MONETARY POLICY UNCERTAINTY AND INFLATION: 
THE ROLE OF CENTRAL BANK ACCOUNTABILITY*

BY

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1 INTRODUCTION

Recently, in many countries both political and monetary authorities have shown an increasing interest in the objective of monetary stability and the constitutional and legal position of the central bank. Recent policy reform, as well as historical experience, suggests two different routes to price stability. The first way is the legislative approach; namely, to create by law a very independent central bank with an unequivocal mandate to focus on price stability. Interest in this approach is motivated by the success of the Deutsche Bundesbank in maintaining a low rate of inflation for several decades. The most recent example of this type of monetary reform is the United Kingdom. On 6 May 1997, just four days after taking office, the Chancellor of the Exchequer announced that the Bank of England would have operational responsibility for setting short-term interest rates. The associated legislation is expected to be approved by Parliament early next year. The academic case for such autonomy has been made by Rogoff (1985),

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1 Note that, depending on whether the CB’s goals are more precisely defined in terms of, say, a numerical target, it has - what Fischer (1994, page 292) calls - less goal independence. For instance, at one extreme the Deutsche Bundesbank has full goal independence, whereas the Reserve Bank of New Zealand has a very precisely specified inflation target, and hence no goal independence.


The second way is the targeting or contracting approach; namely, let the political principal of the central bank impose an explicit, say, inflation target for monetary policy, and make the central bank explicitly accountable for the success in meeting this target. In varying degrees, Australia, Canada, Finland, Israel, New Zealand, Spain, Sweden, and the United Kingdom have all recently made some progress along this route. Important theoretical work on this approach has been done by Walsh (1995). A discussion of the merits of this and other mechanisms for achieving price stability can be found in Leiderman and Svensson (1995) and Canzoneri, Nolan and Yates (1997).

As pointed out by Cukierman (1994, page 1443), delegation of authority over instruments and/or goals of monetary policy to an independent central bank is sometimes criticised as creating a ‘democratic deficit’ on the grounds that it entrusts economic policy to technocrats who have not been elected by voters. He states that a related objection to central bank independence is that independence without accountability may induce central bankers to behave in an opportunistic manner that will not lead to the achievement of society’s policy objectives in various areas including, in particular, price stability. In this view the central bank is a bureaucratic agent with its own private agenda which is not necessarily identical to that of society. The latter view is succinctly illustrated by Fischer (1994, page 293):

‘An important reason to expose central bankers to elected officials is that, just as the latter may have an inflationary bias, the former may easily develop a deflationary bias. Shielded as they are from public opinion, coooned within an anti-inflationary temple, central bankers can all too easily deny that cyclical unemployment can be reduced by easing monetary policy.’

2 It is precisely this democratic deficit argument that has been used in the discussions of central bank independence in the UK. Moreover, since the credibility problem of monetary policy arises precisely because of the way politicians operate, this argument raises a dilemma. Central bank independence reduces the credibility problem at the cost of placing monetary policy in the hands of unelected officials. According to Cukierman this argument becomes more important in times of particularly large unexpected shocks. He suggests that one way of dealing with it while still reaping the benefits of delegation during tranquil times is to grant independence, but also to introduce escape clauses into the CB law. Within the legislative approach the situation in The Netherlands, where the minister of Finance may give the Nederlandsche Bank a so-called directive in matters of monetary policy is - according to Lohmann (1992) – an example of such a construction. For the contracting approach an example is the 1989 Federal Reserve Bank of New Zealand Law.

3 Interestingly, in responding to an early draft of Fischer’s (1990) paper on rules and discretion, Milton Friedman wrote about central bankers: ‘From revealed preference, I suspect that by far and away the two most important variables in their loss function are avoiding accountability on the one hand and achieve public prestige on the other.’