

Central Banks as Economic Institutions

Roundtable Debate* **

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Introduction

As my starting contribution to this Roundtable debate, I shall address three issues:

1. Some implications of globalisation for central banking.
2. The objectives of the central bank.
3. Operational independence and accountability and the case for the minimalist central bank.¹

1. Globalisation and central banking

In a world with floating exchange rates, international coordination between national central banks (NCBs) for normal (non- crisis) monetary policy purposes is, for all practical purposes, redundant. Co-ordination between NCBs could make sense if monetary policy were an effective instrument for fine-tuning the business cycle. However, the lingering belief in the effectiveness of monetary policy as a cyclical stabilisation instrument is, in my view, evidence of the ‘fine tuning illusion’ or ‘fine tuning fallacy’ at work. In a world with unrestricted international mobility of financial capital, monetary policy, working directly through short nominal interest rates and indirectly through other financial and real asset returns and through asset prices, including the exchange rate, is no longer a useful instrument for activist policy aimed at fine tuning the national or global business cycle.² Financial asset rates of return and financial asset prices, including the exchange rate, cannot be influenced in a systematic, predictable way at frequencies that matter for stabilising real output and employment. The proper course of action for NCBs is to pursue the *lexicographic* targeting of national inflation rates over the medium term (I shall explain the meaning of lexicographic or hierarchical inflation targeting in Section 2 of this contribution). Any ambition to do more about real output and employment than can be achieved as the automatic by-product of

¹ For (2) and (3) see Buiter (2006c).

lexicographic inflation targeting is likely to end up destabilising the real economy and to worsen the inflation targeting record.

The recommendation that the monetary authority target the national inflation rate in a lexicographic manner does not mean that the reaction function of the central bank cannot include such arguments as the output gap. Consider e.g. the standard Taylor rule in equation (1) below:

$$\begin{aligned}
 i_{t+1,t} - E_t \pi_{t+1,t} &= \hat{r}_{t+1,t} + \gamma_1 (E_t \pi_{t_1,t_0} - \pi^*) + \gamma_2 (y_t - \hat{y}_t) \\
 \gamma_1 &> 0; \gamma_2 &\geq 0 \\
 t_1 &> t_0 &\geq t
 \end{aligned}
 \tag{1}$$

Here $i_{t+1,t}$ is the short nominal interest rate set in period t (the central bank's instrument), $\pi_{t+1,t}$ is the inflation rate between periods t and $t+1$, π^* is the inflation target, y_t is period- t real output, \hat{y}_t is the level of potential output in period t , E_t is the period- t conditional expectation operator and $r_{t+1,t} = i_{t+1,t} - E_t \pi_{t+1,t}$ is the short real interest rate. This Taylor rule ensures that the short nominal interest rate moves in such a way that the short real interest rate rises when the output gap increases and when expected inflation increases relative to the inflation target. When the output gap is zero and inflation is at its target level, the short real interest rate according to the Taylor rule equals the natural or neutral real interest rate, the real interest rate that would prevail with output at potential and a sustainable current account balance. The short interest rate responds to expected deviations of inflation from target over some future time interval of duration $t_1 - t_0 \geq 1$ starting in period $t_0 \geq t$.

The appearance of the output gap in the Taylor rule need not imply that the policy maker cares intrinsically about the output gap. Even when the monetary authority is a lexicographic inflation targeter, the output gap could appear in the policy rule, decision rule

² Sterilised foreign exchange market intervention is completely ineffective when there is a globally integrated financial system.

or reaction function of the monetary authority because the output gap helps predict future inflation. Indeed, any variable that helps predict ('Granger-causes') future inflation could (and in an optimising policy-making framework should) be an argument in the decision rule. This suggests that a monetary authority for which price stability enters first in a lexicographic ordering of objectives could have a reaction function with a veritable kitchen-sink collection of inflation indicator variables as arguments: the output gap, the exchange rate (because exchange rate changes may feed through into the target price index and may therefore help predict future inflation; other asset prices (because they contribute, through a variety of channels to future inflation and may therefore help predict future inflation, the growth rate of monetary and credit aggregates (perhaps at a range of frequencies) etc.). The fact that the authorities respond (possibly in a non-linear and time-varying manner) to movements in these inflation indicator variables does not mean, of course, that it targets these indicator variables.

Arrangements for joint central bank intervention in times of systemic risk (e.g. 9/11, or the coming financial crisis that will materialise when the current anomalously low levels of risk-free real interest rates and of credit risk spreads are normalised) should of course be in place. This does not, however, require regular high-level and high-profile meetings, but quiet behind-the-scenes discussions of appropriate coordinated responses in times of a global liquidity crisis. The heads of the key central banks should know each other well enough to cooperate without delay when the need arises, but such personal relational capital is built up quite naturally through the many international central bankers' gatherings.

The problem is further simplified because of the fact that currently only two central banks, the Fed and the ECB are truly systemically important. One might wish to add the Bank of Japan, the Bank of England (because of London's position as the world's leading financial centre) and the People's Bank of China (because of its massive reserve holdings), but the number of strategically important players is very small indeed, so the logistics of

cooperation and coordination in times of crisis should be simple. The successful handling of the 9/11 potential liquidity crunch shows that even the then highly inexperienced ECB could do the right things at little or no notice.

If there is a problem with ‘global imbalances’ (e.g. the unsustainable current account surpluses of the rest of the world vis-à-vis the USA), the resolution is (a) fiscal and (b) structural (measures to discourage saving and boost capital formation in China and Japan and measures to boost private saving in the US). The influence of monetary policy on saving rates (under conditions of low inflation) or on investment (through the rate of return on investment) is negligible beyond the short term. Monetary policy is not the right instrument to address structural imbalances.

2. The objectives of the central bank

It is important to distinguish between the fundamental objectives and the operational objectives of monetary policy. For normative economic theory, the fundamental objectives should be based on economic first principles. For practical political economy purposes, the fundamental objects are whatever the central bank has been mandated to do through a politically legitimate process. Indeed, the fact that a given set of fundamental objectives have been assigned by a politically legitimate body to the central bank may itself bestow normative value on these objectives, even if they cannot be derived from conventional welfare economics principles.

Welfare economics concerns the maximisation of household utility, defined over contingent sequences of consumption. The maximisation of consumer surplus is a related, sometimes equivalent objective. What do welfare economics first principles give us as the fundamental objectives of monetary policy. In Buiters (2006a), I show that, in the currently fashionable New-Keynesian models, the following policy prescriptions emerge:

1. The Bailey-Friedman optimal quantity of money (OQM) rule holds: the pecuniary

opportunity cost of holding fiat base money should be set equal to zero. This requires that the risk-free short nominal interest rate on non-monetary financial instruments $i_{t,t-1}$ be set equal to the nominal interest rate on base money $i_{t,t-1}^M$. When the nominal interest rate on base money is zero (as it is for currency), the OQM rule requires a zero nominal interest rate. If the real interest rate is positive, the optimal inflation rate is therefore negative.

2. ‘Core inflation’ is fully accommodated: the actual inflation rate is equated with the rate of inflation chosen by the constrained price setters in the Calvo (1983) model of staggered overlapping prices, who use some simple inflation heuristic rather than choosing an optimal price. In Calvo’s original model the inflation heuristic was to keep nominal prices constant – a pretty poor heuristic in a world with a non-zero underlying rate of inflation and one guaranteed to generate a long-run exploitable inflation-unemployment trade-off (see also Woodford (2003); Calvo has since returned to the path of righteousness (Calvo, Celasun and Kumhof (2003))). The reason accommodation of the inflation heuristic is optimal is that it minimizes relative price distortions between the free and constrained price setters.

3. The deviation of output from its efficient level is minimised. When the efficient level of output equals the potential level of output, this objective is achieved when core inflation is fully accommodated. When the efficient level of output does not equal the level of potential output (say because of monopolistic competition in the output market, without any compensating production or consumption subsidies), the optimal monetary policy depends crucially on the magnitude and persistence of deviations between actual inflation and core inflation that are permitted. If there can be no permanent gaps between actual inflation and core inflation (if, that is, the two must be equal in a deterministic steady state), the argument for doing anything other than equating actual to core inflation in every period become quite weak

The key point is that none of the three properties of optimal monetary policy requires or implies price stability. There are no conventional welfare economics foundations for price stability as an objective, let alone the overriding objective, of monetary policy.

What does the second approach to the fundamental objectives of the central bank – a legitimate (and often legal) mandate, give us? While price stability is almost always among the mandated objectives of central banks, it often has company. The Federal Reserve has a triple mandate: maximum employment, price stability and moderate long-term interest rates. The ECB has price stability as its primary or overriding objective, *subject to* the price stability objective being met, all things bright and beautiful. The Bank of England has virtually the same fundamental objective, with only the words ‘subject to’ replaced by ‘*without prejudice to*’. The Bank of Japan Law sets as the Bank's objectives "to issue banknotes and to carry out currency and monetary control" and "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system." The Law also stipulates the Bank's principle of currency and monetary control as follows: "currency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy."

Price stability is conceptually clear but not operational as an objective. In recent years (since the Reserve Bank of New Zealand introduced inflation targeting in 1989 (see Buitert (2006b)) some form of inflation targeting has become the standard operational expression of price stability. The Fed's triad of fundamental objectives is unique among major central banks. It certainly is the only central bank that has a real economy objective, a price stability objective and an asset market objective, all of equivalent significance, in the sense that it is possible to trade off any one for the others. The operational expression of the Fed's fundamental objectives would therefore be a form of ‘flexible inflation targeting on

steroids', as in (2), where both the weight on the output gap and the weight on the gap between the long-term interest rate, i_j^L and its 'moderate' target level i_j^{L*} are positive.

$$\Lambda_t = \sum_{j=t}^{\infty} \beta^{j-t} L_j$$

$$L_j = (\pi_j - \pi^*)^2 + w_y (y_j - \hat{y}_j)^2 + w_{i^L} (i_j^L - i_j^{L*})^2 \quad (2)$$

$$0 < \beta < 1; w_y, w_{i^L} \geq 0$$

If one takes the legal mandates seriously, however, neither the Bank of England nor the ECB (nor the Reserve bank of New Zealand) can be represented, operationally, as flexible inflation targeters. Flexible inflation targeting, as proposed by Svensson (1997, 1999, 2001, 2005, 2006) and Woodford (2003), is the special case of (2) with a zero weight on the interest rate objective ($w_{i^L} = 0$) but a positive weight on the output gap ($w_y > 0$). The trade off (in preferences) between the squared inflation gap and the squared output gap is inconsistent with a mandate that states that price stability is the primary objective and/or that other objectives can only be pursued 'subject to' or 'without prejudice to' the price stability target being met.

The mandates of the Reserve Bank of New Zealand (RBNZ), of the Bank of England and of the ECB are *lexicographic* or *hierarchical* in price stability and all other *desiderata*: only without prejudice to, or subject to, the price stability objective being met, can other objectives, such as output, employment or exchange rate stabilisation be pursued. Such a lexicographic ordering with price stability in first place, cannot be represented by a period loss function that trades off inflation volatility for output volatility. No positive weight on output stabilisation, that is $w_y > 0$, however low, represents the lexicographic ordering of price stability. Nor does a zero weight on output stabilisation ($w_y = 0$) represent a lexicographic ordering with price stability in the first position. Output gap stabilisation can be, and is, valued, but only without prejudice to the primary price stability objective. Alan

Blinder (2006) also makes the point that the mandates given to the Bank of England, the ECB and most other central banks that have price stability as their primary objective (this excludes few central banks other than the Federal Reserve System and the Central Bank of Norway) implies a lexicographic ordering of price stability ahead of all other objectives and is therefore inconsistent with any version of the ‘flexible inflation targeting’ loss function.

The lexicographic ordering I believe to be inherent in the mandates of, for instance, the Bank of England and the ECB means that the monetary authority chooses a short nominal interest rate rule or a state-contingent sequence of short nominal interest rates to minimize the following loss function, defined just over deviations of inflation from its target rate (assumed constant for simplicity):

$$\Lambda_t^\pi = E_t \sum_{j=t}^{\infty} (\pi_j - \pi^*)^2 \quad (3)$$

If the optimal interest rate rule or state-contingent sequence of interest rates is unique, that is the end of the matter. If there are multiple optimal interest rules, the authority then chooses among these the one that minimises the present discounted value of current and future discounted squared output gaps, or whatever other subsidiary targets the central bank is mandated to pursue, without prejudice to the primary target, inflation. If the output gap is the secondary objective, it would minimize:

$$\Lambda_t^y = E_t \sum_{j=t}^{\infty} (y_j - \hat{y}_j)^2 \quad (4)$$

The version of the flexible inflation targeting loss function that is the most dangerous one for policy makers is the one that replaces the period loss function L_j in (2) with

$$\tilde{L}_{j,t} = \text{Var}_t \pi_{j,j-1} + \lambda \text{Var}_t y_j \quad (5)$$

$j > t$

where Var_t is the variance conditional on information at time t . The period loss function in (2) can be written as

$$\begin{aligned} \tilde{L}_{j,t} = & \text{Var}_t \pi_{j,j-1} + \lambda \text{Var}_t y_j \\ & + \left(\text{E}_t \pi_j - \pi^* \right)^2 + \lambda \left(\text{E}_t y_j - \text{E}_t y_j^* \right)^2 - 2\lambda \text{Cov}_t(y_j, y_j^*) + \lambda \text{Var}_t y_j^* \end{aligned} \quad (6)$$

where Cov_t denotes the covariance conditional on period t information. It follows that for (5) to represent a period loss function for the monetary authority that is equivalent to (5), the following assumptions had to be made:

- (1) $\text{E}_t \pi_j = \pi^*$: there is no inflation target bias (or the inflation bias is independent of monetary policy).
- (2) $\text{E}_t y_j = \text{E}_t y_j^*$: there is no output gap bias: the actual and optimal levels of output are the same on average (or the output gap bias is independent of monetary policy).
- (3) $\text{Cov}_t(y_j, y_j^*) = 0$ (or the conditional covariance is independent of monetary policy).
- (4) $\text{Var}_t y_j^* = 0$ (or the conditional variance of the efficient level of output is independent of monetary policy).

Assumption (4) is pretty standard. Assumption 3 is highly unlikely to be satisfied in most Old- or New-Keynesian models. Assumption 2 is certainly not satisfied, even in the long run (or for the unconditional expectations of the actual and efficient levels of output unless the ‘sure thing’ principle holds. Even if the ‘sure thing principle holds, it is not necessarily satisfied in the short and medium term. Assumption (1) is a necessary condition for effective inflation targeting, at any rate in the long run. To assume that it is automatically satisfied is to assume away all the technical problems, commitment problems and other political problems associated with inflation targeting. It is true that for many of the most popular New-Keynesian and Old-Keynesian models used to address inflation targeting, there are few technical obstacles to meeting the inflation target on average. Indeed, these models all share the property that, when the inflation rate is, on average, equal to the constant target rate of inflation, output gap is, on average, equal to zero. Commitment problems are assumed

to have been solved magically by the act of creating an operationally independent central bank. So, with the ‘first moment’ problems of inflation targeting and output gap targeting solved, the monetary policy maker is left with just the problem of choosing the optimal combination of the conditional second moments of inflation and output.

This trivialises the central problem of inflation targeting, which is meeting the inflation target on average, going forward, that is, achieving a zero inflation bias. When $E_t \pi_j = \pi^*$, the key problem of the inflation targeting monetary authority, that of creating a credible nominal anchor, is solved. This is difficult to achieve in practice, and can never be taken for granted: the first moment problem is also the first-order problem. Monetary authorities in the UK, in the Eurozone, in the US, in New Zealand and in Turkey are concerned, as I write this paper, about the upward drift of inflation expectations above their inflation targets or tolerance ranges. The second-moments period loss function of (5), which assumes that there is no first-moments problem, is an extremely misleading and dangerous construct to dangle in front of the monetary authorities: the second moments are really of second order importance unless the first order first moments problem has indeed been solved.

The apparent similarity of Assumption 2, $E_t y_j = E_t y_j^*$ - no output gap bias - and Assumption 1, $E_t \pi_j = \pi^*$ - no inflation target bias - hides an important difference which can come back to haunt policy makers. For models with the (long-run) natural rate property, the servo-mechanisms of the market economy will tend to drive actual output towards potential output, at any rate in the long run, even without any policies designed to achieve that. There is no such built-in mechanism for ensuring that the actual rate of inflation will be driven towards the target rate of inflation, unless the policy authorities adopt rules (like the Taylor rule) that ensure that this will be the case: there may be a natural rate of unemployment, a natural level of output and a natural real rate of interest but there is no natural rate of inflation – the long-run equilibrium inflation rate is decided by the monetary authorities.

2. Central bank operational independence, accountability and scope

There can be little doubt that the ECB is the central bank with the highest degree of formal or legal operational independence. Since it also sets its own operational objectives (medium term HICP inflation below but close to two percent per annum), it can also be characterized as the most independent central bank, when operational independence and target/goal independence are taken together (Eijffinger (2005)). The ECB's operational independence and its mandate are enshrined in the Treaty establishing the European Community and the associated Protocol. These can only be amended through a Treaty revision requiring the unanimous consent of the EU member states (currently 27 in number).

As regards formal, legal safeguards guaranteeing political independence, financial independence and security of tenure and conditions of employment, the ECB scores as high as or higher than any other central bank. Highly unusually, there is nothing in the Treaty and Protocol governing the ESCB and the ECB that permits the political authorities (in this case the Council of the European Union) to repatriate, or take back, under extreme circumstances, the power to conduct monetary policy from the ECB. The Bank of England Act 1998 created the Treasury Reserve Powers for this purpose; the Reserve Bank of New Zealand Act 1989 contains a similar provision. Dispute resolution through the European Court of Justice provides a further safeguard for its operational independence.

There is just one potential chink in the ECB's operational independence armour. This relates to the ECB's *technical independence*. There is some question as to whether the ECB has the tools to do the job of ensuring price stability.

Responsibility for exchange rate policy is divided between the ECB and the Council of Ministers. There is no substantive problem for central bank independence from the power of the Council of Ministers, acting unanimously, to enter into formal exchange rate

arrangements with non-EU countries. Joining a new Bretton Woods would clearly be a political decision, to be taken by the political leadership of the EU, not by the ECB.

However, the Council can also formulate *general orientations* for the exchange rate. Only a qualified majority is required for this. Divided responsibility for the exchange rate could make a mockery of central bank independence. Not surprisingly, the ECB asserts that it cannot be given binding exchange rate orientations without its consent, and it has good sense on its side. Every French minister of finance since 1999 and a number of other ministers of finance have begged to disagree, however. The issue has not yet been put to the test.

Central bankers are loath to admit that operational independence of the central bank implies at best limited accountability. Yet there can be no doubt that independence and accountability are unavoidable at odds with each other. The distinction between formal and effective or substantive accountability is useful here.

Formal accountability is the aspect of responsibility involving giving, *ex-post*, a statistical or judicial explanation for events, actions and outcomes. Such formal accountability requires that those to whom account is given (the Principal) can properly monitor the actions of Agent. The Principal must have enough information to be able to make an informed judgment as to how well the party held to account has performed. Clear objectives for the Agent and the most complete possible information about the actions of the Agent are necessary for formal accountability to be possible.

Formal accountability requires openness and transparency, at least *ex-post*. Whether, in the case of the ECB, it is enough to know the objectives of the ECB and to observe the narrowly defined actions of the monetary authority (typically the interest rate decisions), or whether more detailed and comprehensive information about the actions of the ECB (such as individual voting records, if voting takes place) and greater procedural transparency

(minutes) are also required, continues to be a subject of disagreement (see e.g. Buiter (1999) and Issing (1999)). It is my position that the relevant actions of the ECB are not just the current and past interest rate decisions, but also the individual votes that produce that interest rate decision, and the (attributed) arguments, opinions, views of the transmission mechanism and forecasts that helped shape past and present interest rate decisions and will help shape future decisions.

Substantive accountability means that, following such reporting, explanation and justification, *judgment (or other pleasant or unpleasant consequences) may follow*. There is substantive accountability if the reporting, explanation and justification is ‘payoff-relevant’ for the party doing the reporting, that is, if there can be punishments, sanctions or rewards for those deemed responsible for actions or outcomes. It is clear from its own website, that the ECB has a minimalist, interpretation of accountability as formal accountability only: it is the (written and oral) *reporting obligations* of the ECB to the European Parliament, the European Commission and the European Council.³ The same holds for the Bank of England (which also has oral reporting obligations towards the UK Parliament) and all other operationally independent central banks.

It is not surprising that truly operationally independent central banks have effectively no substantive accountability at all. Independence *has* to mean that those in charge of monetary policy cannot be fired except for incapacity or serious misconduct, and that financial remuneration and working conditions likewise cannot be used to reward or punish

³ See: <http://www.ecb.int/ecb/orga/accountability/html/index.en.html>. The website states “According to the Statute, the ECB is required to publish quarterly reports on the activities of the Eurosystem as well as a consolidated Weekly Financial Statement. In addition, it has to produce an Annual Report on its activities and on the monetary policy of the previous and the current year. The Annual Report has to be addressed to the European Parliament, the EU Council, the European Commission and the European Council.” Article 113.3 of the Treaty Establishing the European Community (Consolidated Version) states “*The ECB shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and current year to the European Parliament, the Council and the Commission, and also to the European Council. The President of the ECB shall present this report to the Council and to the European Parliament, which may hold a general debate on that basis. The President of the ECB and the other members of the Executive Board may, at the*

them.⁴ It ought to mean also that monetary policy makers cannot be sued in civil courts or be dragged into criminal courts for actions taken in their capacity as monetary policy makers. In the advanced industrial countries we have not (yet) witnessed recourse to the law by those disgruntled with the conduct of monetary policy. The legal immunities and liabilities of central bankers in the performance of their monetary policy making tasks are, however, an uncharted area.

The ECB cannot in any meaningful way be viewed as an Agent performing a set of tasks delegated to it by a Principal, since whoever or whatever we would consider the Principal to be in this case (the European Council, the European Parliament, the citizens of the E(M)U), the Principal has no way of punishing, rewarding or even influencing the Agent. Some, like Majone (2001), have argued that the relationship between the ECB and its Principals should be viewed as that between a Trustee and a Beneficiary. Even this, however, implies to great a degree of accountability. A Trustee is charge with a 'duty of care'. Even though in many Trustee-Beneficiary relationships (think of a legal guardian for a minor ward, for instance; or someone with enduring power of attorney for a mentally ill person) the Beneficiary has little if any capacity to influence the Trustee (there is always a third party that can hold the Trustee to account if the Trustee does not, in the views of the Third party (often some part of the Court system) discharge his duty of care properly. The only institution resembling a third-party enforcer of the Trustees duty of care would be the European Court of Justice. However, the European Court cannot intervene when 'mere' issues of competence

request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament."

⁴ Governing Council members of the ECB, both Executive Board members and NCB Governors, can only be fired for incapacity and serious misconduct. This does not appear to include gross incompetence as a cause for dismissal. The Bank of England Act 1998, permits dismissal when an MPC member is *unable or unfit* to do the job. This would seem to be a weaker test than that of the ECB. In particular, 'unfit' would seem to include 'grossly incompetent'. Other causes for dismissal of MPC members include bankruptcy and a few other irrelevant odds and ends.

are at stake. If the relationship between the ECB and its Principals is that of a Trustee and its Beneficiaries, the Trustee is effectively uncontrolled by any third party.

The higher the degree of operational independence, the lower the degree of substantive accountability. This trade-off is unavoidable. We can, however, minimise the damage this does to the legitimacy of the delegation of monetary policy authority to the central bank by *restricting the domain of unaccountability*

Each and every operationally independent central bank, first and foremost the ECB, should be transformed into a minimalist operationally independent monetary authority. This monetary authority should be mandated to pursue price stability in a lexicographic manner, using the short nominal interest rate as its instrument. All other actual or potential functions of the central bank – none of which require the same degree of operational independence as monetary policy - should be assigned to other agencies, not protected by the same degree of operational independence and de-facto immunity as the central bank.

Specifically, the operationally independent central banks should be denied any of the following functions

1. The supervision and regulation of banks, other financial institutions and financial markets.
2. The ownership, control and management of interbank clearing and settlement systems. This means that the ECB should divest itself of TARGET, although the new TARGET owner(s)/operator(s) should have guaranteed access to ECB liquidity.
3. The ownership, control and management of financial securities clearing and settlement systems. The ECB should therefore not play an active role in proposed TARGET2-Securities system. The TARGET2-Securities owner(s)/operator(s) should, of course, have guaranteed access to ECB liquidity.
4. An active role in prevention and mitigation of financial instability. Effective public

policy towards financial instability requires cooperation and coordination of Treasury (the state agency with the long-term non-inflationary deep pockets) and the Regulator-Supervisor (the agency with the specific information and knowledge). The monetary authority need not be part of Financial Stability Team (FST), even though it has highly liquid short-term deep pockets provided by ability to issue legal tender at will. Uniquely Liquid deep pockets do not make the central bank necessarily the active lender of last resort. The Regulator-Supervisor could be the active lender of last resort, provided it has an overdraft facility with central bank, guaranteed by Treasury. The role of the central bank/monetary authority in the lender of last resort process could therefore be entirely passive.

Far from trying to enhance the legitimacy of the extraordinary degree of independence it has been granted in monetary policy by focusing on its mandate and core tasks, the ECB has made two systematic mistakes in the opposite direction. First, it has become a vocal and highly partisan participant in wider economic policy debates that are well beyond its mandate and competence. Second, it has tried and continues to try, to broaden the scope of its formal powers and responsibilities.

It was a mistake for the Treaty to grant the ECB an official, public (albeit only) advisory role in the process governing the admission of new Eurozone members. The institution has neither the political legitimacy nor the analytical competence to play such an important part in a quintessentially political and broad economic-analytical decision.

The issue is all the more serious because the 13 NCB Governors that are currently members of the ECB Governing Council face a potential conflict of interest when making recommendations on Eurozone enlargement. The reason is that, once the number of Eurozone member states exceeds 15, it will no longer be the case that each NCB Governor has a vote in each interest rate decision. Instead, they will rotate and thus have their voting power diluted. This potential loss of influence is largest for the smallest current Eurozone

members, Luxembourg in particular, once the number of NCB governors reaches 22. If turkeys don't vote for Christmas, Eurozone NCB governors are less likely to vote for Eurozone enlargement.

It is also a mistake for central bankers to express, in their official capacities, views on what they consider to be necessary or desirable fiscal and structural reforms. Examples are social security reform and the minimum wage, subjects on which Alan Greenspan liked to pontificate when he was Chairman of the Board of Governors of the Federal Reserve System. It is not the job of any central banker to lecture, in an official capacity, the minister of finance on fiscal sustainability and budgetary restraint, or to hector the minister of the economy on the need for structural reform of factor markets, product markets and financial markets. This is not part of the mandate of central banks and it is not part of their areas of professional competence. The regrettable fact that the Treasury and the Ministry of the Economy tend to make the symmetric mistake of lecturing the operationally independent central bank on what they perceive to be its duties (which generally amounts to a plea for lower interest rates) does not justify the central bank's persistent transgressions.

There are but a few examples of central banks that do not engage in public advocacy on fiscal policy and structural reform matters. The only examples I am aware of are the Bank of England and the Reserve Bank of New Zealand.

Central bankers indeed have a duty to explain how their current and future interest rate decisions are contingent on economic developments that may include or may be influenced by, the actions of the fiscal authorities and the success or failure of structural reforms. The central bank should clarify what its reaction function is, given the economic environment in which they operate, which includes the fiscal authorities and the government and 'social partners' engaged in structural reforms.

Independent central bankers can, and where possible should, cooperate with and coordinate their actions with those of the fiscal authorities and with those charged with structural reform. If central banks, Treasury ministers and ministers of the Economy were to act cooperatively toward each other, and with credible commitment towards the private sector, good things may well happen. The reason this does not happen in the EU, or even in the Eurozone, is not a question of principle, but of logistics. There is no coordinated fiscal policy in the EU or in the Eurozone, so the pursuit of coordination between fiscal and monetary policy in the EU or in the Eurozone is simply not possible. Mr. Jean-Claude Juncker could have private breakfasts and/or public lunches with Mr Jean-Claude Trichet every day of the week, every week of the year, it would not bring monetary and fiscal policy coordination in the Eurozone an inch closer to realisation.

The only time central banks have the right and duty to speak out on issues beyond monetary policy narrowly defined, is when the independence of the central bank is threatened. Such occasions are few and far between. Unsustainable public finances are not a matter on which the central bank should speak out, even if they threaten to confront the central bank with the dilemma: live with a sovereign debt default or bail out the improvident government through monetisation that threatens the central bank's price stability mandate. The central bank's mandated course of action is clear: they should let the government default on its debt rather than monetise that debt in a way that undermines price stability.

The ECB has always had ambitions to become the leading supervisor/regulator of banks and other financial institutions and of key financial markets in the Eurozone (Padoa Schioppa (1999)). There is a good case for an EU-wide (note, not just a Eurozone-wide) supervisor and regulator of banks and other financial institutions, especially as and when such institutions are established under European statutes. There is no case for the ECB fulfilling this role.

The prospect of the extreme degree of substantive unaccountability of Eurozone monetary policy being extended to financial supervision and regulation is a deeply unattractive one. This important but murky area is at the same time highly technical and deeply political. It involves often intense distributional conflict and fierce fights over property rights. Expertise in monetary policy is no qualification for that job. The notion that it should be discharged by an institution without any substantive accountability is unacceptable.

The ECB's systematic mandate and mission creep has also led it to propose that its monopoly over the provision of euro clearing and settlement services through TARGET be extended to clearing and settlement of Eurozone transactions in financial securities through a proposed TARGET2 – Securities, to be owned, controlled and run by the ESCB (see Norman (2006)). This is of course the exact opposite of what I propose here, that the ECB should not only not be put in charge of TARGET2-Securities, but that it should divest itself of TARGET.

5. Conclusions

The first thing to know about central banks is that they are not as important for economic wellbeing as central bankers and most monetary economists believe and/or argue. While badly managed monetary policy can do real damage, as long as economic disasters (hyperinflations, the Great Depression) are avoided, the differences in wellbeing associated with merely competent monetary policy and best practice are small.

That said, just because there are many economic policies (fiscal policy, regulation, trade policy) that are much more important than monetary policy, it does not follow that we should not try to perfect the art and science of monetary policy. Providing central banks with the right objectives (price stability in lexicographic pole position) and giving them the technical instruments and substantive operational independence to do the job, have been

positive innovations. The fact that both of these innovations originated in New Zealand is a rare example of lightning striking twice in the same place in the world of economics.

Operational independence means lack of substantive accountability. The higher the degree of independence, the greater the lack of substantive accountability. The world's most independent central bank, the ECB is therefore effectively wholly substantively unaccountable. In democratic systems the delegation of policies to operationally independent agencies of the state can be viewed as legitimate if three conditions are satisfied. First, there is a real improvement of performance; second, the institution to which the policy has been delegated although not substantively accountable, is formally accountable, because it is transparent ex-ante and ex-post; third, the scope of the activities that are under the control of the substantively unaccountable agency is as narrow as possible. The ECB meets the first test. It fails the second and the third. Indeed it appears to be intent on broadening its domain of non-accountability rather than restricting it.

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