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Low Inflation and Central Bank Independence

The following is adapted from a speech given by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, at the Commencement ceremonies of the Economics Department at the University of California, Berkeley, May 23, 1992.

The last three years marked one of the longest periods of slow growth for the U.S. economy in the postwar era. And the prospects are for modest growth to continue for some time. One bright spot in the economic picture, though, is inflation. In 1991, the core rate of consumer inflation was a little over 4 percent, and it will likely move closer to 3 percent this year, a good improvement over the 5 percent rate in 1990.

It is tempting in such time to be complacent about controlling inflation. But this would be a mistake. The principal long-term goal of the Federal Reserve is achieving low inflation. And in the long run, a core inflation rate in the 3–5 percent range is still unacceptably high for the health of the economy.

Sticking to policies that control inflation is especially important now, not only in the U.S. but also in many of the major economies of the world. Japan and Germany, two of the staunchest inflation-fighting countries, are struggling against pressures to ease in the face of their worst economic weakness in a decade. And the European Community is making history with its plans for monetary union and for a unified central bank —a so-called EuroFed. Under the Maastricht Accord, EC member countries will assign the conduct of their monetary policy to an independent, supranational authority, with price stability as its prime goal.

The strength of their inflation-fighting policies and the structure of the institutions that shape them will have a profound influence on world prosperity in the years to come. This *Letter* provides a brief perspective on the goal of low inflation, and how a central bank's conduct and structure can contribute to achieving that goal.

Why is low inflation desirable?

The main benefit of low inflation is that it reduces economic risk. There is persuasive evidence that the lower the level of inflation, the lower the uncertainty about inflation. Therefore, low inflation leads to better planning and contracting by business and labor. It also reduces the risk premia in long-term interest rates associated with the uncertainty of future inflation, thereby increasing capital formation and productivity. And since unexpected changes in inflation create many arbitrary transfers of wealth and income, low inflation reduces wasteful hedging activity against these transfers. Furthermore, our tax structure and most financial contracts are only partially indexed for inflation, so it creates tax and financial distortions. And complete indexation is a complex task with known problems.

This description of the benefits of low inflation is not just an academic abstraction. We all learned about the flip side of these effects firsthand, as inflation surged during the 1970s. By 1980, the public, the academic world, and the Fed were all convinced of the terrible costs of high inflation and of the need to get it under control.

But there are transition costs to reducing inflation. The major cost is a temporary rise in unemployment. Of course, there *is* no permanent tradeoff between inflation and unemployment. But the tradeoff *is* there in the short run, and it is painful. Ultimately, how painful this transition cost is depends on the public's expectations of future inflation; and the public's expectations of future inflation depend on whether the central bank's anti-inflation policy is perceived to be *credible*.

Credibility and independence

How does a central bank achieve credibility? To borrow a famous phrase: "You do it the

old-fashioned way: You have to *earn* it." For example, suppose the central bank compromises its commitment to low inflation and follows an expansionary policy in order to boost output and cut unemployment, if only in the short run. This might work a time or two. But it will not work over and over. Sooner or later, the public catches on. They figure the central bank is not serious about low inflation policy anymore, so inflation expectations go up, and there is no short-term reduction in unemployment. In fact, it is even possible that unemployment *rises* rather than declines. Clearly, then, the ability of a central bank to deliver low inflation depends critically on the credibility it achieves over time through consistent policy action.

Since the 1970s, the Fed has made some major strides in improving its credibility. Over a decade ago, the Fed announced a goal of bringing inflation down from the double-digit levels of the late 1970s. It stuck with this policy, despite a rise in unemployment from 5.9 percent in 1979 to 9.7 percent in 1982–83, and it succeeded in getting inflation down to the 4–5 percent range by the mid-1980s.

Central bank credibility and the ability to deliver low inflation have been linked to central bank *independence*. That link can be illuminated by examining the Fed's independence. The Federal Reserve System derives its power from, and ultimately is responsible to, Congress. Therefore, it is *not* independent *of* government. Nor should it be otherwise in a democratic society like ours. Rather, the Fed is independent *within* government. The Fed is not obliged to consult the administration on monetary policy decisions. But it does brief administration officials regularly, and the Chairman reports to Congress twice a year on monetary policy and gives testimony many other times. In contrast, low independence is typically associated with countries where the central bank is subservient to the Treasury or Ministry of Finance.

The point of linking independence and credibility is the concern that government could exert "undue influence" over monetary policy. In other words, it could try to compromise long-term economic goals in order to gain short-term political objectives. A central bank that is insulated from such "undue" government pressures —that is, a central bank that is independent—is in a much better position to make a credible commitment to low inflation.

Do independent central banks actually deliver lower inflation?

A fair bit of research has been done on this issue, and several cross-country studies (for example, Bade and Parkin 1987, and Alesina 1988) suggest that independent central banks *do* tend to deliver lower rates of inflation. For example, these studies find that, among industrialized nations, the central banks with the most formal independence are in Germany and Switzerland. And their inflation rates are also among the lowest, averaging about 2.6 percent and 3.4 percent annually in the 1980s. The U.S. ranks next in terms of central bank independence, with an average inflation rate for the period of 4.7 percent. At the opposite end of the spectrum are the central banks of the U.K. and Italy, which have relatively little formal independence and average inflation rates of 6.6 and 9.9 percent, respectively.

But the relationship between *formal* central bank independence and inflation performance is not ironclad. The case of Japan illustrates this clearly. Since 1980, its inflation rate has been even lower than Germany's and Switzerland's—*without* the benefit of much of the formal independence of other central banks. But thanks to its track record in fighting inflation, and to consistent support from the Ministry of Finance, its credibility is strong. So, while credibility *is* essential, the Japanese case illustrates that formal independence is not.

But formal independence certainly can *help*. This idea is being put into practice today, as countries that have been plagued with high inflation rates are enacting legislation to reshape their conduct of monetary policy. For example, New Zealand, Canada, and Chile all have passed laws that mandate an explicit inflation goal or that give their central banks more independence. In Europe, most governments have anchored their currencies, and hence their monetary policies, to the independent Bundesbank. And the Maastricht Accord calls on EC member countries to modify

their legislation to ensure that their own central banks have a greater degree of independence. In fact, Italy recently passed a law transferring the power to change the discount rate from the Treasury to the central bank. Similar proposals are being considered in Argentina and in a number of East European countries.

Conclusion

Achieving low inflation is the most significant contribution that the Federal Reserve can make to attaining the long-run, full-growth potential of the U.S. economy. And the Fed's ability to deliver low inflation, in turn, critically hinges on the credibility of its commitment to a low-inflation policy. A credible central bank is better able to achieve a lower inflation rate without a prolonged economic downturn because the public expects it to follow through with the policy long enough to be successful.

The independence of the Fed within government does help bolster and safeguard its credibility—but it does not guarantee it. Likewise, the movement in many countries toward central bank structures that are more independent does not guarantee the credibility of their commitment to low inflation. Whether the Fed or any other central bank is credible depends ultimately on the results of its policies. It is only by establishing a consistent *record* of successful action that a central bank can demonstrate that it puts enough emphasis on inflation control to be a credible inflation fighter.

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