Central Banking in a Democracy

Alan S. Blinder

On September 26, 1996, Alan S. Blinder presented the following speech at the Federal Reserve Bank of Richmond. The text of the speech is printed below after J. Alfred Broaddus's introduction of the speaker.

It is a pleasure to welcome all of you this afternoon for this latest program in our series of occasional lectures by distinguished economists on major economic policy issues. Largely for convenience, we hold these programs here at the Richmond Fed, and we are delighted to host them. But let me remind you that they are jointly planned and funded with the three university business schools here in Richmond. I'd like to introduce my colleagues in this endeavor: Dr. Al Altimus, Dean of the Lewis School of Business at Virginia Union University; Dr. Randolph New, Dean of the Robins School of Business at the University of Richmond; and Dr. Howard Tuckman, Dean of the School of Business at Virginia Commonwealth University. It's been a great pleasure working with these folks over the years and I think it's been a very productive collaboration. I would also like to recognize my colleague, Marvin Goodfriend, who is Senior Vice President and Director of Research here at the bank. Marvin is my principal adviser and has played a leading role in planning and putting on these programs in recent years.

It's a particular personal pleasure and an honor to introduce our speaker. Alan Blinder, to put it bluntly but accurately, is one of the most distinguished macroeconomists in the world today. He has done about everything any economist and even a leading economist would do. He earned a Ph.D. from a leading economics department, MIT. He has taught and is teaching at a top university, Princeton, which also happens to be his undergraduate alma mater. He has published numerous scholarly articles in professional journals, a leading

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economics textbook, and a number of other books, including a little gem on major economic policy issues called *Hard Heads, Soft Hearts.* Finally, he has served as an economic policymaker at the highest level. Early in his career, in the mid-'70s, he was briefly Deputy Assistant Director of the Congressional Budget Office when it was just getting started. More recently, of course, he was a member of the President's Council of Economic Advisers in the first year and a half of the Clinton Administration. In that capacity, he was a leading economic policy adviser to the Administration. Subsequently he was our colleague at the Fed, serving as Vice Chairman of the Board of Governors of the Federal Reserve System from June 1994 until he departed early this year to return to Princeton, where he is the Gordon S. Rentschler Memorial Professor of Economics. Some of you who have been attending these lectures regularly will remember that we had Alice Rivlin here not too long ago. She has now become the Vice Chairman of the Board of Governors. We wanted to give an equal opportunity to *former* Vice Chairmen of the Federal Reserve Board.

It's not an idle compliment when I say that as a veteran Fed employee, I greatly enjoyed Alan's all-too-brief tenure at the Fed. Let me share with you a little Fed secret. It's not about interest rates, but about the Federal Open Market Committee, which as you know is the main policymaking body in the Fed. It's a strong and I believe effective committee, but it is not always a terribly lively committee. It was, however, a much livelier committee when Alan was part of it. He challenged us—and also helped us—to confront issues objectively with careful and solid economic analysis. He helped take the edge off the debates that we had in the committee during his tenure with keen and well-timed humor. And he raised the level of discussion in the committee during his tenure. I miss his input very much. It's good to have him back in Richmond. He was here about a year-and-a-half ago and gave a great lecture to the Virginia Bond Club. Please join me in welcoming back Dr. Alan Blinder.

Al, thank you very much for that fine introduction. I want to talk this afternoon about the role of the Federal Reserve in society in very broad terms and, along the way, to make a few rather more specific points. Then I will be glad to entertain questions about what interest rates will do next week, a subject about which I know nothing! But neither does anyone else, so we are all on an equal footing on the subject.

WHO DOES THE FED SERVE?

Relative to their economic and therefore social importance, central banks must be among the least well understood institutions in the entire world. For example, I have been told that millions of Americans still think that the Federal Reserve

System is a system of government-owned forests and wildlife preserves where, presumably, bulls and bears and hawks and doves frolic together in blissful harmony. Having spent 19 months there, I can assure you that that is not the case. The Federal Reserve is an institution that touches almost everyone in America, plus many people outside America, but is itself touched or even seen by relatively few. But its traces are everywhere. Every time you pay or receive paper currency, you are using a “Federal Reserve Note”—a debt obligation of the Fed. Unbeknownst to most of you, your checks are also probably cleared through a regional Federal Reserve Bank; and, if you bank here in Richmond, through this regional Federal Reserve Bank.

When you read in a newspaper ad that a certain bank will pay you 5.7 percent on a certificate of deposit or you hear on television that an automobile company this week is offering 4.9 percent financing, you are seeing tangible evidence of the Fed’s regulatory hand at work. Very few people have any idea that it is the Fed that tells banks and auto finance companies how to calculate and advertise those numbers. And even fewer know that the Fed doesn’t always get it right!

The interest rates themselves, while set in free markets, are heavily influenced by the Fed’s monetary policy. Most Americans these days know that, but few can tell you how that black magic is performed. Even fewer people understand how the Fed’s interest rate decisions impact on the overall economy and therefore influence how many people will find jobs, how many will be laid off, how many businesses will succeed, how many will fail. Most economists will attest to the fact that the Fed has far more influence over these matters than the President and Congress.

The Federal Reserve System has a governance structure that is at least odd and perhaps even byzantine. While most countries in the world have one central bank, we have 12—the one here in Richmond and 11 others. These regional Federal Reserve Banks are, in a legal sense, private corporations. They have presidents, in this case Al Broaddus, and boards of directors. They even have shareholders. And while these corporations are extremely profitable—to the tune of over $20 billion a year for the 12 of them together—their shareholders do not reap the benefits. Instead, the Fed’s prodigious profits are turned over to the United States Treasury—a very friendly gesture. Atop this organization of 12 putatively private corporations, there sits a seven-member Board of Governors in Washington, whose members are not elected by any of the stockholders, but rather are politically appointed. A very, very curious organizational structure.

So the question arises: Who does the Fed serve? Congress and the President? Most certainly not. Although the Fed is a creature of Congress, and its governors are all presidential appointees, the Fed does not exist to do their bidding. After all, that would make a mockery of the doctrine of central bank independence.

What about the banks? Well to some extent, the answer must be yes. The Fed is a bank for banks. It sells to these banks a variety of services, many of them in direct competition with private suppliers. The Fed is also deeply concerned with the health of the banking and payments system and will, when necessary, take strong steps to safeguard it. However, the Federal Reserve is also the supervisor of thousands of banks, either directly or indirectly, through their bank holding companies. (The Fed supervises all the bank holding companies.) It is a very odd arrangement when you think about it: The Fed is regulating its own customers. There are a lot of businesses in America that would like to regulate their own customers, but very few get to do that. In my view, it is a great mistake for the Federal Reserve to see itself as a service organization for the benefit of banks, however. It is a mistake that people in the Federal Reserve System make occasionally, but fortunately not very often.

Does the Fed serve the financial markets? As the nation's central bank, the Fed is naturally and certainly the ultimate guardian and protector of the entire financial system. In times of acute market distress, the Fed stands ready to play its classic role as lender of last resort. In more normal times, the Fed worries about such things as the integrity of the markets, financial fragility, speculative bubbles, the value of a dollar, and a host of other things. As I used to say when I was Vice Chairman of the Fed, we get paid, though not very much, to worry about *everything*.

But, in my view, none of these choices—not the President, not the Congress, not banks, not the financial markets—adequately describes the Fed's true constituency. In my view, that constituency can only be the entire nation. While I was on the Federal Reserve Board, I often said that I viewed myself as working for 260 million Americans. Given the central bank's broad reach and pervasive influence, no narrower constituency seemed appropriate. So I want to talk this afternoon about what the Federal Reserve does and should do to serve the national interest.

I think it would surprise most of you to learn that a time-and-motion study of the daily lives of Federal Reserve Governors would reveal that most of their efforts are devoted to bank regulatory issues, broadly defined. Most of this business is routine, extremely familiar, and intensely interesting to the banking industry, and totally unknown, deeply obscure, and generally quite boring to everybody else in society. This is the Federal Reserve that nobody knows. So as not to bore you with these matters, I will skip directly to the Federal Reserve that everybody knows, for nowhere is the Federal Reserve's public service role more visible than in the conduct of monetary policy. It is monetary policy that puts the Fed in the news constantly, and occasionally puts it in the middle of a political maelstrom.

If you don't live your life in the financial world, it is almost impossible to imagine how tightly focused the media and the markets are on the Federal Reserve. Fixated is not too strong a word. "Federal Reserve fetish" has not yet come into current use as a term of art, but I think it describes a lot of the behavior of the financial press and people in the financial markets. To the financial press, a Federal Reserve Governor is more engaging than a movie star. (Think about that one for a while!) When I was Vice Chairman of the Federal Reserve Board, I simply came to expect to find 15, 20, or 25 reporters, plus several TV cameras, waiting any time I made a public appearance—no matter how boring my speech was going to be. (This, as you've noticed, doesn't happen to me anymore.)

Things were not always this way. The story is told that the only way President Kennedy could remember the difference between *monetary* policy and *fiscal* policy was that the letter "M" for monetary was also the first letter of the name of the Fed Chairman at that time, William McChesney Martin. Times have sure changed. I can assure you that President Clinton had no such problem, and neither did President Bush.

THE GOALS OF MONETARY POLICY

Just how is the Fed supposed to serve the national interest with this strange instrument called monetary policy? Under the terms of the Federal Reserve Act, as amended, Congress has directed the Fed to promote "maximum employment, stable prices, and moderate long-term interest rates." That sounds like three goals, but the phrase is often called the Fed's "dual mandate" because the interest rate objective is considered redundant. Price stability will almost certainly bring low long-term interest rates in its wake.

At this point, I need your indulgence for a very brief Economics 101 lecture on how monetary policy affects employment and inflation. It all works roughly as follows.

In the short run, employment is largely determined by total spending in the economy. Interest rates are one, though not the only, important determinant of that spending. So the Federal Reserve, via its effect on market rates of interest, exerts considerable indirect influence over employment and unemployment. But the process takes time. As economists put it, monetary policy works with long lags. While the lagged effects of monetary policy on unemployment are distributed through time—a little now, a little more the next quarter, and so on—it won't hurt you to think of them as taking about a year or two.

Changes in inflation, up or down, are largely determined by the balance between total spending, which is heavily influenced by monetary policy, and the economy's capacity to produce, which is not. If spending falls short of the economy's productive capacity, as happens in a recession, inflation will fall. If spending overshoots capacity, as sometimes happens in a boom, inflation will rise. But the lag from monetary policy decisions to inflation is even longer than the lag from monetary policy to employment because monetary policy first has to affect spending, and then spending must affect inflation. Think of the whole process—from a decision of the Federal Reserve on monetary policy to the reaction of inflation—as taking more than two years.

The central dilemma of monetary policy is this: Unless inflation is below the Federal Reserve's long-run target, which hasn't been true in a very long time, there is a short-run trade-off between the two goals—maximum employment and stable prices—that are set forth in the Federal Reserve Act. To push inflation lower, the Fed must make interest rates high enough to hold total spending below the economy's capacity to produce. But if it does that, the Federal Reserve will be reducing employment, contrary to the dictum to pursue "maximum employment." So monetary policy is forced to strike a delicate balance between the two goals. It is an excruciatingly difficult decision, with a great deal at stake. As a former holder of my former office once quipped, "That's why they pay them the big bucks!"

THE TRADE-OFF AND JACKSON HOLE

Early in my term as Vice Chairman of the Fed, I allegedly stirred up a controversy at a Federal Reserve conference in Jackson Hole, Wyoming, by acknowledging this trade-off explicitly. The context is important to an understanding of what happened, because the subject of that conference was *reducing unemployment*. Being a central banker at the time, I thought it was appropriate for me to address the role of central banks in that task. In my brief remarks, I noted that monetary policy actions have a profound effect on employment. I also suggested that a central bank could do its part to achieve low unemployment by pushing the nation's total spending up to the level of capacity, but not further. I observed that the Fed's dual mandate could reasonably be interpreted in precisely that way. So I endorsed that mandate as eminently reasonable instructions for the Congress to have given the Fed, rejecting the alternative of concentrating exclusively on price stability and ignoring unemployment.

Nothing I said at Jackson Hole that day was really controversial, and certainly nothing was original. My conceptualizations of monetary policy's role and of the trade-off between inflation and unemployment were totally conventional. My endorsement of the Fed's dual mandate meant that the Vice Chairman of the Federal Reserve was publicly endorsing the Federal Reserve Act. Now there's news for you! Furthermore, my implied "advice" to central bankers was fully consistent with the practices of central banks all over the world, regardless of what they preach. Indeed, I think a very fair academic critique of my little talk that day would have labeled it banal. Had a student in a course submitted that talk to me as a paper I think I would have said, "There is not an original idea here. You have to be able to do better than this."

About a dozen financial journalists were in the audience that day, and all but one of them heard it that way. But Keith Bradsher of *The New York Times* decided that he had just heard "a big story." I had, he was led to believe by some anonymous whispers, violated the sacred trust of central bankers by saying a few obvious things out loud. He told readers of *The Times* that I had publicly clashed with the Fed Chairman. That's funny; Alan Greenspan was sitting right there as I spoke, and he didn't hear it that way at all. I know, because the two of us had breakfast together the next morning, and he never indicated that I had said anything unusual—which I hadn't. No matter. On a slow news day in August Bradsher's story from Jackson Hole wound up on page one of *The New York Times*.

Media firestorms have a life of their own and, until you have been the subject of one, it is hard to imagine what they are like. For more than a month, a seemingly unending barrage of stories appeared in newspapers, magazines, over the financial wires, and even on TV and radio. I was made "controversial," which is one of the ways they try to stick the knife in you in Washington. The Fed, the public was told, had an outspoken new Vice Chairman who had broken several central banking taboos and publicly tangled with his Chairman. The hysteria reached a crescendo with truly a malicious attack published in both *Newsweek* and *The Washington Post* by Robert Samuelson, who decided—without ever bothering to call me up even once to talk about my views—that I was unfit both morally and intellectually to lead the Fed. One would be okay, but *both* morally and intellectually? Whoever said that serving in the government isn't fun?

I recount this episode not to dredge up the ghosts of irresponsible journalists' pasts, but for three reasons that are closely related to today's topic. The first is to give you a little window into what can happen when a Federal Reserve Governor publicly endorses the view that the Federal Reserve should be serving the national interest rather than just the parochial interests of the bond market. But I must insist that serving the national interest is the *only* correct way to conceptualize the Fed's mission; to me, the issue is not open to either compromise or debate.

The second reason is to tell you that I remain totally unrepentant and never retreated one inch from the position that I enunciated that day—not in public, and not inside the Federal Reserve. What I said that day was true then, and it is true now. There is abundant evidence that Keynes was right back in the '30s when he said that modern industrial economies are not sufficiently self-regulating. They need a little help. Total spending sometimes roars ahead of productive capacity, which leads to accelerating inflation. And total spending sometimes lags behind productive capacity, leading to unemployment.

In principle, either fiscal policy—the government's taxing and spending policy—or monetary policy could serve as the balance wheel, propping up demand when it would otherwise sag and restraining it when it threatens to race ahead too rapidly. In practice, however, monetary policy is the only game in town nowadays. And when I say "in town," I don't mean just in Richmond or just in the United States—I mean all over the industrial world. The reason is the same here and in Europe: The need to reduce large fiscal deficits dictates that budget policy remain a drag on total spending for the foreseeable future, regardless of the state of the macroeconomy. With the fiscal arm of stabilization policy thereby paralyzed, a central bank that decides to concentrate exclusively on price stability is, in effect, throwing in the towel on unemployment.

So, to me, the argument for the Fed's dual mandate is both straightforward and convincing. The central bank exists to serve society. The public cares deeply about fluctuations in the pace of economic activity. And well-executed monetary policy has the power to mitigate fluctuations in employment. As the mathematicians say, "QED." Fortunately, almost all central bankers accept this argument nowadays, notwithstanding a great deal of misleading rhetoric to the contrary.

That leads me straight to the third reason for telling you the Jackson Hole story. As a citizen of a democracy, I have always found it intolerable for the government to deceive the governed. As a public servant, I also found it unconscionable. And I see no reason whatsoever why the central bank should have a special exemption from the requirement to level with the public.

CREDIBILITY

It is sometimes argued, to the contrary, that honest acknowledgment of the trade-off between unemployment and inflation, and of the central bank's concern with each, would rattle the financial markets—which want to believe that the central bank cares only about low inflation. This argument is nonsense. Both market participants and the financial press know the score and are far too sophisticated to be taken in by ritualistic rhetoric. I remember very well a conversation I had with a very smart financial reporter shortly after I left the Fed. He said that he has learned over the years to ignore what the Fed *says* and watch what it *does*. I had to concede that he was right, but it troubled me a great deal that the two would be so different. In my view, they should be a matched pair.

There is much talk at the Federal Reserve, as in the central banks all over the world, about the importance of *credibility*, which, according to the dictionary in my office, is "the ability to have one's statements accepted as factual or one's professed motives accepted as the true ones." Let me read the last phrase again: "one's professed motives accepted as the true ones." Precisely the point! Why is credibility considered so important?

The main reason, in my view, is that a central bank is a repository of enormous power over the economy. And if the central bank is independent, as the Federal Reserve is, this power is virtually unchecked. Such power is a public trust, assigned to the bank by the body politic through its elected representatives. In return, the citizens and their elected representatives have a right to expect—indeed to demand—that the bank's actions match its words. And matching deeds to words is, to me and to my dictionary, the hallmark of credibility.

CENTRAL BANK INDEPENDENCE

The Fed's role as the macroeconomic balance wheel is terribly important because it palpably effects people's lives. Stabilization policy is not something abstract; it is about how many jobs there will be, how many businesses will succeed. In my view, it is far and away the most important thing a central bank does for or to its society. And I felt that responsibility keenly every day that I served as Vice Chairman of the Fed, as I know Al Broaddus still does in his role as a member of the Federal Open Market Committee. Society, therefore, has a strong interest in seeing to it that the central bank does its job well. Evidence collected in recent years suggests that making the central bank more independent should help.

Before elaborating on this point, however, I need to define what I mean by an independent central bank—because there is no agreed-upon definition. To me, the term connotes two things.

The first is that the central bank is free to decide *how* to pursue its goals. This freedom does not mean that the Bank gets to select the goals on its own. On the contrary, in a democracy it seems not just appropriate, but virtually obligatory, that the political authorities should set the goals and then instruct—and I use that verb advisedly—the central bank to pursue them. If it is to be independent, the bank must have a great deal of discretion over how to use its instruments in pursuit of its assigned objectives. But it does not have to have the authority to set the goals by itself. Indeed, I would argue that giving the bank such authority would be an excessive grant of power to a bunch of unelected technocrats. In a democracy, the elected representatives of the people should make decisions like that. The central bank should then serve the public will.

The second critical aspect of independence, in my view, is that the central bank's decisions cannot be countermanded by any other branch of government, except under extreme circumstances. In our system of government, neither the President nor the Supreme Court can reverse a decision of the Federal Open Market Committee. Congress can, in principle, reverse such a decision, but only if it passes a law that the President will sign (or by overriding a presidential veto). This makes the Fed's decisions, for all practical purposes, immune from reversal; and, indeed, they never have been reversed. Without that immunity, the Fed would not really be independent, for its decisions would stand only as long as they did not displease someone more powerful.

In recent years, considerable empirical evidence has accumulated in support of the idea that macroeconomic performance is superior in countries that have more independent central banks. Researchers here and in other countries have developed several creative ways to measure central bank independence. Such measures include the bank's legal status, the rate of turnover of its leaders, the legal mandate in the bank's charter (for example, whether it is directed to pursue price stability), and answers to a questionnaire about its organizational structure. The clear weight of this evidence, and by now there is a lot of it, is that countries with more independent central banks have enjoyed lower average inflation without suffering lower average growth. This finding is, of course, completely consistent with economists' general view that, while there is a short-run trade-off between inflation and unemployment, there is no long-run trade-off.

These research results on the benefits of central bank independence raise a provocative question: Why is it that central banks possessing greater independence produce superior macroeconomic results on average? I want to suggest three reasons, all closely related.

First, as I emphasized in my brief Economics 101 lecture a couple of minutes ago, the effects of monetary policy come with long lags. So, to conduct monetary policy well, you must look far in the future and then wait patiently for the results. Farsightedness and patience, I dare say, are not the strong suits of the political process in a democracy. But they are absolutely essential to pursuing a successful monetary policy.

Second, and related to the time-horizon question, inflation-fighting has the characteristic cost-benefit profile of a long-term investment: You pay the costs of disinflation up front, and you reap the benefits—lower inflation—only gradually through time. So, if politicians were to make monetary policy on a day-to-day basis, they would be sorely tempted to reach for short-term gains at the expense of the future—that is, to inflate too much. Aware of this temptation, many governments wisely depoliticize monetary policy by delegating authority to unelected technocrats with long terms of office, thick insulation from the hurly-burly of politics, and explicit instructions to fight inflation.

Third, and related to this point about technocracy, the conduct of monetary policy is at least somewhat technical. It is a bit like shooting a rocket to the moon, though not nearly as exact. Very few elected officials in this or other countries have much understanding of how the monetary transmission mechanism works, of the long lags that I have mentioned, or of a variety of other technical details about monetary policy. So countries can probably get higher-quality monetary policy by turning the task over to trained technicians, subject, of course—and this is important in my view—to political oversight.

CENTRAL BANK INDEPENDENCE AND DEMOCRACY

At this point, a very deep philosophical question arises: Isn't all this profoundly undemocratic? Doesn't assigning so much power to unelected technocrats contradict some fundamental tenets of democratic theory? It is a legitimate question. My answer is: If you assign this power well, it needn't be antidemocratic. And I want to conclude this lecture with a detailed defense of that answer. The question is: How can an independent central bank be rationalized within the context of democratic government? My recipe comes in six parts.

First, we all know that, even in democracies, certain decisions are reserved to what is sometimes called the "constitutional stage" of government, rather than left to the daily legislative struggle. These are basic decisions that we do not want to revisit often; they should, therefore, be hard to reverse. So, for example, amending the U.S. Constitution requires much more than majority votes of both houses of Congress. The Founding Fathers thereby made it almost, but not quite, impossible to change certain basic provisions of law. And they meant it that way; it wasn't an accident.

Similarly with monetary policy. The Fed's independence, which derives from authority delegated by Congress, makes it very difficult, but not quite impossible, for elected officials to overrule or influence a monetary policy decision. Wise politicians made a once-and-for-all decision years ago to limit their own power in this way just as, for example, the Constitution made it very difficult to change the length of the President's term of office. The reasoning was precisely the same as that which led Ulysses to tie himself to the mast. He knew he would get better long-run results even though he wouldn't feel so good about it in the short run!

The second ingredient that helps make central bank independence consistent with democratic theory is something I emphasized earlier: The bank's basic goals are chosen by elected politicians, not by unelected technocrats. So, for example, when people suggest to me that the Fed should content itself with 3 percent inflation, I always answer, "the Federal Reserve Act, which is the law of the land, says 'stable prices,' not 'pretty low inflation.' " If the citizens think that is wrong, they should get the law changed. Until they do, the Federal Reserve should obey the law.

Third, the public has a right to demand honesty from its central bankers. This, again, is a point I made earlier in discussing the idea of credibility, which I defined as matching deeds to words. The central bank, in my view, owes this to the body politic in return for the broad grant of power it enjoys.

The fourth ingredient is closely related to this last point. I call it *accountability*, or perhaps just *openness*. Monetary policy actions have profound effects on the lives of ordinary people. In my view, a central bank in a democracy therefore owes these folks an explanation of what it is doing, why it is doing it, and what it expects to accomplish by its actions. As I often said while I was at the Fed, "It's their economy, not ours." By offering a reasonably full and coherent explanation of its actions, the central bank can remove much of the mystery that now surrounds monetary policy, enable interested parties to appraise its decisions contemporaneously, and then—importantly—allow outsiders to judge its success or failure after the fact, for the verdict of history is the only one that ultimately matters.

Let me assure you that greater openness is not a popular cause in central banking circles, where some see mystery as essential to effective monetary policymaking. Making the central bank more open and accountable, it is alleged, may subject it to unwelcome scrutiny that could threaten its independence.

I couldn't disagree with this argument more. In fact, I think it gets matters exactly backward. To me, public accountability is a moral corollary of central bank independence. In a democratic society, the central bank's freedom to act implies an obligation to explain itself to the public. Thus independence and accountability are symbiotic, not conflicting. Accountability legitimizes independence within a democratic political structure.

Nor, by the way, do I accept the claim, heard so much in central banking circles, that more accountability will harm the central bank—as long as the bank is independent. If the central bank makes good decisions, it should have no trouble explaining them to the public. If the Fed cannot articulate a coherent defense of its actions, maybe those decisions are not as good as it thinks. Indeed, being forced to articulate such a defense would probably be a good disciplinary device. Remember—and this is critical—I am talking here only about explaining the decisions after they are made, not putting them to a vote!

The Federal Reserve, tight-lipped as it is, is far from the worst offender in this regard. In fact, the Fed is probably more open and accountable than most central banks in the world. But the competition in this league is not very stiff—I think the New York Jets could win the championship in this particular league—and I believe the Federal Reserve could and should go much further. After all, we live in the most open society on the face of the earth, so just to say that we've beaten the world average is no great achievement for Americans.

The fifth ingredient in my democratic stew is that the leaders of the central bank should be politically appointed by the President, as is the current practice. When I went to the Federal Reserve Board in June 1994 as the first appointee of President Clinton, I joined Alan Greenspan, Mike Kelley, and John LaWare, who were originally sent there by President Reagan, and Larry Lindsey and Susan Phillips, who were appointed by President Bush. None of us was ever elected to anything. But Bill Clinton and George Bush and Ronald Reagan were. We obtained our political legitimacy from the men who appointed us, and they in turn got it the old-fashioned way—directly from the voters. That is as it should be.

Finally, the sixth ingredient—which I would argue should be present, but very rarely used: Central bank decisions should be reversible by the political authorities, but only under extreme circumstances. Reversal should not be routine occurrences. As I've mentioned already, a Federal Reserve decision on monetary policy can, in principle, be overturned by an act of Congress. And

Fed governors can be removed from office for good cause. These mechanisms have never been used in the history of the Federal Reserve; but America is wise to have them in place nonetheless. Delegated authority should be retrievable, not absolute.

A SUMMING UP

So, in summary, let us review how the Fed, or any other central bank for that matter, can best serve its nation with monetary policy.

To begin with, the central bank must always remember that it exists as a public institution chartered to serve the broad national interest, not the parochial interests of either the banking industry or the bond market. Often those interests coincide. But when they clash, the central bank should not hesitate before taking sides.

The highest calling of the central bank is to help stabilize the national economy. For if the bank should fail at this task, no one else will be around to pick up the pieces. In its role as macroeconomic steward, the Fed, I believe, should pursue two goals—both low unemployment and low inflation—not just one. That is what the people want and, in my view, the people have got it right.

A central bank can perform its monetary policy role better if it's independent from political manipulation, and that's probably why more and more governments around the world are granting their central banks independence these days.

Even though the Fed's independence looks superficially undemocratic, I believe it is consistent with democratic theory for several reasons: it is based on authority delegated by Congress; the basic goals of monetary policy are set legislatively; the leaders of the Fed are appointed by the President; and Congress retains ultimate control in case of dire emergency. But a central bank in a democracy has a duty to level with the public it serves, not to obfuscate. I used to ask some of my colleagues on the Federal Reserve staff in Washington what they would have thought if their father, every time he spanked them, had only said that he was doing it "to promote sustainable non-inflationary growth"—and nothing more. I don't believe that would have been considered good parenting, and I don't think it's good central banking. More fulsome explanation is appropriate.

A great Virginian, probably the greatest Virginian, once wrote, "Governments are instituted among men" (I'm sorry it was only men in those days) "deriving their just powers from the consent of the governed." It is very hard for the governed to give their consent if they don't have a clue about what is going on. Openness, accountability, and credibility are therefore, in my view, moral corollaries of central bank independence.

Furthermore, and finally, I dispute the notion that is so popular in some circles that monetary policy is best done amidst mystery, blue smoke, and mumbo jumbo. Central banks work their will through financial markets, and economists rarely argue that markets function better when they are less well informed. In my view, some small portion of the prodigious uncertainties over the effects of monetary policy exists because the markets have a hard time divining the Fed's intentions. This particular source of uncertainty can, and in my opinion should, be removed by greater openness. But that, I'm afraid, is a story for another lecture and another day.