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Does an Independent Central Bank
Violate Democracy?

by

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DOES AN INDEPENDENT CENTRAL BANK VIOLATE DEMOCRACY?

The question of central bank independence is one of degree. A completely independent central bank is impossible as long as a country has provisions for altering central bank powers, even if that requires constitutional amendments. On the other hand, any central bank has at least some discretion in monetary policy unless it is either in the pocket of a dictator or required by mandate to follow a mechanical rule, such as the central bank in Argentina where monetary policy is effectively determined by the currency board.

In the United States and many other countries, people question the degree of central bank independence, often citing the need to better insulate central bankers from pressure to serve either the political motives of government officials or the financial interests of private individuals and organizations. This school of thought argues that the central bank should be left alone to pursue one monetary policy goal: price stability. It is feared that either government officials with too much influence over central bankers or laws setting inappropriate priorities for them undermine this independence.

The Federal Reserve already enjoys a good measure of independence, but many observers believe that it should have more. In particular, the advocates of greater Federal Reserve independence support reducing the statutory encumbrances on the

Fed, especially the Humphrey-Hawkins Act.^{1 2}

But problems arise. First, allowing an independent group of men and women to weigh tradeoffs and make choices that deeply affect the lives of the citizenry is antithetical to democracy when some of them, the regional Federal Reserve Bank presidents who serve on the Federal Open Market Committee, are appointed by boards of directors who are largely elected by bankers, not citizens. Second, the criteria applied as Federal Reserve Governors are appointed by the president and confirmed by Congress are much narrower than the range of issues affected by monetary policy. The president and Congress evaluate potential governors as if they were merely custodians of price stability, general economic growth, and the financial system when in reality, to an extent probably not realized by most elected officials, they make decisions that directly or indirectly alter public policy on a vast array of important issues, as we will see later. The questioning at confirmation hearings does not reflect

¹ For example, Senator Connie Mack, Chairman of the Joint Economic Committee, has been outspoken in support of a narrow objective for the Federal Reserve's monetary policy: keep inflation at zero. See Berry, John M. "Giving the Fed a One-track Mind," Washington Post, 21 September 1995.

² The 1978 Full Employment and Balanced Growth Act (also known as the Humphrey-Hawkins Act) stipulates that the nation's economic policymakers should strive to accomplish the following objectives: full employment, increased real incomes, balanced growth, a balanced federal budget, growth in productivity, an improved balance of trade and price stability. The Act requires the Chairman of the Federal Reserve to explain before Congress twice a year how the Fed's policies are consistent with the goals outlined above. [Source: Kliesen, Kevin. "A Fed Focused on Price Stability," Regional Economist, Federal Reserve Bank of Saint Louis, April 1995.]

this breadth.

An independent central bank can be consistent with democracy only if two requirements are met:

1. *Monetary policy actions have narrow consequences; they affect price stability and the soundness of the financial system but do not involve social tradeoffs.* An independent central bank must not be able to influence unemployment or other important aspects of the economy. Otherwise, if the Fed rather than duly elected officials chooses among various combinations of unemployment, inflation, and growth, it is violating democratic principles. Thus, not surprisingly, most central bankers and other advocates of independence argue that monetary policy does not affect unemployment, at least not in the long run.³

2. *The central bank has a systematic, objective method of selecting the right policy to meet its goal of a stable currency and a healthy financial sector.* If the central bank can only pursue arbitrary, subjective policies, how will the removal of congressional and presidential influences improve its performance? On the contrary, if central bankers are largely playing a guessing game with enormous stakes, Congress and/or the White House should be readily able to prevent dangerous gambles. If, for example, the Fed is inclined to risk a deep recession in an effort to lower inflation from 2.5% to 0, our elected officials may not feel that America should take that chance.

³ Tietmeyer, Hans. "Reducing Unemployment: Current Issues and Policy Options," Kansas City Fed Symposium, August 25-27 1994, pp. 359-60.

The reality is that neither of the above conditions holds. Monetary policy has a multitude of profound effects on the U.S. economy and society. And monetary policy formulation is far from scientific and objective, as we will see shortly.

Therefore, democracy requires that central bank independence be limited so that the makers of monetary policy cannot stray far from the will of the people as embodied in their duly elected representatives. Moreover, central bankers must be held accountable for all of the ramifications of their policy, not just the inflation rate.

One might ask how top Federal Reserve governors are different from other appointed public servants, who are also a step removed from the electorate. They are all screened before their appointments by elected officials, given finite terms, and can be impeached for gross improprieties or negligence. Yet there are differences. First, the twelve regional Federal Reserve Bank presidents also wield considerable influence, and they are more representative of the banking industry than of the American people. Second, no other government appointment carries both the Federal Reserve governors' high degree of independence and power over so many controversial, socially critical issues.

Supreme Court Justices are even more independent and powerful than governors, but they are not supposed to be concerned with the will of the people; rather, their responsibility is to represent and protect the U.S. Constitution

against, among other things, the "tyranny of the majority". Cabinet Secretaries and many other powerful appointees are directly controlled by the President. Top regulators, such as the head of the Security and Exchange Commission, have legitimate claim to independence, for they are better described as referees enforcing rules than as policy makers.

Federal Reserve governors are in part regulators, and in such roles should enjoy considerable independence, but they also make monumental policy choices for the nation, choices that should be democratically determined. Reducing the accountability of those making these decisions would be a step in the wrong direction.

Instead of the United States government giving the Federal Reserve more independence and a narrower set of objectives, it should make the Fed more accountable. The central bank should be required to justify its actions in view of all the implications of monetary policy.⁴ Congress and the White House should have greater control over the social and economic choices implicit in monetary policy in order to make sure that the policy reflects the desires of the American people.

This discussion focuses on the United States, but most of the arguments could be applied to any economically advanced country.

⁴ Numerous economists have argued for greater Fed accountability. See for example, Galbraith, James K. "A Two-track Growth Program," Challenge, January-February 1993.

Monetary Policy and Employment

In the real world, monetary policy cannot restrain inflation without weakening the economy and curbing employment. This is in direct contrast to the effects of monetary policy in the purely theoretical, idealized world in which the economic actors, including workers, managers, consumers, entrepreneurs, and investors, are all-knowing and thus recognize subtle changes in market conditions virtually instantaneously. In this theoretical world, labor markets adjust wages and product markets adjust prices as soon as higher interest rates slow the economy and the demand for workers; these effects occur so promptly that unemployment never has a chance to rise significantly nor output to fall. In reality, it takes time for the economic actors to recognize changes in market conditions, and, if the changes are small, people may be oblivious to them for some time. They may go into denial, refusing to believe that they cannot get the pay or prices they expected. They may hold out, anticipating that conditions will soon pick up again. And contrary to the model of the rational decision-maker, sometimes people may be indignant, stubborn, or otherwise irrational.

Let's consider real-world inflation. What happens when sellers raise prices? Either they increase their profit margins or they protect margins after an increase in costs. Thus, the two basic types of inflation are *widening profit margins* and *increasing business costs*. To stem inflation, a tightening of monetary policy must succeed in compressing profit margins and/or

limiting cost increases. It does both, but not without curtailing employment.

Rising unemployment is the Federal Reserve's primary means of fighting business cost inflation, and increased joblessness is an inexorable consequence of squeezing profit margins. Monetary policy reduces business cost inflation primarily by curtailing advances in labor costs, which are by far the largest and most important of all business costs. In the idealized world of orthodox economic theory, the Federal Reserve can fine-tune inflation since nearly perfect markets work so well that a small reduction in the pace of monetary growth slows the pace of wage and salary increases, and all the while equilibrium forces prevent the economy from straying far from full employment. In reality, the only way that Fed rate hikes can influence the size of pay increases is by hindering economic activity sufficiently to cause a marked increase in unemployment and a decrease in job security. If high interest rates slow business at General Motors, the company will lay off workers long before it renegotiates compensation rates.

The influence of monetary policy on other business costs is mixed and has much less impact on inflation. For example, Federal Reserve rate hikes tend to strengthen the dollar and lower the cost of imported goods, but they also increase business' interest expenses since the business sector is a net interest payer.

Profit margins account for only a small fraction of prices,

but abrupt changes in profitability can make substantial if brief contributions to general inflation. Also, stable but excessively high profits can lead to labor and other shortages, causing firms to bid up employee compensation rates.

By raising interest rates, the Fed can compress profit margins. The relationships among the terms in the profit identity (Figure 1) are not purely one-directional or simple, but in the short term (periods of three months or less) the dominant dynamic is that profits are largely the dependent variable determined by the other, relatively independent variables.⁵ Rising interest rates affect virtually all the terms on the right side of the equation and therefore affect total profits. The most important effect is through investment; rising interest rates eventually reduce investment and therefore profits. However, since Fed interest rate hikes affect profits in complex ways through many variables, monetary policy is a highly imprecise tool for regulating profit margins.

Since profits typically account for about 10% of prices,⁶ Fed policy must reduce profit margins by 10% to offset one

⁵ Asimakopoulos, A. "The Determinants of Profits: United States, 1950-88", in Papadimitriou, Dimitri B. (ed.), Profits, Deficits and Instability, Macmillan (1992)

Levy, S Jay and Levy, David A. Profits and the Future of American Society, Harper & Row (1983).

⁶ National Income and Product Accounts, profits before tax for domestic corporations. These aggregate profit margins are larger than the average for individual corporations because the profits on sales of business services, crude/intermediate goods, and wholesale finished goods are embedded in the costs of final goods and services sold.

percentage point of inflation. Such a decline would represent a notable deterioration in the business climate and would have a significant impact on employment.

It is sometimes argued that Fed actions lower inflationary expectations without applying the brakes to economic growth and job creation. As soon as monetary policy becomes tighter, workers and employers both lower their assessments of inflation and, therefore, appropriate wage rates. Simultaneously, consumers see less justification for price increases and firms anticipate that they will have smaller cost increases to pass on. The expectation of lower inflation is thus a self-fulfilling prophecy.

But there is a huge problem with this theory. Almost no one forms inflation expectations based on what the Federal Reserve does, with the possible exception of the financial markets. The financial markets are certainly highly sensitive to Fed actions -- often to vague hints by Federal Reserve officials about future actions -- as reflected in the bond market. But do markets respond because their inflation expectations change or merely because their expectations of future Fed interest rate policy changes? Bonds often sell off when the monetary policy is tightening or appears likely to tighten, as during much of 1994. Similarly, bonds often rally when the Fed eases or when the market perceives an increasing chance of easing. At best, the case that markets lower inflation expectations when the Federal Reserve tightens policy is questionable.

Regardless of how or why the credit markets respond to changes in monetary policy, their effect on the overall economy is only through changes in the cost of capital. The markets may accentuate or dampen the Federal Reserve's efforts to raise the cost of capital, but they have no other effects on business costs or profit margins. The great bulk of decisions affecting inflation are made by firms, workers, and consumers. Certainly, inflation expectations affect compensation negotiations, consumer decisions, and how much firms are willing to pay for goods and services. But the great majority of these decision makers are either ignorant of Fed policy or consider it too abstract for incorporation when formulating inflation expectations based on experience in their markets. Imagine an employee or union representative reducing the size of the pay raise he or she is seeking or a firm that lowering prices upon hearing the news that the Federal Reserve has tightened monetary policy!

Thus, the Federal Reserve does face a tradeoff between unemployment and inflation, at least in the short run. Tightening credit combats inflation by squeezing profit margins and increasing unemployment -- by weakening the economy. To significantly affect prices, the Fed must engineer a meaningful change in the profits trend and materially soften labor markets.

Many economists argue that such short-term effects are transient and that monetary policy will not affect unemployment in the long-run. Their arguments are either purely theoretical -- the economy gravitates to full employment equilibrium

regardless of monetary policy -- or based solely on the empirical evidence that there is no clear, demonstrable, long-run Phillips curve. But the theoretical arguments are contested on numerous grounds, and the empirical ones are misapplied.

The failure to demonstrate a clear, long-run relationship between *inflation* and unemployment by no means implies that *monetary policy* has no long-run effect on unemployment. Indeed, many central bankers and economists explicitly recommend using unemployment as a long-term price-stabilization strategy. They advocate preventing inflation by maintaining adequate "slack" in the economy -- by keeping the rate of capacity utilization below a threshold (usually 85%) and by maintaining a minimum rate of unemployment. This rate is the unfortunately named "natural rate of unemployment," also known as the "nonaccelerating inflation rate of unemployment (NAIRU)". In the past few years, NAIRU in the United States has been estimated to be anywhere from 5.5% to 6.5%, although recently some economists are making downward revisions in their estimates.⁷ Statements by Fed officials during the period of rising interest rates that began in February of 1994 frequently reflected concern about tightening labor markets,⁸ although the central bankers have not publicly

⁷ The unemployment rate broke 5.5% in December of 1994 without evidence of a significant acceleration in wage trends. Some economists who believe in the NAIRU concept, such as Edmund Phelps and Robert Gordon have been lowering their estimates, as noted in The Wall Street Journal, 24 January 1995.

⁸ Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco doubts that anyone can pinpoint the precise unemployment rate that triggers inflation,

acknowledged a target unemployment rate nor explicitly endorsed the concept of NAIRU.

Whatever the limitations of monetary policy for controlling economic activity, the Federal Reserve can virtually always cause more unemployment. Moreover, if the alleged NAIRU is to be the lowest unemployment rate tolerated by the Fed--a floor for the unemployment rate--and if the central bank is successful in keeping the unemployment rate above the NAIRU, unemployment will usually be well above NAIRU. This is because, unless the business cycle is eliminated, the unemployment rate will move up and down within a range. The average unemployment rate will be well above the NAIRU floor, since the unemployment rate vacillates by several percentage points during a typical business cycle. For example, if NAIRU is assumed to be 6% by monetary policy makers, then the average unemployment rate will likely be well over 7%.

Even if the claim that monetary policy does not affect long-run unemployment were true, serious short-term unemployment should be weighed against any short- or long-term reductions in inflation. And that is a trade-off that should be evaluated by the people's elected representatives, not just by appointees who disproportionately represent the financial sector. Moreover, if the long-run relationship between unemployment and monetary

but he suggested it lurks somewhere between 6% and 6.5%, and probably "in the higher part of that range." See Los Angeles Times, 1 June 1994.

policy is uncertain, then elected officials should have the ultimate say on what risks are worth taking.

Monetary Policy and Deficit Reduction

One of the great mysteries of our time is how, despite the swelling of sentiment for deficit reduction that has come to dominate national politics, with government assailed at every turn for spending the taxpayers deeper and deeper into debt, one U.S. agency, the Federal Reserve, lumps tens of billions of dollars onto the annual deficit at will -- and remains virtually unscathed by criticism for the fiscal effects of its actions.

The Fed raised interest rates seven times between February 4, 1994 and January 31, 1995, a total of three percentage points. Was there a newspaper headline that read "Central Bank Raises Rates, Adds Billions More to Federal Deficit" after even one of those occasions? For that is precisely what the Federal Reserve did. When the Fed tightens credit, it widens the federal deficit both directly, by increasing federal interest payments, and indirectly, by reducing tax revenues and raising economic assistance outlays.

The impact on federal interest outlays is considerable. In 1995, approximately \$1 trillion of federal debt is being either refinanced or created. Adding 300 basis points to the interest rates on these new Treasury securities increases the annual rate of federal interest payments by about \$30 billion within a year. Moreover, the longer interest rates remain elevated, the greater

will be the share of Treasury debt affected by the rate hike. Thus an ongoing anti-inflation vigil by the Fed as during the 1980s has a long-term, cumulative effect on federal interest payments. Figure 2 shows the federal government's net interest payments as a percentage of GDP. The steep rise in the late 1970s and early 1980s reflects in large part the jump in interest rates engineered by the Fed. The decline of the early 1990s despite continued, large deficits reflects the steep 1989-1992 rate decline.

Moreover, if Fed rate hikes keep profits 10% below what they would otherwise have been, the government loses more than \$15 billion in corporate income tax revenue during the year. If monetary policy reduces the annual collection of personal income and social security taxes by 1.5% (which would be consistent with a marked slowdown but not a recession), the government deficit rises by about \$17 billion. Add a few billion dollars more for unemployment insurance and other cyclical outlays. The bottom line is that tight money policies that are potent enough to seriously affect price trends add many tens of billions of dollars to deficit spending -- even without creating a recession.

Monetary Policy and the Current Account Balance

Repeated, large U.S. trade deficits in the 1980s wiped out America's formerly huge net holdings of foreign assets. In 1988, The United States became a net debtor country, making headlines and provoking much hand-wringing. Subsequently, our

international balance sheet was all but forgotten by most commentators, and the trade gap made headlines only as a "jobs" issue until the dollar began to drop against the yen, deutschemark, and a handful of other European currencies in early 1995. Even then, the falling dollar was widely viewed as the problem; there was little discussion of the rise in U.S. net international debt.

But our net foreign debt keeps growing, as shown in figure 3. As long as the nation runs current account deficits, the debt must grow (unless Americans perpetually enjoy much larger capital gains on their foreign assets than foreigners have on their U.S. assets, a most unlikely situation). As a result of the United States huge foreign obligations, a new problem has emerged: a widening deficit in *factor income* payments as more profits, interest, and dividends flow out of American hands to foreigners than flow in (figure 4). Until recently, the United States' current account deficit was caused entirely by the excess of merchandise imports over merchandise exports; with the emergence of the factor income deficit, the country now has two current account problems.

Wynne Godley and William Milberg analyzed the implications of continuing large current account deficits.⁹ They concluded that a continuation of current trends would increase the net

⁹ Godley, Wynne and Milberg, William. "US Trade Deficits: the Recovery's Dark Side," Challenge, November-December 1994.

Godley, Wynne. "US Foreign Trade, the Budget Deficit and Strategic Policy Problems: A Background Brief," The Jerome Levy Economics Institute Working Paper, No. 138, April 1995.

outflow of factor income to over 1% of GDP by 2000 and about 2% by 2005, figures that now look conservative. These trends are not sustainable, and, as the authors argued, the longer they go on, the greater the pressures for a plunge in the dollar and the more serious the domestic and international implications.

Godley¹⁰ shows that if the U.S. current account deficit is not sharply reduced, an international currency crisis will become virtually inevitable -- a crisis so severe that it is likely to cause global deflation.

Federal Reserve policy has a direct impact on the current account deficit and, indeed, is aggravating the problem in a number of ways. Rising interest rates have tended to delay currency adjustments that might foster more balanced trade. Moreover, interest rate hikes have increased the volume of interest payments flowing from American to foreign accounts. One may argue that the Fed and other G7 central banks have also delayed currency adjustments by sporadically intervening directly in the foreign exchange markets in defense of the dollar, although whether any of these actions have significantly affected exchange rates more than briefly is questionable. Finally, by maintaining high interest rates and inhibiting growth, the Federal Reserve may be hindering capital investment and impeding

¹⁰ Godley, Wynne. "A Critical Imbalance in US Trade: The US Balance of Payments, International Indebtedness and Economic Policy," The Jerome Levy Economics Institute Public Policy Brief, No. 23, 1995 (forthcoming).

American competitiveness.¹¹

Given our stubborn current account imbalance, trying to keep the dollar from weakening to avoid the inflationary impact of higher import prices is akin to avoiding the dentist when you know you have a cavity. The longer you wait, the more painful the remedy.

Monetary Policy and Social Consequences

Many economists today talk about "full employment" when 5.5% to 6.5% of the labor force is jobless; twenty years ago 3% or 4% was the goal. The change represents an increase in those allegedly unable to productively contribute to the economy as employees -- a rise in "structural" unemployment.

There is evidence that chronically high unemployment breeds unemployability, as well as a wide range of social problems. If the unemployment rate is higher over a period of years, the nation may well experience more prevalent social problems such as impoverished households, school drop-outs, single-parent families, substance abuse, gang membership, crime, illiteracy, and cultural alienation. When unemployment rises a little nationally, it expands a lot more in distressed communities, and

¹¹ Except for extreme interest rate movements, rates probably have little direct effect on business capital investment decisions [See Fazzari, Steven. "The Investment-Finance Link: Investment and U.S. Fiscal Policy in the 1990s," The Jerome Levy Economics Institute Public Policy Brief, No. 9, 1993.] However, by undermining residential construction outlays and otherwise slowing the economy, high rates reduce corporate cash flow and sales growth, two powerful influences on investment (ibid.).

social problems increase. Young adults emerging from these environments are more prone to remain outside the economy and alienated from society. The research and analysis in these areas by William Julius Wilson, Richard Freeman and Harry Holzer, Robert Haveman, Christopher Jencks, and many others cast serious doubt on the notion that macroeconomic policies have no social consequences.¹²

Even if one is unconcerned with the people so excluded from the economy, one should not disregard the costs of the disenfranchised on all of society such as crime, vandalism, higher insurance premiums, increased security needs, and other economic and quality of life costs. At issue is not whether the government should spend more money on aid to the poor, but whether the Fed should prevent the private economy from providing jobs that could keep more people constructively engaged in our society.

Weighing such expected social outcomes and risks against anticipated improvements in price stability is too subjective, too reflective of value judgments, and too important to leave to a highly independent panel usually comprised of bankers and economists -- unless, of course, Americans wish to significantly

¹² Freeman, Richard B. and Holzer, Harry J., eds. The Black Youth Employment Crisis, Cambridge: National Bureau of Economic Research (1986).

Haveman, Robert. Starting Even, New York: Simon & Schuster (1988).

Jencks, Christopher and Peterson, Paul E., eds. The Urban Underclass, Washington DC: The Brookings Institution (1991).

Wilson, William J. The Truly Disadvantaged, Chicago: University of Chicago Press (1987).

compromise democracy.

Monetary Policy and the Standard of Living

A disturbing, often asserted objective of monetary policy is to limit the economy's growth to a "sustainable," noninflationary pace. The Fed is supposed to act as the highway patrol, enforcing the speed limit as the economy motors along the expressway. A policy of fine-tuning growth with monetary policy is troubling enough, but when tight-money advocates proclaim that the speed limit should be 2.5%, the nation really has a problem.

A growth rate of 2.5% annually is approximately what occurred in the U.S. economy over the past quarter century. But 2.5% is not a permanent rule. Economic growth is uneven; a longer view of history reveals decade-long or multi-decade periods of vibrant growth, extended depressions, and spells of stagnation. Figure 5 illustrates the variations in growth since the inception of the NIPA data in 1929.

The notion that 2.5% is a maximum, sustainable rate for the economy assumes that the future will be a replay of the rather dismal performance of the past 25 years. It is also what many economists estimate for the years ahead based on expected labor force and productivity growth. However, labor force forecasts rely on projections of labor force participation rates (which can vary substantially with economic conditions and social trends), immigration (which is also highly variable), and the reliability of population data. Productivity growth varies from decade to

decade according to a variety of sociological, demographic, and economic trends. I would argue that growth over the next generation is more likely to average 4% than 2.5% as the long period of corporate downsizing and weak fixed investment relative to GDP evolves into a new era of booming investment in new, more efficient business capacity.¹³ But even if we merely note the uneven historical record and agree that the growth potential is uncertain, do we want the Fed to aggressively fight growth anytime the economy expands at a rate faster than 2.5%?

Consider what would have happened had the Federal Reserve limited growth to 2.5% during 1946-1966. Real GDP would have increased by a total of only 64% instead of 106%. The standard of living of the average American in 1966 would have been one-fifth less than it actually was. During these years, the average annual inflation was about 2%; had the Fed been able to assure 0% inflation and 2.5% growth, would the absence of this modest inflation have justified the lost purchasing power? How many Americans would take a 20% cut in standard of living to avoid 2% inflation?

Moreover, interest rates, especially after adjusting for inflation, would have been chronically higher. Residential construction and business investment would have been weaker, productivity gains smaller, and the United States' position in

¹³ Levy, David A., "From Contained Depression to Prosperity." Paper presented November 12-13, 1993 at The Jerome Levy Economics Institute conference, "Restoring America's Economic Growth and International Competitiveness."

world markets less dominant. Unemployment would have been higher, and the absorption into the labor force of millions of discharged veterans would have been much slower and more troublesome. Federal deficits would have been higher, and the nation's debt-to-GDP ratio would not have dropped from a huge 117% in 1946 to 34% by 1966. Americans, who just a few years earlier had lived through the Great Depression, might well have thrown out of office the public servants who allowed the Federal Reserve to perpetuate high interest rates, high unemployment, and obstacles to business prosperity.

In summary, reality glaringly violates the first requirement for an independent central bank to be consistent with democracy: narrowness of scope. Monetary policy does not have narrow consequences, affecting only price stability and the soundness of the financial system. It does indeed involve numerous social tradeoffs concerning some of the issues most important to the American people. It affects unemployment, the federal deficit and debt, the nation's deteriorating international debt position, social welfare and tranquility, and the standard of living.

What about the second requirement for a highly independent central bank to be consistent with democracy: "The central bank has a systematic, objective method of selecting the right policy to meet its goal of a stable currency and a healthy financial sector." This condition does not hold up too well either.

Does the Federal Reserve Know What It is Doing?

The Federal Reserve does not have a systematic and effective method of choosing the monetary policies that will attain its goals. Papadimitriou and Wray (1994)¹⁴ retrace the history of modern Fed intervention and observe that every method tried or seriously considered -- targeting M1, M2, M3, P-star, gold and so on -- has turned out to have serious problems, leaving the Fed, in the candid words of Governor Lawrence B. Lindsey, to "look at a whole raft of variables -- we ignore nothing and focus on nothing."¹⁵ Yet it is advantageous for the Fed to provide a rationale for its actions to Congress, and Chairman Greenspan emphasized *real* interest rate targets in 1994. Papadimitriou and Wray apply Mr. Greenspan's suggested rule in their paper and find that it produces notably poor policy decisions.

The explanations and rationalizations of monetary policy sometimes become so esoteric that it is tempting to ignore them and just look at the record. Figure 6 shows the federal funds rate with the shaded areas indicating recessions. If one knew nothing about the rationale for monetary policy and had to guess how decisions are made based on this chart, he would say that the Federal Reserve begins raising interest rates after an expansion is underway and keeps on raising them until the economy gets into

¹⁴ Papadimitriou, Dimitri and Wray, L. Randall. "Monetary Policy Uncovered: Flying Blind: the Federal Reserve's Experiment with Unobservables," The Jerome Levy Economics Institute Public Policy Brief, No. 14, 1994.

¹⁵ Bradsher, Keith. "Bigger Role For Intuition Seen at Fed," The New York Times, 28 February 1994.

serious trouble, and then it cuts rates. Serious trouble usually has meant a recession, although occasionally the economy has only slowed, as during the so-called "growth recession" of 1967 and "rolling recessions" of 1984-1986.

Neither this record nor the absence of a consistent method in Federal Reserve policy decisions inspires confidence that the central bank can manage inflation without causing or aggravating numerous problems.

Special Risks in 1995-1996

The weakening of the economy in 1995 highlights the problems of giving the Fed too much freedom and too narrow an objective. The economy has deteriorated in 1995; whether the result will be a recession or merely a worrisome near miss, one cannot help questioning the wisdom of the Federal Reserve's doubling of short-term interest rates in 1994 and early this year. Higher interest rates have substantially aggravated the deficit outlook for 1996 and beyond.

Congress and the President are struggling to design a budget that cuts the deficit in 1996 and eliminates it in seven to ten years. Federal interest payments have recently been larger than the Treasury's shortfall. Had the Federal Reserve not raised interest rates in 1994 and early 1995, the saving in fiscal 1996 federal interest payments alone would exceed the \$27.4 billion in cuts called for in the Congressional Budget Resolution of June 26, 1995. After taking into account revenue losses and other

indirect effects of higher interest rates on the deficit, the 1996 deficit could have been considerably smaller without cutting a single program!

It is not the purpose of this paper to discuss fiscal strategy, so let us assume that the country will pursue a balanced budget by 2002. How many student loans, defense purchases, state and local grants, or Medicare benefits are we willing to sacrifice for each 25 basis points of "inflation fighting" by the central bank? Ought not our elected representatives to have a large say in the decision?

Today's fragile international economic environment should make Americans especially wary of Federal Reserve gambles with the economy in a clumsy and perhaps unnecessary pursuit of price stability. The global economy of the middle 1990s is fraught with profound financial and economic problems: Canada, Mexico, Argentina, Japan, most of Western Europe, Eastern Europe, and Russia are all experiencing high unemployment, severe financial crises or economic declines deep enough to threaten social and political instability. Simultaneous tightening of fiscal policies in most of the industrialized world will put the global economy to a difficult test. Should the Federal Reserve, the Bundesbank, and other central banks be allowed to fight inflation with little or no responsibility for all the other consequences of their actions and with no overseeing representative of the people?

The political and economic circumstances of the 1990s ought

to flash a clear warning signal to those who would further liberate central banks from responsibility for their actions. Ironically, political momentum in the United States is moving toward granting the Federal Reserve greater freedom and reducing its accountability as evidenced by growing calls in Congress to amend or abolish the Humphrey-Hawkins Act, which contains a provision that requires the Federal Reserve to work toward a 4% unemployment rate.

Keeping Central Banking In Perspective

Preventing inflation is a legitimate concern for the United States, as anyone living on a fixed income during the 1970s could testify. Inflation redistributes income in an arbitrary and often unfair manner. It hurts retirees and other pensioners. It obfuscates fairness in pay negotiations and adds uncertainty to business decisions. It also distorts tax policy, makes financing and owning a home more speculative and risky, destabilizes currency markets, and generally discourages activity by creating uncertainty about future inflation, interest rates, exchange rates, and asset values.

Nevertheless, American policymakers are gripped by a fear of inflation that is far out of proportion to the dangers. Since the late 1940s, America has experienced serious, noncyclical peacetime inflation only from 1973-1981. Nevertheless, that experience generated a fear of inflation that leads to widespread concern that the nation is embarking on a new period of seriously

accelerating prices every time the pace of price gains experiences a cyclical increase. The record of postwar inflation (figure 7) illustrates that not every wiggle portends a new inflationary or disinflationary trend.

Moreover, there are good reasons to expect prices to remain well behaved in the 1990s. First, labor cost increases have been and are likely to remain small. The United States has regained what it lost in the late 1960s and 1970s, a culture of wage stability, which is reflected in the employment cost index (figure 8). The current business-labor culture stresses price stability and pay related to productivity. Most firms have great difficulty in passing along higher costs to their customers because of keen competition from domestic and often foreign companies, and workers are more aware than they have been in years that their jobs depend on the competitiveness of their employers. Firms have institutionalized cost-reduction goals in every area from purchasing to production to sales, and managers who have gone through the painful experience of shedding employees are loath to become loose with their budgets again. Capacity utilization data, which, according to many economists in the financial sector, the press, and in government, indicated the imminence of inflationary bottlenecks earlier this year in fact seriously understate the production potential of U.S. manufacturers. Moreover, the capacity utilization rate has fallen this year, and idle capacity is vast overseas.

Taking a longer view, America will undoubtedly be challenged

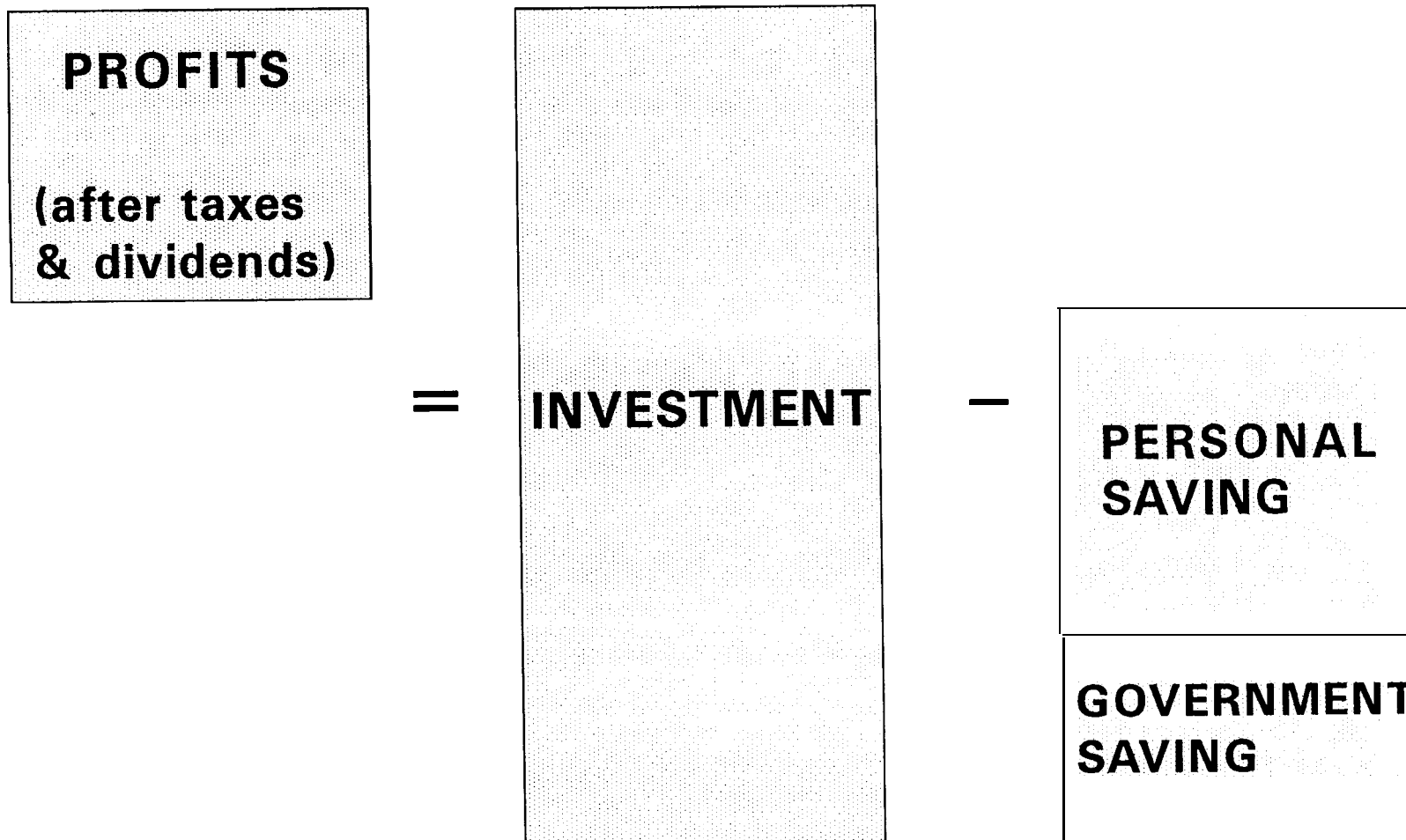
with rising commodity prices and other inflationary shocks, but these will not necessarily lead to prolonged increases in inflation. Nor will viciously tight money necessarily be the key to preventing inflation from acquiring momentum.

That chronic monetary drag and restrained growth are necessary to keep inflation under control is often taken for granted. Yet in Japan, the country most noted for growth and low unemployment in the postwar era, inflation has been modest (figure 9). The inflation rate exhibited considerable cyclical movement and miscellaneous fluctuations, but its trend remained subdued. Even the oil shocks of the 1970s did not have long-term effects. And Japan did not rely on high unemployment or extraordinary interest rates to keep inflation in check.

Inflation is not so great or obvious a danger that Americans should be willing to undermine their democracy by giving the Federal Reserve more independence. Nor is it clear that doing so would improve economic performance. On the contrary, the Fed should be held more closely accountable for its actions. Congress should reject the arguments of those who would exclude unemployment from the monetary policy debate. It should also insist on the inclusion of numerous other important issues in the monetary policy debate: the national debt, the nation's international indebtedness, U.S. competitiveness, the standard of living, social stability, the quality of life, and a broader consideration of what constitutes an inflation threat and what alternatives might exist to chronic monetary drag. Finally,

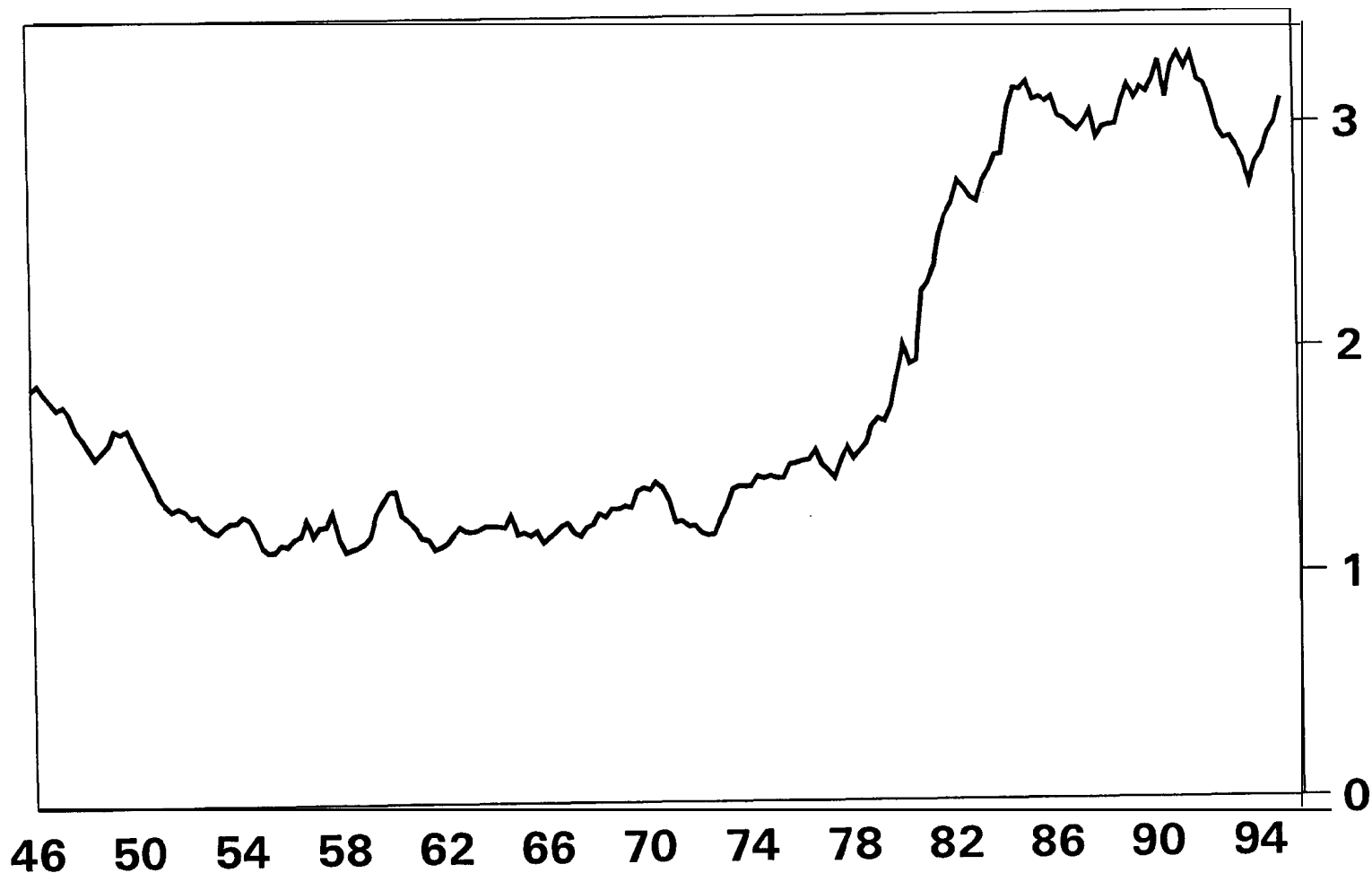
Congress must take the Federal Reserve to task for aggravating problems in all areas affected by monetary policy. More independence for the Federal Reserve is about the last thing the American people need.

Figure 1. Total Business Profits Equation



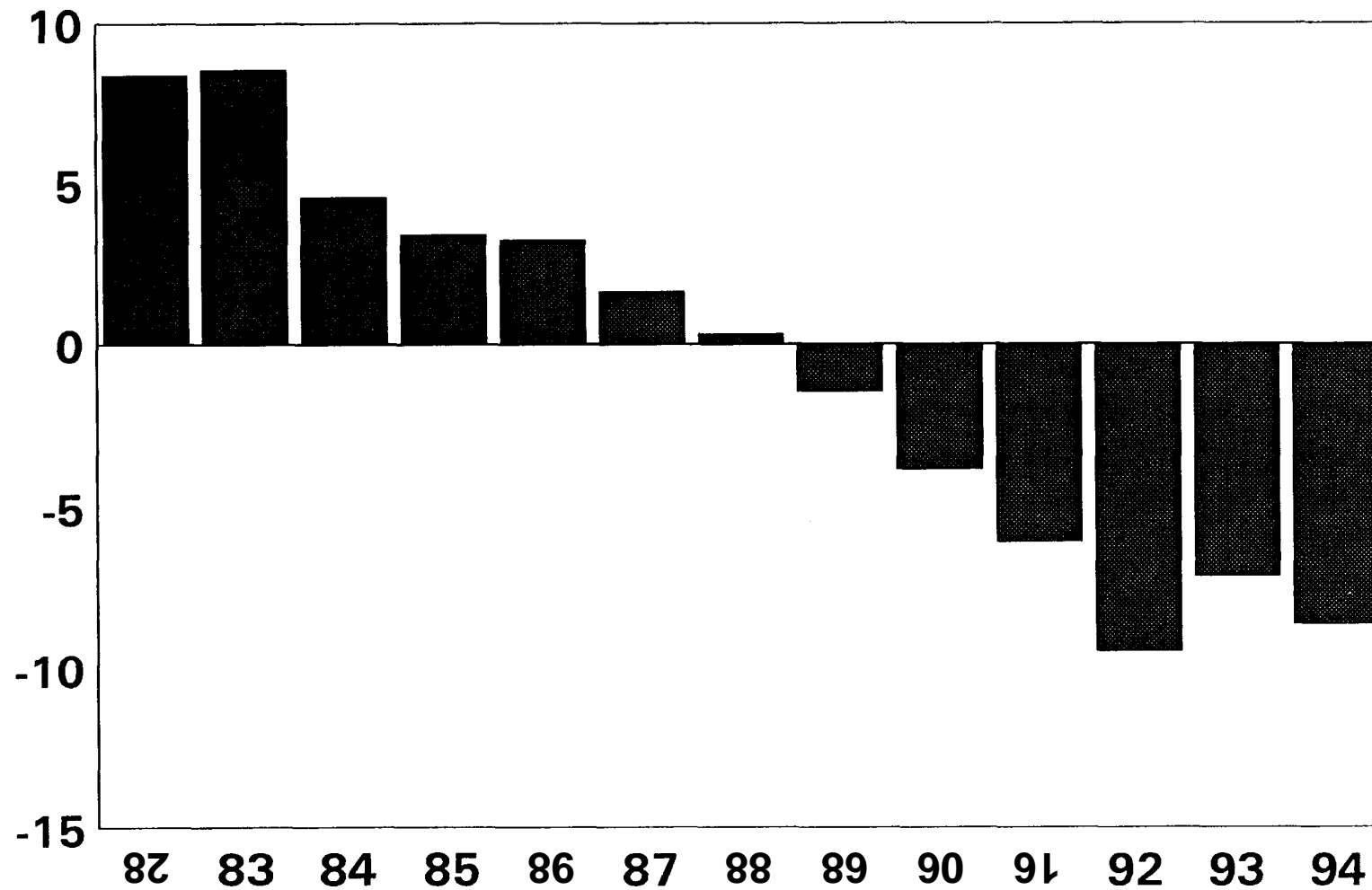
"Investment" includes net foreign investment, which is essentially the current account surplus. Lately, this term has been negative. This accounting is consistent with the National Income & Product Accounts.

Figure 2. Net Federal Interest Payments As a Percentage of GDP



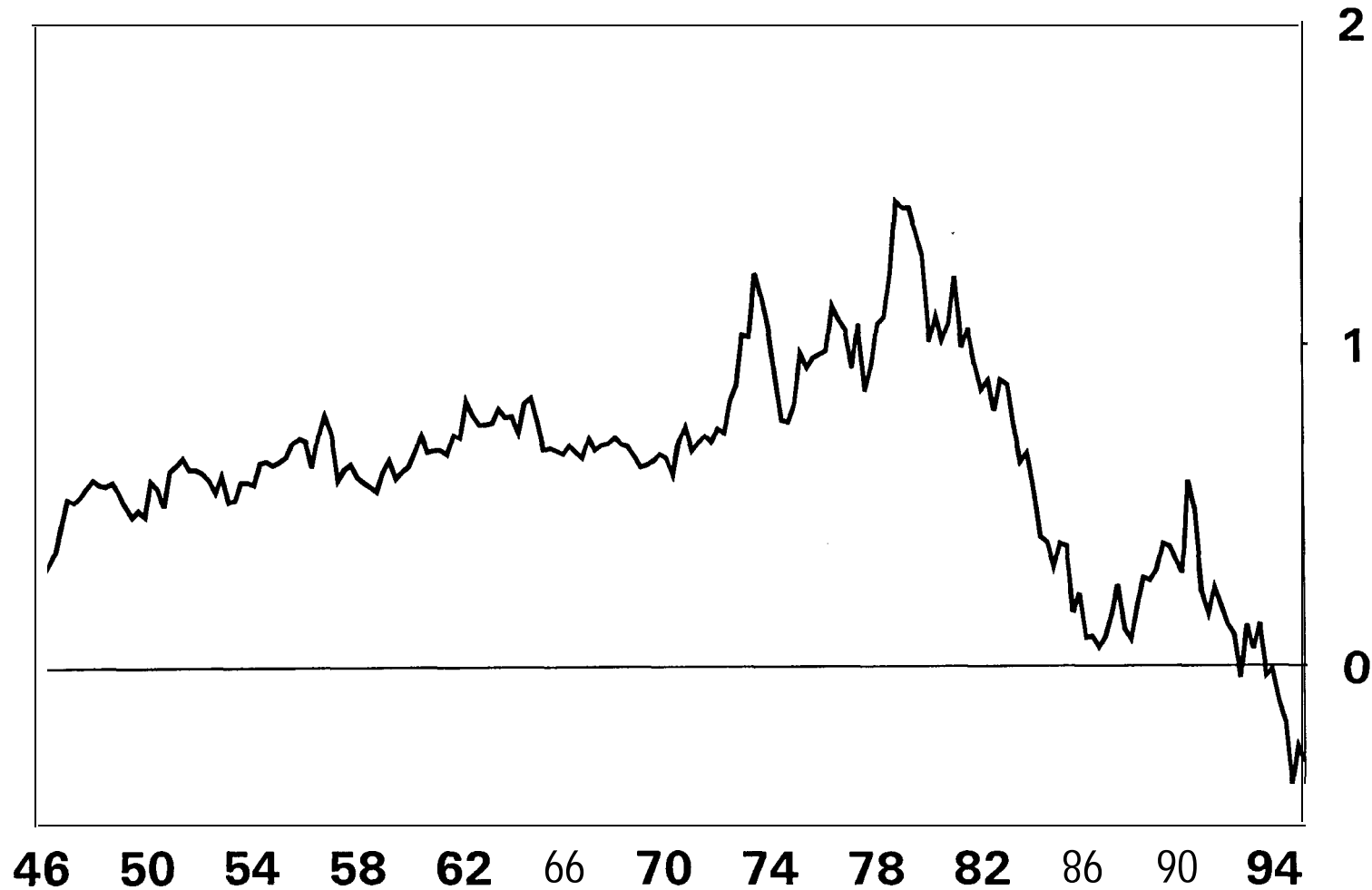
Source: National Income and Product Accounts

**Figure 3. Net Investment Position of the United States
as a Percentage of GDP**



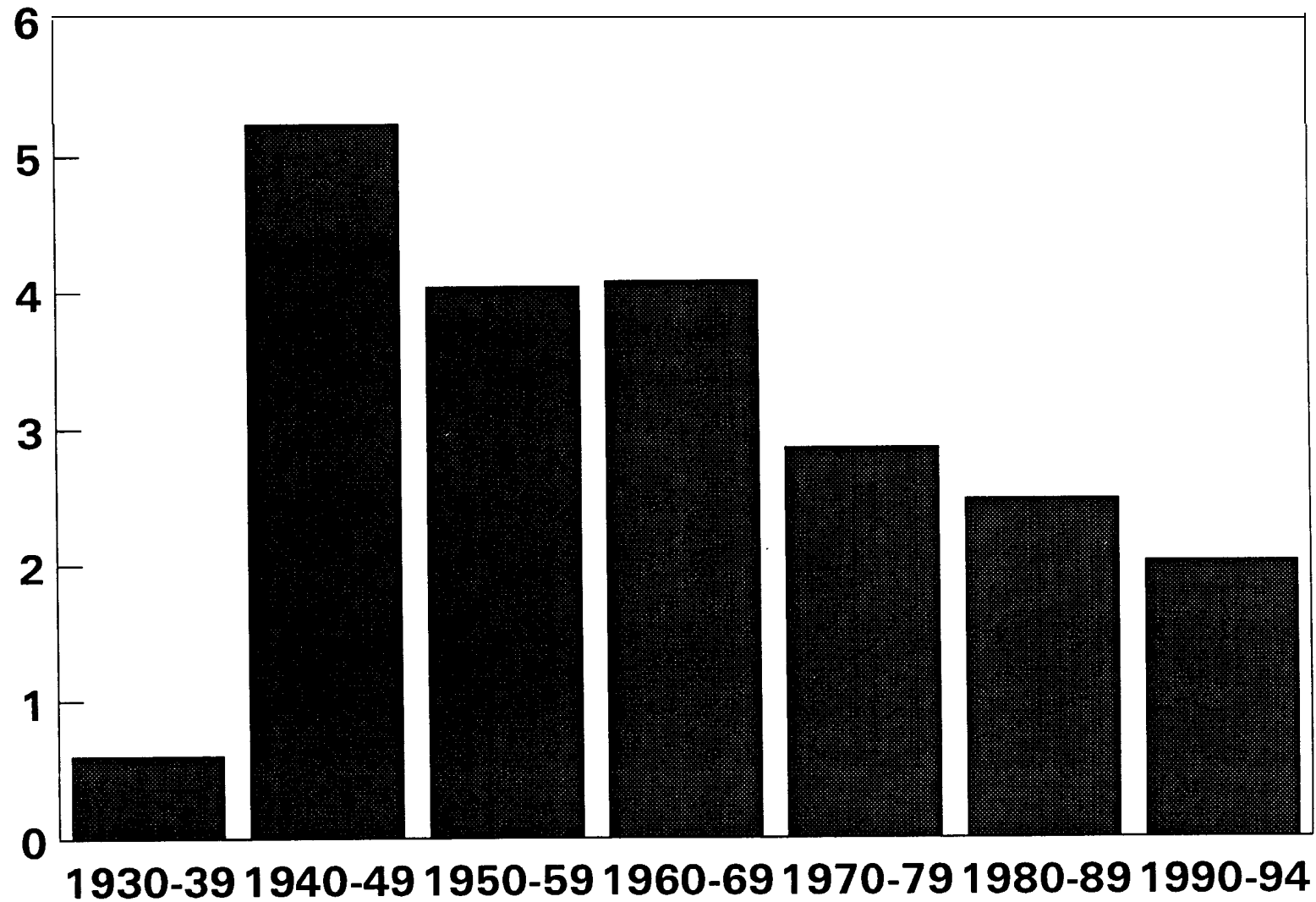
Source: US Department of Commerce, Bureau of Economic Analysis

**Figure 4. Net Factor Income
as a Percentage of GDP**



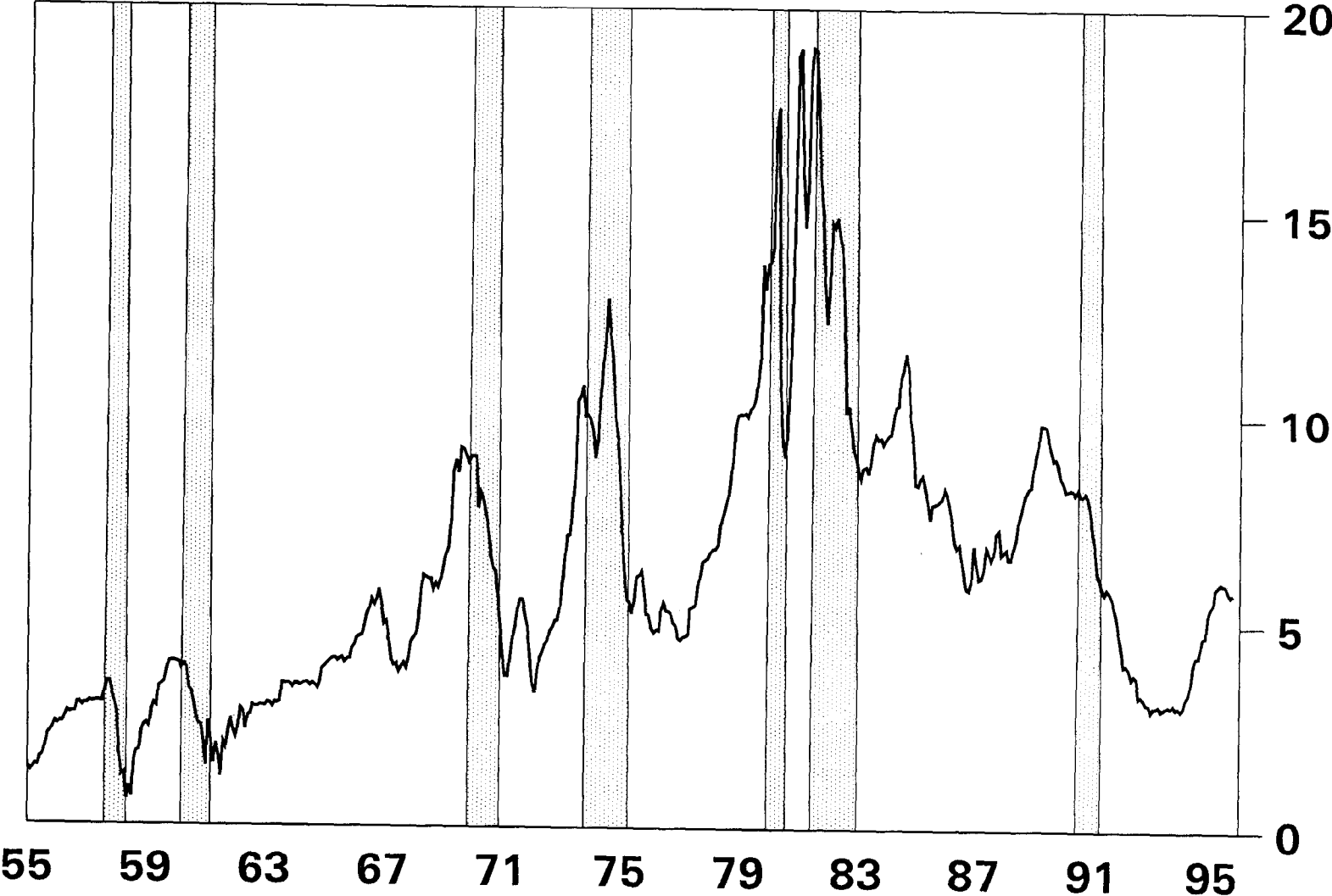
Source: National Income and Product Accounts

Figure 5. Average Annual Growth in Real GDP



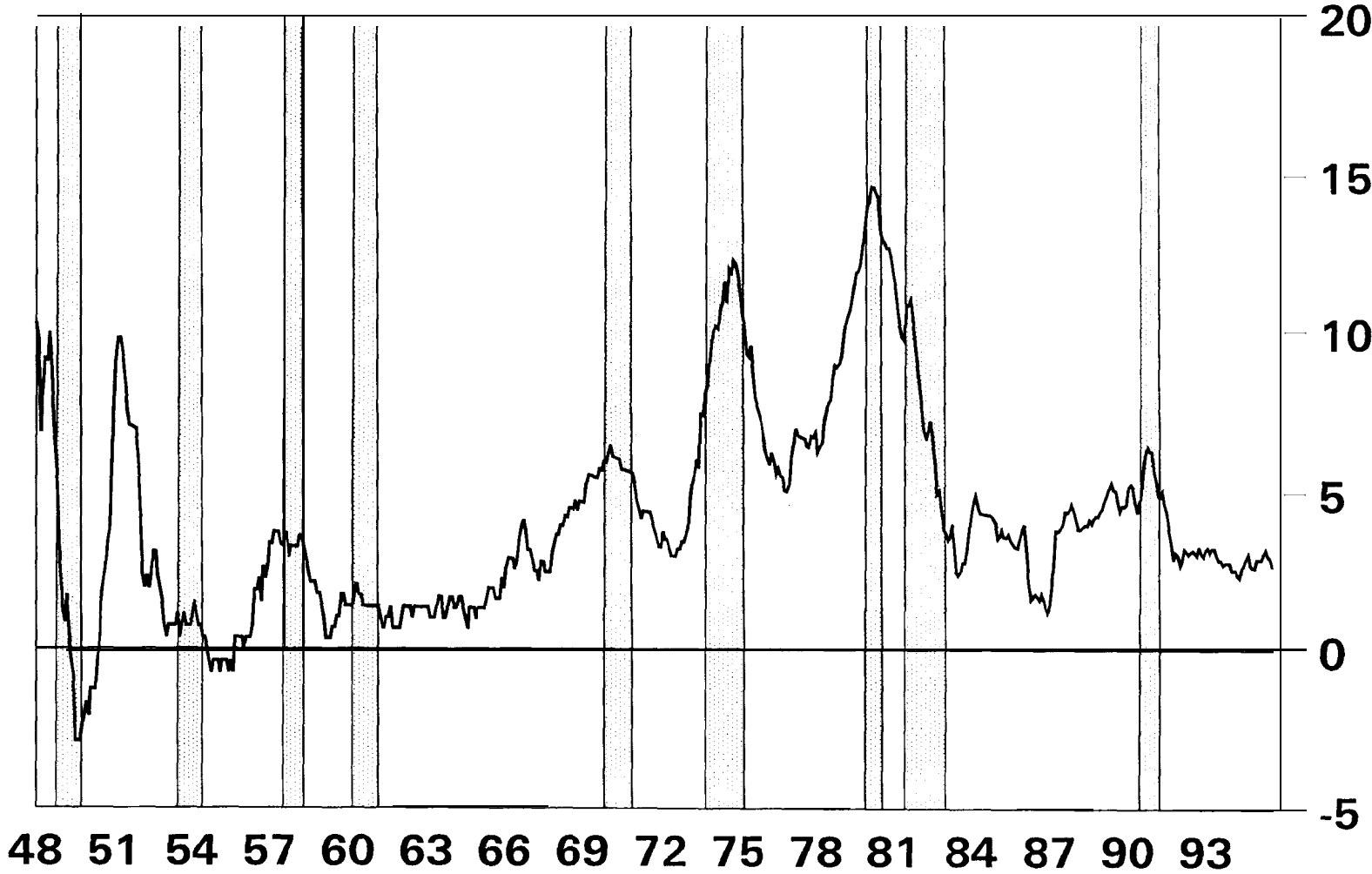
Source: National Income and Product Accounts

Figure 6. Federal Funds Rate



Source: Federal Reserve Board

**Figure 7. Consumer Price Index
12 month percent change**



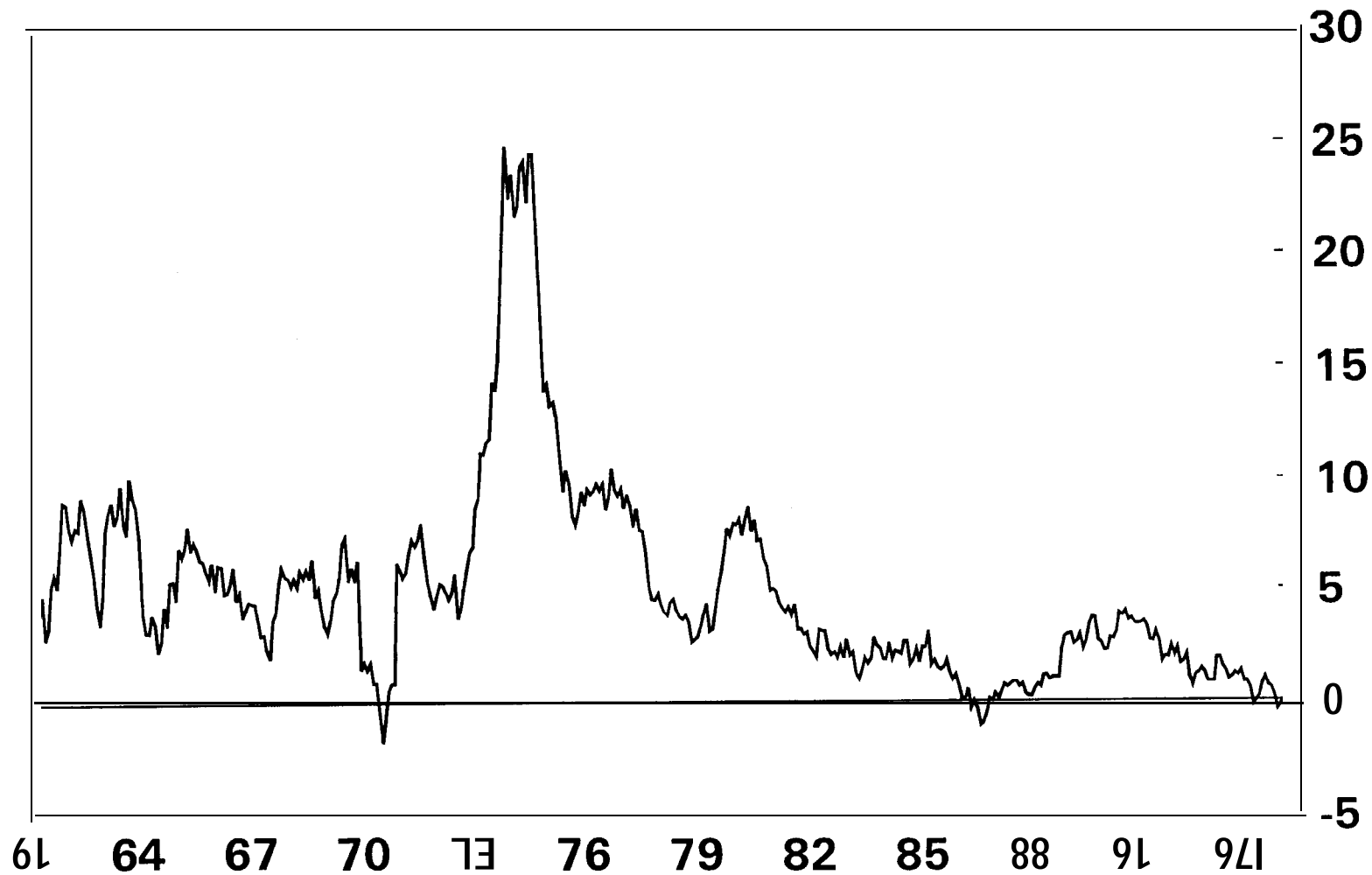
Source: Bureau of Labor Statistics

**Figure 8. Employment Cost Index
4 quarter percent change**



Source: Bureau of Labor Statistics

Figure 9. Japanese Consumer Price Inflation 12 month percent change



Source: OECD