Reforming Central Banking?

Stephen Kirchner (1997), Reforming Central Banking, Centre for Independent Studies, Sydney, paper, pp. 147, A$ 16.95, ISBN 1 86432 021 4.

This book is about which monetary institutions and monetary regimes are most likely to promote price stability. As such it is a welcome addition to the literature on this much debated question, especially because it provides such a lucid account of Kirchner's side of the debate. The questions he explores are important because central banks have become much more important in recent times. Indeed, momentous changes in political economy, especially in the last decade in the wake of global and domestic financial deregulation, have propelled monetary policy and central banks to a new prominence.

Kirchner comes from the 'sound finance' school which prioritises very low inflation or price stability (usually defined in the range of 0-2 per cent inflation) as the key to successful macroeconomic performance. He even sees sound money as 'a condition of civility' and worries that the fight against what the *Financial Times* has called the 'beast of inflation' might slacken now that low inflation has seemingly been achieved in the 1990s. 'This is not the first time that inflation has been declared beaten' he warns (p. 14).

The central problem for Kirchner, however, is that politicians and the authorities cannot be trusted to pursue price stability with sufficient vigour. The assumptions and postulates of public choice theory and neo-institutional economics provide the main basis for this claim and one of the strengths of the book is that it provides an excellent example of this type reasoning at work. Essentially, the idea is to accord 'institutions, the incentives they create and the self-interested behaviour of economic and political actors', a central place in determining outcomes (p. 2).

The most obvious solution to Kirchner's problem is to follow a growing trend (most recently illustrated in Britain) and hand things over to an *independent* central bank with a firm and singular mandate for achieving price stability. Such a mandate is said to help focus the minds of monetary authorities. Kirchner also argues that accountability requirements (especially with an independent central bank) will be simplified and more easily monitored if central banks are given only one clear goal. Kirchner, then, along with monetary orthodoxy, is against goal 'dualism' of the kind championed particularly by former RBA Governors, Johnston and Fraser, and which amounts to the simultaneous pursuit of goals relating to inflation *and* growth. Beyond this, Kirchner also devotes a sizeable chapter to rationales for central bank independence. For the most part, these stem from the presumption that politicians, for political and opportunistic reasons, will be softer on inflation than central bankers. The most obvious straight-forward solution here would be central bank independence, but this will not do because, according to Kirchner, central bankers cannot be trusted either. The latter are seen as too close to vested interests in the financial sector, central bankers face incentives to boost the Bank's revenue, and their responsibilities for prudential supervision may conflict with maintaining price stability. Kirchner also argues that independent central banks can become 'prisoners of their independence' if central bankers decide that preserving their formal independence and statutory arrangements is worth the odd concession to government. Hence, for these and other reasons, Kirchner claims that 'the anti-inflationary preferences of the central bank cannot be taken for granted' (p. 61).

Because politicians and central bankers cannot be trusted, Kirchner argues that the discretion of such actors should be limited through new institutional designs and rules. By this path Kirchner arrives at a kind of institutional or more precisely a 'constitutional fix'. In a useful exposition of the new constitutional political economy, Kirchner seeks a method by which both governments and central banks can be made 'subject to the higher law of the state' (p. 66). However, on the long-standing rules vs. discretion debate in monetary policy, Kirchner opts for a discretionary policy regime. This is largely because of the inevitable uncertainly of monetary policy (especially the long lead times between implementation and effect), and also because of the potential for major supply shocks which might require a flexible response. The best solution, then, according Kirchner, is a contracting approach which gives central bankers day-to-day policy discretion, but within a context of stringent and *constitutionally embedded* reporting, accountability and inflation targeting strategies. Kirchner is especially attracted to the constitutional fix because he sees this as a way beyond the more easily reversible legislative mandate for central bank independence and sound money.

Kirchner assess the post-1989 central banking reforms in New Zealand the light of the above. He sees the reforms as 'the most ambitious of recent attempts to put the [reformist] theories associated with central banking into practice' (p. 98). The pre-1989 regime was one of direct ministerial control over Reserve Bank policy (like the former Bank of England model). The pre-1989 regime also charged the Bank with responsibilities to promote the dualist charter of price stability and full employment. The 1989 reform package, however, retained only the price stability goal. It also gave the Bank operational independence to conduct policy as it saw fit. Policy, however, was to be conducted within the framework of an inflation target consistent with price stability, as set out in an annually negotiated Policy Targets Agreement with the government. In this set up, following Westminster principles, the government retains a good deal of authority but essentially gives the Bank day-to-day discretion within a specified framework. Under a performance based accountability system, Kirchner emphasises that the government retains the power to dismiss the Bank's Governor. The government also has the power to override the price stability mandate and of course the government must also be a partner in setting the annual Policy Targets Agreement.

Despite New Zealand's achievement of low inflation, Kirchner remains critical of the new arrangements. The problem is that an anti-inflation policy must rely on *ongoing* support from the government. This is much too voluntarist for Kirchner. As the Central Bank of New Zealand Governor, Don Brash, has argued, the whole system 'is open to political reversal, and as such is not a permanent rearrangement of the institutional structure for monetary management' (p. 100). Kirchner also argues that the initial phases of the NZ reforms were associated with high output losses and a high 'sacrifice ratio' which he partly attributes to policy 'credibility' problems and the alleged limits of the New Zealand model. 'These problems suggest at least two solutions', he writes:

> Central bank independence could be given constitutional status to further raise the cost to government of defaulting on their commitment to an independent central bank and its price stability mandate. The central bank could also be given additional anti-inflation incentives, in the form of a performance contract that would [financially] penalise central bankers for their failure to secure preferred policy outcomes (p. 123).

Kirchner concludes his book speculating that perhaps all the political and institutional dilemmas of central banking could perhaps fad away if there was a shift to 'free banking'; essentially a situation where the monopoly and regulatory powers of central banks are more or less dissolved in favour of market allocation (and higher consumer risk).

Low Inflation?

There is, however, another way of reducing stress levels about central banking and that is to reduce our level of concern about inflation. One of the normative pillars of Kirchner's analysis and one the factors driving much of the concern about central banking is the fixation on low inflation. Politically, this is easy to explain. The wealthy have most to lose from inflation (it directly erodes the value of money) and who would deny the political power of wealth holders, especially in terms of the punitive potential of the financial markets. Governments also face voters who say they strongly support low inflation and governments regularly sing the praises of achieving low inflation. Yet economically the case for an inflation fixation is harder to explain and some economists are now starting to question it (Bell 1997a).

According to orthodox theory, the case against inflation is that it distorts the price mechanism and leads to uncertainty about future prices which in turn distorts investment decisions and leads to an inefficient allocation of resources within the economy. Because of these distortions and particularly because of heightened uncertainly in an inflationary environment, growth, investment and productivity are said to suffer. Empirically, however, these effects have been hard to find. As one Canadian economist has put it, there is an 'unbearable lightness' to the anti-inflation case (Fortin 1993). True, there are a range of studies that depict inflation having a negative impact on growth. In 1993, for example, Stanley Fischer, a leading monetary economist and now deputy President of the IMF, found in a study involving panel regressions for eighty countries for the period 1961-88, that a ten percentage point increase in inflation (from 5 percent to 15 per cent per annum) is correlated with a decline in output growth of 0.4 per cent per annum (Fischer 1993). Another more recent study conducted at the Bank of England by Robert Barro (1996), a leading Harvard economist, examined over 100 countries covering the period 1960-90. Barro found that increasing inflation by 1 per cent reduces the rate of economic growth by between 0.02 and 0.03 per cent per annum.

What is striking about these studies, however, is that the supposed effects of inflation on growth are relatively small. Indeed, Bruno (1995: 35), in discussing the findings of a World Bank study of 125 countries between 1960 and 1992, concludes, as inflation moves up, even to 20 to 25 per cent, 'average growth rates seem to fall only slightly'. Referring to Barro's study, when it was released in England, the *Economist* (1995: 90) was forced to admit that the results are not 'exactly earth-shattering'. As it notes, according Barro's estimates:

> a country that reduced its inflation rate from, say, 7 per cent to 2 per cent would see its growth rise by only a little more than one-tenth of a percentage point. Since reducing inflation is itself costly - it demands a (temporary) loss of output and jobs - governments that took Mr. Barro's numbers seriously would be forgiven for wondering whether that price was not often to high.

If the studies above find weak effects, a range of other studies (cited in Bell 1997a) have found no effects from inflation on growth. For example, Levine and Zervos (1993: 428-29), after examining inflation and growth in 119 countries between 1969-89 argue that their analysis:

> shows that inflation is not significantly negatively correlated with long-run growth....Given the uncharacteristically unified view among economists and policy analysts that countries with high inflation rates should adopt policies to lower inflation in order to promote

> prosperity, the inability to find simple cross-country regressions supporting this contention is both surprising and troubling.

These findings suggest that the orthodox approach to inflation is open to dispute and that positive assessments of the benefits of very low inflation may be misplaced. Beyond this, Kirchner accepts without comment the orthodox view that any costs (such as unemployment) associated with a deflationary policy aimed at low inflation will be short-term. This view too is being questioned by a range of economists who point to 'hysteresis' effects in labour markets whereby episodes of high unemployment appear to raise the base level of unemployment permanently. Other economists argue there may be a structural break beyond which the costs of inflation mount but below which inflation is relatively benign. Writing in the IMF staff papers, Sarel (1996) suggests this level may be around an inflation rate of 8 per cent. Some economists have even argued that moderate inflation can help 'oil the wheels' of the economy, particularly in facilitating labour market adjustment (Akerlof et al. 1996).

It may be time for a more robust debate on the goals and efficacy of contemporary monetary policy. This idea would no doubt make Kirchner's hair stand on end. But if there is a basis for questioning the current price stability orthodoxy, much of the steam goes out of Kirchner's reformist case.

Public Choice....and Reality

As noted above, Kirchner relies on a public choice methodology and this too is problematic. The book is largely based on a 'let's assume, let's suppose' approach, one decidedly short on real empirical analysis, despite a chapter devoted to the New Zealand case. A key question is do politicians and central bankers actually behave the way Kirchner assumes they do? In particular, is there much evidence that politicians systematically interfere with monetary policy and central banks in a partisan manner? Interestingly, Kirchner does not ask this question of his New Zealand case. Generally speaking, empirical research in a related field of fiscal policy and political business cycles cannot find much evidence that supports Kirchner's behavioural assumptions. Moreover, recent empirical research conducted by Bell (1997b) found very little evidence that politicians have tried to interfere with the Reserve Bank in the last decade in Australia. Indeed, for reasons set out briefly below, it would appear that politicians now generally have a positive aversion to such activity. At one point Kirchner suggests that central bankers, to enhance their private interests, 'will attempt to shift blame for policy failures onto others'. Yet such a claim is not supported in the case of the RBA. In 1992, the wake of the disastrous monetary policy miscalculations of the late 1980s boom and early 1990s recession, the (then) deputy-Governor, Ian Macfarlane stated:

> all the decisions, all the reductions in interest rates, have occurred because they have been recommended by the Board of the Reserve Bank - the timing has been determined by the Reserve Bank and the size of the changes has been determined by the Reserve Bank. So if you don't like how monetary policy has turned out, if you think it is a terrible mess, blame us. Blame Martin Place (quoted in Tingle 1994: 322).

The point, then, is that the theoretical assumptions of public choice theory may be a poor guide to actual behaviour. Contrary to Kirchner's assumptions, governments these days are very reluctant to interfere in a partisan manner in monetary policy. To a strong extent this reflects the current historical context in which central banks, governments and monetary policy operate.

History Matters

Kirchner's analysis is weak on empirics and because it is driven by an abstracted methodology, it is also weak on history. This matters, especially in this case, because, as noted above, central banking and monetary policy have experienced major changes in the last decade in the wake of financial deregulation and Kirchner misses the profound significance of these changes. For example, at one point, he approvingly cites a study that states that central banks are 'usually subordinate to the treasury or the finance ministry in formulating policy' (p. 25). In the pre-deregulation era, this was true. But this is no longer true in the current deregulated era in which monetary policy and central banks have become much more central to the operation of macroeconomic policy (Macfarlane 1996). At another point, Kirchner claims that what he sees as a lack of monetary 'policy credibility should not be entirely surprising given that the policy making institutions which presided over reductions in inflation in the early 1990s were largely the same institutions that were responsible for high inflation in the 1970s and 1980s' (p. 15). Again, this shows no understating of the major institutional changes that have radically altered central banking, post-deregulation. In the 1970s and early 1980s, in Australia, for example, the pre-deregulation institutional regime saw the Treasurer and Treasury controlling the instruments of monetary policy. But after deregulation, all those instruments were abolished leaving the Reserve Bank in control of the only monetary policy instrument left, short-term interest rates. Most importantly, Kirchner misses the significance of the fact that deregulation has vastly increased the size and power of financial markets. In Kirchner's hands the markets are treated simply (a la public choice theory) as a 'vested interest', one likely to corrupt policy if given a chance. This completely misses the monetary policy discipline that financial markets are able to impose on both governments and central banks and which greatly constrains any attempt at partisan manipulation of monetary policy. As Bernie Fraser (1996: 14) explains:

> These days...such manipulation will be caught out...the financial markets in particular will see through the ruse and punish the perpetrators. Today's politicians appreciate that extended front page reportage of a plunging exchange rate, for example, could easily outweigh any positive effects of a politically inspired cut in interest rates.

Overall, then, Kirchner's approach exaggerates the supposed political softness of politicians on inflation, it fails to recognise the new market constraints on partisan intervention and assumes politicians have more freedom to manipulate policy (especially at the macroeconomic level) than they actually do. The model is also ahistorical in that it fails to recognise important technical changes to the operation of monetary policy how the policy and institutional context of monetary policy has changed radically in the last decade. If these criticisms are admitted, much of the steam goes out of Kirchner's reformist cause. As Bob Gregory (1992: 16) has argued with respect to the RBA: 'the present Bank Act and institutional framework [not to mention market constraints] can deliver whatever policy is wanted so it is a little difficult to understand why so much emphasis is placed on formal structures'.

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