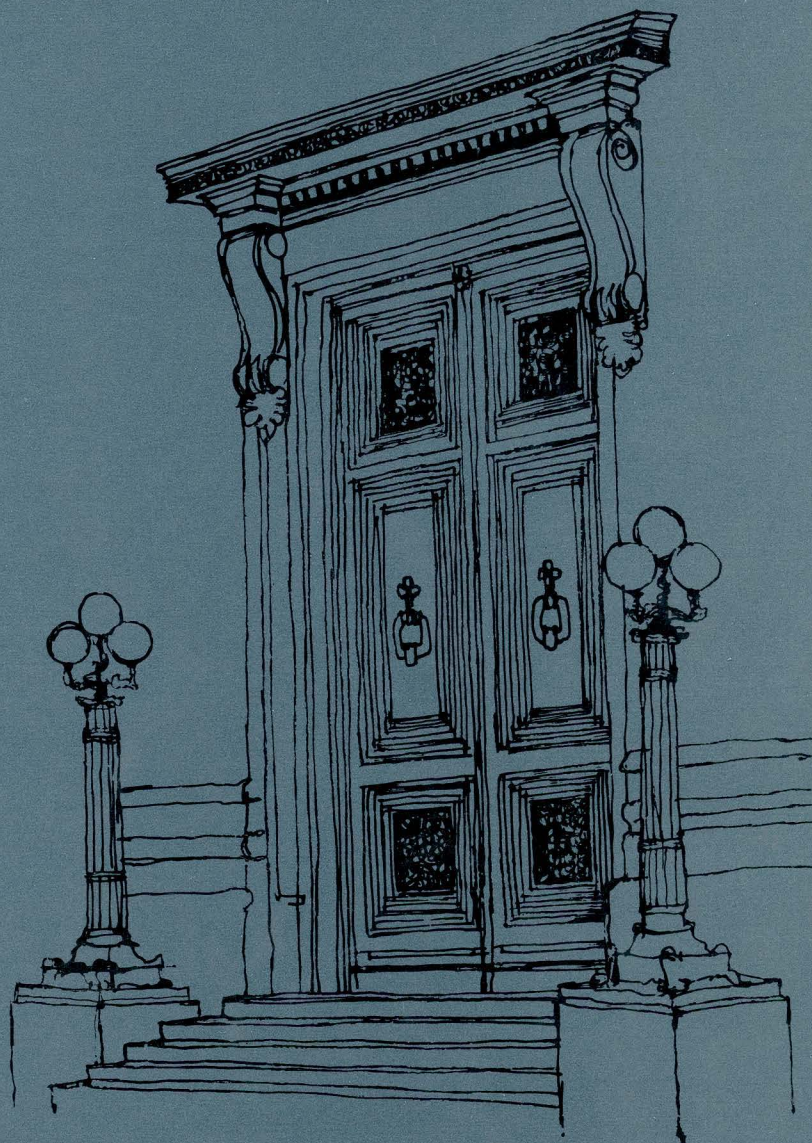


MONETARY STUDIES XI

SEMINAR "EXPERIENCES
ON CENTRAL BANKS AUTONOMY"



DIRECCION
DE ESTUDIOS



BANCO CENTRAL DE CHILE
1989

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INAUGURAL SPEECH

PRONOUNCED BY MR. ENRIQUE SEGUEL M., FORMER
PRESIDENT OF THE CENTRAL BANK OF CHILE, ON
MARCH 31, 1989.

Chile, as of 1974, has been subjected to deep transformations that enable us now to show the world a nation that walks assuredly towards development.

These transformations have been based upon fundamental principles no longer questionable, such as the openness of the economy, the subsidiary role of the State, next to the private sector driver of development, all of it within the framework of responsible public financial management, granting the first priority to social expenditure intended to aid the poorest sectors, thus intending to create effective equal opportunity for all Chileans.

The above mentioned transformations could not have brought about the efficient assignment of the resources our economy presently exhibits, had the conditions for the full development of the diverse markets not been created, and eliminated abominable and ineffective distortions such as price controls or tariffs, as well as exchange and tax discriminations that have accompanied Chile's economic experience for several decades.

In synthesis, we can say that our model has a legitimate right to be called a social market economy.

This sustained advance towards development has not been free of difficulties. We have had to face two international crisis (1975, 1982-83) that have partially obstructed our road. There is no doubt, however, that had it not been for a basically healthy economic structure originating in the deep transformations carried out, we would not have overcome the reverses experienced by the world's economy in such a wholesome way.

One of the main transformations became a fact with the Political Constitution of the Republic of Chile, approved in 1980, that established the existence of an

autonomous institution, the Central Bank of Chile, while proceeding to forbid the financing of the public sector by the Central Bank. The above established the fundamental bases to project into the future a higher level of economic stability than the country has experienced in the past.

The same Constitution of 1980 established that the structure, the organization, the functions and the attributions of the Central Bank would be defined by an Organic Law of constitutional character that will be drawn to that effect.

As you are aware, the Honorable Government Junta is presently studying the respective draft.

This Seminar, however, does not intend to submit the draft to debate, its purpose is to become acquainted with the experience of countries whose central banks act autonomously in their monetary and exchange decision-making process.

For this reason, the Central Bank of Chile, co-sponsored by the Faculty of Economy and Administration of Universidad Católica, Universidad de Chile, Universidad de Santiago, Universidad Adolfo Ibáñez, have planned this event and have invited prominent individuals from the International Monetary Fund and from the Central Bank of Germany, the United States and Switzerland to share their experience and their point of view concerning autonomous Central Banks.

I believe the quality of our guests and the high technical and professional reputation of the institutions they represent, will increase our understanding and enrich the discussion of the legal draft for the Central Bank of Chile. The initiative to make an autonomous entity of the Central Bank has been based upon our own history and economic reality, taking also into account the experience of central banks in developed nations. This is a valuable opportunity to increase our knowledge in this latter aspect.

This Seminar is inserted in the objective the Government has had from the beginning concerned with making this project widely known considering this draft as a fundamental part in the process of institutional modernization intended to reduce the risk of serious economic imbalances, thus guaranteeing adequate growth for the benefit of all Chileans.

On behalf of the Central Bank of Chile and the Universities co-sponsoring this event, I cordially welcome Doctors RICHARD ERB, LEONHARD GLESKE, GERALD CORRIGAN and GEORG RICH.

**CENTRAL BANK AUTONOMY:
THE INTERNATIONAL MONETARY FUND'S APPROACH**

EXPOSITOR: Mr. RICHARD D. ERB (*)

(*) Joint Managing Director of the International Monetary Fund.

CENTRAL BANK AUTONOMY: THE INTERNATIONAL MONETARY FUND'S APPROACH

I am pleased to participate today in this seminar on central banking experiences, although I do so with some trepidation since I am the only member of the panel who is not a certified central banker, but I will try to address this subject from my perspective at the International Monetary Fund. As many of you know, throughout its history, and indeed it's a relatively brief history, the IMF has provided a framework within which its members cooperate to pursue certain economic objectives. Now, these objectives, which are specifically stated in the IMF articles of agreement of our constitution, a constitution which all of our members have joined, include the objectives of sustained growth in output, employment and rates, price and exchange rates stability, and open and unrestricted exchange markets. Now, in pursuing these objectives, members of the IMF have agreed to mutual surveillance of each others' economic policies. Now, in the context of this surveillance activities, the IMF staff conducts annual economic consultations with each member. The staff then prepares a report on the economic developments in each member's country and then that report is discussed in the executive board. This allows member countries an opportunity to comment and critique, and try to influence each others' policies, mainly through persuasion and peer pressure. I suppose, in what is its most public and visible function, and one that certainly is well known in this country and many others, the IMF also provides temporary financing to members undertaking broad macroeconomic policy adjustments, to correct payments imbalances and to achieve, again, the objectives that I have described earlier, sustained growth, price stability, stable exchange rates. In this context, the Fund is also a collaborative institution. Yes, a great deal depends on the work of the staff in discussions with member countries in negotiating economic programs, but those economic programs are reviewed and discussed in the executive board and the financing that is provided to members, in effect, comes from other members who are in a strong balance of payments position. These are members where the resources are provided often from central banks and through Central Bank reserves. Now, each of these functions brings the International Monetary Fund in close contact with central banks, but also in close contact with other economic agencies in each of the member

governments. This, of course, reflects the fact that a number of government policies have an impact on a member's economic prospects, on price developments, exchange rates and balance of payments prospects. I mention this because when assessing the experience of central banks in individual countries, it is important to take account of the broader institutional and policy framework of each country and also important to take into account other features of a country, other factors, such as the size, structure, and general resource base of the country. Thus, as I reflect on the diverse membership of the IMF, and with one exception, and I'll come back to that exception shortly, I find that it is not easy to make general statements about the experience of central banks and what makes a Central Bank successful and it is not easy to generalize on the lessons that one can learn from looking at the experience across a set of countries and over time.

What I would like to do today in my comments is focus primarily on the role that central banks have in the conduct of monetary policy and, to the extent that time permits, I will say something about the role of central banks in safeguarding and promoting the financial system through regulation, supervision and as a lender of last resort. Turning now to the general monetary policy function of central banks, I may begin first by saying that, through the instruments of monetary policy, central banks have a significant impact on a broad range of macro-economic developments, and these include, of course, again, growth, inflation, interest rates, exchange rates and the balance of payments. But this brings me to the one categorical conclusion that I would make about the experiences of central banks, and that is the conclusion that central banks have the primary responsibility for influencing the course of inflation over time. Through its influence on the course of inflation over time, monetary policy, of course, will indirectly be a dominant force in affecting the nominal levels of interest rates and exchange rates over time. With respect to growth, the promotion of relative price stability, again, the primary objective that I would assign to a Central Bank, and in turn, the impact that price stability has on promoting interest rate and exchange rate stability, it is through this mechanism that central banks provide the most effective means of promoting economic growth over time.

Now, I know it is easy to say that one must look at economic policies, and particularly monetary policies over time, but, even within the context of the very short run decision-making that monetary authorities must make on a day to day basis, and recognizing that decisions by monetary authorities can have significant shorter term effects on economic developments in a country, that the monetary authorities must continue to maintain their focus on the implications of their day to day actions on price stability and inflation prospects over time.

Now, this, of course, again as I indicated, does not preclude the impact of, and does not deny the effect that monetary policy has on economic growth in the short run, and, of course, one of the dilemmas that a Central Bank faces frequently is the dilemma between a policy action that would establish a better basis for longer term price stability and thus, longer term growth prospects, and the effects of those policy actions in the short run on economic growth. We, of course, we know those, that when inflation is rising, efforts to tighten credit creation has an upward effect on interest rates, and this, in turn, may have a negative effect on economic growth. But if it is to fulfill its primary responsibility, a Central Bank must be able to look beyond and look through these short run effects, which may be negative, of economic or monetary policy decisions. Now, I would put a qualification on this because I think that, if a Central Bank

established credibility over time in its ability to control inflation over time, a Central Bank, then, has more ability to have a positive impact on developments in the shorter term. Or to put that a different way, the more credibility a Central Bank has in pursuing its primary objective of price stability, the less likely will be the negative consequences of actions taken in the short run on developments such as economic growth, employment and interest rates.

Turning now to the question of instruments and methods of managing monetary policy. Now, this, of course, has been subject of extensive studies by scholars over time, it is always day to day the discussion of economic journalists in the press. It was once put by Paul Volcker that the actual decisions, on a day to day basis, of a Central Bank are quite simple. Now, I may have a laugh here from some of my colleagues on the panel, but he said that essentially each day, as he would walk into the office, he would have, in effect, two decisions to make: buy or sell, in effect, create liquidity or reduce liquidity. Now that sounds simple, but in reality, the judgments that go into making that decision on a day to day basis are, of course, very difficult, and these judgments will vary from country to country, again depending on the institutional characteristics, the size and structure of an economy, it will depend on the size and structure of the financial markets and money markets in an economy, it will depend on the competitiveness of the banking institutions, the main institutions through which the central banks have an influence on the economy. We know, of course, the debates about the relative role of the monetary aggregate targeting, interest rate targeting, exchange rate targeting, but I think in the reality it comes down to important judgemental decisions made by the monetary authorities again, always keeping in mind the primary objective of promoting price stability.

Monetary policy implementation is not easy also because institutions change over time and also because the external position of a country may change over time and indeed, the degree to which a Central Bank can influence monetary developments in a country will depend very importantly, of course, on the openness of the economy and the mobility of capital. Now, in some countries, whether the Central Bank is autonomous or not, the targeting of the exchange rate may be the most effective way that the monetary authority can achieve its longer term objective of pursuing price stability. The key question there is what is the monetary policy of the Central Bank or central banks that are on the other side of the exchange rate with which the Central Bank may be targeting. Again, the degree of independence that a Central Bank may have in targeting exchange rates or, in the short run, targeting domestic economic variables, will depend importantly on the openness of the economy and the mobility of the economy. So, quite independent of the institutional structure of the Central Bank itself, the institutional and economic structure of the economy has a central impact on the degree of autonomy of economic and monetary policy decision-making made within the Central Bank. Of course, central banks, whether they be autonomous or not, will find their ability to influence monetary policy affected by other developments in the economy and, to be sure, a lesson that we draw as we look across many countries, fiscal policy plays a central role in the ability of monetary authorities to conduct their policies and to pursue the essential objectives of monetary policy. Fiscal authorities can have an influence in two ways on the ability of monetary authorities to pursue their essential objectives, one is through variations on the fiscal deficit and we see many countries where an increase in the fiscal deficit will put great pressure on the monetary authorities to finance that deficit through the impact of the deficit on money markets, on

exchange markets; decisions by the fiscal authorities on expenditures and the structure of taxes will also have a secondary effect on the level of private sector savings again, which would have an impact on the general economic environment within which monetary policy decisions are made. So we have to pay very close attention within the International Monetary Fund, as we look at the performance of monetary policies on the performance of fiscal policy. Beyond fiscal policy, the ability of central banks to pursue their objectives in a steady way depends also on the extent to which an economy is vulnerable to external shocks. To the extent that an economy depends on one or two basic commodities, in the very short run period, sometimes the very short run period may last for two or three years, the ability of the monetary authority to maintain monetary conditions, to maintain a growth in liquidity and credit creation that is conducive to longer term price stability, will often be severely tested. Another aspect of economies that have a significant effect on monetary policy management is, of course, the situation of domestic financial institutions. As we have seen across many countries, including those countries that have an autonomous monetary or an autonomous Central Bank, that monetary policy-making becomes much more complex in countries that are faced with widespread risk and insolvency among financial institutions. Often the existence of such risk, the existence of such problems will necessitate in the shorter term, special liquidity support by the Central Bank of these institutions. In some countries, where a Central Bank, either directly or indirectly, has become involved in guaranteeing exchange contracts, again, sudden developments in the exchange markets can have a dramatic impact in the degree of freedom of the Central Bank authorities to, in fact, manage, on a day to day basis, the liquidity creation and monetary conditions in the country. One conclusion that I would draw in that connection is that it is important to protect a Central Bank's balance sheet from actions which can, over time, weaken the Central Bank balance sheet, either because the institutions that are supported by the Central Bank authorities no longer remain solvent or because they indicated if there are exchange support that these require at some stage large drawings from the Central Bank. So, in this context, it is important for the Central Bank balance sheet to, itself, remain independent of these kind of encumbrances and is important for the Central Bank balance sheet to be open and transparent, so that there are not, in effect, off balance sheet financing commitments that are made by central banks in many developing countries, indeed, in many industrial countries. We have seen problems created because of commitments of that kind by central banks. This leads to the general subject, beyond the issue of monetary policy management, of the role of the Central Bank in safeguarding and promoting stability within the international financial system. Now this is, in effect a separate subject, and a rather complicated subject in itself. I think there are two dimensions here that are important. First, it is important to limit the implicit or explicit guarantees provided by the Central Bank for the performance of financial institutions in the economy. The second general point that I would make is that, to the extent that there are implicit or explicit guarantees provided by the Central Bank to financial institutions, for example, through protection of depositors, through either explicit deposit insurance or, as we find in many countries, that when a problem arises in the bank, the government, through the Central Bank, assumes the responsibility of protecting the depositors, but when these guarantees do exist, that it is vital for the Central Bank to have a hand in the regulation and supervision of the financial institutions involved. As we have seen in many countries, including in my own country, the United States, when there are financial institutions that are not effectively supervised, that are not effectively regulated, this can lead to very large imbalances, very large financing problems for those institutions and, again, pose particularly difficult

challenges for the management of monetary policy.

Let me now draw some conclusions about the implications of my perception on experiences in different central banks on the institutional structure of central banks. And I will not comment, in that context, on the legal structure of central banks, though I think the legal structure is important and I am sure other members of the panel will be commenting on that issue in relating their own experiences. The autonomy of a Central Bank, the ability of a Central Bank to effectively perform its functions, I think depends on several important factors. Now, one factor I would mention and perhaps my colleagues will be a little reluctant to mention it since they are from central banks, and that is a primary importance in a central banking institution is the professional quality of the staff and of the management. There is no doubt that in most countries, that I have seen, in centrally planned economies, market economies, those with autonomous central banks, those with central banks that are not autonomous, professional quality of the central banking staff is given and must be given a high priority. Secondly, I would indicate the importance of an institution, a central banking institution having an historical memory. Again, this goes to the quality, the permanence of the staffs in the institutions, but it is a memory that must be accumulated that draws on the experience of individual countries over time, and recognizes that, as circumstances change, and, indeed, if fads and thinking in the business community and the academic community about monetary policy, there are new fads, it is important to have a Central Bank with a historical memory to know what has worked in the past and what has not worked in the past. We find that, in working with central banks, it is critical for the central banks to have a solid empirical base. This includes an empirical base of not only of the economic data for the country but also the institutional knowledge of the country. A Central Bank must also have a high degree of independence in its decision making. When there is a dilemma between short and long run considerations, and given the central role of the Central Bank in promoting price stability over time, it will often be necessary for the Central Bank to take a decision that may be difficult in the short run for the general public to accept. But it is the medium term orientation of the Central Bank that is so critical for sustaining the conditions for economic growth and financial stability over the longer term. Another dimension of an effective Central Bank which I would not underestimate is the important role that public support and understanding plays. I believe this means that a Central Bank, in its operations, while being independent must also be open and transparent in its objectives and also in its general methods in pursuing those objectives. This does not mean, of course, that the public should be involved in the day to day decision-making or aware of all the circumstances that affect decisions to buy or sell in anyone period of time. But it is important for a Central Bank, through its public statements, through its publications, through its testimony before political bodies as occurs in many countries, to be open and explicit with respect to the objectives that it is pursuing and the means through which it is pursuing those objectives. I think in that context, Central Bank authorities cannot be shy about their expressing their views on the performance of economic policy-making in other institutions within the government and, thus, the Central Bank must have that independence to be able to critique fiscal policy as needed, critique other policies that may be jeopardizing the economic prospects of a country. Of course this must be done with some sensitivity as we see in many countries but, again, it is part of the process of gaining public recognition of the objectives and methods and approach of the Central Bank as well as a public understanding of how other developments in the economy, including the policies of other institutions in the economy, are influencing the ability of

the monetary authority to conduct its affairs. Without that public understanding, our experience has been that it is very difficult for a government generally to maintain a steady course in economic policy-making. Of course, that is essential when establishing conditions for investment, for savings, all of those things that go to create the basis for longer term economic growth.

If I may conclude with an anecdote, and it relates to Paul Volcker, that occurred at a farewell dinner when Paul Volcker resigned and left the Federal Reserve Board as Chairman of The Federal Reserve Board, there was a dinner held for him in the State Department and this dinner was hosted by the five secretaries of Treasury going back to the Secretary of Treasury in the early nineteen sixties and it was a major affair, and President Reagan spoke. Among many other things, he said that he was very impressed with the career of Paul Volcker. And he outlined that career, the ex President said, well, when Paul Volcker graduated from school he joined the Federal Reserve Bank of New York, from there he went on and joined the staff of the Chase Manhattan Bank, and in that capacity reported to David Rockefeller, he then went on to the Treasury Department and in that capacity at one stage he reported to Secretary Dillon, Secretary Faller, George Schultz, and then he became Chairman of the Federal Reserve Board, and in that capacity, Paul Volcker reported to God.

Questions

Q.: There are not many instances in the world where Central Banks are legally independent from the political power but I have the feeling that in practice they behave increasingly more independent. What is your and the IMF's experience regarding this issue?

A.: I believe that the legal arrangements do have an important impact on the degree to which a Central Bank is autonomous and independent. However, they are not the primary considerations, even in those countries where the central banks have a high degree of legal autonomy. They are, in effect, still subject to political oversight in one fashion or another. I agree with your statement that there has been a trend, independent of legal changes, a trend toward greater independence, greater autonomy on the part of central banks. I think this has been particularly true in those countries that have come to recognize the important role that central banks play in promoting price stability over time and in those countries where it is recognized that sometimes there is a need for central banks to look beyond the immediate circumstances and pursue policies that are conducive to longer term stability and economic growth. Now sometimes these two reinforce each other. I see a tendency in many countries for government to adopt the legal framework that makes more explicit the autonomy and independence of central banks. The seminar being held here today is not unique. In two months time, we will be having a seminar in the People's Republic of China. In that country they, too, are looking at the question of the role of the Central Bank, they are looking at the institutional arrangements that will strengthen the role of the Central Bank. This is true in many other countries, particularly in those countries that have had inflationary experiences in the recent past.

Q.: I would like to know how the autonomy of the Central Bank is coordinated with the economic policies that generally pertain to the executive branch, because the main criticism brought forward concerning the autonomy of the Central Bank is acknowledging the faculties that belong to the Central Bank and how those policies will fit or will be coordinated with those that belong to the executive branch?

A.: First let me say, I think it is important for policies to be consistent within a country, that is, that fiscal and monetary policies in particular, be consistent with each other. The way in which coordination takes place does vary as I see the experience across a wide range of countries. Sometimes the coordination can be quite explicit through the direct participation in Central Bank decision-making of, say, the Finance Minister, for example. In some cases there is a sharper separation between the two. Where there is such a sharp separation, then I think coordination must take place through indirect means and this is why I had said earlier that I believe that it is important for monetary authorities to open and explicit in their policy-making and for there to be a general recognition by the public that fiscal policies and monetary policies must complement each other and there must be a recognition by the public that when there are times when fiscal

policy may not be able to respond quickly enough to changing circumstances, that it is then the Central Bank that must carry, in fact, the weight, of promoting the conditions for financial and general economic stability. So the coordination that takes place is one I think more of a general explicit understanding within a country itself, that it is very difficult to have a stable monetary policy if fiscal policy is not being disciplined and, viceversa, that in a country where fiscal policy may be disciplined, that it is not possible to achieve stability if monetary policy is not following a prudent course. I believe that the independence of the decision-making units is important but communication, sometimes explicit collaboration and coordination, can be part of the process of bringing policies in line with each other so that they consistently support, on a medium term framework, the objectives of growth and price stability and exchange rate stability.

Q.: You mentioned that among the main aspects to consider in the autonomy of the Central Bank you would include the professional quality of its staff. Do you think that the staff that forms part of a Central Bank should be genuinely professional or should it be a staff subject to the changes of governments in time? What is your opinion on this?

A.: I think in every country that is important for the professional staff to remain a professional staff. This is true in the International Monetary Fund. We attach a great deal of importance to having a staff that makes a commitment to a career in the institution and brings the skills and other qualities the integrity that is necessary for a member of the staff of a Central Bank. Now, for the decision-making officials of a Central Bank, of course, as we see, there are different structures in different central banks on how decisions are actually made, it is the decision-makers who, in effect, bring a sense of the general economic, social and political realities to their own decision-making. I think many governments that have not been able to achieve stable economic conditions and stable financial conditions have developed a decision-making process in the central bank that insulates it from shorter term pressures, but yet, it is the decision-making process that itself does remain sensitive to, again, the general developments in the economy and the general concerns in the economy. I think that is a challenge in structuring a Central Bank Board that makes the policy decisions, to have a Board that is able to have that sensitivity and, yet, at the same time, be able to keep the eye on the central task of the Central Bank and pursue that task with, though, some flexibility and delicateness in its day to day operations.

Q.: Concerning the responsibility of the Central Bank authorities that you referred to in the anecdote about Paul Volcker reporting to God, will there be an intermediate instance or an institutional mechanism to report to other instances or other authorities?

A.: Now, when President Reagan said that at Paul Volcker's farewell dinner, he did so with great respect for the ability of Paul Volcker to bring to the leadership of the Federal Reserve Board the ability to understand the central role of the Central Bank and to pursue that role with a high degree of professionalism, at the same time that Paul Volker was able to communicate and work with the rest of the

public and often in the United States this would mean testifying before the U.S. Congress. Sometimes it meant indeed criticizing the economic policies of the Administration, but I think a test of a good Central Bank governor doing the job of a Central Bank governor is to do that in a way that gets across to the public, again, the basic objectives and approach that the Central Bank is taking in dealing with economic policy and I think that is, Paul Volcker is not alone among central bankers who have had to at times stand up and be taking and advocating courses that may not, at the moment, be popular but yet gain the acceptance of those policies. And that requires an astuteness, as I said before to the question earlier, a political sensitivity and astuteness that is important for a Central Bank to have and at the time to be perceived by the public as acting in the general interest of the public and this depends on how the Central Bank articulates its goals and methods.

Q.: You pointed out, Mr. Erb, that it was necessary for fiscal and monetary policies to be consistent and coordinated. My question is then the following: To what extent may that necessary coordination be interfered with by a legal statement prohibiting a Central Bank to finance, to some degree, the fiscal deficit?

A.: Those legal provisions affecting the direct financing of the deficit are important in protecting a Central Bank at critical moments in its decision making but, at the same time, markets are integrated and whether the financing of the government is directly financed by the Central Bank or through direct financing from the Central Bank, or whether the fiscal authorities are borrowing in the markets, one way or another, that borrowing is going to influence the ability and the difficultness with which the Central Bank is going to conduct its task of establishing again stable financial conditions and conditions that would be conducive to price stability. Thus I think that is why it is important for fiscal authorities to also attach importance to the longer term objectives. I do not think it should be only the Central Bank that has a longer term view of the impact of its economic policies, but I believe that the fiscal authorities must also, in every country, have that longer term perspective. One of the roles of the International Monetary Fund, in this context, as I indicated earlier, we do an economic consultation every year with almost every member, and that economic report is discussed in the executive board, I would say that, on balance, most of the criticism that is expressed in our executive board of member country policies, is criticism aimed at fiscal authorities. Fiscal authorities who are either borrowing too much, given the level of saving in the economy and the external balance of payments position, or they are doing things with the tax structure, expenditure and so on, that are having a negative effect on domestic savings and investment. So we find, as we work with many countries every year, that the real attention must be focused on the performance on the fiscal side to assess whether that is consistent with the longer term conditions, in addition to the shorter term considerations which may be legitimate concern also of the fiscal authorities. This is why, when we have our consultations in countries, often we have more difficulty in our working relationship with the fiscal authorities than we do with the Central Banks.

Q.: When the International Monetary Fund visits member countries, what type of

central banking does it prefer to encounter, with an autonomous Central Bank and all that means in terms of dealing with the political power and including the confrontations that might imply in a given moment, or with a docile and subjected Central Bank absolutely committed to the political power including the coincidence of criteria this situation might bring about?

A.: The way you ask the question itself invites an answer. I would say that, whatever the legal structure, it is important for a Central Bank to be independent and autonomous in its basic decision-making, particularly with respect to its decision-making and the creation of credit and liquidity in an economy. But, having said that, a good Central Bank is also a Central Bank that recognizes the complexity of the relationships that it is dealing with, the economic relationships, and understands also the circumstances and conditions which are affecting the decision-making of the public authorities and other parts of the government. Without that sensitivity, it is easy for a Central Bank, whether it has a legal independence or not, to lose the credibility that a Central Bank must have in conducting its affairs and business over time. So I think the answer is not a yes or no, or one side or the other, but I would put the emphasis on independence and autonomy but, again, the sensitivity and the recognition of the larger economic environment within which, the economic and political environment within which a government must work. In our experience in working with many governments, I think these are the characteristics of the most effective central banks.

Q.: Could you give us some examples of autonomous central banks in developing countries and, if this were the case, I would also ask you to add what kind of faculties do these banks have. I pose this question for the following reason: there is a proposal for an autonomous Central Bank in Chile in which the faculties of the Central Bank, in addition to those concerning monetary policy, include control of the exchange policy, control of the external debt negotiation or renegotiation, control of foreign investment and also supervision of the financial institutions operating inside the country. So, when you refer to autonomous central bank you have in mind what I understand for an autonomous Central Bank in developed countries; I am trying to figure out if there are central banks in developed countries that have so much control over such variety of monetary policy instruments as that presently implied in the discussion of an autonomous Central Bank in Chile and I am particularly interested in the case of developing countries, if you know how they operate and if there is a case that is similar to the one being discussed here.

A.: I also have, as a member of the staff and management of the International Monetary Fund, it is very difficult for me, in a public forum, also, to comment on a very specific developments in individual countries and all of my comments today are comments and observations that I am drawing from a broader ray of experience and that is how I hope that these are taken.

**CENTRAL BANK AUTONOMY:
A SWISS PERSPECTIVE**

EXPOSITOR: Mr. GEORG RICH (*)

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CENTRAL-BANK AUTONOMY: A SWISS PERSPECTIVE

I. Introduction

Since its creation in 1907, the Swiss National Bank (SNB) -Switzerland's central bank- has enjoyed a high degree of independence from the government. The Swiss public's preference for an autonomous central bank reflects its deep-rooted distrust in centralized approaches to policy making. In the 19th century, many Swiss were strongly opposed to the establishment of a central bank with far-reaching powers in the monetary arena. Until 1907, notes were circulated by over thirty banks of issue. They were convertible into gold or silver at fixed exchange rates, that is, Switzerland -as a member of the Latin Monetary Union- was on a bimetallic monetary standard. However, it is important to note that, toward the end of the 19th century, the bimetallic standard was effectively reduced to a gold standard, due to a sharp decline in the world price of gold relative to that of silver following the gold discoveries in South Africa and Alaska. The bulk of Swiss bank notes was circulated by the cantonal banks, that is, commercial banks owned by the cantons (Switzerland operates a three-tier system of government, with the cantons placed between the Confederation and the municipalities). Needless to say, the cantons strongly objected to federal government encroachment on their note issue because of the attendant loss of seigniorage on printing money.

It was not until 1891 that the Swiss federal constitution was changed and the federal government acquired the exclusive right to issue bank notes. The new provision in the constitution allowed for two possible modes of issuing notes. The federal government was empowered either to set up a state bank of issue or to vest the note issue privilege in an autonomous central bank, organized as a corporation with separate legal identity. However, the new constitutional provision remained dead letter for the next fourteen years. The 1891 revision of the constitution was followed by a protracted debate on which of the two alternatives should be selected. At first, the Swiss parliament opted for a state bank of issue. This solution did not appeal to the

Swiss voters, who rejected the proposal for establishing a state bank of issue in a referendum held in 1897. After the voters' verdict, parliament could not help abandoning the project of a state bank of issue. In 1905, the voters approved an alternative law under which an autonomous central bank was created. I do not claim to be an expert on the history of central-bank autonomy, but I suspect that Switzerland is the only country in which the voters ever had to take a stand on this issue

In contrast to many other central banks, the SNB has been able to preserve the autonomy conferred to it by Swiss voters. Like their predecessors, the Swiss of today believe that their interests are served best by an autonomous central bank. As a matter of fact, central-bank autonomy has ceased to be a controversial issue in Switzerland. The existence of an autonomous central bank is largely taken for granted. For this reason, the pros and cons of central-bank autonomy are seldom discussed now. In my opinion, there are two main reasons why the Swiss public tends to favor an autonomous central bank.

In the debate preceding the creation of the SNB, the proponents of central-bank autonomy stressed the need for a strict separation of monetary policy from the government's fiscal and debt-management activities. Otherwise, the government would be tempted to finance expenditures by means of the note printing press. The fear that the government would abuse the note issue privilege was probably exaggerated. Swiss fiscal authorities, on the whole, have pursued responsible policies and have endeavored -with varying success- to maintain balanced budgets. Nonetheless, the Swiss public continues to favor an institutional set up that minimizes the risk of monetary policy being influenced by fiscal considerations.

The second argument in support of central-bank autonomy is of more recent vintage. It concerns the institutional set up that will allow the SNB to achieve best its monetary policy objectives. The Swiss public -by and large- shares the SNB's view that price stability constitutes the principal objective of monetary policy. Due to long lags in the effects of monetary policy, however, the SNB cannot achieve price stability overnight. Therefore, it is important to have a central bank that does not lose sight of price stability even if a lot of persistence and patience is required achieve this goal. Since politicians do not tend to look beyond the next election, so the argument goes, their influence on monetary policy should be limited. The SNB should be sufficiently detached from the political process to be able to focus its attention fully on price stability, rather than the short-run whims and wishes of politicians

Although the Swiss public, on the whole, is convinced that an autonomous central bank is more likely to achieve price stability than an institution closely controlled by the government, central-bank autonomy, by itself, does not ensure that monetary policy makers will act in the public interest. Early in the 20th century, the Swiss critics of central-bank autonomy were mainly concerned about one possible abuse of the SNB's note issue privilege. The SNB, they feared, might be more inclined to maximize its own profits than to act in the public interest, and exploit its privileged position to gain a competitive advantage over ordinary commercial banks (in principle, the SNB may conduct business with both banks and non-banks, but in practice it has ceased to deal with non-banks). To dispel these fears, the proponents of an autonomous central bank agreed that the SNB -though not part of the federal administration -should be supervised by the federal government. Moreover, to discourage the SNB from

competing with ordinary commercial banks, it was (and still is) not permitted to pay interest on its deposits, except on funds deposited by the federal government.

Other possible abuses of the note issue privilege did not figure in the early Swiss debate on central-bank autonomy because Parliament and the voters only accorded a very limited policy role to the SNB. Its task was to act as a lender of last resort to the banking system by assisting commercial banks with liquidity problems. Furthermore, it was expected to enhance the responsiveness in the supply of bank notes to seasonal and other movements in money demand, a problem that the old banks of issue had failed adequately to resolve. In line with prevailing laissez-faire attitudes toward economic policy, however, the SNB was not conceived as an institution with broad powers to stabilize the price level or to smooth fluctuations in output and employment. Even if the SNB had aspired, to play a macroeconomic role, it would have been unable to do so because of the fetters imposed by the gold standard. As long as its room for maneuver was circumscribed by the gold standard, the SNB possessed little scope for abusing its note issue privilege.

The fetters on the SNB's freedom of action were partly loosened in the 1930s after the collapse of the gold standard. However, even under the postwar system of Bretton Woods, Switzerland's insistence on maintaining a fixed exchange rate vis-à-vis gold and the U.S. dollar meant that the SNB could not significantly affect the domestic price level, output and other macroeconomic variables. The need for a more activist monetary policy stance became apparent late in the 1960s and early in the 1970s, when the SNB discovered that it was unable to shield the domestic economy from the world-wide surge in inflation, despite various restrictive measures it had taken. To enhance the potency of monetary policy, the Swiss authorities decided to float the Swiss franc in January, 1973.

After the shift to a floating exchange rate, the issue of central-bank autonomy took on a new dimension. Unlike in earlier periods, the SNB, from 1973 onwards, became an important political force. It employed its newly-won powers to launch an assault on inflation. In the remaining sections of my paper, I will explore the question of whether central-bank autonomy has improved the SNB's policy performance. In Section 2, I sketch the institutional environment of Swiss monetary policy. Section 3 focuses on the objectives and targets of Swiss monetary policy. In Section 4, I show to what extent autonomy has helped the SNB to achieve these objectives.

II. The Institutional Environment

The legal base for the SNB's activities is a special act of company law. The SNB is a legal entity in its own right and is endowed with a share capital of 50 million Swiss francs. Only half of its share capital has been paid up. About 60% of outstanding shares are owned by the cantons and cantonal banks (the note issuers in the pre-SNB period), while the remainder is held by private shareholders. The shares of the SNB -which may be acquired only by Swiss citizens- are listed on the stock exchange. The federal government does not own any SNB-shares. The law places a ceiling on the dividend the SNB is entitled to pay on its shares. At present, the return on SNB-shares corresponds approximately to the yield on federal government bonds.

The SNB possesses management, supervisory and control bodies that are similar to those of private corporations. The SNB must call a meeting of shareholders once a year. Due to the SNB's public functions, the powers of the shareholders are not as extensive as in the case of private corporations. The main function of the shareholders is to elect 15 members of the Bank Council, a body corresponding to the board of directors of a private corporation. The Bank Council consists of 40 members. Its remaining 25 members, including its president and vice-president, are appointed by the federal government. The Bank Council has supervisory and budgetary functions, but plays only a limited role in setting monetary policy. The president and vice-president of the Bank Council, as well as eight other members delegated by that Council, constitute the Bank Committee, which closely controls and supervises the SNB's management. The Bank Committee must be consulted on (but may not veto) changes in the SNB's official lending rates. The Bank Committee's right to participate in the setting of the official lending rates is not as significant as it may seem at first sight because these rates no longer constitute important policy instruments in Switzerland.

The Governing Board -which corresponds to the executive board of a private corporation- bears the primary responsibility for Swiss monetary policy. It consists of three members elected by the federal government on the recommendation of the Bank Council. The federal government also appoints the deputies of the members of the Governing Board, as well as the managers of the SNB's eight branches.

In addition to its power to appoint the top officials of the SNB, the federal government must approve the SNB's annual report, including its annual profit and loss account, before that report is submitted to the meeting of shareholders. Furthermore, the federal government must sanction the key regulations -pertaining exclusively to administrative matters such as the SNB's salary scales- passed by the Bank Council. Most importantly, the federal government and the SNB are obliged to consult and inform each other on the principal macro and monetary policy decisions they intend to take. The head of the Federal Finance Department acts as the principal link between the federal government and the SNB.

Thus, the relationship between the SNB and the federal government is a complex one. The SNB is an entity that is legally and administratively separate from the federal government. Moreover, the Swiss federal constitution authorizes the SNB to take autonomous monetary policy decisions. In particular, the federal government is not allowed to issue directives to the SNB. However, to ensure that the SNB's monetary policy broadly conforms to the federal government's overall economic policy objectives, the SNB and the federal government must coordinate their measures.

In the contrast to the federal government, the federal parliament has no direct influence on the activities of the SNB. Its responsibilities are limited to renewing the SNB's note issue privilege every twenty years (the next renewal date will be 1996), and to certain matters concerning the SNB's share capital and profits.

III. Objectives and Targets of Swiss Monetary Policy

The Swiss federal constitution is rather vague about the objectives monetary

policy: the SNB's main task is "to regulate the country's money circulation, to facilitate payment transactions and to pursue a credit and monetary policy serving the interests of the country as a whole". As I pointed out earlier, the SNB interprets this constitutional provision as a mandate to achieve and to maintain a stable price level. The SNB's view that price stability should be the principal objective of monetary policy is shared by the Swiss federal government and is largely accepted by the Swiss public.

While there is broad agreement in Switzerland about the main objective of monetary policy, the question as to how this objective ought to be achieved tends to stir greater debate. Our experience suggests that changes in the money stock affect the price level with a long time lag ranging from two to three years. The length and variability of that lag implies that the SNB is more successful in influencing the inflation trend than in achieving short-run targets for the price level. Therefore, the SNB focuses its attention on the trend, rather than short-run fluctuations, in inflation. As a matter of fact, we strongly oppose policies of "fine tuning" the price level. If we were to react instantaneously to every twist in the inflation rate -no matter whether transitory or permanent- we would be liable to enhance instability in the price level.

Another controversial issue concerns the weight the SNB ought to attach to output and employment objectives. There is little doubt that changes in the Swiss money stock influence output and employment -at least temporarily. However, like the price level, output and employment tend to respond to monetary disturbances with a long and variable time lag. For this reason, the SNB not only refrains from fine tuning the price level, but is also highly skeptical about its ability to smooth cyclical and other short-run fluctuations in output and employment. This does not mean that it completely ignores output and employment growth. Real developments have impinged on Swiss monetary policy in three instances. First, the SNB in recent years has followed a gradualist approach to combating inflation in an effort to minimize the output and employment effect of its policies. Second, erratic and unpredictable movements in the exchange rate of the Swiss franc have occasionally played havoc with the SNB's anti-inflationary monetary policy. The events of 1978 are a good case in point.

After the shift to a floating exchange rate in 1973, the SNB instituted a tight monetary policy by placing a lid on money growth. As a consequence, the inflation rate fell gradually from a peak of over 10% at the end of 1974 to less than 1% in 1978. The drop in the inflation rate was supported by a strong upvaluation of the Swiss franc both in nominal and real terms. In 1978, the real upvaluation began to reach levels that seriously jeopardized the competitive position of Swiss industry on the world market and raised the prospect of a drastic slump in economic activity. For this reason, the SNB -reluctantly- decided to abandon temporarily its policy of controlling money growth and to set a target for the exchange rate of the Swiss franc vis-à-vis the Deutsche mark. While the SNB managed to halt -and even partly reverse- the real upvaluation of the Swiss franc, its policy of stabilizing the exchange rate triggered a new burst of money growth. Although the SNB quickly returned to a policy of controlling money growth, it could not prevent a resurgence of inflation, which reached a new high of over 7% in 1981. At present, the inflation rate is slightly more than 2%.

A third instance, in which the SNB was concerned about a slump in economic activity, was after the stock market crash of 1987. Like the Federal Reserve and other central banks, it loosened monetary policy temporarily late in 1987 in an effort to

counter a decline in aggregate demand that was widely expected to occur as a result of the stock market crash. However, as a rule, the SNB does not pursue output and employment objectives. Admittedly, the SNB faces fewer obstacles in achieving price stability than most other central banks. Since the end of World War II, unemployment has rarely been a significant problem in Switzerland.

To achieve a stable price level, the SNB -since 1975- has relied on an annual growth target for the money stock. From 1975 to 1978, it targeted the money stock M1. Since 1980 it has fixed targets for the monetary base. In 1979, the SNB failed to set a money stock target because of the exchange rate problems mentioned earlier. On the whole, the money stock targets have helped the SNB to achieve its ultimate objective. The trend in the Swiss inflation rate is related to both the growth in the Swiss monetary base and the money stock M1 in a reasonable stable manner. Furthermore, both aggregates are fairly reliable leading indicators of changes in the inflation trend. Econometric studies suggest that the SNB should increase the monetary base by about 2% per year if it is to achieve and maintain price stability (which it defines as a trend inflation rate between 0% and 1%).

In the short run, by contrast, the link between the inflation rate and money growth is far less stable. In other words, the income velocity of money -in short run- frequently behaves in an unpredictable manner. Unpredictable movements in velocity complicate the SNB's task of correctly gauging monetary policy and of fixing money stock targets consistent with price stability. But as I have shown elsewhere (Rich, 1987), unpredictable movements in velocity need not render money stock targeting useless, as long as the SNB contents itself with stabilizing the price level trend and does not endeavor to fine tune the economy. For this reason, the SNB is not prepared to throw its money stock target overboard whenever it is confronted with an unexpected velocity shift. It has occasionally accommodated such shifts by allowing the monetary base to deviate from its target. However, accommodation of unexpected velocity shifts is a tricky matter. When velocity moves unexpectedly, the SNB normally does not know whether it faces a transitory or permanent shift. To ensure that it does not overreact to transitory disturbances, it will accommodate -if at all- only part of the unexpected velocity shift.

To sum up, the SNB's approach to monetary policy may be characterized as persistence without stubbornness. It strives to control money growth with a view to stabilizing the trend in the price level. Since its focus is on a stable price level trend, it must adopt a long-run outlook and keep in mind the long-run effects of its policy actions. For this reason, it does not pay a great deal of attention to transitory movements in prices, output, employment, and velocity. Nonetheless, the SNB cannot entirely ignore the short run. In particular, temporary movements caused by excessive - and frequently unpredictable- swings in the exchange may harm the Swiss economy and prompt the SNB to adjust its policy course. The openness of the Swiss economy is an important reason why the SNB must keep an eye on the short run, despite its preferences for a long-run strategy. Should the SNB decide to react to short-run developments, its response tends to be sluggish. In this manner, it strives to minimize the risk of enhancing instability in prices, output and employment by overreacting to disturbances that may turn out to be transitory.

IV. Central-Bank Autonomy and Policy Performance

Considering the advantages of pursuing a long-run policy strategy, I would argue that the SNB has benefited greatly from its autonomous status. Since it is shielded to a large extent from the political process, it is able to impart persistence to its policy behavior. Persistence in the pursuit of its objectives has no doubt enhanced the effectiveness of its anti-inflationary monetary policy, as indicated by the relatively low inflation rates in Switzerland. Owing to its status as an autonomous central bank, it may - and from time to time does - pursue policies that are at variance with prevailing political sentiments. Nonetheless, the SNB cannot and should not be immune to the political process. As an institution embedded in a democratic system of government, it cannot be oblivious to the preferences of the public. For this reason, it refuses to pursue the objective of a stable price level trend in a rigid and mechanical fashion. Its persistence does not imply stubbornness. Its most difficult task is to find the proper mix of persistence and flexibility to ensure that it keeps track of the long-run objective of price stability without downplaying short-run developments that may seriously harm the Swiss economy.

The SNB's emphasis on persistence is not always well understood by the analysts of Swiss monetary policy. Frequently, they recommend that the SNB adopt a more aggressive and activist policy approach. For example, at the present moment, the Swiss inflation rate is on the increase. The SNB believes that by keeping the growth in the monetary base near 2%, it will be able to bring inflation under control. Some of our critics, however, consider our anti-inflationary stance to be timid. In my opinion, past experience does not suggest that a more aggressive policy stance would accomplish much, aside from enhancing the risk of a slump in economic activity. The SNB must live with the fact that persistence is frequently harder to sell to the public than bureaucratic activism. Nonetheless, I believe that the Swiss public, on the whole, prefers the SNB to be persistent even if some of our critics confound persistence with procrastination.

Although the SNB's autonomy has strengthened its ability to keep inflation under control, I must nevertheless admit that its status in the Swiss political system is odd. It is an institution operating in a democratic society. It is empowered to take far-reaching policy decisions; yet its activities are neither directly controlled by the executive or legislative branches of government, nor are Swiss voters permitted to review its decisions through public referenda, as would be the case for most other aspects of Swiss economic policy. As I pointed out earlier, Swiss law provides for coordination of monetary policy with the federal government's macro policies. The cooperation requirement subjects the SNB to an indirect mode of democratic control. However, this indirect control mechanism -though essential in a democratic society- probably does not suffice to ensure that the SNB will act in the public interest. Something else is required. An autonomous central bank, operating in a democratic society, must be prepared to subject its policies to public scrutiny and debate. This aim may be achieved by adopting a monetary rule that limits an autonomous central bank's scope for discretion in monetary policy.

Monetarists have long advocated monetary-policy rules for central banks. They feel that the record of discretionary monetary policy has been dismal and, therefore, favor rules such as money stock targets that limit central banks' freedom of action.

Although I do not believe that central banks can do entirely without discretion, there is nonetheless considerable merit in the monetarists' postulate of a monetary-policy rule. Such rules are likely to improve the performance of central banks in two respects.

First, a rule such as a money stock target makes the central bank accountable to the public. Accountability in turn may serve as a substitute for the lack of democratic control of an autonomous central bank. A pre-announced money stock target or some other pre-announced rule invites public scrutiny of monetary policy, which will aid central banks in devising optimum policy strategies. Moreover, should the central bank fail to abide by the pre-announced rule, it must explain its actions to the public. Accountability is socially desirable because it reduces the chance that economic agents misinterpret the intention of central banks and, thus, take decisions based on erroneous forecasts of future monetary policy. Accountability also enhances the reputation of central banks and strengthens the public's conviction that their autonomy is well deserved.

Second, a well-designed rule forces central banks to follow a long-run policy approach and to stick to price stability as the principal objective of monetary policy. It strengthens their ability to ward off pressures to react -or overreact- to disturbances that may be little more than random movements in macroeconomic variables. If the rationale for central-bank autonomy is the ability to follow a long-run monetary-policy approach, an autonomous institution cannot help adopting a well-designed rule. By following a rule, the autonomous central bank underlines its determination to fulfill its public mandate, that is, to be concerned about the long run.

For these reasons, the SNB takes its money stock target seriously. As I showed earlier, however, the SNB has not rigidly adhered to its money stock target, despite its preference for an approach based on rules. It cannot ignore the difficulties arising from excessively large fluctuations in the exchange rate. Occasionally, it must act as a lender of last resort and it must deal with unpredictable shifts in the velocity of money. Therefore, the SNB cannot but qualify its money stock target. This need not imply that it allows discretion to re-enter through the backdoor. Admittedly, it does not follow a mechanical monetarist rule of constant money growth. Its rule is rather more complex than a simplistic monetarist prescription. Essentially, the SNB builds various contingencies into its money stock target. The precommitment to a contingency plan is not the same thing as discretion. The SNB does not deviate from its money stock target at the spur of the moment. On the contrary, the Swiss public is aware of the conditions under which the SNB is likely to depart from the target. The precommitment to a contingency plan makes Swiss monetary policy more understandable and predictable than if the SNB acted in a purely discretionary manner. In my opinion, adherence to a rule is essential if the SNB is to preserve its autonomy. ⁽¹⁾

V. Conclusion

In this paper, I attempted to show that the Swiss public's insistence on an

(1) Among the various rules discussed in the academic literature on monetary policy, the one proposed by McCallum (1989, Ch. 16) comes closest to capturing the spirit of the SNB's approach.

autonomous central bank was originally motivated by a desire to separate clearly monetary policy from the government's fiscal and debt management activities. In practice, fiscal behavior of the Swiss public sector has been highly responsible and has not impinged on the SNB's ability to conduct a monetary policy designed to achieve and maintain price stability. For this reason, the Swiss case for central-bank autonomy rests more on the need for a long-run approach to monetary-policy making than on fiscal considerations. In Switzerland, autonomy has helped the central bank to achieve its objective of a stable price level trend. Swiss experience further suggests that an autonomous central bank is more likely to act in the public interest if it is prepared to adopt a monetary-policy rule than if it relies exclusively on discretion.

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GERMAN CENTRAL BANKING AND THE BUNDESBANK'S STRUCTURE

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GERMAN CENTRAL BANKING AND THE BUNDESBANK'S STRUCTURE

The Deutsche Bundesbank's present structure and its legal and institutional operating basis may be said to reflect the troubled history of more than 100 years of German central banking. During this period the German currency broke down twice under the impact of wartime inflation and the monetary disturbances following two lost world wars. These traumatic experiences left a characteristic imprint on German thinking in the field of central banking and currency order. Their consequences can still be felt today.

The financial shock events culminating in the currency reforms of 1924 and 1948 had important consequences for central banking legislation in Germany. In 1924 the Reichsbank, over which the Chancellor had exercised ultimate control since its foundation in 1876, was given a new charter as part of the reorganization of the German monetary system in 1923-24. The new Banking Act expressly laid down that the central bank was independent of the Government. Supervision by the Chancellor was dropped, and lending to the government severely limited. Under the dictatorial Hitler regime (1933 to 1945), the prerogatives of the Reichsbank were however formally abolished and its Directorate dissolved in 1939, after it had boldly protested against inflationary budget financing.

Soon after World War II, renewed efforts were made to set up a central banking system in Germany which could exercise monetary control free from destabilizing political interference. In 1948 the Allied military powers in West Germany set up a two-tier central banking structure broadly mirroring the US Federal Reserve System. This consisted of legally independent regional central banks (the "Land Central Banks") and joint "umbrella-type" subsidiary of the Land Central Banks (the "Bank Deutscher Länder"). The latter performed the note issue and other central functions on behalf of the regional institutions. This predecessor of the Deutsche Bundesbank was from the start independent of German political bodies and gained full autonomy from the military powers in 1951.

I. Establishment and Organization of the Deutsche Bundesbank

After protracted deliberations (lasting about six years) within the Government and Parliament, the German legislature passed the Deutsche Bundesbank Act in 1957. The Bundesbank came into being through the amalgamation of the Land Central Banks and the Bank deutscher Länder. The Land Central Banks lost their independent legal status and, while retaining their previous designations, became "Main Offices" of the Deutsche Bundesbank in the 11 Länder (states) making up the Federal Republic of Germany. In administrative matters, however, they kept their independent powers. Their Presidents, together with the members of the Directorate of the Bundesbank, constitute the Bundesbank's supreme policy-making body, the Central Bank Council. It is responsible for all decisions in the field of domestic and external monetary policy. The President of the Bundesbank is at the same time the Chairman of both the Central Bank Council and the Directorate of the Bank. Both bodies are organized entirely on the collegiate principle.

The responsibilities of the Directorate and the Land Central Banks are regulated by the Bundesbank Act. The Directorate is responsible for all the external transactions of the Bank, the administration of its monetary reserves, lending and deposit business with the Federal Government and its Special Funds (such as the Federal Post Office and Federal Railways) and business with the central institutions of the banking industry and with banks with special functions throughout Germany. The Land Central Banks are responsible for all business with the banks in their area and with the Land Governments. They are also responsible for bank supervision in their respective Land.

The organizational structure of the Bundesbank reflects the federative constitutional structure of the Federal Republic of Germany. In a uniform monetary area, however, monetary policy can itself only be uniform. It cannot differ from region to region or take account of special regional features or requirements. But federative forces, in the shape of the Land Central Bank Presidents, as well as centralist forces, in the shape of the members of the Directorate, are duly involved in an appropriate manner in the necessarily uniform monetary policy opinion-forming and decision-making process. This system has stood the test of time, and we believe that it could indeed be a model for a future European central bank system. Incidentally, this federative structure is also a major factor in the Bundesbank's independence. It is perhaps no accident that the world's most independent central banks have come into being in federatively-structured countries: the United States, the Federal Republic of Germany and Switzerland.

II. The Functions of the Deutsche Bundesbank

(a) "Safeguarding the Currency"

The Bundesbank Act (section 3) assigned to the German central bank the main task of regulating the amount of money in circulation and of credit supplied to the economy with the aim of safeguarding the currency. According to the origins of the Act

and its generally accepted interpretation, this clause makes stability of the domestic price level the Bundesbank's primary task. This implies that an appreciation of the Deutsch Mark may be required as "ultima ratio" if the global inflation rate significantly exceeds the advance of the German price level. The Bundesbank is obliged to support the general economic policy of the Federal Government, but only to the extent that this is deemed to be compatible with the Bundesbank's primary price stabilization task (section 12). This "classical" perception of the role of monetary policy clearly reflects Germany's troubled currency history during the first half of this century, and has always been strictly respected by the decision-makers at the helm of the Bank.

(b) Secondary Functions

Within the framework of the Bundesbank Act, the Bundesbank performs the traditional central banking functions. These may be regarded as ancillary functions and are meant to be performed in such a way as to ensure that the Bundesbank is not prevented from properly discharging its primary stabilization policy task. The Bank's secondary functions may be characterized briefly as follows:

1. Support of the Payments System

The Bundesbank is required by its Charter to arrange the handling by banks of domestic and external payments. To this end, the Bundesbank makes available a clearing and giro network which includes facilities for the rapid and automatic processing of cashless payments. About one-third of the credit transfers, cheques and direct debits handled by German banks passes through the central bank's facilities.

As the "banker's bank" the Bundesbank refinances the banking system and normally smoothes out fluctuations in the interbank money market. In very rare circumstances it offers emergency lending facilities to individual institutions affected by liquidity stresses. But it has always shown great reluctance to promise "lender of last resort" support in advance, in relation to both the domestic banking system and international institutions. This reluctance is motivated by "moral hazard" concerns and the strict compliance with the requirements of domestic monetary control.

Last but not least, the Bundesbank issues banknotes denominated in Deutsche Mark. These are the only unrestricted legal tender in the Federal Republic. The Bundesbank also puts Deutsche Mark coins into circulation on behalf of the Federal Government, which holds the coinage prerogative.

2. Bank Supervision

Bank supervision is regarded as a government function in Germany. It is entrusted to the Federal Banking Supervisory Office in Berlin. However, the Office cannot issue general supervisory regulations without the formal participation of the Bundesbank. Moreover, the Bundesbank makes its local branch offices and expert knowledge available for the ongoing bank

supervision and assists the Supervisory Office in many ways. In practice, bank supervision is thus carried out in close cooperation between the Supervisory Office and the central bank.

3. Fiscal Agent Function

The Bundesbank also acts in several respects as the "principal banker" of the Federal Government and -to some extent- the regional governments. It administers the central government sector's cash and overdraft accounts, executes their domestic and external payments and facilitates the Federal Government's debt management operations. But credits to the Federal Government and to local governments are strictly limited by the Bundesbank Act, and the Bundesbank can refuse to grant such overdrafts if this conflicts with its monetary policy objectives. The Bundesbank is also legally prohibited from purchasing government paper on its own account, unless such transactions can be shown to serve monetary control purposes in the money market.

4. Guardian of the Currency Reserves

The Bundesbank is the only German public body which holds official currency reserves. It thus carries out any obligatory interventions which may become necessary under the rules of the European Monetary System (EMS).

Similarly, it may intervene in the DM/\$ market in order to maintain orderly market conditions and participates in any coordinated intervention efforts agreed upon under the "Louvre Accords" of February and December 1987 and similar international arrangements. Reflecting the Bundesbank's central role in managing Germany's external reserve position, the President of the Bundesbank also acts as the German Governor in the IMF and the BIS.

III. The Control of Money and Credit

(a) Guiding Principles

In 1957 Bundesbank Act not only defines the maintenance of stable prices as the Bundesbank's main task. It also indicates how the Bundesbank should discharge its primary responsibility, namely by regulating the supply of money and credit. This quantity-theoretical approach to monetary control has a long-standing tradition in German central banking. It is not derived from modern monetarist doctrine. The Reichsbank Charter of 1876 and the Reichsbank Act of 1924 explicitly obliged the central bank to "regulate the money supply". The fathers of the 1957 Bundesbank Act therefore continued a well-established legal practice when they linked the ultimate policy goal of price stability with the control of money and credit expansion.

The underlying notion that -at least in the longer run- inflation can be regarded as a monetary phenomenon was derived from the "classical" or "Fisherian" quantity theory

as well as from historical inflation experience in Germany. This quantity-theory tradition in central banking was not abandoned in Germany after World War II, when post-Keynesian thinking influenced monetary policy-making in other industrial countries. We never forgot in Germany that "money matters".

Economic and monetary policy-making in post-war Germany was also characterized by other principles close to "classical" economic doctrine. These included the following salient features:

- (i) the firm belief in the superiority of a free market system - this led to the complete rejection of price and wage controls and an early liberalization of the domestic financial system and of international trade and payments;
- (ii) distrust in the virtues of macroeconomic "fine-tuning" and the use of activist demand management policies for economic growth - this left only a marginal role for monetary and fiscal policies as anticyclical weapons in the early post-war decades;
- (iii) a "social consensus" approach to economic policy-making - in this context voluntary cooperation by both sides of industry (known in Germany as the "social partners") in the field of price/wage formation and macroeconomic stabilization was assigned a major role.

This policy environment provided an almost ideal background for successful monetary stabilization policies pursued by the Deutsche Bundesbank.

However, in the ten years up to the late 1970s, the socio-economic climate deteriorated and complicated the Bundesbank's task:

- fiscal policy was ambitiously used as an anticyclical instrument, the size of the government sector expanded rapidly and the public sector moved into sizeable deficit;
- the social climate deteriorated and was characterized by increasing union militancy and aggressive wage bargaining;
- "imported inflation" from abroad and destabilizing capital inflows undermined the Bundesbank's capacity for controlling monetary aggregates and domestic prices prior to the transition to a floating Deutsche Mark in 1973,

As a result, the German inflation rate accelerated from a long-term average of 2 to 2.5% in the 1950s/1960s to 5.5 to 7% in the early 1970s. A further, permanent ratcheting-up of the general price level seemed to be likely after the outbreak of the first oil crisis in 1974. The oil price shock triggered a sharp upward adjustment of German wage rates and a rapid increase in inflationary expectations.

(b) **Money Stock Control since 1975**

In response to these threats and owing partly to the transition (in 1973) to a

floating exchange rate regime, the Bundesbank came under severe pressure to demonstrate its ability and firm determination to pursue a non-accommodating monetary policy in order to break the domestic inflation spiral. This was the dominant political consideration which led to the adoption of a formal monetary targeting framework in Germany in the mid-1970s. As the first major central bank, the Bundesbank publicly announced an annual target for the growth of a broad, "weighted" measure of the money stock (known as "CBM" = "central bank money stock") for the year 1975.

In the given German context, this action was designed to provide private and public decision-makers with a monetary framework for nominal spending and price/wage setting. The ultimate aim was to facilitate agreement among the social groups minimize friction between the various areas of economic policy and reduce the potential output and employment cost of inflation control.

Although target-guided policies could not always be implemented without friction and underwent technical changes, the Bundesbank has adhered to this practice ever since. Monetary targeting proved to be particularly useful to break inflation spirals after the first and second oil price hikes (in 1974 and 1979) and the D-Mark "depreciation crisis" of the early 1980s. Since then, a supply-side orientation of economic policy, the budget consolidation course pursued by the Federal Government, moderate wage settlements and the temporary marked falls in world energy and raw material prices have greatly facilitated the Bundesbank's task. Inflation has virtually been brought down to zero in recent years. The authorities, nevertheless, feel that adherence to monetary targets may be a good method of consolidating the disinflation process, even if it has proved difficult in the more recent period to reconcile domestic monetary targeting with the requirements of short-run exchange-rate management.

(c) Policy Instruments

The Bundesbank Act of 1957 makes a wide range of policy instruments available to the central bank. The Act also permits it to adjust its instruments to concrete policy requirements and changing institutional arrangements. As a result, today the Bank has a multi-faceted armoury at its disposal, with which it can influence the interbank money market, banks' lending and deposit-taking behaviour and developments in the capital market.

Reflecting the early post-war free market philosophy in Germany, the instruments available under the Act confine the Bundesbank's operating procedures to intervention methods that entail little interference with the smooth functioning of competitive markets. The Bundesbank is not permitted to impose administrative ceilings on bank lending, nor can market interest rates be subjected to guidelines or controls. Partial restrictions on international capital inflows, which were administered by the Bundesbank under government ordinances up to the 1970s, no longer exist. The Bundesbank thus relies entirely on indirect market and interest rate mechanisms for carrying out its general policy intentions and for controlling the money supply.

Our experience of these monetary policy instruments, which are consistent with

the free market system, has been encouraging. Administrative methods are apt to lead to attempts to doctor the symptoms only, rather than the underlying disease. Similarly, we remain unimpressed by selective monetary policy. In any case, both administrative and selective methods are proving less and less effective under conditions of liberalized money and capital movements. In the countries of Europe, in so far as they have played a significant role at all in the past, they have been replaced by market-consistent methods.

Interest rate policies are today mainly conducted with the aid of open market instruments. However, traditional official discount and lombard rates have retained some monetary policy significance inasmuch as they mark out the limits within which the Bundesbank manages money market rates. Changes in these official interest rates are therefore a clear signal about the interest rate trend which the Bundesbank is trying to bring about.

Banks' liquidity position can be influenced through variations in minimum reserve ratios, rediscount and lombard credit quotas. Since about the mid-1970s these conventional quantity policy measures have been used less frequently and partly been replaced by short-run open market operations (notably "repos", i.e. securities repurchase agreements). Open market operations and "fine-tuning" measures in the money market finally became the main short-run "cutting edge" of monetary management in Germany in early 1985, when the call rate was deliberately detached from the Bundesbank's lombard rate and "repos" assumed the role of a dominant short-run refinancing instrument.

Through day-to-day management of banks' reserve position and interbank money market rates, the Bundesbank can exert an indirect impact on conditions in credit and capital markets. These are dominated by the "universal" domestic bank system, which offers virtually all types of financial services "under one roof" (except insurance business). Over the rather longer term the Bundesbank's operations in the money market influence banks' willingness to lend and acquire securities as well as the non-bank public's demand for money and credit. Owing to this indirect nature of the monetary control mechanism, adjustments take time and can never be forecast with absolute precision. Although the Bundesbank uses a wide range of statistical and econometric tools as policy implementation aids, the Bundesbank ultimately "feels its way" in implementing its monetary policy objectives through a trial-and-error process.

(d) Reconciliation of Domestic and External Requirements

The openness of the German economy, its relative size and the international role of the Deutsche Mark force the monetary authorities to pursue a policy approach in which domestic monetary objectives are continuously reconciled with external policy requirements and constraints. The medium-sized German economy, which accounts for 8.5% of OECD output (against a 40% share held by the US), cannot hope to dominate other countries in determining its economic and monetary policies. On the other hand, the ancillary reserve currency function of the Deutsche Mark and its role as a reliable "anchor" for the stabilization policies pursued by many European countries, notably EMS members, compels the German monetary authorities to set national

stabilization policy standards which are in accordance with Germany's good post-war inflation record.

The short-run volatility of fluctuating major exchange rates and notably the intermediate-run random swings of the real US dollar rate have time and again forced the German authorities, even after the transition to floating in 1973, to flexibly adjust domestic monetary management to external policy requirements.

In the course of a longer-term learning process, the authorities were forced to recognize that floating exchange rates failed to provide an ideal "buffer" mechanism for shielding domestic monetary policy from external influences. In dealing with exchange rate volatility and aberrations, two characteristic types of domestic monetary policy response have emerged over time.

On the one hand, the Bundesbank has tended to make purely tactical policy adjustments. It has shifted its choice of policy instruments in favour of flexible "fine-tuning" operations. With the help of these instruments, the central bank can give relatively low-cost support to exchange rate management by making subtle changes to money market conditions. In the same vein, "fine-tuning" measures can be used to engineer domestic policy adjustments while limiting their repercussions on the exchange market. Similarly, the Bundesbank may delay or advance domestic policy measures to take account of exchange market conditions. In doing so, the Bundesbank has tolerated short-run deviations of monetary growth from annual objectives.

On the other hand, the Bundesbank has also made fundamental adjustments to domestic monetary management in response to external pressures. In what may be labelled a "mixed" policy strategy, the Bank has tolerated longer-run unusual swings in money growth while intervening heavily in the exchange market. Such policies were motivated by the following stylized macroeconomic configurations:

- During periods of excessive D-Mark appreciation (1977-8 and 1986-7), prices tended to advance more moderately than anticipated. At the same time, the weakening export outlook, heavy import penetration and declining export profitability depressed business confidence and corporate investment. Under such conditions, the Bundesbank was willing to produce an expansionary monetary "countershock" in order to dampen the appreciation of the Deutsche Mark and simultaneously support domestic demand.
- During years of excessive D-Mark depreciation (such as the early 1980s), the Bundesbank pursued a more restrictive policy than originally intended, as long as higher import prices threatened to trigger an uncontrolled price/wage inflation process or "vicious circle".

In pursuing such "mixed" strategies, the Bundesbank never easily moved away from original domestic monetary objectives. It hardly ever responded immediately to outside financial and real shocks (such as shifts in world real interest rates, world money growth, foreign fiscal policies or oil price shocks) which could be expected to create disturbances in the exchange market. Moreover, as a rule, real exchange rate aberrations have been quite sizeable before monetary policy fully reacted. As long as

there was a chance that the original economic shocks or the destabilizing real exchange rate movements could be reversed within a reasonable time, the Bundesbank allowed market forces to take their course. Only when it became clear that policy-maker's objectives for non-inflationary growth were being seriously threatened owing to lasting and destabilizing real exchange rate shocks, were counterbalancing joint monetary and exchange market intervention measures brought into play. This behaviour reflects the undeniable fact that the monetary authorities know little about the process of exchange rate determination and possess only limited knowledge of the monetary transmission process at home. Such uncertainties severely reduce the scope for responsible discretionary monetary policies and underscore the advantages of a credible, medium-term-oriented monetary targeting approach.

IV. Political Independence of the Bundesbank

The Bundesbank's present reputation and powerful role in the German policy-making process rest largely on its post-war policy record and the anti-inflation mentality which, for historical reasons, is firmly built into German society. During the 40 years of the existence of the Deutsche Mark the cost of living has risen by 2.7% a year. This is far less than in many comparable industrial countries. It is true that inflation accelerated during the 1970s, but the German economy was spared the experience of double-digit inflation, and its currency appreciated markedly over time.

Hence, given the sensitivity of the German population after its experience of two hyperinflations in a single generation, the preconditions for pursuing a stability-oriented monetary policy were particularly favourable. With respect to economic and monetary policy, among those responsible in Parliament, in government as well as in the central associations of business and even in the trade unions, there was a large measure of consensus about the value of stable money and of a monetary policy geared to safeguarding monetary stability. But for this basic consensus, there would no doubt never have been such a broadly-based decision in favour of a central bank independent of the Government and Parliament. Such an act of self-restraint by Parliament and the Government can by no means be taken for granted, and is I think only comprehensible against the background of Germany's historical experiences.

(a) The Bundesbank's Legal Position

By law, the Bundesbank's primary function is to safeguard the stability of the value of money by means of its instruments. Under the Bundesbank Act (section 12), it is at the same time required to support the general economic policy of the Federal Government. Thus, the Bundesbank has not only to respect the economic policy decisions of the Federal Government, but also to work actively towards their realization by deploying its instruments. However, the legislature made this obligation to render support subject to the proviso that the Bundesbank must perform its primary function of safeguarding the currency. The obligation to render support applies only as long and as far as it is reconcilable with the primary function. In assessing whether these preconditions are fulfilled, the Bundesbank acts at its own discretion, as required by

law. In this case, it is just as independent of instructions from the Government as it is in exercising the powers conferred on it by the Bundesbank Act. This independence of the Bundesbank from instructions from the Government in questions relating to the Bank's monetary policy is one of the key provisions of the Act.

In section 13, however, the Bundesbank Act also provides an institutional framework for cooperation between the Federal Government and the Bundesbank:

- the Bank must advise the Federal Government in monetary policy matters of major importance (even without having been requested to do so);
- the members of the Federal Government are entitled to attend meetings of the Central Bank Council; they have no right to vote, but may propose motions and defer decisions for up to two weeks. In addition, the Bank's by-laws, which for their part, incidentally, are subject to the Federal Government's approval, provide that the Federal Minister of Economics and the Federal Minister of Finance are to be invited to attend every meeting of the Central Bank Council by being sent the agenda. In practice, in fact, these ministers are sent not only the mere agenda but also the preparatory memoranda for the Central Bank Council's meetings;
- finally, the Federal Government should invite the President of the Bundesbank to attend its discussions on important monetary policy matters.

At the time, the legislature also reviewed the question of whether it should make arrangements for the possibility of a conflict between the Federal Government and the Bundesbank. It decided against it, the argument being that no generally valid institutional arrangements could be made in an Act of Parliament for the possibility of a conflict. What is more, the committee concerned added at the time that, in the event of a conflict of principle, the parties concerned would be free to "dramatize" the disagreement (evidently implying publications in the press), which should then be thrashed out publicly and in the full spotlight of public opinion, which should result, if possible, in an understanding being reached.

Another of the key factors contributing to the Bundesbank's independence is the circumstance that members of the Central Bank Council are ordinarily appointed by the Federal President for an irrevocable tenure of 8 years. This prevents the Federal Government (which proposes Directorate members) and the organs of Land Governments (which propose the Presidents of the Land Central Banks) from gearing the selection of Bundesbank Board Members to four-year parliamentary sessions.

(b) Political Independence in Practice

Given the independent legal position of the Bundesbank, efficient economic policy making in Germany essentially rests on voluntary cooperation between all public sector bodies concerned. This must be regarded as a continuous process based on mutual consultation and information at the political and technical levels. Thus the announcement of annual monetary objectives is preceded by informal consultations

with the Federal Government. As a corollary, the President of the Bundesbank regularly participates in the Federal Cabinet meetings at which important economic policy decisions are taken and the Government's Annual Economic Report is set up. Similarly, Bundesbank representatives attend important meetings at which budgetary decisions are prepared at the administrative level. On the other hand, the Ministers of Finance and Economics, and in exceptional cases the Federal Chancellor, too, attend meetings of the Central Bank Council in order to discuss important issues.

Moreover, through its publications, press conferences and speeches given by board members, the Bundesbank makes a virtually continuous effort to communicate with the German public and gain political support for its policies. It explicitly invites the voluntary cooperation of management and labour in economic crisis conditions to enhance the efficiency of its policies. Public opinion may thus be said to exercise ultimate democratic control over monetary management in Germany, and the Bundesbank's autonomous role is only guaranteed politically to the extent that it can establish a credible and convincing policy record.

**CENTRAL BANK AUTONOMY:
A PERSPECTIVE OF THE FEDERAL RESERVE BOARD
OF THE UNITED STATES OF AMERICA**

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Let me begin by saying, if I may, how delighted I am to be in Chile again and to renew acquaintances that I made in my last visit over a little more than a year ago. I am also very honored to have the opportunity to share with you some of my own thoughts and experiences on the subject of this important seminar. Needless to say, as someone who has been a central banker for twenty years, I come to the subject matter with some biases, that will become quite apparent I think, as I proceed.

When we ponder the subject of central banking, I think a couple of things are rather clear to all of us. And that is that central banks around the world, regardless of the individual country, the state of development, its heritage, its political philosophy; regardless of all those things, central banks almost universally do share a special position within most countries. Now, the definition of that position varies considerably from one country to another. Not only in relation to the subject of autonomy, but in many other respects as well.

And what is often true is that some of the reasons why central banks do differ can be found in the circumstances surrounding their creation, and certainly the Federal Reserve is no exception to that circumstance. For example, as many of you know, for all practical purposes, the United States went from its founding, in 1776 to 1913, in other words for almost a hundred and forty years, without a central bank. And much of the reason why it did not have a central bank for that long period was because of the very strong populist political tradition in the United States. A tradition which is in evidence even today. And one hallmark of that populist political tradition and heritage has been, and still is, a fear of excessive concentration of power in any one institution, in any venue of public policy. And it is fundamentally for that reason that our constitutional form of government has such a complex system of checks and balances. Checks and balances that were to become an important feature of the structure of the Federal Reserve itself.

Against that backdrop of almost a hundred and forty years of choosing not to have a central bank, it was in the United States the financial panic of 1907 which was the straw that broke the back of the camel in terms of the ultimate decision to go ahead and establish a Central Bank. But as with Germany, in the post-war period, that decision was not reached easily or lightly. Indeed, the debate lasted for six years, from 1907 till late 1913 when President Woodrow Wilson finally signed into law the Federal Reserve Act. Now, the circumstances of the banking crisis and the financial crisis of 1907 had much to do with the early features of the Federal Reserve. That crisis was characterized by runs on banks, by breakdown in the check-collection system, and by a inability of many individual banks to meet deposit flows because of what was called a pyramiding of reserves.

Because of those circumstances, much of the thrust of the Federal Reserve Act, as it was originally written in 1913 was aimed at what we today would call "financial stability". The workings of the payment system, the supervision of banks in the banking system, and there was only a very vague and loose concept of monetary policy, at least as we know it today, incorporated into the original version of the Federal Reserve Act. Indeed, in the early years of the Federal Reserve, it was not at all uncommon for each of the twelve Federal Reserve Banks, that are spread out across the United States, to conduct unilaterally their own open market operations whether those happen to coincide with what one of the other Reserve Banks might be doing.

It was not until 1935, when the Federal Reserve Act was amended in a major way, that we began to see the focus and the orientation of the Act directed more at what we today recognize as monetary policy considerations. And, once again, the 1935 amendments were obviously importantly influenced by the depression and all the events that went with it in the early part of the 1930's. That is simply another way of saying, in our system as in most, central banking arrangements and, indeed, underlying central banking statutes and laws tend to evolve over time. They are not static, they are not carved in stone, nor should they be.

The Federal Reserve of 1989 is quite different than the Federal Reserve of 1913 or even 1935. Its overall mission, I think, is widely accepted as being fundamentally directed at fostering price stability and financial stability, which are viewed almost universally in the United States as necessary pre-requisites for overall economic stability.

But I do want to make an important distinction between necessary pre-requisites and sufficient pre-requisites. Indeed these days I think it is probably true, in the United States and elsewhere, that perhaps too much reliance is put on central banks and too little on fiscal policy and the fiscal side of the equation. And under any regime that I can imagine, an appropriate blend of monetary, fiscal, regulatory, and structural policies will be needed to produce truly optimal results.

Now, in the case of the Federal Reserve, it is probably fair to say that, within that broad mission or mandate, its specific functions are probably more numerous and broader than is the case in many if not most other countries. For example, contained within the law are specific mandates in areas such as monetary policy, of course, the lender of last resort functions, of course, broad responsibilities, shared with other agencies, for the supervision of banking and certain other financial institutions. Specific

legislative authority to be the bank for the Government in term of paying its bill in a mechanical way, helping it to issue its debt, helping it to manage its debt. A function that is also of great importance, that is carried out jointly with the banking system, is the operation of the payment system. And that includes everything from the issuing of currency to helping in the process of clearing and collecting checks, and these days, most importantly, the operation of the electronic computerized payment system which is so vital, these days, to the efficiency of our money and capital markets, and so absolutely indispensable from the point of view of the stability of the financial system as a whole.

In addition to those functions, it also has a host of other specific functions as a matter of law, ranging from things such as the establishment of margin requirements for stock traded in the major stock exchanges, to the establishment and enforcement of a wide range of consumer protection measures in the areas of banking and finance.

Last but not least, and in this case, not explicit in the law, it is also widely seen as having the implied responsibility for maintaining a broad public policy perspective and oversight in the operation of our financial and capital markets, broadly defined. Now, that as I say, is implicit, but as you will see in a moment, there are times in which, however implicit it may be, it becomes very, very important in terms of what I, at least, associate with the essential role of the Central Bank in times of stress.

Now, against that background, it can probably be said that the Federal Reserve is readily viewed as one of the more autonomous central banks in the world. But that needs a bit more definition, and I can provide that definition two-ways. One would be to go back to two phrases that were coined years ago by William McChesney Martin who, as many of you know, was Chairman of the Federal Reserve from the early fifties to the late sixties. Martin said, at one point, that the essence of the Federal Reserve was its independence within the government and not its independence of the government. And that concept of independence within government, I think, is a very important distinction. Now, Martin also said something else, that is a shorthand explanation of why that independence within government is important. Martin once said that the principal job of the Federal Reserve was to take away the punch bowl just as the party got rolling. Now, the analogy, I think, is quite clear. When the punch bowl is taken away, the partygoers are not very happy, but the next morning, when they arise with a clearer head, they recognize the value and the virtue of the discipline of having taken away the punch bowl. Now, that, of course, is simply another way of saying that the essence of central banking requires vision, it requires the capacity to take the longer view, and it requires the discipline associated with both.

Now, in the case of the Federal Reserve, there are certain essential, formal, legal arrangements built into the Federal Reserve Act which produces this autonomy or independence. Let me briefly run over them with you. But, to do that, let me just briefly also identify the three major policy-making bodies that constitute the Federal Reserve as a whole. The first and most important is the Federal Open Market Committee. The FOMC is made up of the seven members of the Board of Governors in Washington and the twelve Federal Reserve Bank presidents. At any one time, twelve of the total of nineteen have voting privileges. The seven governors, always, the President of the Federal Reserve Bank of New York, always, the other four voting slots rotate among the other eleven Reserve Bank presidents. That is the Federal Open Market Committee.

The second key body is the Federal Reserve Board of Governors in Washington which, as you know, has seven members; third key body are the Board of Directors of the twelve Federal Reserve Banks. There are nine directors in each bank. Six are elected by the banks in the districts and three are appointed by the Board of Governors in Washington.

Now, if you can keep those three bodies in mind, and I apologize that this is typically complicated even by United States standards, let me, against that backdrop, share briefly with you the key legal features that create this autonomy or independence.

The first has to do with how the key officials are appointed to their positions, their terms of office and the question of whether and under what circumstances they can be removed from office. The seven members of the Board of Governors in Washington are appointed by the President of the United States and must be formally confirmed by the United States Senate. Their terms of office are fourteen years, so that in the normal course, one governor is appointed or reappointed every two years. Again the theory being that, among other things, insures that no one president should ever be able to appoint all or even, in the likely case, the majority of the Board. That does not always work that way since right now, for a variety of reasons, we have a Board that was all appointed by President Reagan. But the concept is, fourteen year terms provide several layers of insulation and protection.

The Reserve Bank presidents, on the other hand, are appointed by the Boards of Directors of the individual Reserve Banks; but those appointments must be approved by the Board of Governors in Washington. But there is no political input whatsoever, from either the executive or the legislative branch associated with the appointment of the presidents of the Reserve Banks. Now, the presidents of Reserve Banks have five-year terms but they can be renewed, and they typically are. So that, again, not only do you have insulation but the notion is you have continuity as well. And indeed I would argue that the continuity can be just as important as the insulation. But that whole complex apparatus is the first element that preserves that notion of independence as defined by Martin independence within government. The second key element that's built into the law: the Federal Reserve cannot, directly or indirectly, finance the Government or any of its agencies in any way, shape or form. And that any way, shape or form includes permitting an overdraft of the account of the Treasury on the books of the Federal Reserve. We simply would not let it happen.

A third key element that preserves that autonomy is in the area of administrative matters, but especially budgetary autonomy and personnel autonomy. The Federal Reserve, like many central banks makes a lot of money, and we take most of that money and we give it back to the Treasury, and it counts the equivalent of a tax collection. But, before any money is given back to the Treasury, we pay our own expenses. And in the process of doing that, we do not have to go to the legislature for any form of appropriation or authorization of money to pay our operating expenses and our capital expenses. Now, that element of autonomy is extremely important.

By the same token, our staff are not civil service employees and the general arrangements under which we employ our staff are, to the fullest extent possible, compatible with practices in the private sector, rather than practices in government as a whole. That, I think, is very important in terms of something that Richard Erb mentioned

and that is, of course, maintaining highly competent and professional people in the central banks.

Now, there are other features I could mention, as well, that bear on the formal legal arrangements that create the autonomy that we see in the Federal Reserve. But, in the interest of time, I will skip them and make two other important points.

One is, regardless of how the law is crafted, it seems to me that the Central Bank must earn its autonomy and its independence. And by that I mean, it must conduct its affairs with the highest degree of professional standards and, indeed, the highest degree of integrity. For that reason, we, in the Federal Reserve, impose upon ourselves various standards in areas such as conflicts of interest that are, on balance, stricter than the government, as a whole, imposes on itself and we do it voluntarily. We work very hard at managing the Reserve Banks in a way that can leave no question that we are abusing our independence from the budgetary process. Just as an example of that, at the Federal Reserve Bank of New York, for example, as recently as 1976 or '77, we had over 5,500 employees. Today we have under 4,000. In the decade of the '80s, the average annual growth rate on our total expenses following customary private sector accounting principles has been well below the rate of inflation per year. That is what I mean when I say, I think we have earned our independence. We have to conduct our affairs in a way that leaves no doubts as to our professionalism, our integrity and our seriousness of purpose.

Now, these legal arrangements and the way we chose to function within them are important. But there is more to it than that. In my judgement, a truly effective Central Bank must have an element of moral authority that transcends its formal legal responsibilities and authority. Now, what do I mean by moral authority? Or, perhaps, the simplest example of it is in the British tradition, and many of you I am sure have heard reference to the idea that what London has called "the governor's eyebrow". And what, of course, that refers to is that if a bank or a financial institution or whatever is doing something or raising something with the Bank of England that the Bank of England is not very fond of, it has been something of a tradition that the governor would raise his eyebrow and that was the end of the subject. It did not take days of negotiations with lawyers and technicians, the message was clear: the answer is no. That is moral authority.

Now, I cannot define that in specific terms and I certainly do not think it can be written into a law, but I know it is important. Let me cite two recent examples from my own experience at the Federal Reserve. One has to do with the role that the Federal Reserve has played over the past six and a half years in trying to be something of an honest broker in our collective efforts to manage the debt problem in the developing world. I think and I hope that most would agree that we have had a measure of success in trying to play that role. Not as much as we would like but, certainly, a measure of success. You will not find a place in the Federal Reserve Act, any suggestion as to what authority was brought to bear and is being brought to bear in that effort. Look as hard as you will, it ain't there. And there is a concrete illustration of what I mean.

Another, perhaps more graphic, has to do with the events surrounding the stock market crash in October of 1987. I can assure you, if I had to check the statutes, to see what I could and could not do, I think the results would have been different and, I think,

worse.

What I am suggesting is that there are some things that cannot be and should not be written into the law but, when it comes to central banking, a good central bank and, especially, a great central bank, in my judgement, we will have to find the will and the way to create the environment in which its moral authority can be used when needed to supplement its formal legal authority.

Now, let me return, by way of conclusion, to this notion of independence within government and spend just a few minutes on how it does work in practice. In the area of domestic monetary policy, the autonomy of the Federal Reserve is really quite thorough. In our situation, unlike, for example, even in the case of the Bundesbank, the Secretary of the Treasury does not attend the meeting of the FOMC, is not consulted in advance, has no veto power, so the degree of insulation in that particular realm is quite substantial. In the area of exchange rate policy and intervention, it is more of a shared responsibility and, indeed, at least in the United States, there is a primacy in that area that does fall to the Treasury. But insofar as domestic monetary policy is concerned that, certainly, would not be the case.

But even in the area of domestic monetary policy, to make this concept of independence within the government work in the United States, is very complex. Because we have to deal with not just the executive branch of the government but, also, the legislative branch; because, in the United States, the legislative branch feels just as strongly as the executive branch that it is the one, not the executive branch, that should be overseeing the Federal Reserve, if not telling it what to do.

Now, in practice, I think we all recognize that these cooperative efforts will vary from time to time, will certainly vary depending upon circumstances, and will clearly vary depending upon personalities. In our case, I think it is fair to say that the channels of coordination and the channels of making independence within government work, fall in two areas.

First, there are certain formal requirements that we, in the Federal Reserve, face. For example, under Federal Law the Chairman of the Federal Reserve must appear before the Congress, and through the Congress the public at large, twice a year to explain in great detail our monetary policy targets for the next eighteen months, as well as developments over the preceeding twelve months with regards to the earlier targets, the behavior of the economy and all the rest of it. That requirement, I think, has been very constructive. I think it has worked well for us, I think it has worked well for the Congress, the public at large, and financial markets at large. In addition, there are various other formal reports that we are required to make to the Congress from time to time on a wide variety of subjects. Again, ranging from status of LDC debt considerations to reforming the international monetary system and so on. And these, too, provide an important and valuable element of coordination and cooperation. For this purpose, our senior Federal Reserve officials appear before various committees of the Congress with great frequency and, again, I think, with great effectiveness. There are formal disclosure requirements, in terms of our financial position and condition, various other disclosure requirements having to do with administrative procedures. I could go on, but there is a long and complex series of things, formal in nature, which are aimed at making sure that all interested parties know what we are doing and know

why we are doing it. Those are formal.

On the informal level there are numerous avenues of informal consultations with other key officials of the government or branches of the government. These range from regular weekly breakfasts between the Secretary of the Treasury and the Chairman of the Fed, to inter-agency reviews of, again, any number of issues. But most importantly and, again, as Dr. Gleske said earlier, a major part of this informal effort are our broad public relations and public outreach programs designed not just to reach the Congress or the financial community but as broad a cross-section of the population, as a whole, as we can. We put a lot of time and effort into that. And I think, again, with a reasonable, if not a genuine, measure of success.

To summarize, the way we are structured is complex, the way we operate is probably more complex. But what we are trying to do, is not and how we are trying to do it, is not. Based on my experience, I am quite convinced that, at least for the United States, the broad structure within which we are operating does make sense, in part because the law is well crafted, in part because we do it at this moment. I think have at least a measure of that moral authority I spoke of earlier, but also in part because we, ourselves, do not view the overall arrangements as static, they, too, must evolve as conditions evolve but never, in my hope, evolve in a way that undermines and undercuts that essential independence within government.

Questions

Q.: Mr. Corrigan, I would like you to explain some more about an issue centered on the subject of financial instability, the role that the Federal Reserve plays as lender of last resort in two different cases it has intervened. First, in the October 1987 crash, who took the initiative in terms of what to do in that case, to what extent were the Federal Reserve actions totally independent from the government or was there an interaction within the government's proposals. The second case that I would like you to describe relates to the financial position of a large North American bank in crisis or subject to financial prohibition as is the case, for example of the Continental. Who took the decision of rescuing or not rescuing the Continental and, what role does the government play there, what role does the Federal Reserve have in all that?

A.: The two cases that you cite are very interesting and very different, so I think it is a very good question. Let me take the Continental Illinois case first. As the condition of the Continental Illinois Bank began to deteriorate over a period of time, there was multiple governmental agency involvement in assessing the situation. The Federal Reserve was there in two capacities. One as the formal legal supervisor of the bank holding company and the second as the lender of last resort. The Office of the Comptroller of the Currency was the primary supervisor of the Bank itself as distinct from the bank holding company. And, finally, the Federal Deposit Insurance Corporation was there as the insurer of deposits. And both the FDIC and the Comptroller but, especially the Comptroller, do are part of the Treasury Department in a formal sense so, through that mechanism, the Treasury was involved as well. The sets of decisions that had to be made, and they really are sets of decisions, but the threshold decision was, do we protect all the depositors rather than simply those that were legally insured depositors? That was a very difficult decision. The decision that was ultimately made was to protect all of the depositors and that decision was made primarily because of the fear that the secondary effects on global banking markets of not protecting the uninsured and, especially the large international depositors, was simply too risky. That decision was made jointly by the agencies involved and not easily, I should say, but maximum collaboration in the process of making that threshold decision. Then there were a series of other decisions that flowed from that, in terms of, okay, how are we going to piece this thing back together? How much liquidity and under what circumstances will the Federal Reserve provide that liquidity? In those cases the ultimate decisions rested with the FDIC in the first case, and the Federal Reserve on the second. But, again, in a context of maximum collaboration. And I think that is one of the reasons why having the Central Bank involved with bank supervision is important, but it is also why I think that authority should not be uniquely associated with the Central Bank. I think that having more than one party involved with those decisions at times can make it difficult, create tensions, but I think the decisions you ultimately make are better with some checks and balances built into the apparatus.

Now, that is one case. The stock market crash was a completely different situation. Because this is a situation that, first of all, came on very quickly, whereas the Continental thing and most bank problems you can see them

coming. But the stock market thing was very sudden and it immediately had very broad systemic implications. It was not a matter of one institution, it was a matter of a whole lot of institutions, a whole lot of markets around the world. Now, in those situations, and that one is extreme, it seems to me, at least within the traditions of the United States, that the Central Bank has to be the entity that is on the point of dealing with that kind of situation. And that involves a lot of things. For example, we, as everyone knows in our sister central banks in other countries, put an awful lot of money in the market, but we deliberately did not do it in a way that drove interest rates down to the floor because that could have reduced discipline even more. And we certainly did not want to, fundamentally, compromise the longer term intents of monetary policy. But we did a lot more than just put reserves in the market. A very, very close collaboration with all the stock exchanges, the futures exchanges, the banks, the securities firms, where we have no legal authority at all, while at the same time consulting closely with the Treasury in Washington, to some extent with the White House, certainly, again, with our central bank colleagues in London and Frankfurt, and Tokyo, and Hong Kong; but, in that case, speed of response was of the very essence and, in that kind of case you cannot have administrative, and legal, and technical barriers that are so formidable and so inflexible that no one can do anything. So I think there are very sharp distinctions between those two cases and, as I said, in the second case we are looking at something that obviously had very major systemic implications and you have to treat it and respond to it with that in mind. And, again, that is where this thing that, for lack of a better term, I call moral authority, the stuff that is not written in the law, becomes so important.

Q.: Dr. Corrigan, would you so kind as to give us some indication concerning the position of the Federal Reserve Bank towards the Brady Plan, that interests this country so much?

A.: I am sure that is on the agenda but let me say a few words about it, in any event. First of all, I welcomed the effort made by Secretary Brady to put some fresh ideas and suggestions. Those are his words: "ideas and suggestions on the table". I think we had reached the point where that was both necessary and desirable. I think it is also fair to say that these ideas and suggestions do constitute an important adaptation of policy and I emphasize the word adaptation, rather than change in policy. But the important adaptation, of course, is that the Secretary has raised the possibility and, indeed, gone one step further, and offered a form of official support and potential official financing of debt reduction and/or debt service reduction. Obviously, either or both of those do represent an important further adaptation. But I stress adaptation for several reasons which the Secretary also stressed. And that is that, even as our efforts evolve, we cannot lose sight of certain fundamentals. Those fundamentals include the absolute prerequisite of sound economic policy, of both a macroeconomic and a structural nature, in the developing countries. They certainly must include a continued vital role for the international financial institutions, the World Bank, the IMF, in a context in which it remains true that those international financial institutions are the only institutions that can work with the debtor countries in ways that are aimed at fostering the kinds of economic policies that are needed in the first place, and they are, they being the international financial institutions,

they are and will remain a very important source of finance to developing countries. The other fundamental we have got to keep fresh in our minds, even as we speak about debt and debt service reduction, is that, in my judgement, it is unambiguously in the interest of the debtor countries to approach the future in a manner that preserves a continuing association with the private commercial banks as sources of new money finance. I think that continuation of those associations even though they obviously will change is important for two reasons. One is pragmatic, and that is that there are limits, financial and otherwise, as to how much debt or debt service reduction is either viable or desirable. But secondly, and more importantly, when I think of the developmental needs of the middle-income developing countries, I think in terms of not two or three years, not even five or ten, but I think in terms of ten or twenty; because if these countries, individually and collectively, are really going to prosper it is in the essence of things that developmental process, that process of true growth in economies, true rises and gains in living standards is going to have to be sustained for a long time. And that long time, it seems to me also means a continuing need to have some confidence that voluntary finance will reappear. So I think there is much to be said and welcome, indeed, I applaud, the Secretary's initiatives. I think we will inevitably need some time and some concrete examples to put some flesh on the bones, to let these things get better, to find, but in a context in which we keep our eyes on the things that are really important over time, and in a context in which we do not fall victim to unrealistic expectations about what can be achieved. I think that, in fact, a great deal can be achieved. I think that is about as much as I would like to say today. I hope that is broadly responsive to your question.

CLOSING SPEECH

PRONOUNCED BY Mr. ENRIQUE SEGUEL M., FORMER
PRESIDENT OF THE CENTRAL BANK OF CHILE, ON
MARCH 31, 1989.

Today's has undoubtedly been a highly enriching experience concerning our knowledge referred to the operation of the economies of industrialized countries.

The interesting papers that have been presented are soundly based first-hand accounts of the basic elements involved in the administration of monetary policies that depends upon autonomous entities and contingent policy decisions stemming from the respective central governments.

Our guests have clearly described, in fact, the relevant role played by the Central Bank in each one of their countries in the achievement of the extraordinary results their economies have exhibited for long periods of time. Specifically, their presentations have clearly demonstrated the importance of the existence of a Central Bank oriented towards long term actions, an entity that rejects the temptation of temporary gains resulting from short term interests, and pursues the establishment of a stable environment - basic pre-requisite to achieve sustained economic growth.

By the same token, we have been reminded of the relevance of price stability as a basic objective of monetary policy, highlighting the importance of designing coherent policies that appear credible to public opinion.

The papers presented by our guests have also expressed to us the need of establishing efficient coordinating procedures amongst the various entities participating in the design of the country's economic policy. From the successful experience of the economies represented by the participants, however, it is possible to extract that such coordination should not jeopardize the achievement of stability, the primary objective of the monetary authorities. Thus, the design of flexible policies, simultaneously attentive to maintaining an environment of price and payment's stability, has proved to be an efficient means, not only to achieve the above mentioned objective, but to promote a judicious and responsible management of public finance.

I think, interpreting the feelings of the audience, that the opinions expressed by our guests will widen our perspective as we proceed to carry out the final discussion concerning Banco Central's Organic Law Draft, while they also leave issues to reflect upon and inquiries for academicians and researchers, alike.

I believe that the interesting papers we have heard today provide objective information to carry out a realistic assessment of the advantages residing on the concept of autonomy concerning the tasks of Chile's Central Bank in the future.

Our country's economic past has been marked by cycles of accelerated expansion followed by periods of sharp contraction where monetary and exchange instability brought desorientation to economic agents and created incentives to divert resources towards speculative activities that, more than once, made them look for haven abroad.

Also in the past we have been witnesses to the manner in which the Central Bank was subjected to strict dependence upon the Government and became an instrument to obtain easy coverage for the Government's fiscal deficit that inevitably translated into price hikes and the consequent deterioration of the currency's value and the sneaky establishment of the most burdensome mandatory tax that can exist for those who depend solely on a salary.

During the last few years we have been able to appreciate how a balanced environment and a stable economy have fostered sustained product growth, increased savings and investment, and how an adequate exchange policy has contributed to the country's structural adjustment and has transformed Chile into a real project for exports, thus making the onerous external debt burden easier to endure

The contrasts certainly become sharper if we compare Chile with the other countries of the region, where they struggle in serious economic crisis that contribute, also, with serious social and political troubles.

It is my belief that the experiences described confirm the idea that autonomy for the Central Bank amounts to capitalizing on these preceding years' achievement of greater levels of stability in our process of development.

I thank, in the name of the Central Bank and co-sponsoring universities, the soundly based presentations of the honored participants, and I wish that this encounter and their stay in Chile will further nurture presently existing relationships at the personal as well as the institutional level.

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**DIRECCION
DE ESTUDIOS**

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