard, 1993). Problems associated with these studies are considered in Arestis and Sawyer (1995). Even if it is conceded that independent central banks are more effective at controlling inflation, it is often unclear why this should be the case.

Secondly, and equally crucially, the case for "independent" central banks is not buttressed by investigations of the nature of such a central bank - its institutional imperatives or the motivation of those who control it. To assume that it is "apolitical" is apparently held to be sufficient. It is accepted that an independent central bank is given an objective (or objectives) in relation to which its performance can be judged. This, together with requirements that the central bank governor report regularly to the government or the parliament or one of its committees, is held to provide the necessary democratic accountability. Independent central bankers are then reduced to the level of objective technicians who expertly use the instruments available to them to meet targets which are set taking into account "the long-term interests of the economy as a whole" (the meaning of which we consider below). Yet it cannot be the case that an independent central bank will ever be set an objective which does not require some interpretation on the part of central bankers.

The attitudes and approach of the Bundesbank are salutary in this respect. Both the choice of money supply targets and the attitude to deviations from the set targets are typically approached in a very pragmatic and flexible manner. This was made very clear by the evidence given by the Bundesbank to the UK Treasury and House of Commons Select Committee on Monetary Policy in 1980-1981. Further, both the memorandum from the Bundesbank to the committee and the evidence given to the committee by Dr. Duder of the Bundesbank emphasized the fact that the Bundesbank felt obliged to take into account the views of the government, trade unions and employers in drawing up the macroeconomic projections on which money supply targets were based.

An essential precondition for the success of a stabilisation policy guided by money supply targets is a basic public consensus, ensuring a wide measure of support for the Deutsche Bundesbank's aims and actions. (Vol. II Minutes of Evidence, para 160).

Interpretation is plainly an important part of Bundesbank behaviour. Certainly it is possible to set for the central bank a relatively narrow objective which greatly reduces the bank's scope for interpretation. However, the more limited and inflexible is the objective which it has to meet, the more likely it is that the central bank will be required to take actions which are patently not in the interests of everyone in the economy (that is, the more likely it is that there will be losers - both long-term and short-term - as well as winners). The required scope for flexibility in interpreting objectives has increased (and goes on increasing) with the continuing growth in the interdependence of national economies. For example, the notion that a central bank can be given a single target expressed in terms of a desired rate of inflation is based upon a simplistic assumption that all inflation has a domestic origin. However, the greater the degree of flexibility which is built into the central bank's objective function the more one needs to ask about the influence on the bank and its bankers.

As Arestis and Sawyer (1995) have suggested, this allows us to treat the "independent" central bank in the same way that we would treat any regulatory agency and to raise the possibility of "agency capture" (Stigler, 1975). That is, the central bank may be seen to act not in the interests of the economy as a whole but in the interests of the financial markets and institutions. Alternatively, we can apply public choice theory and raise the possibility that the central bank acts principally to maintain the importance of the central bank itself in the policy-making process. To ensure this, the central bank will need constantly to stress the damaging effects of inflation and constantly to point to the possibility of increasing inflation as well as trying to insist on the importance of the interest rate instrument in the fight against inflation. In other words, theories of institutional behaviour must be applied to the "independent" central bank.
bank and it cannot be taken for granted that the wishes of the central bank are synonymous with those of the economy as a whole or even of a majority of citizens.

Thirdly, it is assumed that if countries with politically independent central banks are successful at maintaining low rates of inflation, the central bank must in some sense have control over monetary policy and the monetary system. Plainly, this may not be so, as we show in section II.

II. CENTRAL BANKS AND CONTROL OVER MONETARY POLICY

Let us consider next this assumption that the central bank must in some sense be able to control monetary policy and the monetary system. Clearly, if this is not true any correlation between measures of central bank independence and inflation rates must:

1) indicate that there must be reverse causality;
2) indicate that some other factor must be causing both the degree of independence and the inflation rate, or
3) be merely accidental.

Thus, we need to explore in what sense this could be held to be true. According to the monetarist theory, the central bank's power must come from control of the rate of growth of the money supply through control of the monetary base of the economy. Not only that, but this is meant to operate through the establishment of medium- or long-term monetary rules. We know however, that monetary base control is not practised by monetary authorities. Goodhart (1994), arguing from the perspective of central bankers, suggests indeed that monetary base control is impossible, although he notes that most economists go on believing mistakenly that the monetary base is controllable within a narrow margin. In practice, all central banks, including the Bundesbank, operate monetary policy indirectly through control of short-term interest rates. This is meant to influence the full spectrum of interest rates and, through this, aggregate demand, the demand for credit, bank deposits and hence the rate of growth of the money supply. The first question relates to the sense in which an "independent" central bank is actually in control of short-term interest rates.

The bank, in the terms of Fischer (1994), have operational independence but not goal independence. That is, it will have been given

An additional objective which stresses control of the rate of inflation. This stress on control of inflation is both desired by financial markets and used to generate expectations as to what the central bank is likely to do. The few attempts at the establishment of long-term monetary rules have had little apparent success. Nonetheless, economists continue to debate at some length whether interest rate policy should be decided on the basis of some measure of the money stock (despite the problems with definitions caused by financial innovation in several countries) or a final target such as nominal GDP, the level of prices or the rate of inflation. In practice, central banks are likely to make their decisions about interest rate policy on the basis of changes in a number of indicators chief among which are likely to be the rate of growth of the money supply, the rate of growth of demand (in relation to what is perceived to be a "sustainable" medium-term real rate of growth for the economy), unemployment figures and other evidence concerning pressure within labour markets, the rate of inflation shown by a variety of price indices, and exchange rates. Interest rate changes occur quite regularly in all industrial countries and policy accounts much more with the "discretionary" label which used to be attached to Keynesian policies than with the idea of a monetary rule. All of this is true even for "independent" central banks, including the Bundesbank.

Many of the changes in interest rate are small, often 0.25 or 0.5 of a percentage point. For example, in the period between February 18 and May 13 in 1994, the Bundesbank lowered its discount rate from 5.75 per cent to 4.5 per cent in three discrete movements (two of 0.5 per cent; one of 0.25 per cent). Why are such changes believed to work in the way that the central bank wishes? We have, it is true, moved a long way in recent years from belief in Keynesian interest-inelastic investment demand curves, but it remains that surely very few people are likely to think that a change of 0.25 per cent in short-term interest rates would, of and by itself, produce a significant change in the investment decisions of firms or in consumption decisions of households. No, the mechanism which is generally held to operate is that of credibility and reputation.

We are led to believe that the central bank would have the power to control demand through the interest rate if it chose to exercise it. But it does not need to do this as long as financial markets believe that it could

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4 For the most detailed statistical analysis of this link, as well as the fullest statement of the case for independent central banks, see Calhoun (1992). Calhoun (1994) summarizes much of the argument.
and would do so if required. Thus, the central bank operates through a series of signals to the financial markets. The catch is that these signals only have power as long as the financial markets believe that the policy of the central bank is "credible," by which is meant that the central bank follows the path that the markets think it should do in order to achieve the target which the markets accept as desirable.

Worse than this, if the central bank's policy is not held to be credible, and it does wish to achieve a low rate of inflation, it will need to push interest rates up much faster and much further than would otherwise be necessary in order to overcome the skepticism of the markets. This, almost inevitably, will produce a much deeper recession than would otherwise have been needed. An experience of this kind then seems certain to lead the bank to be even more cautious than previously as the economy struggles its way out of recession.

Under these circumstances, does it actually matter who makes the interest rate decisions? If politicians make them, we are told, markets will not believe in the authorities' determination to control inflation, the policy will not be credible and the economy will not respond to small interest rate changes. But what would follow if an "independent" central bank chose, against market expectations, to follow an expansionary path? Surely, the outcome would be exactly the same as if the decisions had been made by politicians. Thus, it is significant that even an "independent" central bank either has to have an anti-inflation reputation built up over many years, as with the Bundesbank or the Swiss National Bank, or it must have its hands tied in a very specific way, as in the New Zealand case where achievement of a narrow target rate of inflation (0.25%) is linked to the possibility of re-appointment for the central bank governor. It is not irrelevant either that the evidence seems to suggest, even to strong supporters of the case for independence, that central bank independence "appears to be efficient mostly as a safeguard against the onset of high inflation rather than as a remedial device" (Cukierman, 1994, p. 144).

In the language of the debate, authorities who do not have a strong anti-inflation reputation must pre-commit monetary policy to a pre-announced (low inflation) course.

And what of the power of those central banks with high anti-inflation reputations? Even the Bundesbank acknowledges its very limited influence:

"Against the growing globalization of the financial markets, Germany was unable to disengage itself from the international interest rate trend, it is true, but, given the credible anti-inflation thrust of the policy, interest rates in Germany rose less than in most other countries... an aggressive interest-rate cutting strategy on the part of the central bank... would have been doomed to failure. It would have risked causing mistrust in the future movement of the domestic and external value of the currency, and in the final analysis would probably have led to higher, rather than lower, capital market rates" (Deutsche Bundesbank, 1995, p. 71).

In other words, some central banks may be able to build up a reputation for "monetary stability and sound public finance" by consistently following those policies preferred by financial markets. What this then gives to the countries concerned is some small degree of independence from international trends. This hardly suggests the degree of control implied by most of the central bank independence literature. In any case, since the small degree of freedom is obtained through the strength of a currency and since this arises because the markets prefer it to other currencies, it must follow that only a small number of central banks can achieve this state. The Bundesbank has achieved the very limited power that it has to detch German interest rates from market trends because of its relative monetary stability.

Consider, next, a government which decided to make the country's central bank independent of it and drew up a constitution for the bank but included in this an objective function for the bank which stressed the importance of the rate of growth and the level of employment ahead of any concern with the rate of inflation. Is there any reason to believe that the financial markets would regard the policy of such an independent central bank as credible? Again, in a country where the control of inflation wins votes, politicians are likely to choose policies which will keep inflation in check. Would there be any difference in such a case between the central bank policy followed by a government and that followed by an "independent" central bank which was required to maintain a low rate of inflation as a priority?

An alternative argument suggests that gains arise from politically independent central banks because they can build a reputation for pre-commitment (to a low inflation policy) which is not, by definition, available to politicians. The central bank can then exploit this reputation to allow it to use monetary policy for short-run purposes (expanding the money supply, for instance, to counter deflationary shocks) without raising long-run inflationary expectations. Thus, a politically independent central bank could, so long as it allowed itself or was allowed the freedom to move away in the short run from its inflation target, achieve a combination of low inflation in the long run and stable short-run output.

But isn't there something odd here? If the argument against politicians is that they adopt short-run policies in order to win elections, why does that generate long-run inflationary expectations? The answer must be

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6 Deutsche Bundesbank (1995, p. 71)
that politicians do not have a reputation for achieving low inflation in the long run. But there is no clear theory of political behavior to justify this. Indeed, the standard theory of the political cycle does not necessarily suggest that there is any long-term bias towards over-expansionary policy since, between elections, governments may be forced (often by the balance of payments constraint) to operate restrictive policies. In any case, if people understand that the economy is best-served in the long run by low inflation, they surely will not vote for politicians who have a long-run bias towards inflation. In short, we are back to the position that it is not the distinction between politicians and a politically independent central bank which is important but the nature of the target and whether or not that target is accepted by financial markets.

III. - “INDEPENDENT” CENTRAL BANKS AND DEMOCRACY

The conclusion to the above argument must surely be that an “independent” central bank is in fact not independent of the preferences and expectations of financial markets. Interestingly enough, the third independence requirement for the Federal Reserve system created by act of Congress in 1913 was that it should be independent of “private financial business interests”. It is true that this may be interpreted as relating to individual business interests rather than to the financial or business sectors as a whole. Thus, the intention may have been to ensure that the central bank did not pursue policies which favoured one set of business interests at the expense of others. Nonetheless, it leads to two questions.

Firstly, is it necessarily the case that the preferences of the financial sector reflect the preferences of the market economy in general? The answer might only be yes, if there were conclusive evidence that low rates of inflation led to higher and more stable rates of economic growth (although changes in income distribution may mean that higher rates of growth are not Pareto-improving 7). However, as we have indicated above, such evidence does not exist. Studies such as that by Alesina and Summers (1993) suggest that although central bank independence, however measured, is accompanied by lower inflation, it is not associated with lower unemployment, a more stable economy, higher economic growth, or less volatile rates of economic growth 8. If this is so, it must be true that monetary policy which only becomes effective when it is credible to financial markets must from time to time be against the interests of other business interests.

Secondly, even if the interests of different elements of the business sector were always in accord, does this justify the view that, with regard to monetary policy, the preferences of that sector should dominate those generated by the political system? We have seen above that the principal argument against the political system is that politicians are governed by short-term concerns while in this area of policy there is a conflict between the short-term interests of the voters and the long-term interests of the economy. The implication appears to be that voters do not know the long-term interests of the economy and are thus easily fooled by politicians. The problem here is that, as agents in the market system, people are assumed to have rational expectations and to be able to understand both how governments are likely to respond to economic circumstances and what the impact of government policy will be. Indeed, the whole Kydland and Prescott/Barker and Gordon time inconsistency construct assumes that people know very well exactly what politicians are up to. Yet, as actors in the political system, people are assumed to be short-sighted and easily fooled. It is difficult to justify this inconsistency. If the political system generates a long-run inflationary bias which voters do not want, politicians will surely appear who will win votes by promising what voters want. And to be re-elected, governments will ensure that low inflation is delivered.

If, on the other hand, voters have a long-run inflationary bias, in what sense is lower inflation best for the economy? Who is the economy in this case?

This is, naturally, all part of a deeper problem which derives from the assumption that there is such a thing as the long-term interests of the “economy” as distinct from the separate and conflicting long-term interests of different groups within the economy. If we were to take this latter view, we could easily provide an alternative interpretation of the independent central bank agenda—that it is for the deliberate substitution of the preferences of the market system (in which

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7 There is also the precautionary argument which suggests that differential rates of inflation may be justified among countries and that higher rates of inflation may be desirable in countries with inefficient public finance structures.

8 Cukierman (1994) suggests that central bank independence may be related to higher rates of economic growth in developing countries — but, in countries in which the average
voting power is replaced by market power) for those generated by the democratic system in circumstances in which it is not possible to see one set of preferences as being objectively "superior" to the other. After all, if voters are short-sighted but market agents are "forward-looking", it must surely be the case either that:

(a) market agents are only a subset of voters - that is, that substituting the judgement of the market for the judgement of the political system is allowing some minority to dominate;

(b) voters consist of a mixture of short-sighted and long-sighted people but there is a strong correlation between long-sightedness and wealth/market power, causing the long-sighted to dominate in the market - the outcome is the same as in (a);

or (c) that the same group of people make one set of judgements in one context and a different set in another.

If we opt for (c), we need some clear justification for it. We can hardly assume that they are irrational in one context and rational in another since this would be extremely dangerous for much of modern economics. If we assume that both sets of decisions are rational, on what grounds do we believe that the decisions generated by the market should dominate, other than to approve of what is implied by (a) or (b)?

An extreme version of this argument is that of Greider (1987) who saw the US Federal Reserve as a non-elected body with an anti-inflationary bias that restrains economic growth in order to preserve the value of financial assets, most of which are owned by wealthy people. That is, the short-term versus long-term distinction is merely a cover for a conflict of interests. Historically, we might say, people with market and/or military power resisted the growth of political democracy. Where that battle is lost, the aim becomes to remove as much decision-making power as possible from the political system. Independent central banks determining monetary policy may be seen as one very small part of that agenda.

We have mentioned above a variant on the argument against democracy - the suggestion by Grilli et al. (1991) that the democratic system produces instability, polarization and conflicts in policy-making. This, too, derives from the simplistic notion that there exists a set of policies which we can all agree are "in the interests of the economy as a whole". In reality, different groups in the economy have different interests and compromises are frequently possible. Polarization and conflicts in policy-making will only be avoided if the interests of one group are always dominant.

IV. THE QUESTION OF CONTROL OVER THE FINANCIAL SYSTEM

Let us now turn to the question of supervision of the financial system. We suggested at the beginning that the "soundness" of money was dependent not only on the maintenance of the purchasing power of money but also on confidence in individual banks and in the banking and financial sector as a whole and hence on the adequacy of supervision of that sector. It is this which leads to the proposition that the central bank should also have a supervisory role. It is possible, of course, to argue that there is no short-term gain available to politicians from the supervisory function in the same way that there is from generating inflation through a loose monetary policy. Thus, the supervisory role may be placed in the hands of a non-independent government agency while the independent central bank is left to deal only with monetary policy. It has been argued, indeed, that the separation of the monetary policy and supervisory roles has positive advantages for the control of inflation since where central banks are not involved in bank supervision, financial sector representatives will be less inclined to lobby central banks for easier monetary policy to reduce the regulatory burden on banks and financial companies (Posen, 1993). Whether this is true or not, under present circumstances, we see no objection to the separation of the two roles. However, if an attempt was made to recapture monetary policy for the political system (an issue we shall return to at the end of the paper), they would need to be brought together. Even if they are kept separate, it should be conceded that the two roles are complementary and that the supervisory role is at least as important whereas the writings of economists have been directed heavily towards the monetary policy role.

Whichever carries out the supervisory role, severe problems exist with respect to the power of the supervisor to control the banking and financial sector. There are two difficulties, at a minimum. The first is that of competitive deregulation. No single national authority is in a position to exercise firm control over the sector, for fear that the market will simply move to other financial centres. This is of particular significance to London where the world importance of its financial markets cannot be accounted for by the strength of either the British economy or sterling.

The second difficulty is the lack of information held by supervising authorities. World financial markets continue to evolve so rapidly and capital moves with such speed that there is only a slight possibility that the authorities can know precisely what is happening. As the Barings affair showed, the Bank of England has effectively to depend on self-regulation and this has proved itself to be inadequate on numerous occasions. Its role is not so much one of controlling the market as it is one of limiting the
damage to the reputation of the market and containing the fallout, when things go wrong.

Putting together what is happening to monetary policy and the way in which world financial markets are developing produces a paradox. At a time when more and more attention is being drawn to central banks and the demand for their independence from government is growing, implying that these banks have considerable power which cannot be trusted to politicians, they are being shown to be virtually impotent. The debate over the form of control of central banks seems then to be barely relevant to the question of control of economic policy and of economics.

As a side-issue, we may here address the question of why politicians everywhere seem to be adopting central bank independence with such enthusiasm in most cases. One possible answer is that politicians are aware that in allowing central bank independence, they are merely giving up a nominal power — a power which, in effect, already been lost to the markets. Thus, they lose nothing but gain by publicly shifting responsibility for the control of inflation on to a non-elected body.

V. — THE CONTROL OF ECONOMIC POLICY — A SUMMARY

As macroeconomic policy has developed in recent years, governments have increasingly moved in the direction of restricting themselves to the use of one instrument of policy — the rate of interest — and to one policy target — control of the rate of inflation. It has been in this context that the role of the central bank has been given so much attention along with the governance of that central bank. At the same time, we have seen that there has been a considerable move to increase the independence and power of central banks.

This would appear to be placing macroeconomic policy almost entirely in the hands of central banks (except for “crises” or other particular sets of circumstances when governments, according to some constitutions, may take power back from politically independent central banks). Yet monetary policy seems only likely to be effective when central banks behave in the way that financial markets expect and wish them to. At the same time, governments seem to have little control over the operation of financial markets. This appears to remove macroeconomic policy entirely not just from short-sighted politicians but from any institutions which might be expected to have the best interests of the entire economy at heart, on the assumption that such interests exist and can be identified.

Is there any way out of this trap? One major one has been proposed — that of James Tobin to place a tax on international capital movements in order to make speculative capital movements less profitable and hence to reduce the flow, restoring some degree of control to national governments. But, as Tobin accepts, this would only work if the tax was applied by all governments. The possibility of reaching this degree of agreement and trust among countries may not seem very great. Yet an increasing realization of the powerlessness of national economies in the world of mobile capital may concentrate minds wonderfully. In this broader context, the issue of central bank independence seems of minor importance. And yet, it is important in the sense that it may be another example of economists attempting, even if with the purest of motives, to conceal a conflict of interests behind an apparently objective argument based upon some simple correlations.

REFERENCES


The Institutionalization of Deflationary Monetary Policy

Thomas J. Palley
Dept. of Economics
New School for Social Research
New York, NY 10003

Natural rate theory now dominates the economic counsels of the central banks. Though theoretically contested and empirically unsubstantiated, it has provided the necessary pretext for implementing deflationary policy. There is now an emerging second stage agenda that seeks to institutionalize such policy through the creation of independent central banks. The claim is that this would improve macroeconomic performance by eliminating the putative inflationary bias of democratically controlled central banks. However, independent central banks have a deflationary bias because central bankers tend to be drawn from the ranks of financiers who have a mild preference for deflation. Thus, independence entrenches the interests of financial capital, and institutionalizes deflation.

La théorie du taux naturel est couronnée par les comités des banques centrales. Bien que cette théorie ait été critiquée sur le plan empirique, bien qu’elle ne soit justifiée par aucune évidence empirique, elle sert à justifier la politique monétaire de déflation. Maintenant, on assiste à une deuxième phase : il s’agit d’institutionnaliser de cette politique en créant des banques centrales indépendantes. L’argument est qu’en rendant indépendante la banque centrale on améliorerait la gestion macro-économique en abolissant à tout jamais la tendance à l’inflation de banques centrales soumises à des contrôles démocratiques. Cependant, il est établi qu’une banque centrale indépendante aurait tendance à imposer une politique de déflation car les dirigeants des banques centrales proviennent des milieux financiers qui préfèrent une déflation modérée. Il est ainsi provoqué que l’independance entrenches les intérêts du capital financier et institutionnalise la déflation.