Chapter 26

Central Bank Independence and Democracy: A Historical Perspective

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26.1 Introduction

Augusto Graziani has made important contributions to the literature on the role of money and the conduct of monetary policy. Within the literature on the 'monetary circuit', his work occupies an outstanding place, and his recent reflections on central bank independence are equally worthy of note (see Graziani, 1998).

Our chapter deals with the relation between central bank independence and democracy, examining the literature from the rise to dominance of the Keynesian school to the present day. Following a general trend in economics, there have been major changes in the analysis of this subject since the mid 1970s. Some of these changes have given cause for concern: one conclusion of the new dominant position, which has affected most central bank reforms during the last decade and the conduct of monetary policy, is that to increase the effectiveness of monetary interventions it is necessary to violate some rules of democracy (see Bowls and White, 1994; Samuelson, 1994; Tobin, 1994; Briault, Aldane and King, 1996; Blinder, 1997 and 1998; de Haan, 1997; Eijffinger and Hoeberichts, 2000).[i]

Here we aim to provide an overview of the literature in order to clarify the origin and content of the theoretical positions that have influenced recent central bank reforms and the state of the debate on the contradiction that is nowadays manifest in the dominant literature between central bank independence and democracy. It is pointed out that the approach that has become dominant since the 1970s is based on assumptions on the working of the economic system, which eliminate from the beginning the problems of effective demand that had been the main preoccupation of theory and policy up to then. Moreover we argue that up to the 1970s the economic literature accepted that the analysis of central bank independence was mainly the subject of those disciplines, which examine the organisation of the State and the relations among its institutions. Economic theory then cooperated with those disciplines to find the most convenient solution to this problem, a solution depending on the historical and political situation of each society. Since the 1980s, instead, the economic literature has narrowed the interaction with other disciplines, trying to solve the problems of the organisation of State institutions within its own domain. It has centred on the relations between the State and society in order to design their optimal configuration, but has adopted a representation of these relations, which is considered by other social disciplines over-simplified and unable to satisfactorily comprehend the phenomena it seeks to organise. As a consequence, this literature faces a theoretical problem. Through its simplistic representation of State-society relations it shows the existence of a contradiction between central bank independence and democracy. Other works, using different representations of State-society relations, show instead that this contradiction does not exist in the actual organisation of monetary policy and that central bank independence is legitimate in a democratic society.

The starting-point of this paper is that the dominant positions in the economic literature do not only depend on the degree of analytical elaboration of the theories, but also on the consensus achieved by certain views over a specific historical period. Thus, the 1929 Great Depression enhanced Keynesian ideas, making them dominant for some decades. Some events of the 1970s shifted the consensus towards economic liberalism. Our chapter is organised as follows. Section 2 clarifies some different meanings that can be given to central bank independence. Section 3 examines the literature between the Great Depression and the 1970s oil shocks. Section 4 deals with some events of the 1970s that may have contributed to the adoption of economic liberalism in the organisation and conduct of monetary policy. Section 5 describes the literature that has introduced new positions on central bank independence. Section 6 recalls some criticisms raised against this literature, focussing on its belief that the economic system is permanently in a position equivalent to full employment and on its conclusion that to improve the efficacy of monetary interventions it is necessary to violate some rules of democracy. Section 7 describes the recent contributions, which use different representations of State-society relations and show that there is no contradiction between central bank independence and democracy in the actual organisation of monetary policy. Section 8 presents some conclusions.

26.2 Different Meanings of the Term Independence

The term central bank independence is used in different ways. It has several qualifications, whose meanings change from author to author (see de Haan, 1997; de Haan and Kooi, 1997). To avoid ambiguity let's introduce the following expressions:

- Goal independence
- Priority independence
- Instrument independence
- Money issue independence
- Personnel independence.

Goal independence is the power of central banks to define the level of the objective-variables of economic policy. This kind of independence is seldom given to central banks and most recent reforms have entrusted this power to elected bodies, which can learn, through the electoral mechanism, society's preferences and identify accordingly the results to be achieved by economic policy.[ii]

Priority independence is the power of central banks to define the order of priority over the different policy goals. This power too can be attributed to democratically elected bodies, from the standpoint that they must take the most important decisions for the life of a society. The recent literature, however, has placed this kind of independence at the centre of the debate, considering it convenient for society to hand over this power to central banks.

Instrument independence is the power of central banks to decide discretionarily the different aspects of the operation of monetary policy, once the goals and the priorities have been defined. They can decide the tools to use and the intensity of their intervention. This kind of independence is granted to central banks to guarantee the professional autonomy of institutions having great competence.

Money issue independence regards a particular aspect of monetary policy. It refers to the ability of central banks to control the amount of money in circulation. Since the 1970s there has been a tendency in most countries to increase the power of central banks to control the domestic channels of base money issue, in particular that used to finance the government sector. The external channel, by contrast, has eluded the control of central banks on account of the liberalisation of international capital movements. The existence of these two opposite tendencies is the result of the dominance of positions favouring economic liberalism and the consequent tendency to reduce the role of the State in the economy. On the one hand, it is believed that reducing the influence of democratically elected bodies on monetary decisions can increase the effectiveness of monetary policy. On the other, it is believed that it is possible to rely on the spontaneous working of market forces, including the speculative movements on international financial markets, to increase the rate of growth of the economy and social welfare.

Finally, *personnel independence* is the capacity of the monetary authorities to resist the pressures of other agents with political and economic interests. It depends on the procedures regarding the appointment and dismissal of the monetary authorities, the earnings of central bank staff, their career development after their term of service. Different laws can be introduced to increase or reduce this capacity of the monetary authorities. These laws have been the focus of great attention by the applied literature that has recently tried to define quantitative measures of central bank independence (see Grilli, Masciandaro and Tabellini, 1991; Cuckierman, Webb and Neyapti, 1992).

26.3 From the Great Depression to the Oil Shocks

The uncertain growth of economies in the 1920s led many economists to doubt the validity of the prevailing *laissez-faire* policies. These doubts were strengthened by the 1929 Great Depression, giving rise, in the following years, to widespread acknowledgement of the need of an active role for government intervention.

Harrod wrote in 1933 that the Great Depression had posed a new problem for politicians and economists. Its severity had endangered political stability and shaken confidence in the belief that the economy was able to return to full employment. This situation had raised the problem of a new political approach and a new economic theory able to clarify whether market forces can lead the economy towards full employment or government intervention is required.[iii]

The theories worked out by Keynes and Harrod concluded that the spontaneous operation of market forces does not necessarily bring about full employment and the exploitation of the growth potential of the economy. Without denying the benefits of competitive forces, they recognised the possibility of market failures and inefficient allocation of resources, thus admitting that government intervention can play a positive role in regulating and supporting the economy.

The neoclassical theory before the Great Depression distinguished between a *real* and a *monetary* department of economics.[iv] The real department examines the long-run equilibrium level of *real* variables (the level of production, relative prices and distribution). The *natural* interest rate is determined in this part of the analysis, where monetary factors play no role. It depends on technology, consumer preferences, the availability of productive factors and their distribution among agents. The monetary department deals with the nominal price level and the fluctuations of the economy, and analyses the movements of the market interest rate, which depend on monetary factors, including the actions of monetary policy. When it is equal to the natural rate, the economy is at full employment and the rate of inflation is zero. When, instead, it differs from the natural rate, there are disequilibria in employment and inflation. As a consequence, the monetary authorities have to keep the market rate of interest at its natural level. This policy allows the economy to enjoy optimality conditions and prevents a political use of monetary policy, i.e. a use that favours, through inflation and deflation, some sectors of the economy at the expense of others. Thus, according to traditional neoclassical theories, the use of the natural rate of interest makes it possible to identify a technical, or neutral, or non-political, conduct of monetary policy.

Before the Great Depression Keynes adopted this approach. After this event his position changed. At the beginning, in the parts of the *Treatise on Money* written after the Great Depression, he acknowledged the practical difficulty of the monetary authorities in recognising the level of the natural interest rate which they have to use as a guidance of policy (See Keynes, 1930, chapter 37, and in particular pp. 304-315 and 338-347). Subsequently, with the introduction of the notion of a monetary theory of production in 1932, he took a more radical position. He rejected the distinction between a real and a monetary department of economics and the related use of the natural interest rate as a guidance of monetary policy.[v] According to Keynes, monetary events have a *direct* effect on the equilibrium level of economic variables, including the level of production and income distribution. As a consequence, the choices of the monetary authorities always have political implications. They favour some sectors of the economy at the expense of others.

The influence of monetary events on the equilibrium level of real variables makes it impossible to separate the management of monetary and fiscal policy. This position was dominant during the twenty years following the Second World War. Both policies, it was thought, have to pursue the same final goals. They must be co-ordinated in order to achieve what Samuelson (1956) called *national economic stability*[vi], which consists of the stability of the value of currency and financial institutions, the safeguard of international reserves, the stability of growth and employment, the reduction of divergences in regional growth and income distribution. At the time it was widely believed to be opportune to give priority to full employment over price stability, when such goals cannot be simultaneously achieved. Inflation, it was thought, is worrying when it overtakes levels that, after the stabilisation periods that immediately followed the Second World War, were not reached up to the 1973 oil shock.[vii]

As to the conduct of monetary policy, it was thought necessary for monetary issues to maintain stable interest rates. A policy based instead on a rigid control of monetary issues, bringing about instability of the interest rates, would have several undesirable consequences:

- the rates of interest would increase;
- the debt of the government and of the other sectors of the economy would grow and become unmanageable;
- financial speculation would be favoured and would dominate at the expense of channelling funds to the productive sectors of the economy;
- financial institutions would see their balance sheets weaken owing to the variability of the value of the securities used as second line reserves and to the increase in unrecoverable loans;
- economic growth would slow down and unemployment increase.

As to central bank independence, the economic literature of the time accepted that this was mainly the subject of those disciplines, which examine the organisation of the State and the relations among its institutions. It was widely agreed that the democratically elected bodies must take responsibility for the most important decisions, allowing the experts of central banks to decide the practical operation of policy, not its goals. The central bank was seen as ‘a highly skilled executant in the monetary field of the current economic policy of the central Government’ (Radcliffe Report, 767). It should be given instrument and personnel independence, but not goal and priority independence. As to money issue independence, *under normal conditions* this should not interfere with the need to co-ordinate the actions of all authorities to achieve national economic stability.

The literature of the time acknowledged the technical character of the expertise of the monetary authorities. Yet it considered the latter *political actors* with an interest in strengthening their institutional role. The limits of the mandate of a central bank, and thus its independence, were seen to depend on the position it had historically acquired in society. Its decisions may be consequently influenced by the need to defend this position. By following these lines, Kaldor (1970) likened central banks to *constitutional monarchs*, who must avoid using the large powers that they formally have in order to preserve them.

The Radcliffe Report, published in 1960, represents the moment of maximum consensus to these positions. Economic liberalism had limited prestige, even if Friedman and his colleagues in Chicago had already started to rehabilitate the quantity theory of money and conduct research that led to the birth of monetarism in the 1960s. Friedman, following the neoclassical tradition, believed that the operation of market forces was able to lead the economy to a full employment position, which was not influenced by monetary factors. He argued that the monetary authorities should not have the same goals as the fiscal authorities and should only be preoccupied with price stability. Moreover, he pointed out that economic analysis can only provide limited information on the time of reaction of the economic variables affected by monetary policy measures. For this reason, he concluded, the monetary authorities have to avoid intervening discretionarily, since the effects of their actions can manifest themselves when they are no longer necessary, thus aggravating the existing disequilibria, rather than correcting them.

As to the issue of independence, monetarists were adverse to it. The recognition of the limited knowledge of the reaction time of economic variables to the impulses of monetary policy and the opposition to any form of concentration of power led them to fear the errors and abuses of independent authorities more than the damage of unemployment. According to authors fully confident of the operation of competitive forces, this damage can only be minor. Friedman (1962, pp. 50-51), presenting his main argument against central bank independence, said: ‘To paraphrase Clemenceau, money is too serious a matter to be left to the Central Bankers’. For him, monetary policy should be conducted by defining a rule of monetary issue that central banks have to follow in a rigid way. They should not be allowed any discretion, since this can bring about errors or abuses. Neither goal, nor priority, nor instrument independence should be attributed to these institutions, while the rules regarding the funding of the government sector should prevent it from financing its deficits with a monetary base.

During the 1960s, the dominance of Keynesian over monetarist positions gradually waned. The reviews of the Radcliffe Report already show that it had not been received enthusiastically in central banking circles (see Musella and Panico, 1995, in particular the essay by Roosa reprinted there), preoccupied with the growth of the international liquidity produced by the policies pursued under the Bretton Woods agreements. These preoccupations were enhanced by the currency crisis of the following years, which broke down the Bretton Woods agreements in 1971, and by the stagflation that followed the 1973 oil shock.

These events caused a gradual change in the conduct of monetary policy. The central banks of the German Federal Republic and Switzerland were the first, soon after the oil shock, to introduce policies that focussed more on inflation by adopting restrictive trends of monetary issues. United States, Canada, Great Britain, France and Australia made similar choices from 1976. Yet it was in October 1979, after the second oil shock, that the Federal Reserve announced the introduction of new operative procedures. As prescribed by monetarism, they introduced a rigid control over monetary issues, leaving aside the concern for the stability of the interest rates. In 1980 the Bank of England also adopted what was defined as a *monetarist experiment*. It went on up to 1982, when consequences similar to those forecasted by the Radcliffe Report forced the Federal Reserve to abandon the new procedures. The halt to the monetarist experiment was caused by the increase in interest rates, which in turn caused an explosion of foreign debt in several countries, balance-sheet problems for the US banks, which found it difficult to recover a large part of their loans, economic recession and unemployment. The literature has reached broad consensus on this interpretation of the events (see Musella and Panico, 1995). Even authors who had previously favoured the development of monetarism accepted it.[viii] Since then, the conduct of monetary policy has followed a pragmatic approach. On the one hand, it has rejected the use of a rigid rule for monetary issue; on the other, it has taken a more restrictive stance than in the year preceding the oil shocks, giving priority to price stability over full employment, but avoiding focusing only on the former goal. The idea of separating the goals and the functions of monetary and fiscal policy was considered by Cobham (1992, p. 266), who had previously developed monetarist positions, an aberration of the early 1980s. Those in favour of economic liberalism abandoned monetarism, replacing it with a new approach, which will be considered in the next section.

26.4 The 1970s and the Great Changes in Economies and Societies

Affecting economies and societies as severely as the Great Depression, the events of the 1970s set the conditions for gradual, yet profound changes in the world economy and in policy. These major events were as follows:

- the breakdown of the Bretton Woods agreements;
- the oil shocks of 1973 and 1979;
- the emergence of a literature worried by the abuses of government intervention;
- the birth of a new approach to economics, differing from monetarism, but even more confident of the spontaneous working of market forces.

The breakdown of the Bretton Woods agreements was sanctioned by President Nixon's decision in August 1971 to abolish the convertibility of dollar into gold at the official parity. The agreements were also based on *adjustable fixed exchange* *rates* and on the use of administrative controls on capital movements to limit financial speculation and allow the use of monetary policy for domestic goals.

The abandonment of the fixed exchange rate regime induced the European countries to adopt other agreements: the monetary snake in 1972, the European Monetary System in 1979, the European Monetary Union in 1999 and the introduction of the Euro in 2002.

Another consequence of the disruption of the fixed exchange regime was the growth of international financial transactions, which was further strengthened by the subsequent tendency to eliminate the administrative controls on capital movements. The United States, Switzerland and the United Kingdom were the first in 1979 to allow the free circulation of capital. The countries of the European Union followed them in the second half of the 1980s. The boom in international financial transactions during this period is a significant indicator of the profound changes occurring in the world economy from the 1970s onwards. The amount of such transactions increased 89 times from 1977 to 1998, much more than the increase in international transactions in goods and services, which rose 3.5 times during the same period.[ix] As a consequence, the weight of financial sectors in the economy and in society has increased, particularly in the United Kingdom and United States, where the most important financial centres are located.[x]

The economic literature considers the financial sector a major opponent of inflation, owing to the re-distributive effects that it causes between lenders and borrowers, and a major supporter of market liberalisation. Hence the growth of the financial sector during the last few decades may be considered one of the factors that have enhanced the adoption of economic policies based on market liberalisation and giving priority to price stability over full employment.

The oil shocks of 1973 and 1979 caused other changes in the world economy. That of 1973 caused stagflation. The world recession, attended by high inflation and international trade disequilibria, increased international competition and stimulated innovation at the corporate level. The rate of inflation overtook the two-digit threshold and touched levels previously reached during wartime. After the Second World War, as happened in Italy in 1947, stabilisation policies rapidly restored the confidence of those investing in the medium and long-term bond markets. By contrast, after the 1973 oil shock, there was no investment in these markets for a long time. The postponement of this kind of investment can be seen as a sign that investors (not only financial institutions, but also individuals belonging to the household sector) were preoccupied with the instability of the rate of inflation. This uncertainty may have contributed to orient electoral preferences towards policies giving priority to price stability.

Another major event of the 1970s was the development of a critical literature on the problems that government intervention poses for representative democracy. Buchanan (1975) and Nordhaus (1975) made two outstanding contributions to this literature. They start from the assumption that political parties and elected representatives act in their own interests, which do not necessarily coincide with those of society. Buchanan (1975) underlines that the parties in power can have an interest in strengthening government intervention to favour their re-election. According to Buchanan, government intervention tends to be characterised by inefficiency and low morality. Nordhaus (1975) describes the existence of a political production cycle due to the fact that the parties in power, to be re-elected, tend to stimulate production through government expenditure before the election date. According to Nordhaus, the increase in government expenditure has a short-term positive effect on production and employment, while the effects on inflation tend to manifest themselves later. The parties in power can thus take advantage of the difference in the reaction time of these variables. They can take in the voters, benefiting from their positive evaluation of the increase in the level of production and leaving to the new government the task of dealing with inflation. The attention given by this literature to the inefficiency of government intervention and to electoral tricks testifies to the lack of confidence of different sectors of society in the political world. This lack of confidence can be seen as another cause of the change occurring in electoral preferences, which have appeared more favourable than in the past to the reduction of government intervention in the economy.

Finally, let us focus on a new approach, the New Classical Economics (NCE), which has replaced monetarism as a reference theory for *laisser faire* positions. This approach, which consists of complex arguments and advanced formal elaborations, has strongly influenced the recent literature on the role of the State and central bank independence. It considers that the economy is permanently in a full employment position, thereby meaning lack of involuntary unemployment. The problems of effective demand, which were the main governments' concern from the Great Depression to the 1970s, are thus eliminated from the beginning.

The presence of this element is evident in the formulation of the most widely used tools of this school, the Lucas aggregate supply curve, which assumes that the economy is always at full employment and tends to a position related to the natural rate of unemployment that depends on the imperfections in the circulation of information in the labour market. This position of the economy; like that of full employment equilibrium of the traditional neoclassical theory, is determined by non-monetary factors. The income produced when unemployment is at its natural level allows the full use of the potential of the economy, given the lack of perfect circulation of information in the labour market. If this kind of imperfection could be reduced, the natural rate of unemployment would decrease.

The Lucas curve also assumes that the income actually produced may diverge from the level corresponding to natural unemployment. This divergence is caused by mistakes in the forecast of the price level, which are not due to problems of the theory, but to the operation of stochastic forces. This conclusion comes from the belief that the theory proposed by the NCE takes into account all elements producing a systematic influence on the economy. As a consequence, the forecasts made on the basis of this theory are *on average* correct. The occurrence of events, which are not systematic, is thus the only cause of the divergence between the actual and the expected price level, which, in turn, causes that between the income actually produced and that corresponding to the natural rate of unemployment.[xi]

One implication of this approach is that economic policies are unable to reduce unemployment. Since agents foresee the effects of government interventions, these can be effective if they take the operators by surprise, i.e. if they contradict what had been previously announced by introducing unexpected measures that raise inflation and reduce unemployment. The surprise effect is however short-lived: as soon as agents realise the changes which have occurred, unemployment goes back to its natural rate, leaving the price level at a higher level.

The picture outlined above differs from that proposed by monetarism, according to which monetary policy affects real variables, but can have undesired consequences owing to the fact that the limited information provided by the theory does not allow one to make good forecasts. The possibility of mistakes is thus the main argument recalled by monetarists against the use of government intervention. By contrast, the NCE considers that economic policies are ineffective because economic theory allows agents on average to make good forecasts. Policies are effective if they are the result of dynamically inconsistent behaviour of the authorities. The arguments proposed by these economists thus underline the demagogy of the governments and the tendency of society to avoid the sacrifices related to the complex working of the economic system, like those coming from the imperfect circulation of information in the labour market.

The differences with monetarism and the peculiarity of some assumptions have not prevented the NCE and the Lucas curve from becoming the main theoretical reference of *laissez faire* positions and having great influence on the literature on the role of the State and on central bank independence.

26.5 The Recent Literature on Central Bank Independence

The literature that has recently had the most influence on monetary policy and on the reforms of central banks tends to present a homogeneous approach based on the Lucas supply curve. The origin of this literature can be found in the 1977 essay by Kydland and Prescott, whose analyses show that the attempts of the authorities to maximise social welfare lead to interventions that are *dynamically inconsistent*, that is to interventions contradicting those previously announced.

The results of Kydland and Prescott stimulated a large set of contributions that have examined the implications of dynamic inconsistency for different fields of economics. Barro and Gordon (1983) dealt with monetary policy. Following the NCE, they assumed that the monetary authorities control the rate of inflation and that the agents sign their contracts in money terms by taking into account their rational expectations on the rate of inflation. The underwriting of the contracts generates the dynamic inconsistency problem in the monetary authorities' decisions. Taking the agents by surprise, they can attempt to increase social welfare by pursuing a policy to bring about a higher rate of inflation than that expected by the agents, but also, as foreseen by the Lucas curve, a rate of unemployment temporarily lower than the natural one. The opportunity taken by the authorities, however, is short-lived. Rational agents will anticipate the surprise effects exploited by authorities endowed with discretionary powers. They will thus stipulate contracts that incorporate a higher rate of inflation. The conclusion is that the dynamic inconsistency of the monetary authorities represents a problem for society, since it leads to a lower level of social welfare. As a consequence, the introduction of rules that deprive the authorities of discretionary powers leads to a positive result for society. It affects the rate of inflation expected by the agents, leading them to stipulate contracts which bring about a lower rate of inflation.

The preference attributed by such analyses to rules over discretion does not imply similarity between their positions and those of monetarism. The term rule has for the recent literature a different meaning from that attributed by monetarism. It does not mean a fixed prescription on the rate of growth of some monetary aggregate, independent of conditions of the economy, but a behavioural norm that prevents dynamic inconsistency (see Kydland, 1992, p. 379).

The introduction of laws setting irrevocable constraints to the behaviour of the authorities, however, is not considered feasible in a reality where it is always possible to modify previous rules. This difficulty has stimulated the search for different solutions, able to reduce, within the analytical models used, the loss of social welfare due to the presence of discretion.

Barro and Gordon (1983) introduced a line of research based on the notion of reputation. They argued that a central bank interested in acquiring an anti-inflationary reputation[xii] can act in such a way as to reduce the loss of welfare due to discretion, even if it is unable to lead to the same level of welfare as that of an irrevocable rule. The attempts of the central bank to improve its reputation have positive effects on the agents' expectations as to the rate of inflation.

Rogoff (1985) started a second line of research, which introduced the issue of central bank independence. Again within the framework of NCE, he proposed delegating the conduct of monetary policy to a *conservative central banker*, i.e. to a banker more adverse to inflation than government and society. A conservative central banker gives the struggle against inflation a higher priority than does society. Consequently, the attribution of priority independence to the central bank leads to a rate of inflation lower than that occurring in the case of discretion but higher than that of an irrevocable rule.

The line of research initiated by Rogoff (1985) is called *institutional design*. Unlike the previous economic literature, which considered that the issue of central bank independence mainly belonged to other social disciplines, it tries to solve the problem of the organisation of State institutions by using the methods of economic analysis. The aim is to define the optimal configuration of these institutions and to identify a system of constraints and incentives that can lead private and public utility maximising agents to act in such a way as to allow society to enjoy the best combination of low inflation and reactivity of monetary policy to the shocks undergone by the economy.

After Rogoff (1985) the institutional design literature produced a large body of contributions. Major contributions include Lohmann (1992) who introduced in

Rogoff's analysis an *escape clause*, which allows the government to dismiss the conservative central banker, in the presence of shocks that bring about a rate of unemployment considered too costly by the community. The introduction of this clause, according to Lohmann, induces the central banker to act in such a way as to avoid excessive gaps between actual and potential output of the economy.

Another key contributor (Walsh, 1985) reformulated Rogoff's analysis in terms of contract theory. It shows that the trade-off between independence and responsiveness to output shocks, which is present in Rogoff's work, stems from the system of incentives implicitly adopted by this author and considers the possibility of improving on Rogoff's results by offering the central banker a contract with incentives and fees related to the achievement of the announced objectives. At present, most literature on policy organisation follows Walsh's attempt to identify the most convenient set of incentives. Within this literature, the approach called *inflation targeting*, in its complex articulation, underlines the role of transparency in monetary policy. According to this approach, the monetary authorities can enjoy full discretion in the choice of the analytical model to be used to define monetary interventions. Yet this discretion must be constrained by transparency: the authorities must clarify to the elected bodies the reasons for their choice. According to these authors, the laws on this subject must specify in detail, as done by the recent reform of the Bank of England, what information is to be published and the forms and dating of such publications.[xiii] This kind of transparency allows the elected bodies to exert a democratic control on the conduct of monetary policy, which can be based, according to them, only on the simulations provided by the model chosen.

26.6 Critique of the recent literature on central bank independence

In spite of the consensus achieved, several criticisms have been levelled against the recent literature on central bank independence. Here we deal with four of them, which refer to:

- the claim that the economy is always in a full employment position and that unemployment depends on the imperfections in the circulation of information in the labour market and not on the lack of demand of goods and services;
- the simplistic characterisation of the relations between State and society;
- the empirical evaluation of the causal link between independence and inflation;
- the contradiction between independence and democracy, known as the problem of the accountability of the monetary authorities.

The idea that the spontaneous operation of market forces leads to full employment is no more scientifically founded than the opposite idea that the operation of market forces can fail in generating an efficient allocation of all available resources.[xiv] As to the claim that unemployment depends on the imperfect circulation of information in the labour market and not on the lack of demand for goods and services, although it comes from the theoretical positions on the tendency to full employment, it has been evaluated by the literature on an empirical basis. This evaluation has tried to estimate a *natural* rate of unemployment, which can play the role of reference point for the conduct of policy. This rate is calculated on the basis of those actually occurring and thus depends on them. In the case of the American economy in the 1990s the actual rates of unemployment progressively decreased, thus reducing the value of the natural one. This phenomenon has induced Solow to doubt that the natural rate can be used as a reference point for the conduct of policy. This role requires that the natural rate must be clearly identified by the model and must undergo slow and occasional changes. In the contrary case, Solow concludes (2000, p. 157), the story of a natural rate of unemployment as a reference point for policy loses its meaning.

The approach used by the literature on institutional design, like that followed by Kydland and Prescott, Barro and Gordon and the subsequent literature on reputation, faces a problem with the characterisation of the relations between State and society. Recent works, which integrate the knowledge of economists and political scientists (see Cama and Pittaluga, 1999; 2000), have pointed out that this characterisation is simplistic. By using the categories of political science, they have defined as *socio-centric* the representation proposed by the recent literature on dynamic inconsistency. Socio-centric models are those assuming the existence of a one-way relation between State and society. They do not allow any dynamic interaction between these two entities. State institutions have no autonomous interests. They automatically express in a political form the preferences of society. The critique raised by these inter-disciplinary works thus underlines a weakness of the dynamic inconsistency literature. Although it centres on the relations between State and society in order to design their optimal configuration, this literature adopts a theory with no detailed description of the political process affecting these relations. By paying scarce attention to the analyses of other social disciplines, the approach has produced analyses which contain refined formal elaborations, but which show a superficial understanding of institutional phenomena.

The empirical tests on the relationship between independence and inflation have lent support to the claim that central bank independence produces low inflation (see Berger, de Haan and Eijffinger, 2001). Yet in two contributions to this literature, Posen (1993; 1995) argues that the order of causality between inflation and independence should be reversed: rather than claiming that inflation is low when the content of laws favours central bank independence, one should say that societies with a real interest in pursuing monetary stability attribute independence to the central bank in order to achieve this result. By attributing a primary role to politics, Posen's empirical tests show that central banks are more independent in the societies where the financial sector is stronger. According to Posen, the financial sector is a major opponent of inflation, since nominal net creditors are interested in avoiding the loss in the real value of financial activities. Thus, he argues, the independence of the central bank is the epiphenomenon of the economic interests of the financial sector in monetary stability.

The question of the accountability of the monetary authorities has attracted the attention of some outstanding economists, sensitive to the implications of the theory of independence for the institutional equilibria. They have doubted the legitimacy, with respect to the values and the procedures of democracy, of Rogoff's solution, which allows a non-elected institution, like a central bank, to pursue objectives that differ from those expressed by society through its elected representatives. Tobin (1994) expressed some preoccupations for the safeguarding of democracy, which is founded on the respect of procedures and not on the mere achievement of results defined by economic theory as socially optimal. McCallum (1996) noticed the unrealism of the institutional design literature, since it is impossible that the government and the central bank can maintain different preferences for a long period of time. If the central bank systematically pursues different objectives from those of the government, it would be reasonable to expect a change in the laws regarding the powers of the monetary authorities. Greenspan's views (1996) confirm this position. He claimed that central bank independence has to be limited by the fact that the American people and their representatives must consider adequate the policies implemented. According to Greenspan, it is unacceptable that in a democracy non-elected individuals are given responsibilities, which are crucial for the life of society without giving account of their decisions.

26.7 The Contradiction Between Democracy and Independence: Real or Apparent

The contradiction between democracy and independence, as testified by the contributions recalled, has attracted the attention of academics and professionals. Some have denied its existence in the actual organisation of democratic societies.

Blinder, a Princeton academic who was appointed Vice President of the Federal Reserve, has greatly contributed to this position. Without the background of a political scientist, but with the intelligence of a person able to appreciate the complexity of the political processes affecting the formation of American policy, he criticises the dynamic inconsistency approach for its limited comprehension of institutional phenomena and concludes that there is no contradiction between independence and democracy in the actual organisation of American monetary policy.[xv] According to Blinder, the monetary authorities have been attributed autonomy and responsibility over monetary policy by the elected representatives of the American people. These representatives attribute powers to the central bank in a moment of the political process that can be called *constitutional*, which is different from that of the ordinary political production. Blinder claims that a central bank endowed with a high degree of independence has to operate transparently, making clear to the public how the policy objectives have been achieved. Although he is not an advocate of inflation targeting, which considers it possible to conduct monetary policy only on the basis of the prescriptions from the simulations produced by the analytical model chosen by the authorities, Blinder approves the use of transparent information which, according to him, further contributes to the democratic legitimacy of the activity of the monetary authorities.

Stiglitz, another academic who served as Chairman of the Council of Economic Advisers of the President of the United States and as Chief Economist and Senior Vice President of the World Bank, also recognises the legitimacy of some degree of central bank independence in a democratic society. Starting, like Blinder, from direct appreciation of the complexity of the political processes affecting the formation of American policy, he argues that the degree and forms of independence that a central bank should have depend on the situation and history of each country (see Stiglitz, 1998, p. 224). His analysis, which presents arguments similar to those proposed by Blinder, is less detailed than that of the latter (see Stiglitz, 1998, pp. 220-224). Yet it pays more attention to the extent to which the views of the monetary authorities represent the values of the whole society and reaches more cautious conclusions on the respect of democratic values. In his opinion, although the United States has struck a good balance in the institutional arrangements governing the Fed, there are some aspects of this problem in which questions may be raised (See Stiglitz, 1998, p. 223). The main point is that

> those who make the decisions are not representative of society as a whole, and in some countries, they are chosen in ways which is hard to reconcile with democratic values. In many countries, bankers are disproportionally represented …Few countries ensure that workers and their interests are represented, even though the actions of the central bank have a vital impact on them (Stiglitz, 1998, p. 217).

To reinforce his view, Stiglitz (1998, pp. 217-18) claims that ‘the separation of technical expertise from value judgements is not as clear as is sometimes depicted’ and ‘the bias values imparts to what is ostensibly technical analysis’. In the case of monetary policy this problem is particularly relevant, since ‘value judgements often assert themselves in what should be purely «positive» discussions of the trade-off between inflation and unemployment’. According to Stiglitz, the problem can be solved within the existing institutional arrangements governing the Fed and it should be solved in order to avoid that the central bank be seen ‘as a mechanism for the imposition of the values of a subset of the population on the whole’.

Some recent interdisciplinary works, combining the knowledge of economists and political scientists, also recognise the legitimacy of central bank independence in a democratic society. These works (see Cama and Pittaluga, 1999; 2000) provide a richer analysis than those developed by Blinder and Stiglitz, which are based on brilliant intuition rather than a systematic interdisciplinary approach. They deny the existence of the contradiction between independence and democracy, which is manifest in the literature on institutional design, by adopting an articulated dynamic representation of State-society relations[xvi] and clarifying the reasons that make monetary stability crucial for democratic life.

According to Cama and Pittaluga, monetary instability has re-distributive effects for income and wealth among the sectors of the economy. These effects can be hindered or accommodated by monetary policy. Moreover, since it is possible to mask as technical, decisions that have political content, in the sense that they favour some groups of society at the expense of others, it is possible to mask the true reasons for such decisions, making nobody appear responsible for them. Yet the principle of political responsibility is fundamental for democracy. The responsibility for the decisions taken must always be transparent, so that the citizen can confirm or withdraw, through his or her vote, support for the policies implemented by the government. Thus, for Cama and Pittaluga, central bank independence guarantees the citizen that the monetary authorities have a neutral position in the distributional conflicts over income and wealth. Independence is thus seen as a prerogative reserved to those bodies that in a democratic system play the role of *constitutional embankment*, that is of preserving the rules of the games and protecting the citizen against surreptitious attempts to re-distribute benefits within society. The importance of this function can be further appreciated by considering that democracy does not simply require that decision-making reflect the preferences of the majority, an aspect of democratic life underlined by the *Rousseauian* tradition. It also requires, as underlined by the *Madisonian* tradition, the protection of the citizen against the abuses made by those in power, including the democratically elected representatives. Now, the attribution of the decisions regarding monetary stability to an independent authority can contribute to making transparent the political responsibility of crucial decisions over re-distribution of income and wealth. In this way, central bank independence, instead of leading to a deficit of democracy, preserves an essential condition of orderly democratic life.

Cama and Pittaluga (1999, p. 260) also point out that the forms and the degree of independence attributed to the monetary authorities change in every society. They are the result of a political process that has balanced the demands of different groups of voters to safeguard democracy, on the one hand, from the excess of responsiveness to voters' preferences, which can lead to demagogy or to favouring the most influential political groups and, on the other hand, from the excess of autonomy, which can lead the authorities to pursue their own interests instead of those of society.[xvii] This equilibrium can be achieved in different ways, including the introduction of norms relative to personnel independence. Thus, Cama and Pittaluga, like Blinder, consider that the political appointment of some members of the Federal Reserve Open Market Committee, seeks to guarantee the need to make the monetary authorities respond to the preferences of the majority, while the technical appointment of other members guarantees the citizen against the risks of demagogy or of favouring the most influential political groups.

To sum up, the literature that has recently had the most influence on the conduct of monetary policy and on the reforms of central banks has, on the one side, the merit of using refined formal instruments and of underlining the problems related to the search for electoral consensus; on the other, it has presented a simplistic characterisation of the economy and of the society. By assuming that unemployment is due to the imperfections in the circulation of information, it has excluded that expansive economic policies be used to solve this problem, even when the rate of unemployment is high. By proposing a simplistic representation of the dynamic relations between State and society, it leads to a limited comprehension of institutional phenomena. This simplistic representation leads to the conclusion that to increase the efficacy of monetary interventions it is necessary to violate some rules of democracy. This conclusion has raised several critical reactions, some of which have underlined that when more complex representations of the relations State-society, like those used by other disciplines, are employed to analyse the organisation of State institutions, the contradiction between central bank independence and democracy disappears. The organisation of the relations between monetary authorities, government and society can thus be seen as the solution of a political process which has to guarantee the citizen that the decisions regarding the re-distribution of income and wealth are taken transparently.

26.8 Conclusions

The analysis on the relation between central bank independence and democracy presented in the previous pages has focused on two aspects of the changes occurring in the literature after the mid 1970s. Firstly, it has pointed out that the theories developed during this period are based on assumptions that eliminate from the beginning the problems of effective demand, which had been the main preoccupation of government policies after the Great Depression. Secondly, it has shown that the economic literature up to the 1970s accepted that analysis of central bank independence was mainly the subject of those disciplines which examine the organisation of the State and the relations among its institutions. It cooperated with those disciplines to find the most convenient solution to this problem, a solution that depends on the historical and political situation of each country. Since the 1980s, instead, the economic literature has restricted the interaction with other disciplines, trying to solve the problems of the organisation of State institutions within its own domain. This attempt has the merit of using refined formal instruments and has contributed to underlining some specific aspects of the organisation of monetary policy, like the problems related to the search for electoral consensus. It has however adopted a representation of the relations State-society, considered over-simplified by other disciplines. As a consequence, it faces a theoretical problem, since it offers a limited understanding of the institutional phenomena it seeks to analyse and an unsatisfactory answer to the identification of the general guidelines according to which the activity of the monetary authorities should be organised. Its simplistic representation of State-society relations is the source of a contradiction between central bank independence and democracy which other works, using different representations of these relations, prove to be non-existent in the actual organisation of monetary policy. According to these works, central bank independence, instead of leading to a deficit of democracy, preserves an essential condition of orderly democratic life. These contributions also underline that the degree and forms of independence given to a central bank depend on the situation and history of each country, since they are the result of the political process which has taken place in that particular context. This conclusion recalls those reached by the economic literature up to the 1970s.

Notes

i Interest in these problems within central banking environments is testified by Greenspan (1996) and by the conferences of the Federal Reserve Bank of Boston on Goals, guidelines and constraints facing policy makers, held in 1994, and of the Bundesbank on Transparency in monetary policy held in 2000.

ii The European Central Bank however decides the goal-variable rate of inflation.

iii Harrod's 1933 paper is a memorandum written for the Trade Unions. It is unpublished and belongs to the Harrod Papers, available at the Chiba University of Commerce in Ichikawa (Japan). The part recalled is quoted in Young (1989, p. 16).

iv This distinction can be found in the writings of Walras, Marshall, Wicksell and other outstanding neoclassical figures.

v Keynes's new approach entailed the abandonment of the concepts of natural interest rate and neutral monetary policy: 'It cannot be maintained that there is a unique policy which, in the long run, the monetary authority is bound to pursue' (Keynes, 1979, p. 55; Nov. 1932). He pointed out that the divergence between the traditional and his new position is 'most marked and perhaps most important when we come to the discussion of the rate of interest' (Keynes, 1973, p. 410; 1933). The centre of his investigation therefore moved along these lines: (a) to reject the notion of a natural interest rate; (b) to propose an alternative theory of the interest rate; (c) to try to criticise the consistency of the traditional theory of the rate of interest. For an analysis of this point, see Panico, 1988, pp. 102-41.

vi Intervening in a debate between the Treasury and the Federal Reserve, Samuelson wrote: 'I do not wish to go into the merits of the struggle between the Treasury and Federal Reserve. Let me simply state dogmatically that the Secretary of the Treasury should be just as concerned for the nation's stability as the Central Banker. ... there is no legitimate clash between Treasury and Central Bank policy: they must be unified or co-ordinated on the basis of the over-all stabilisation needs of the economy, and it is unthinkable that these two great agencies could ever be divorced in functions or permitted to work at cross purposes. (In particular it is nonsense to believe, as many proponents of monetary policy used to argue, that fiscal policy has for its goal the stabilisation of employment and reduction of unemployment, while monetary policy has for its goal the stabilisation of prices. In comparison with fiscal policy, monetary policy has no differential effectiveness on prices rather than on output) … I have already asserted that the Treasury and Central Bank have to be co-ordinated in the interests of national stability, so I am little interested in the division of labour between them' (1956, pp. 14-15).

vii Stiglitz (1998, pp. 210-212) re-states the validity of this position against what he calls the current rhetoric of monetary policy. For him, the recent applied literature shows no evidence that inflation is costly when it is below a certain level. Quoting Akerlof, Dickens and Perry (1996) he claims that 'low inflation is actually beneficial. Some inflation … helps maintain full employment by facilitating the downward adjustment of real wages' (Stiglitz, 1998, p. 211).

viii Friedman (1984) is among the exceptions. For him the experiment failed because the authorities did not apply the monetarist prescriptions with competence.

ix Variations from 1977 to 1995 are calculated by Haq, Kaul and Grunberg (1996, p. 291) on data of the Bank for International Settlements, Central Bank Survey of Foreign Exchange Market Activity, of 1993 and 1996,. Variations from 1995 to 1998 are calculated on data of the same Survey, published in 1999. For further information on international transactions, see Eatwell (1997) and Panico (2000).

x Around one third of the international financial transactions takes place in London; another 25% in New York. By adding the transactions made in Tokyo, Singapore, Honk Kong, Zurich, Frankfurt and Paris, quoted in order of importance by volume of activity, one exceeds, according to 1996 data, 83% of total transactions.

xi Lucas and Sargent (1979) discuss these issues from the NCE's standpoint.

xii In this literature the notion of central bank credibility, to which anti-inflationary reputation is related, differs from that used in ordinary language. For this literature, rational agents consider credible those central bank announcements which are consistent with the existent system of incentives and constraints. This definition of credibility is criticized by Blinder, who argues that the reputation of a central bank is built through the discipline of the persistent adhesion to the announced objectives. He challenges the view of dynamic inconsistency, based on the belief that the monetary authorities control inflation, that one deviation from the announced objectives is sufficient to persuade the agents to revise their inflation expectations. The Bundesbank, he claims, did not lose its reputation in 1992, when the rate of inflation was above the announced one. Blinder also argues, against the view of dynamic inconsistency, that central bankers are unaffected by inflation bias, since they value highly their reputation as monetary stability custodians.

xiii The recent reform of the Bank of England dictates the publication of a quarterly Inflation Report, containing information on the factors that have influenced the rate of inflation, on the analytical model used, on the forecasts obtained with it, on the quality of these forecasts, on the problems of the existing models, on the values of the informative and instrumental variables. Moreover, the minutes of the meetings of the Directors of the Bank of England and of the meetings with the Chancellor of the Exchequer must be published within 15 days of their occurrence.

xiv According to the present state of knowledge, it is possible to solve the problem of the existence of solutions of a general equilibrium model of a perfectly competitive economy. The lack of realism of this model is generally recognised, as it is known that the attempts to mitigate its restrictive assumptions, for instance that relative to the symmetry in the distribution of information among agents, have failed to reach satisfactory results. As to the dynamic analyses of a perfectly competitive economy, which deal with the working of the economy and the tendency to full employment, the literature has concluded that, even under the unrealistic conditions just mentioned, nothing can be said on the stability of the existing equilibria.

xv According to Blinder, the problems raised by the dynamic inconsistency approach give a false representation of the actual working of central banking. On these points, he says, this approach 'is barking at the wrong tree' (1998, p. 24).

xvi That adopted by Cama and Pittaluga (1999, pp. 247-251) is called the political exchange approach.

xvii This conclusion, like that of Posen, attributes a primary role to politics. A recent empirical analysis (see Rizza, 2001, chapter 4), which relates central bank independence to the degree in which decisions regarding income distribution are concerted, further supports this view. The interpretation of this result is that a society taking decisions over income distribution through a participatory process tends to watch over the interference of monetary policy.

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