NEWS

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We need a transparent not independent Bank of England

Should the Bank of England be granted independence? One of the preconditions for entry into European Monetary Union is central bank independence. Whether EMU occurs or not, if Labour wins the election they appear keen to give greater autonomy to the Bank of England.

Following recent proposals to free the Bank of Japan from political control, Britain will soon be the only major economy without an independent central bank.

The Chancellor decides interest rates, after listening to the advice of the Bank of England. As has been evident in recent months, the Chancellor does not need to act on this advice – he can ignore it. One of the strongest arguments in favour of central bank independence is that it prevents politicians from setting interest rates with a view towards only the short term, particularly in the run-up to an election. This view was made in a speech last week by New York Fed president McDonough, who said that if central banks are "to ensure long-term credibility for monetary policy by sustaining low inflation environments... they are better able to meet this challenge if they are substantially immunised from short-term political pressures, and are firmly committed to price stability as the overriding goal of monetary policy". McDonough's comments follow rumours that even the US Federal Reserve, which has handled policy well, may be under political pressure not to raise rates.

Yet one should not assume all politicians are short-termist. The Chancellor's tough approach to fiscal policy in recent years suggests he is not manipulating policy to boost the Tory Party's re-election chances. In current circumstances the Chancellor is right not to raise rates, despite Bank of England concern. The strength of sterling and continued consumer price resistance suggests disinflationary pressures prevail.

Following sterling's devaluation in September 1992, there was a strong case for greater transparency in monetary policy. Greater transparency is fine when all sides agree. When there are disagreements it can create uncertainty, but as long as this allows discussion to focus on the facts, and not the individuals involved, it should help the debate.

Even though the Bank has been too pessimistic about immediate inflation prospects, its medium-term projections have been credible and it is right to highlight the inflation risks. Research shows central banks cannot gain broad popular and political support for changes in interest rates until there are signs of actual, rather than expected, increases in inflation. From a central bank's perspective this means policy changes may occur too late, and thus it is better to smooth interest rates by adjusting them at a slow and deliberate pace towards some desirable level.

Judging from the press coverage, one might imagine there is a problem in UK monetary policy. If there is, it is not because of the policy set-up but the inflation target, which makes no allowance for the state of the economic cycle and is thus too tough. As the target has not been met for over two years this may justify the Bank of England's position, but it creates the wrong impression, that inflation is high.

I think we should stick with the present policy set-up. There are three main arguments against greater independence.

First, an independent central bank does not guarantee consistency between monetary and fiscal policy. For economic policy to be effective, both monetary and fiscal policy should be working towards achieving the same goal. Of course, an independent central bank can act as a brake on a profligate government whose fiscal policy is too loose but, in such an environment of tight money and loose fiscal policy, the result is usually an appreciation and overshooting of the currency.

Second, independence can result in monetary overkill, especially if a central bank is aiming to prove its anti-inflationary credibility. The way round this problem is to give the central bank twin objectives, reflecting the possible trade-off in policy. The US Federal Reserve not only has to achieve price stability, but also has to conduct policy to maintain employment conditions. The key issue is to try and ensure the central bank carries out its policies in a responsible fashion.

This is linked into the third issue, that of making central bankers accountable for their actions. Although this may impose a constraint on how a central bank conducts its policy, it should be seen as desirable. Greater accountability should go hand in hand with independence, but it does not always work like this. As we have seen in the UK, the monetary mechanism since Black Wednesday has resulted in increased accountability and transparency in monetary policy, but this has been as a substitute for independence. The Bundesbank is one of the least accountable central banks, but in view of its credibility there is no desire to change this. And this is set to be the blueprint for the European Central Bank.

Often the key lies with the individuals involved. US Fed Chairman Alan Greenspan has handled monetary policy well. The so-called Rogoff model argues that monetary policy should be set by an authority which is more anti-inflationary than society as a whole, namely a central bank. But there is a potential problem. For the best outcome the degree of central bank conservatism must not be too high, otherwise policy will be too tight and the cost of bringing inflation down will be too great. Thus, if the Bank of England is to be granted independence, we should follow the US Federal Open Market Committee example, with a broad-based policy committee deciding policy.

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ECONOMICS WEEK

Bank of England independence may soon become a fiercely debated topic. **Gerard Lyons** examines the issues