

No Free Lunch

*Forrest Capie, Charles Goodhart, Stanley Fischer and Norbert Schnadt,
The Future of Central Banking: The Tercentenary Symposium of the Bank of
England, Cambridge University Press, Cambridge, 1994*

Reviewed by Stephen Kirchner

THE substantive papers in this record of the proceedings of supposedly the largest ever gathering of past and present central bankers are those by Charles Goodhart on 'The Development of Central Banking' and Stanley Fischer on 'Modern Central Banking'. The volume also contains the text of the 1994 Per Jacobssen Lecture, given by Alexandre Lamfalussy, General Manager of the Bank of International Settlements, and titled 'Central Banking in Transition'. The discussants include some of the world's leading central bankers, including Alan Greenspan, Paul Volcker, Karl-Otto Pohl and the central bank governors of France, Japan, New Zealand, Mexico, and the Czech Republic. The Reserve Bank of Australia was apparently not formally represented at the symposium.

Goodhart's paper, co-authored with Forrest Capie and Norbert Schnadt, contains a lot of insightful analysis and a wealth of historical and current data on central banking. Its two appendices provide a short history of money market operations and central bank objectives and functions in a wide range of countries. Although Goodhart dismisses free banking as an 'academic diversion' (p.90), he notes that 'should the current enthusiasm for central bank independence prove a disappointment, in terms of the successful re-establishment of price stability, then it is possible, though far from certain, that the cause of "free banking" would obtain renewed support' (p.87). His paper also makes clear that free-banking scholarship has come a long way quickly. From near total neglect prior to Larry White's publication of *Free Banking in Britain* in 1984, there is now an extensive literature on the subject, and free banking has a large number of distinguished academic adherents. Goodhart's criticism that free banking has little support from central banking 'practitioners' (p.86) would come as no surprise to, and carry little weight with, its advocates. One would hardly expect central bankers to welcome proposals to do away with their jobs, not to mention trips to international symposia like this one!

Stanley Fischer covers the major theoretical developments in the study of the costs of inflation, the rule-versus-discretion debate, the game-theoretic dynamic inconsistency literature and the debate over central bank independence. He reviews the evidence that central bank independence constitutes a 'free lunch': that it can bring about improved inflation performance with no apparent costs in terms of real economic performance. The theory suggests that an independent central bank should enjoy a 'credibility bonus' in its conduct of monetary policy, allowing it to reduce inflation at lower cost in terms of output than would be the case for a central bank with a closer relationship to government. But Fischer concludes that the exist-

ing evidence does not bear out the prediction. On average, the more independent central banks pay a higher output price per percentage point of inflation to reduce the inflation rate. There may be other factors at work here. But, when coupled with the strong arguments in favour of the endogeneity of central bank independence, the 'free lunch' argument begins to look decidedly weak.

Lamfalussy is concerned that rapid changes in international financial markets will make it increasingly difficult for central banks to implement their preferred monetary policies and to prevent systemic instability or crises through prudential supervision of financial institutions. He notes that financial markets are becoming more robust and therefore perhaps less in need of oversight from central banks. In particular, globalisation has increased the depth and liquidity of financial markets, while securitisation has led to a wider distribution of risks. Lamfalussy has perhaps missed the broader significance of these trends for the future of central banking. National monetary authorities that once had a commanding role in national financial markets are becoming increasingly irrelevant to the activities of global financial markets. And financial innovations, including the growing use of electronic money, may result in a form of currency competition, with or without free banking, that will radically challenge the traditional prerogatives of central banks.

Lamfalussy quotes Henry Wallich to the effect that inflation is a monetary phenomenon, but only in the sense that shooting people is a ballistic phenomenon. The important issue is to explain why people are being shot, by whom and for what reasons, and not the particulars of how they are being shot. The traditional benevolent social-planner model of central banking cannot provide answers to these questions, because it fails to recognise that inflation is ultimately a political phenomenon. A public-choice perspective on the institutional and other incentives involved in the determination of monetary policy is more likely to produce the answers, as indeed does Stanley Fischer's paper in this volume.

The Tercentenary Symposium was intended as a celebration of central banking, so it is not surprising that there are plenty of references to the 'revered Old Lady of Threadneedle Street' and lots of ritual homage paid to the goal of price stability. The singular failure of central banking to promote price stability throughout its history has been glossed over in the light of recent victories achieved against inflation in a number of leading industrialised countries, including Australia. But many of these apparent victories have been the result of opportunistic macroeconomic policies that have taken advantage of favourable supply and cost shocks to ratchet down inflation, rather than the result of monetary institutions geared explicitly and exclusively to achieving and maintaining price stability over the longer term. Although this symposium was devoted to the future of central banking, there is little serious soul searching or long-range thinking to be found here. The conference might more usefully have addressed the question of whether the Bank of England will see its way to another centenary celebration. But the time horizons of central bankers are not quite as long as they are sometimes given credit for.

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