Should the Central Bank be Independent?

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I. Introduction:

Money by virtue of its functions as a medium of exchange, a unit of account, and a store of value has a strong influence on economic activity. It is therefore natural that political philosophers from various civilizations have inquired on how best to manage the production, and the use of money in a way that is best conducive to the welfare of the nation. Here are a few examples. Aristotle theorized money in terms of its function as a medium of exchange, and did not consider it to be a genuine form of wealth (Rima, 1991: pg 7). The French Monk Nicolas Oresme is considered a pioneer for his inquiry into the links between the prince's exercise of his seignorage privileges, and the changes in the price level. Karl Marx explored the role that money plays in the class struggle within a monetary exchange economy (Rima, 1991, pg 207-214).

More recently, events like the great depression have revealed how the mismanagement of monetary policy could have devastating consequences for the economy[1]. Initially the Federal Reserve was created in 1913, to pool human resources under one institution, the Central Bank, to best

[1] The Great Depression was the catalyst for a more active role in monetary policy for the Federal Reserve.

manage the conduct of monetary policy[2]. Following the Second World War, under the ideological influence of the Monetarist School of thought, best epitomized by the work of Milton Friedman, the Independence of the Central Bank from political authority has been dogmatically accepted by policymakers as necessary for the best conduct of monetary policy (Shull, 1996). The Monetarist School of thought is characterized by its strong emphasis on the control of inflation as the most worthy target of monetary policy.

While Monetarist thought continues to have a preponderant influence on monetary policy, there exists an alternative conception of how monetary policy should be conducted. Post Keynesian analysis demonstrates that monetary policy is far more potent to achieve real macroeconomic objectives such as the reduction of unemployment, and the maximization of long run growth than is generally accepted by neoclassical economists. Post Keynesian monetary theory is based upon the works of John Maynard Keynes, and other economists such as Kalecki, Robinson, and Wicksell (Fontana, 2002).

In this essay, it is my aim to demonstrate that Monetary Policy is most effective for the realization of

[2] Federal Reserve Board. Federal Reserve Act. Retrieved March 15, 2006 from the World Wide Wed: http://www.federalreserve.gov/generalinfo/fract/.

real macroeconomic goals, when it is dependent on, and accountable to the political authority. To achieve my goal, I will structure my argument in three parts.

Firstly, I will criticize the theoretical foundations of Neo Classical monetary theory from a post Keynesian perspective, and provide evidence that Neo Classical monetary policy has not been very effective in achieving its self declared goals.

Secondly, I will articulate some of the key elements of Post Keynesian monetary theory by demonstrating that monetary policy is effective both in the short run and the long run to affect real economic variables such as employment and growth.

Thirdly, I will argue that under the current regime of central bank independence the central bank's policies are not designed and implemented to enhance national welfare because the Central Bank is controlled by, and biased towards certain economic and social interest groups that are not representative of the majority of economic agents. Further, I will show that because of the aforementioned incoherence, the principles that are currently put forward to defend Central Bank Independence (CBI) are a disguise to maintain an undemocratic decision making process that favors the interest of a privileged minority of economic stakeholders.

In conclusion I will integrate my main arguments to defend my contention that a dependent Central Bank is best conducive to welfare of the nation. Before we begin our discussion, I will outline my understanding of the concepts from which I will derive my arguments.

II. Conceptual Definitions:

I will refer to the Central Bank as the institution responsible for the conduct of monetary policy in western industrialized nations.[3] As such I assume that most Central Banks of WIN have clearly defined statute objectives, with the control of inflation being the most favored one (Alesina & Summers, 1993).

Secondly, I assume that the Central Bank is free to use any instruments necessary to achieve its goal, which implies that it is economically independent (see Fischer, 1995). Thirdly I assume that the Central Bank is practically free of government interference in its conduct of monetary policy because of such considerations as: the

[3] I have narrowed my scope to ***Western*** Industrialized Nations because monetary policy Goals, Objectives, and Instruments in developing countries are not the same as in western industrial nations. Further I assume that the Goals, Objectives and Instruments of monetary policy in western industrialized nations are homogeneous enough for my discussion to be relevant to all western industrialized nations.

length of appointment of governors, the fact that government officials do not sit on the Central Bank’s board (which is the case in the United States for example), and the difficulty of the political process needed to force the resignation of an unpopular Central Bank governor (see Franzese, 1999).

Thus while the Central Bank is legally politically dependent by statute, the freedom it enjoys in its pursuit of its set objectives, its lack of coordination of monetary policy with Fiscal policy, and the difficulty for the government to observe, criticize, and alter if necessary the behavior of the Central Bank makes its actions independent of the political authority (see Akhand, 1998).

III. A Critique of Neo Classical Monetary Theory:

The Neo Classical argument for central bank independence relies on the assumption that if the government was fully responsible for the conduct of monetary policy, its preference for inflation would fluctuate according to the pressure on politicians facing reelection to deliver short term employment and output results, which will trigger undue inflation (Fischer, 1995). This implies that the variation in the changes in the price level will force inflation expectations to be above the real long term preferences of market agents and the median voter. Therefore the only way to achieve the public's long term preference for a low inflation rate is by insulating the conduct of monetary policy from the short run fluctuations of the political cycle by letting an independent central bank regulate economic activity (Alesina & Summers, 1993).

This argument is elitist because it is based on the notions that the government cannot be trusted with the means to pursue its economic objectives, and most importantly that individuals are fundamentally self-interested people that maximize their life outcomes, irrespective of how their behavior will affect others.[4] While this assumption allows elegant demonstration of the principal agent problem using game theory and other mathematical tools, it is sociologically unrealistic (Henrich & al, 2001). In reality, all individuals, politicians included, base their decisions on their recognition of their interdependence with others, and seek to maximize communal outcomes as opposed to individual ones.

[4] For an excellent critique of the assumption that Homo Economicus is fundamentally self interested, consult: Henrich & al, 2001.

Secondly, Neo Classical economists believe that inflation is the only legitimate target of monetary policy, because in the long run (LR) monetary policy is incapable of affecting real variables as the economy always operates at its potential in the LR, irrespective of the price level.[5] Those views on inflation are based on the quantity theory of money which is nothing more than an identity that cannot be falsified considering the fact that empirically velocity is not constant like it was theorized by Milton Friedman (Duca & VanHoose, 2004). Graphically this theoretical view is represented by a vertical LR output supply curve, and any change in the money supply, which in turn shifts the aggregate demand, has no impact on output in the LR, because the price level would adjust proportionally to the change in the money supply to maintain the economy at its 'potential'.[6] Of course, the 'potential' output entails a 'natural' rate of unemployment.

This Neo Classical monetary theory is flawed for several reasons. Firstly, Neo Classical theoretical

[5] This tautological representation of monetary policy, gives Neo Classical economists the fake notion that there is no alternative to a Neo Classical monetary policy.
[6] Bartel (1996) describes the situation as follows: "By the end of the 1970's, two broad policy alternatives existed. One essentially Keynesian, acknowledged the complex structure conditions of inflation and recognized the high cost of monetarist restraint. The other, essentially monetarist, deliberately belittled the short term unemployment costs (Bartel, 1996: pg. 241)."

conceptions of monetary policy do not explain how the transition from the short run to the long run takes place. This is because Neo Classical economics uses theoretical time in its analyses, and thus the economy is always at its potential in the LR, because time is assumed to be ergodic (see Dunn, 2003). The use of theoretical time instead of real time is inappropriate to guide policy decisions because in reality the state of affairs thirty years from now, ultimately depends on the successive state of affairs in each of the next thirty years. Current economic conditions affect social and political affairs that determine the future state of the economy. For example: a persistently high rate of unemployment today may irremediably lower the level of economic activity tomorrow, by reducing future workers willingness and capacity to acquire the tools necessary to produce a given future level of output.

Secondly, Neo Classical monetary policy relies on the assumption that inflation is a monetary phenomenon that arises when the quantity of money in the economic system exceed the economy's productive capacity. This view is erroneous because it relies on unrealistic theoretical assumptions that: firms are perfectly competitive, they have no market power, and an individual firm cannot charge a price above the equilibrium market price. Since each firm is supposed to be a price taker it always operates at full capacity because its output has no influence on the equilibrium market price. However in the contemporary economic context, this assumption is not true because most industries in WIN are populated by differentiated oligopolies that interact strategically with each other by competing with prices, and most importantly: by maintaining surplus productive capacity to deter entry. A survey of the price setting behavior of Canadian firms reveals that the price charged by competitors, and the actions of competitors were more significant in firms' pricing decision that demand conditions, or input prices (Amirault & al, 2005). Once we take these arguments in consideration, then it becomes clear that the theoretical transmission mechanisms between the quantity of money and the price level via capacity utilization, according to Neo Classical monetary policy are inaccurate.

The theoretical flaws in Neo Classical monetary policy are reflected in the empirical record of the Central Bank. In a research paper, Richard Bartel examined the Federal Reserve's anti-inflationary stance, and finds that the Federal Reserve has raised interest rates on numerous occasions even when American firms' capacity utilization was declining (Bartel, 1996). According to Federal Reserve officials, notably Chairman Greenspan, the Fed acts preemptively to stem inflation by maintaining a high rate of interest (Bartel, 1996: pg 243). The consequences of that pre-emptive reflex are two folds. One, by maintaining an interest rate greater than warranted by economic data, even under Neo Classical assumptions, the fed in effect incapacitates fiscal policy by increasing the debt servicing requirements of the government, particularly because policymakers believe that a balanced budget is a golden standard (Levy, 1996). Secondly, to be able to act preemptively, the FED maintains an unemployment rate above its own self identified NAIRU[7] by constraining effective demand with a higher than warranted interest rate (Weller, 2002).

One may wonder why the FED acts in an ideological manner that defies its own theoretical precepts? The reason is simple: the FED's short term influence on the economy is derived from market agents' conviction of its power, therefore making FED policies self fulfilling prophecies. The sad reality of the FED's impotence is revealed by the fact that between 1950 and 1992 the Fed was unable to

[7] For a discussion of the instability of the NAIRU and its implication for monetary policy see Meyer & al (2001).

control inflation as the price level increased by more a factor of five (Brockway, 1994).

In fact, the recent academic controversies over the income elasticity of money demand ($\varepsilon_Y^{M^d}$), and the interest rate semi-elasticity of money demand ($\varepsilon_R^{M^d}$) reveals the theoretical flaws of the monetarist's point of view[8]. Lucas (1988) evaluates those elasticities as $\varepsilon_Y^{M^d} \approx 1$ and $\varepsilon_R^{M^d} \approx -0.10$, but other researchers found them to be significantly lower $\varepsilon_Y^{M^d} \approx 0.5$ and $\varepsilon_R^{M^d} \approx -0.05$ (Ball, 2001 for example). Those contradictions led to a scramble to change the definition of monetary aggregates in order to make the data fit the theory (Teles & Zhou, 2005).

Yet the most damaging finding for Neo Classical monetary policy is the fact that long run interest rates are responsive to the FED's actions (Atesoglu, 2005). That, supports the "horizontalist" view of money demand, which claims that monetary policy is most effective when the central bank sets the interest rate and lets the market choose quantity demanded because of monetary policy potency in both the short term and the long run (Atesoglu, 2005). In the following section I am going to articulate how monetary policy does affect real variables in the long run.

[8] If the Long Run Money Demand is unstable this implies that in the long run money is not neutral.

IV. Effective Monetary Policy in Both the Short Run and the Long Run:

Post Keynesian monetary policy, according to Giuseppe Fontana (2002), is characterized by three essential features "(a) the rejection of the equilibrium method in favor of sequential analysis, (b) the adoption of the monetary context of economic behavior, and (c) the principle of effective demand (Fontana, 2002: pg 504)." The conceptual basis of Post Keynesian monetary policy is provided by Keynes Liquidity Preference Framework which establishes the links between monetary variables and real economic activity (Chick & Dow, 2002).

To understand the Post Keynesian view, it is critical to recognize that it is the quantity of money required by consumers and entrepreneurs, in the pursuit of their best economic interests that determines the quantity of money demanded (Sicsú. 2001). Unlike Neo Classical theory, Post Keynesian theory implies that it is investment that determines savings and not the opposite, because agents are not necessarily willing to invest more than they have planned simply because there are savings available.

Once we recognize that it is market agents, and not the central bank, that affect the quantity of money supplied through the intermediary of depository institutions' demand for reserves, then this implies that the interest rate is exogenous (Chick & Dow, 2002). In fact a careful analysis of the determination of the overnight rate of interest reveals that the central bank accommodates bank's reserve requirement at the set interest rate which supports the exogenous interest rate argument [9](see Fontana, 2002). While the determination of the interest rate is exogenous because it is set by the central bank, and not determined by the market, this does mean that the interest rate is neutral.

Any contractionary or expansionary monetary policy relative to the interest rate desired by market agents induces a substitution in the moment when entrepreneurs realize their economic projects (Rymes, 1996). This substitution mechanism is reflected by the fact that the Federal reserve's actions changes the spread between long term and short term maturity financial assets, measured by the yield curve (Chick & Dow, 2002). For a more thorough discussion of the mechanisms whereby monetary policy induces substitution see Chick and Dow (2004), discuss how

[9] Note: The exogenous view of the interest rate determination adopted by Post Keynesian theory, does not advocate an uncensored lending strategy by depository institutions. In fact Post Keynesians recognize that in order to preserve the integrity of the financial system lending must be extended only to credit-worthy borrowers, and a high degree of trust between institutional agents is necessary (See Wolfson , 1996).

different changes in the interest rate by the bank of England induce chartered Banks to change the composition of their portfolios between short term liquid assets (such as T-Bills) used for transactions purposes, and long term (speculative) bonds[10] (Chick & Dow, 2004).

According to Rymes (1996), since the change in nominal monetary magnitudes caused by the monetary authority's policy decisions creates an intertemporal substitution effect in agents' willingness and capacity to initiate productive projects, then monetary policy has real effects on the economy both in the short run, and the long run. The significance of the potency of monetary policy in the long run is reinforced by the sequential interdependence that exists between economic conditions in successive time periods[11].

The omni-potency of interest rates is the condition which suggests a normative monetary conduct aimed at minimizing unemployment, and maximizing output. For monetary policy to maximize real variables, the central authority must determine a level of interest that does not

[10] While I rely on the technical analysis of the monetary policy transmission mechanism, done by Chicks and Dow, I do not concur with their non dualistic treatment of "money and liquidity preference" in my investigation of the legitimacy of CBI.

[11] Clearly, by practicing a defensive inflationary policy the Central Bank maintains a high interest rate which denies access to the credit market to agents with limited financial means, and thereby constraining aggregate demand.

constraint agents' "animal spirits", and let the market determine the quantity of money it needs to satisfy its creative potential (Mosler, 1998). There are three key elements that Post Keynesian authors identify as being necessary for a proper monetary policy.

Firstly, to maximize economic output and employment, the Central Bank must accommodate the reserve requirements of banks, provided that they lend to credit worthy borrowers. Since the Central Bank can create reserves at will because reserves are essentially costless, accommodating banks' reserve requirements will not adversely impact the economy (Mosler, 1998). Government deficits, which are financed by the issuance of bonds, play a crucial role in the creation of reserves that are necessary for the smooth operation of the banking system (Mosler, 1998). Therefore Post Keynesians view fiscal deficits as useful for a vigorous economy through the effect of government deficits in enhancing aggregate demand for goods and services, and their necessity to create reserves in the banking system [12] (Rymes 1996).

[12] From a Post Keynesian theoretical perspective, Neoclassical economists' beliefs that fiscal deficits are harmful to the economy because of their intergenerational redistribution effect (argued in the Ricardian Equivalency Theorem), and that in the long run monetary policy is neutral are doubtful.

Secondly, the synergic complementarities that exist between fiscal and monetary policies leads Post Keynesians to argue that it is a mistake to devise monetary policy independently of fiscal policy, and vice versa (Sicsú, 2001). This fact supports my argument that a dependent central bank is necessary to enhance economic welfare, because it will enable the government to fully harness the real potential of monetary policy.

Thirdly, Post Keynesians are fully conscious of the fact that to a large degree, inflation depends on the psychological attitude of market agents, and that monetary policy needs to operate through the open market (Rymes, 1996). Thus, in order for a Post Keynesian approach to monetary policy to be effective, market agents' understanding of the mechanisms and expectations that causes inflation, and conceptions about what is 'normal' inflation must be altered (Rymes, 1996). According to Joăo Sicsú: "any government that wishes to execute a credible anti-unemployment monetary policy must aim for trust, cooperation, and consensus (João Sicsú, 2001: p 676)."

It is my opinion that beyond clear, effective, and collaborative efforts by the monetary authority to reassure financial agents of the soundness of an anti-unemployment monetary policy, a transition from the current 'neutral' view of monetary policy to an activist monetary policy will require strict regulatory constraints to ensure that financial speculators will not undermine the credibility of a dependent central bank by speculating against the government's resolve to implement such a policy.

Now that I have shown that monetary policy does affect real variables in the short run and the long run, I will argue that in order to implement such a policy the central bank must be dependent on the government authority.[13]

V. A Democratic and Accountable Central Bank:

Many critics have rightly claimed that under the current politico-economic systems in WIN, the independence of the Central Bank is undemocratic because the people who are in charge of monetary policy are not elected, and cannot be easily held accountable for the consequences of their actions (Levy, 1996). The inadequacy of the current arrangement is exacerbated by the fact that the actions of

[13] The characteristics by which I define a dependent central bank are as follows: a) the Central Bank's objectives and the means by which it achieves those objectives should be directly determined by the government; b) Central Bank officials notably the president of the Central Bank should be appointed, held accountable, and be fired if necessary like any other cabinet ministers; c) the management of the central bank should broadly reflect the political and ideological distribution of parliament; d) the Central Bank's policy rule should by charter be flexible enough to allow the government to establish the best course of action necessary to maximize the people's economic, and social welfare. For a more extensive description of the degree of Central Bank Independence, see Shull (1996).

the central bank have a tremendous barring on people's economic welfare, and social wellbeing. Central Banks lack of transparency has led to a severe asymmetry in the political interests represented in the decision making process of the Central Bank. David Levy (1996), referring to the way the US' Central Bank operates, describes this situation as follows:

> "allowing, an independent group of men and women to weigh trade-offs and make choices that deeply affect the lives of the citizenry is antithetical to democracy when some of them, the regional Federal Reserve Bank Presidents who serve on the Federal Open Market Committee, are appointed by boards of directors who are largely elected by bankers, not citizens (Levy, 1996: pg 190-191)."

Those who defend the independence of the central bank have argued that shielding the Central Bank from the political pressure emanating from the government allows it to preserve the interests of the median voter, and therefore serves the interests of the people (Alesina & Summers, 1993 for example). Implicit it that assertion is that the central bank has the capacity to remain impartial, and if that was the case its independence would be comparable to that of other independent federal institutions that maintain a delicate social justice balance by refereeing amongst competing interest.

What distinguishes the Central Bank from, say, the Supreme Court (SC), is that the SC decisions, generally do not arbitrage the welfare of one segment of society at the expense of another (Levy, 1996). While the Central Bank's political biases in the constitution of its members have led it to favor the interests of the privileged segments of society, the capitalists, at the expense of those of the workers, because fighting inflation is primarily done at the expense of employment: "indeed, many central bankers… explicitly recommend using [high] unemployment as a long-term price stabilization strategy (Levy, 1996: p 195)."

Central bankers are well aware of the consequences of their action and have resorted to petty methods to maintain their oligarchic power. Shull (1996) notes that central bank "officials with a concern for public welfare (Shull: p 221)" are strongly discouraged to express their views. Furthermore, the Federal Open Market Committee has deliberately concealed the transcripts of its deliberation and explicitly misleads the congress, all in an attempt to prevent any interference with its biased policies (Bartel, 1996: pg 236).

It is thus clear that Central Bank Independence favors the interests of a privileged minority at the expense of the greater public good. The only way to remedy this situation is by reigning in the central bank, and making it dependent on government authority (see Bartel, 1996). Only a Central Bank that is under the influence of the government can defend the interests of the people. Regardless of the political orientation of the government, a dependent central bank will be in a better position to strive for full employment and maximize out put, because, there is no political party whose core beliefs are antagonistic to a vigorous economy.

VI. Conclusion:

The theoretical inadequacy of Neo Classical economics has led to a monetary policy that is harmful to economic activity, and the people’s welfare, irrespective of the time frame of action under consideration. Post Keynesian monetary theory reveals the flaws of the Monetarist framework of analysis, and offers an alternative policy framework that is superior in its capacity to enhance citizens’ wellbeing and quality of life by increasing economic growth through greater employment.

However in order to implement this better alternative, whereby the Central Bank strives to reduce unemployment and maximize growth, the democratic deficit of the Central Bank created by its independent status must be corrected by making it dependent upon the government, which, is accountable to the people.

It is my belief that two courses of action are necessary for a better monetary policy conduct. Market agents must be educated about the real transmission mechanism of monetary policy, and most importantly, the people must recognize that monetary policy significantly affects their livelihood, so that they can repossess what is legitimately theirs, through a democratic political process.

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