Independent central banks in democracies?

By Villy Bergström
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In the past decade central banks in many countries have changed from stabilising the exchange rate to letting it float. The earlier objective of a fixed exchange rate has been replaced by "monetary stability", in most cases operationalised as 2 or 2.5 per cent inflation. Along with this realignment, monetary policy has been separated to varying degrees from the political process in governments and parliaments. Many central banks have been given a more independent status. In Sweden this was a direct consequence of membership of the European Union – central bank independence is required by the Maastricht Treaty.

The increased independence of the Riksbank, which in several respects has existed at least since the early 1990s, is for many people a controversial matter. The opposition to the new arrangement is in part a projection of opposition to the European Union; membership of the Eurosystem would mean that monetary policy is even further removed from the national political process than it is with the Riksbank's current independence.

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The view that democracy is eroded, firstly by the Riksbank's more independent status and secondly even more so in the event of future membership of the Eurosystem, is particularly widespread in the trade union movement and social democracy. The labour movement has not forgotten how, with the assistance of liberals, universal suffrage replaced a system whereby limited élites, claiming to rise above special interests, dominated parliament, constituted the government and controlled the Riksbank. For the same reasons there is in the labour movement an instinctive aversion to a law court or other body that would review decisions made by a political majority, as this is felt to infringe on the will of the people.

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The Riksbank is, of course, subject to indirect popular control by its General Council, which is appointed by the Riksdag (Sweden's parliament). The General Council appoints the Bank's Executive Board and each year one of the appointments is reviewed. The Chairman and Vice-Chairman of the General Council may attend Executive Board meetings and thereby follow the Board's work. The Executive Board appears before the Parliamentary Standing Committee on Finance twice a year to motivate and answer questions about monetary policy.

The Executive Board endeavours to gain public credibility by being notably transparent. Besides applying to monetary policy's objective, this approach is underscored by the Board making the policy's analytical foundation public, motivating monetary policy decisions and, not least, publishing the minutes of its monetary policy meetings.

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All this is well known and has been described at length in a number of the Bank's publications.[1] But the fact remains that the formation of monetary policy involves a delegation of power in several steps, from the people to parliament, from there to the General Council and finally to the Executive Board. This means that in certain respects control by the electorate is weaker than in the case of government policy.

As pointed out by a political scientist[2], the type of restriction of democracy that unquestionably arises, in that the Riksbank is given a certain degree of independence of the political process in government and parliament, can be said to serve the purpose of protecting voters from their own weaknesses. To be acceptable, such a restriction must be reversible. Hermansson considers that in the context of democracy, a permanent abdication of popular rule is inherently unacceptable. Recurrent reviews and reassessments of the delegation are called for.

The independent status of the Riksbank is, of course, subject to new decisions by the Riksdag. For the countries that make up the euro area, the situation is different. The increased independence of the Riksbank amounts to a *delegation* of power to an agency of the Riksdag and what is delegated can be amended or

[1] See Heikensten & Vredin (1998) and Apel & Viotti (1998).
[2] See Hermansson (1999).

recalled. Participation in the euro area amounts in practice to a *transfer* of power to a supra-national body. The German constitutional court interpreted this as a "loan of power" and recommended Germany's membership of the monetary union. Even so, recalling power from the European Central Bank would clearly be a more troublesome and costly process than cancelling the delegation of power to the Riksbank.

Even with the present arrangement, however, the formulation of the Riksbank's assignment is restricted by the Maastricht Treaty. The international financial markets exert a similar constraint. Besides constituting a breach of the treaty, a reformulation of the Riksbank's objective would be scrutinised closely. The credibility of maintaining low inflation would be questioned, leading to reactions in interest rate and currency markets.

Price stability the pre-eminent objective

When stabilisation policy is constructed with an inflation target as its central feature, the central bank usually has some discretion in the *formation* of policy. The central bank is given the task of maintaining price stability. This is something that has been practised successfully for many years in the United States as well as in Germany and Switzerland.

At the same time, with this arrangement, price stability has the status of stabilisation policy's pre-eminent objective. This was expressed authoritatively in the 1991 Budget Statement: *"This task* (combating inflation) *must have precedence over other ambitions and demands"*. That was a new approach after many years when price stability had not been achieved.

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With an independent Riksbank focusing on price stability, fiscal policy is not in a position to have employment as a short-term target. Two independent power centres pursuing separate targets would be prone to frequent conflicts, either because employment policy would be liable to endanger price stability or because the Riksbank's monetary stance would be liable to upset the Finance Ministry's employment policy.

The fact that the Government has targeted 4 per cent unemployment and 80 per cent labour force participation rate is a completely different matter. These are structural targets, to be fulfilled by consolidating the government finances and thereby bringing interest rates down, as well as through deregulations, growth-promoting tax cuts and other measures – not by short-term budgetary stimulation of demand. So these targets are entirely compatible with the inflation target and the Riksbank's independence.

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In the event of short-term conflicts between inflation and full employment, employment has to give way, although the practical formation of monetary policy – with a period of up to two years for adjusting inflation to the target – means that the stability of the real economy and the labour market are taken into account. Previously it was the other way round: when these targets conflicted, price stability deferred in practice to full employment.

The argument for giving precedence to combating inflation was that cross-country comparisons suggested that unemployment was not dependent on the rate of inflation. Opponents of the policy realignment rejected this because it said nothing about what would happen to a high-inflation country with full employment when it switched to a low-inflation regime. Their scepticism was justified in so far as that a decade after the realignment, Sweden still has mass unemployment: about 7 per cent including labour market programmes and about 4 per cent open unemployment. In the post-war period up to 1990 the annual level of open unemployment never exceeded 4 per cent.

Experience indicates, on the other hand, that once inflation expectations have been expunged from the economy, the inflation target seems to get locked in. For despite rising oil prices during autumn 2000, survey data show that expectations are anchored around the Riksbank's target. This is valuable; the Riksbank's most important function is perhaps to maintain the target's public credibility because breaking high inflation expectations costs so much in terms of lost output, mass unemployment and impaired welfare.

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It is, however, hardly the scientific basis for a policy regime that explains why a new economic policy has been established; the decisive reason lies instead in the direction of policy in the leading OECD countries. The change has been driven by the fact that Sweden is a small country and heavily dependent on large international corporations with their origins here. Sweden is not in a position to deviate at all markedly from the course the major OECD countries are following. Both the general public and politicians lack the self-confidence to seek an alternative to the dominant policy in the club of industrialised countries.

At the same time, it should be underscored that the new direction of stabilisation policy, centred on monetary policy, does not necessarily mean that full employment is cynically abandoned. The active stabilisation policy in the 1970s and 1980s led to a combination of rising unemployment and high inflation, with abrupt alternations between an overheated labour market and plummeting economic growth that entailed mass unemployment. Recently, therefore, the first two post-war decades, with high growth rates and stable prices, have been highlighted as a good example for economic policy.

A long-term stabilisation of inflation at a low level – as a step towards more scope for market deregulation in many areas of the economy – seems to be an important condition for rapid growth and higher employment. That, at least, is the perception behind the reorientation in many countries in favour of price stability and an independent central bank.

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As far as Sweden is concerned, there is nothing at present that contradicts this hypothesis. Inflation is firmly anchored around 2 per cent at the same time as employment is rising and unemployment is falling. But as the sceptics feared, the process took a long time, exacted welfare losses and entailed appreciable shifts between centres of civic power, away from political assemblies and trade unions.

The Riksbank in the limelight

Central banks' recently acquired independence has been likened to the courts' independent interpretation of the law. Judges are appointed for their legal competence and it is up to them to apply the laws passed by the Riksdag without parliamentary or governmental interference. There is, however, a difference. The doings of central banks are debated more intensely, critically and continuously, not only because their independence is a new phenomenon but also because the level of interest rates and economic activity have a strong bearing on the public good. Hence the close and critical attention paid by media to central bank policy.

That is not all. The financial markets follow central bank policy professionally and critically because the players' potential profits and losses are bound up with the ability to foresee this policy. So monetary policy is scrutinised continuously and professionally in a way that is not true of any other aspect of society with the possible exception of the recurrent presentation of government budgets and tax policy. Professional journals, the financial pages of the daily newspapers and the experts employed by

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banks and other financial institutions all monitor the Riksbank's policy regularly and critically, sometimes it seems almost to excess.

It is not only the judiciary that can be seen as a model for the Riksbank's new status. Sweden's administrative authorities have had an independent position in relation to the government ever since the first Instrument of Government was promulgated in the days of Axel Oxenstierna in 1634. Our administrative tradition, characterised as it is by authorities deciding particular cases without recourse to political bodies, might therefore be expected to make the new-found independence of the central bank seem less provocative than in continental countries. In this respect there is no difference between the Riksbank and, say, the National Labour Market Board (LMB).

The Government can direct the LMB through ordinances and budget allocations but is not entitled to a say in particular cases. The Riksbank does differ from the LMB in that it is not a government agency but an authority under the Riksdag, and above all has its own funds. Consequently, the Riksbank does not have to submit annual budget requests in order to finance its operations. The significance of this is evident from the competence the Riksbank has been able to build up compared with many other public institutions.

Other differences are that the Riksbank has a very clear objective – as its fulfilment is easy to control, this obliges the bank to be very transparent – and that its decisions have greater economic consequences than those of the LMB. The actions of the Riksbank therefore appear to be more spectacular than isolated measures by the LMB, although taken as a whole, the economic consequences of the latter can be considerable.

What kind of independence?

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When discussing the Riksbank's independence, it is important to distinguish between *targets* and *instruments*. Target independence leaves the central bank free to formulate its policy objective. Instrumental independence means that the central bank is free to formulate its policy with a view to fulfilling the objective the government or parliament has stipulated.

The Sveriges Riksbank Act states that with respect to monetary policy: "The objective of the Riksbank's operations shall be to maintain price stability." Thus, the Riksdag has formulated the objective in general terms. It is the Riksbank that specified this as 2 per cent inflation with a tolerance interval of ±1 percentage point and this has subsequently been accepted in a number of statements by the Riksdag. So the Riksbank can be said to have instrumental independence and, to some extent, target independence as well.

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For the Bank of England, for example, the arrangement is somewhat different; it is the British government that has set the inflation target at 2,5 per cent. Last autumn the French Finance Minister, Laurent Fabius, proposed that the monetary policy target of the European Central Bank be set by the Euro Group (the euro countries' body for economic policy cooperation). The suggestion that the ECB's target should be formulated by the politicians caused a certain amount of concern in the financial markets.

Central bank independence has arrived in part to resolve the problem of *time inconsistency*, by which is meant that official price stability targets have been abandoned repeatedly, thereby undermining monetary policy's credibility.[3] The importance of credibility was heightened by the move to free capital mobility. These new conditions – deregulations and failures that eroded confidence in policy – hardly require target independence.

Indeed, a central bank may stand to gain by having its function specified by the government and parliament or, in the case of the ECB, by some other political body. Would it not be an advantage to have a target that elected representatives clearly backed? A central bank without target independence does not mean that target fulfilment loses credibility.

In my opinion, moreover, having monetary policy's objective formulated fairly specifically by the government or parliament – that is, more precisely than the general formulation in the Riksbank Act – would be a better democratic arrangement. While it is true that the Riksdag has subsequently accepted the Riksbank's operationalisation of the objective, having a target formulated precisely by the Riksdag from the beginning would not have been to the Riksbank's disadvantage.

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Authorities need to interact

Swedish law prohibits the Riksbank from taking instructions from another authority. The Riksbank is to endeavour to fulfil the price stability objective inde-

[3] In Sweden this took the form of a series of devaluations in the 1970s and 1980s.

pendently. This amounts to instrumental independence. However, some coordination of economic policy is always required. The British solution is to have a Treasury observer present at meetings of the Monetary Policy Committee when the interest rate is decided. In this way the observer obtains direct information about the Bank's analysis of the economic situation and provides the Committee with information from the Treasury.

In this way there is a coordination of monetary policy, not so far-reaching as when the government decided both monetary and fiscal policy but still sufficient to give the government an insight into the central bank's monetary policy. When the operative inflation target has been set on behalf of the government by the Chancellor of the Exchequer, there can hardly be any uncertainty about what the central bank is aiming for.[4] Uncertainty may of course arise, on the other hand, about the Bank's view of the prevailing economic situation and how it will react to Treasury policy.

For the ECB, the British form of coordination would not be feasible since it would involve having twelve finance ministry observers at meetings of the Governing Council. Instead there is a very indirect arrangement whereby the chairman of the Ecofin Council (as well as a Commission representative) participates in meetings of the Governing Council without a vote.

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The Swedish arrangement lies in between the Bank of England and the ECB in that the Chairman and Vice-Chairman (the latter is at present not a member of parliament) of the Riksbank's General Council have the right to be present at Executive Board meetings. This right is exercised frequently, thereby providing a link to the General Council and indirectly to the Riksdag and the political parties. The Finance Minister is informed of Executive Board decisions before these are published but the Swedish system for economic policy does not have the same degree of coordination as the British. There is, however, an informal exchange of information through the Riksbank's transparent approach in speeches, minutes and reports, as well as the flow of economic policy documents from the Government Offices.

One of the countries that pioneered inflation targeting is New Zealand. There the government and the central bank governor conclude a contract on the inflation target. In the event of deviations from the target, the governor has to provide an ex-

[4] Changing the target suddenly would presumable be very costly, politically as well as financially, on account of the ensuing uncertainty about the future direction of British policy.

planation and is liable to dismissal for failing to fulfil the target. This has not yet happened even though the target has been missed. Moreover, in recent years the target has been changed.[5]

The independence paradox

Since the collapse of the Bretton-Woods system in 1971–72, most industrialised countries have adopted a flexible exchange rate and central bank independence. But why is it that the financial markets do not trust governments that undertake to coordinate their fiscal and monetary policies and promise low inflation, whereas they are prepared to believe that central banks will deliver price stability on behalf of the same governments? After all, as the Riksbank's objective is inscribed in an ordinary act of parliament, not in constitutional law, the Riksdag can issue new instructions to the Bank at any time.

So while governments or parliaments are perceived as being incapable of fulfilling a credible policy, it is expected that they can get one of their institutions, the central bank, to do so. This is a paradox but the delegation does evidently have an important function in economic policy.[6] Why is it that just the delegation from the political bodies to an independent central bank confers credibility and how can the central bank create confidence in the monetary policy that the government cannot be trusted to fulfil?

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The delegation surrounds monetary policy with a palisade that the political bodies, if they regret the delegation, cannot remove without further ado. A move to recall the delegation would act as a clear early warning to the financial markets and people in general that a realignment of monetary policy is on the way. This rules out the possibility of taking people by surprise with an expansionary policy and inflation. A recall would be costly, politically as well as economically, and lead to rising inflation expectations that are difficult to rectify, as well as to higher interest rates. Growth and employment would be pushed down.

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[5] New Zealand, along with Canada, served as a model for the Riksbank when Sweden abandoned the fixed exchange rate at the end of 1992. Canada had had the longest history of a flexible exchange rate (in the period 1950–62 and from 1970 onwards) and advice and experience from the Canadian central bank were important for the Riksbank during the change of regime.

[6] See Buiter & Sibert (2000).

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ments. The targets of monetary policy are simple and unambiguous; for the Riksbank they are 2 per cent inflation and the promotion of a safe and efficient payment system. The targets are simple, not in the sense of being easy to fulfil but because the central bank does not have the government's problem of reconciling conflicts between different political targets. This is one interpretation of the paradox that the financial markets do not trust governments but have confidence in an institution, the central bank, that receives instructions from parliament.

Economic policy and ideology

The economic theory in this respect necessarily involves some simplifications. Put rather bluntly, it holds that governments are tempted to surprise a gullible public with inflation and high growth and thereby gain an advantage in an election. This formulation is stylised, far too simple and often at odds with the real world's complexity.

Government policy can be perceived as an infinitely repeated game with trade unions, companies and other civic groups. If expectations are at all rational, breaking promises repeatedly should not pay. There must be additional reasons why governments fail to deliver price stability, while the delegation of monetary policy seems to be successful. So let us try a somewhat different, historical approach.

Supply shocks of the magnitude and extent that hit the global economy in 1973–74 and 1979–80 had had little or no precedent in the post-war period.

Perhaps there is a much simpler explanation for the failure of Keynesianism, in the limited sense of coordinating economic policies for full employment and price stability. The oil price hikes, wage cost crises and poor harvests during the 1970s were supply shocks that at least some governments countered with demand policy, quite simply because they were accustomed to dealing with demand shocks. Supply shocks of the magnitude and extent that hit the global economy in 1973–74 and 1979–80 had had little or no precedent in the post-war period.

This mistaken application of economic instruments discredited Keynesianism and stabilisation policy in the form of demand management. At the same time, theoretical and empirical research appeared to refute Keynesianism. However, misperceptions of reality and misuse of economic instruments need not give an earlier type of ambition in stabilisation policy an eternally bad name if the current approach turns out to be less successful.

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The "fall of Keynesianism" meant that the significance of demand policy was unfortunately played down. Its true importance is evident from developments in Sweden: from 1989 to 1993 the saving ratio of household disposable income rose from –5.5 to +8 per cent; together with economic policy's cuts in demand during these four years, this exposed the Swedish economy to a negative demand shock of more than 10 per cent of GDP, leading to mass unemployment and a GDP fall of 5 to 6 per cent. In a *Manifesto* published in 1998,[7] Modigliani et al. wrote as follows about mass unemployment in Europe: "… at present the concept (aggregate demand policy) has become taboo among many European central bankers and political leaders, even though there is plenty of evidence that, in recent years, it plays a significant role in accounting for rising unemployment".

When more liberal economic policies replaced Keynesianism, economic liberalism and deregulation – as a way of freeing markets and enhancing individuals at the expense of collectives – were as much a part of the game as the failure of stabilisation policy.

Economic policy often has an ideological background. It should be realised that the "fall of Keynesianism" was not solely a matter of the concept's narrow sense in terms of stabilisation policy. In a broader economic sense, Keynesianism stands for a general welfare policy, regulations, strong trade unions, corporatism and so on. When more liberal economic policies replaced Keynesianism, economic liberalism and deregulation – as a way of freeing markets and enhancing individuals at the expense of collectives – were as much a part of the game as the failure of stabilisation policy. There were and still are strong links between political ideologies and schools of economic thought. There is nothing unusual about that. In the final analysis it is basic perceptions and experiences of the nature of reality and how it works that determine both political and economic allegiances.[8]

[7] Modigliani, F. et al. (1998). The *Manifesto*, written by Nobel laureates Modigliani and Solow with five other prominent economists, attracted support from about twenty-five European and American economists. A Swedish translation has been published in Meidner (1999) but otherwise the contribution has received hardly any attention in the qualified Swedish debate on economic affairs. For the saving ratio, see Sveriges Riksbank (2000).

[8] The present author has developed this idea in Bergström, V. (2000).

By increasing the welfare of people with low or no incomes, a reduction of unemployment may do more than anything else to equalise living conditions.

Historical experience does not indicate that free capital movements, deregulation and an absence of a stabilisation policy focused on combating unemployment can unite full employment with pronounced income equality. Even today, income inequalities seem to be growing, above all in those countries (the United States and the United Kingdom) where deregulation has been practised longest and carried furthest.[9] On the other hand, employment is rising in those countries and, by increasing the welfare of people with low or no incomes, a reduction of unemployment may do more than anything else to equalise living conditions.

Concluding remarks

Sweden's current monetary policy regime is based on a carefully thought-out philosophy that, although not entirely finalised, has worked very well in the latter part of the 1990s and is still being deliberately developed.

Both the credibility of the Riksbank's monetary policy among people in general and a proper understanding of the focus on an inflation target call for transparency. That insight has guided the Executive Board's working arrangements.

An open approach clarifies the Riksbank's deliberations. If market players understand the Riksbank's line of thought, the risk of unnecessary fluctuations in the exchange rate and interest rates will be small. Hopefully, the analytical framework and how the arguments run will be sufficiently clear for the market to predict the interest rate in the light of the current information. That should contribute to a stable economic trend, with rapid growth and high employment.

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The Riksbank, along with the Bank of England, stands out among central banks for its transparency. In this respect the Bank of England has served the Riksbank as a guide. Democracy requires that the targets of decision-makers are clear, decision processes are transparent and those in power are held accountable. In brief: insight, control and accountability. The Executive Board of the Riksbank is not elected by the people. Power is delegated more than one step, which inevitably weakens democratic control

[9] See Atkinson (2000) for international comparisons and, for Sweden, Nelander & Lönnroos (2000).

and dilutes the process of accountability. Still, those who direct the Riksbank are indirectly responsible to the Swedish electorate and as this article should have made clear, the Bank fulfils many of democracy's criteria.

In the event that Sweden adopts the single currency and the current rules for ECB decision-making still apply, insight into monetary policy's decision-making process will be impaired and so, accordingly, will control. People in Sweden would have considerably less opportunity of exacting responsibility and the possibilities that remain would be very indirect. Compared with the present arrangement in Sweden with an independent Riksbank, there would be less insight, control and accountability, which raises questions about one of the fundamental characteristics of a democracy, namely that those over whom power is exercised shall be in a position to hold those in power responsible.

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