

## **Ben S Bernanke: Central bank independence, transparency, and accountability**

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the Institute for Monetary and Economic Studies International Conference, Bank of Japan, Tokyo, 25 May 2010.

*The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.*

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The financial crisis that began nearly three years ago has caused great hardship for people in many parts of the world and represented the most profound challenge to central banks since the Great Depression. Faced with unprecedented financial stresses and sharp contractions in economic activity, many central banks, including the Federal Reserve, responded with extraordinary measures. In the United States, we lowered the federal funds rate target to a range of 0 to 1/4 percent to help mitigate the economic downturn; we expanded the scale, scope, and maturity of our lending to provide needed liquidity to financial institutions and to address dislocations in financial markets; we jointly established currency swap lines with foreign central banks (including the Bank of Japan) to ensure the global availability of dollar funding; and we purchased a large quantity of longer-term securities to help improve the functioning of financial markets and support economic recovery.<sup>1</sup> Looking to the future, central banks around the world are working with their governments to prevent future crises by strengthening frameworks for financial regulation and supervision.

In undertaking financial reforms, it is important that we maintain and protect the aspects of central banking that proved to be strengths during the crisis and that will remain essential to the future stability and prosperity of the global economy. Chief among these aspects has been the ability of central banks to make monetary policy decisions based on what is good for the economy in the longer run, independent of short-term political considerations. Central bankers must be fully accountable to the public for their decisions, but both theory and experience strongly support the proposition that insulating monetary policy from short-term political pressures helps foster desirable macroeconomic outcomes and financial stability.

In my remarks today, I will outline the general case for central bank independence and review the evolution of the independence of the Federal Reserve and other major central banks. I will also discuss the requirements of transparency and accountability that must accompany this independence.

### **The case for central bank independence**

A broad consensus has emerged among policymakers, academics, and other informed observers around the world that the goals of monetary policy should be established by the political authorities, but that the conduct of monetary policy in pursuit of those goals should be free from political control.<sup>2</sup> This conclusion is a consequence of the time frames over

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<sup>1</sup> The currency swap lines were reinstated with several foreign central banks recently in response to financial disruptions associated with stresses in Europe. See Board of Governors of the Federal Reserve System (2010), "Federal Reserve, European Central Bank, Bank of Canada, Bank of England, and Swiss National Bank Announce Re-establishment of Temporary U.S. Dollar Liquidity Swap Facilities," press release, May 9; and Board of Governors of the Federal Reserve System (2010), "FOMC Authorizes Re-establishment of Temporary U.S. Dollar Liquidity Swap Arrangement with the Bank of Japan," press release, May 10.

<sup>2</sup> A useful distinction is that between "goal independence" and "instrument independence." Goal independence for central banks – the freedom of the central bank to set its own goals – is difficult to justify in a democratic

which monetary policy has its effects. To achieve both price stability and maximum sustainable employment, monetary policymakers must attempt to guide the economy over time toward a growth rate consistent with the expansion in its underlying productive capacity. Because monetary policy works with lags that can be substantial, achieving this objective requires that monetary policymakers take a longer-term perspective when making their decisions. Policymakers in an independent central bank, with a mandate to achieve the best possible economic outcomes in the longer term, are best able to take such a perspective.

In contrast, policymakers in a central bank subject to short-term political influence may face pressures to overstimulate the economy to achieve short-term output and employment gains that exceed the economy's underlying potential. Such gains may be popular at first, and thus helpful in an election campaign, but they are not sustainable and soon evaporate, leaving behind only inflationary pressures that worsen the economy's longer-term prospects. Thus, political interference in monetary policy can generate undesirable boom-bust cycles that ultimately lead to both a less stable economy and higher inflation.

Undue political influence on monetary policy decisions can also impair the inflation-fighting credibility of the central bank, resulting in higher average inflation and, consequently, a less-productive economy. Central banks regularly commit to maintain low inflation in the longer term; if such a promise is viewed as credible by the public, then it will tend to be self-fulfilling, as inflation expectations will be low and households and firms will temper their demands for higher wages and prices. However, a central bank subject to short-term political influences would likely not be credible when it promised low inflation, as the public would recognize the risk that monetary policymakers could be pressured to pursue short-run expansionary policies that would be inconsistent with long-run price stability. When the central bank is not credible, the public will expect high inflation and, accordingly, demand more-rapid increases in nominal wages and in prices. Thus, lack of independence of the central bank can lead to higher inflation and inflation expectations in the longer run, with no offsetting benefits in terms of greater output or employment.<sup>3</sup>

Additionally, in some situations, a government that controls the central bank may face a strong temptation to abuse the central bank's money-printing powers to help finance its budget deficit. Nearly two centuries ago, the economist David Ricardo argued: "It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it....There would, I confess, be great danger of this, if Government – that is to say, the ministers – were themselves to be entrusted with the power of issuing paper money."<sup>4</sup> Abuse by the government of the power to issue money as a means of financing its spending inevitably leads to high inflation and interest rates and a volatile economy.

These concerns about the effects of political interference on monetary policy are far from being purely theoretical, having been validated by the experiences of central banks around the world and throughout history. In particular, careful empirical studies support the view that more-independent central banks tend to deliver better inflation outcomes than less-independent central banks, without compromising economic growth.<sup>5</sup> In light of all these considerations, it is no mystery why so many observers have come to see central bank

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society, but, as I will argue today, instrument independence – the ability of the central bank to determine the appropriate settings of monetary policy without interference – is vital for economic stability.

<sup>3</sup> This problem is known in the technical literature as the "time-inconsistency" problem; this literature was pioneered by Kydland and Prescott (1977) and Calvo (1978). This problem is analyzed in the context of monetary policy by Barro and Gordon (1983).

<sup>4</sup> Ricardo (1824, p. 506).

<sup>5</sup> See, among others, Alesina (1988); Grilli, Masciandaro, and Tabellini (1991); Cukierman (1992); Cukierman, Webb, and Neyapti (1992); Alesina and Summers (1993); Cukierman, Kalaitzidakis, Summers, and Webb (1993); and Cukierman, Miller, and Neyapti (2002).

independence as a critical component of a sound macroeconomic framework, and economists have studied a variety of approaches to enhance the independence and credibility of monetary policymakers.<sup>6</sup>

To be clear, I am by no means advocating *unconditional* independence for central banks. First, for its policy independence to be democratically legitimate, the central bank must be accountable to the public for its actions. As I have already mentioned, the goals of policy should be set by the government, not by the central bank itself; and the central bank must regularly demonstrate that it is appropriately pursuing its mandated goals. Demonstrating its fidelity to its mandate in turn requires that the central bank be transparent about its economic outlook and policy strategy, as I will discuss further in a moment. Second, the independence afforded central banks for the making of monetary policy should not be presumed to extend without qualification to its nonmonetary functions. For example, many central banks, including the Federal Reserve, have significant responsibilities for oversight of the banking system. To be effective, bank regulators and supervisors also require an appropriate degree of independence; in particular, the public must be confident that regulators' decisions about the soundness of specific institutions are not unduly influenced by political pressures or lobbying. But for a number of reasons, the nature and scope of the independence granted regulatory agencies is likely to be somewhat different than that afforded monetary policy. In the conduct of its regulatory and supervisory activities, the central bank should enjoy a degree of independence that is no greater and no less than that of other agencies engaged in the same activities; there should be no "spillover" from monetary policy independence to independence in other spheres of activity. In practice, the Federal Reserve engages cooperatively with other agencies of the U.S. government on a wide range of financial and supervisory issues without compromising the independence of monetary policy.

The case for independence also requires clarity about the range of central bank activities deemed to fall under the heading of monetary policy. Conventional monetary policy, which involves setting targets for short-term interest rates or the growth rates of monetary aggregates, clearly qualifies. I would also include under the heading of monetary policy the central bank's discount-window and lender-of-last-resort activities. These activities involve the provision of short-term, fully collateralized loans to the financial system as a means of meeting temporary liquidity needs, reducing market dysfunctions, or calming financial panics. As has been demonstrated during financial panics for literally hundreds of years, the ability of central banks to independently undertake such lending allows for a more rapid and effective response in a crisis. On the other hand, as fiscal decisions are the province of the executive and the legislature, the case for independent lender-of-last-resort authority is strongest when the associated fiscal risks are minimal. Requiring that central bank lending be fully secured, as is the case in the United States, helps to limit its fiscal implications. Looking forward, the Federal Reserve supports measures that help further clarify the dividing line between monetary and fiscal responsibilities. Notably, the development of a new statutory framework for the resolution of failing, systemically important firms is not only highly desirable as a means of reducing systemic risk, but it will also be useful in establishing the appropriate roles of the Federal Reserve and other agencies in such resolutions.

The issue of the fiscal-monetary distinction may also arise in the case of the nonconventional policy known as quantitative easing, in which the central bank provides additional support for the economy and the financial system by expanding the monetary base, for example, through the purchase of long-term securities. Rarely employed outside of Japan before the crisis, central banks in a number of advanced economies have undertaken variants of quantitative easing in recent years as conventional policies have reached their limits. In the

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<sup>6</sup> Rogoff (1985) suggested the appointment of a central banker predisposed toward keeping inflation low and stable as a solution to the time-inconsistency problem; additional discussions are presented in Persson and Tabellini (1993) and Walsh (2003, chapter 8). Alesina and Gatti (1995) and Waller and Walsh (1996) address how establishing an independent, nonpartisan central bank can help insulate monetary policy from political pressures.

United States, the Federal Reserve has purchased both Treasury securities and securities guaranteed by government-sponsored enterprises.

Although quantitative easing, like conventional monetary policy, works by affecting broad financial conditions, it can have fiscal side effects: increased income, or seigniorage, for the government when longer-term securities are purchased, and possible capital gains or losses when securities are sold. Nevertheless, I think there is a good case for granting the central bank independence in making quantitative easing decisions, just as with other monetary policies. Because the effects of quantitative easing on growth and inflation are qualitatively similar to those of more conventional monetary policies, the same concerns about the potentially adverse effects of short-term political influence on these decisions apply. Indeed, the costs of undue government influence on the central bank's quantitative easing decisions could be especially large, since such influence might be tantamount to giving the government the ability to demand the monetization of its debt, an outcome that should be avoided at all costs.

### **The historical evolution of central bank independence**

Support for the idea of central bank independence has evolved over time. In the United States and many other countries, the historically high and volatile inflation rates in the 1970s and early 1980s prompted a reexamination of monetary policies and central bank practices. Since that time, we have observed the confluence of two global trends: the widespread adoption of improved monetary policy practices and the virtual elimination of high inflation rates. The improved policy practices prominently include a broad strengthening of central bank independence, increased transparency on the part of monetary policy committees, and the affirmation of price stability as a mandated goal for monetary policy. Inflation targeting, in which the government sets a numerical target for inflation but assigns responsibility for achieving that target to the central bank, has become a widely used framework embodying these principles, but other similar monetary frameworks have also proved effective.

In recent years, the number of central banks with a relatively high degree of independence has steadily increased, and the experience of some major central banks testifies to the importance of that independence. The Bank of England, one of the oldest central banks in the world, was essentially an agent of the British Treasury for a substantial part of the 20th century. When the government announced on May 6, 1997, that the Bank of England would be reborn as an independent central bank, U.K. Treasury bond yields fell sharply at longer maturities, likely reflecting a substantial decline in investors' inflation expectations and their perceptions of inflation risk. Moreover, several studies have shown that U.K. inflation expectations exhibited significantly greater stability in the years following independence.<sup>7</sup>

Prior to the creation of the European Central Bank (ECB) in June 1998, independence was seen as such a crucial element that it was enshrined in the Maastricht Treaty, an international agreement that can only be changed by unanimous consent of its signatories. The independence of the ECB has helped to keep euro-area inflation expectations firmly anchored.<sup>8</sup>

The importance of central bank independence also motivated a 1997 revision to Japanese law that gave the Bank of Japan operational independence.<sup>9</sup> This revision significantly

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<sup>7</sup> See, for instance, Castelnuovo, Altimari, and Rodriguez-Palenzuela (2003); and Gürkaynak, Levin, and Swanson (2006).

<sup>8</sup> Beechey, Johannsen, and Levin (2008) find that long-run inflation expectations in the euro area are not significantly affected by surprises in macroeconomic data releases, suggesting that those expectations are well anchored.

<sup>9</sup> The new Bank of Japan Act went into effect on April 1, 1998.

diminished the scope for the Ministry of Finance to influence central bank decisions, thus strengthening the Bank of Japan's autonomy in setting monetary policy.

Although the Federal Reserve was established as an independent central bank in 1913, its effective degree of independence has gradually increased over time. Initially, the Secretary of the Treasury and the Comptroller of the Currency sat on the Board; they were removed when the current structure of the Federal Open Market Committee (FOMC) was introduced with the Banking Act of 1935. The act also extended the terms of Board members from 10 years to 14 years; the long, staggered terms of Board members have also served as a brake on political influence.

During World War II, the Federal Reserve agreed to peg Treasury yields at low levels to reduce the cost of financing wartime deficits. After the war, the Fed sought to resume an independent monetary policy, fearing the inflationary consequences of continued political control, but the Treasury was still intent on containing the cost of servicing the debt. The conflict was resolved in 1951 through the negotiation of the Treasury-Federal Reserve Accord, as it came to be known. The accord reestablished the Federal Reserve's ability to freely set interest rates, but with active consultation between the Fed and Treasury. It was only by the amendment of the Federal Reserve Act in 1977 that the Fed's current objectives of maximum employment and stable prices were specified by the Congress.<sup>10</sup> A clear mandate of this kind is a key pillar of central bank independence.

Over the years, a consensus developed among U.S. political leaders that the Federal Reserve's independence in making monetary policy is critical to the nation's prosperity and economic stability. In 1978, the Congress formally recognized this principle by approving a provision that exempts monetary policy, discount window operations, and the Fed's interactions with other central banks from Government Accountability Office policy reviews. In 1979, President Carter appointed Paul Volcker chairman of the Federal Reserve with the expectation that Volcker would strengthen the central bank's inflation-fighting credibility, even though those steps would likely involve short-term economic and political costs. Subsequently, President Reagan's support for Volcker's politically unpopular disinflationary policies and for the principle of Federal Reserve independence proved crucial to the ultimate victory over inflation, a victory that set the stage for sustained growth.<sup>11</sup> Presidents and other U.S. political leaders have since then regularly testified to the benefits of an independent Federal Reserve. For instance, President Clinton said in 2000, "[O]ne of the hallmarks of our economic strategy has been a respect for the independence and the integrity of the Federal Reserve."<sup>12</sup> President Bush noted in 2005, "It's this independence of the Fed that gives people not only here in America[,] but the world, confidence."<sup>13</sup> And President Obama said in August 2009, "We will continue to maintain a strong and independent Federal Reserve."<sup>14</sup>

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<sup>10</sup> The Employment Act of 1946 established the objectives of "maximum employment, production, and purchasing power" for all federal agencies, whereas the 1977 amendment to the Federal Reserve Act gave the Federal Reserve the specific mandate of promoting "maximum employment, stable prices, and moderate long-term interest rates." Price stability requires that the central bank not attempt to drive employment above its sustainable level, and so in practice the Federal Reserve has interpreted its mandate to include maximum *sustainable* employment. The goal of moderate long-term interest rates is frequently dropped from statements of the Federal Reserve's mandate not because the goal is unimportant, but because moderate long-term interest rates are generally the by-product of price stability.

<sup>11</sup> For example, in February 1982, President Reagan stated: "This administration will always support the political independence of the Federal Reserve Board." See Reagan (1982).

<sup>12</sup> See Clinton (2000).

<sup>13</sup> See Bush (2005).

<sup>14</sup> See Obama (2009).

## Transparency and accountability

Central bank independence is essential, but, as I have noted, it cannot be unconditional. Democratic principles demand that, as an agent of the government, a central bank must be accountable in the pursuit of its mandated goals, responsive to the public and its elected representatives, and transparent in its policies. Transparency regarding monetary policy in particular not only helps make central banks more accountable, it also increases the effectiveness of policy. Clarity about the aims of future policy and about how the central bank likely would react under various economic circumstances reduces uncertainty and – by helping households and firms anticipate central bank actions – amplifies the effect of monetary policy on longer-term interest rates. The greater clarity and reduced uncertainty, in turn, increase the ability of policymakers to influence economic growth and inflation.<sup>15</sup>

Over the years, the Federal Reserve – like many central banks around the world – has taken significant steps to improve its transparency and accountability. Policymakers give frequent speeches and testimonies before the Congress on the economic situation and on the prospects for policy, and the Federal Reserve submits an extensive report to the Congress twice each year on the economy and monetary policy.<sup>16</sup> The FOMC, the Fed's monetary policymaking arm, releases a statement after each of its meetings that explains the Committee's policy decision and reports the vote on that decision. The FOMC also publishes the minutes of each meeting just three weeks after the meeting occurs and provides, with a lag, full meeting transcripts. In addition, the FOMC has begun providing the public a quarterly summary of Committee participants' forecasts of key economic variables and, more recently, their assessments of the longer-run values to which these variables would be expected to converge over time.<sup>17</sup> The information released by the FOMC provides substantial grist for the activities of legions of "Fed watchers" who analyze all aspects of monetary policy in great detail.

Apart from traditional monetary policy, the Federal Reserve's response to the financial crisis has involved a range of new policy measures, about which the Fed has provided extensive information. For example, the Board has regularly published detailed information about the Federal Reserve's balance sheet and the special liquidity facilities that were introduced. We created a section on our website devoted to these issues and initiated a regular monthly report as well.<sup>18</sup> And we are committed to exploring new ways to enhance the Federal Reserve's transparency without compromising our mandated monetary policy and financial stability objectives.<sup>19</sup>

## Conclusion

As a result of the crisis, countries around the world are implementing significant financial and regulatory reforms. Such reforms that reduce the chance of a future crisis and that mitigate the effects of any crisis that does occur are worthy of our full support. As we move along the path of reform, however, it is crucial that we maintain the ability of central banks to make monetary policy independently of short-term political influence. In exchange for this independence, central banks must meet their responsibilities for transparency and accountability. At the Federal Reserve, we will continue to work to facilitate public

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<sup>15</sup> See Woodford (2005).

<sup>16</sup> See *Monetary Policy Report to the Congress*.

<sup>17</sup> See Bernanke (2007) for a discussion.

<sup>18</sup> For further information on the Federal Reserve's balance sheet, see Bernanke (2009) and "Credit and Liquidity Programs and the Balance Sheet."

<sup>19</sup> See, for example, Bernanke (2007) and Alvarez (2009).

understanding of both our monetary policy decisions and our actions to ensure the soundness of the financial system.

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