PERFORMANCE EVALUATION AND ACCOUNTABILITY OF CENTRAL BANKS

COMPTON BOURNE

Office of Planning and Programming
The University of the West Indies
St. Augustine

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INTRODUCTION

Central banks are potentially one of the more powerful and influential economic institutions in Caribbean states. In legislative and regulatory terms, they are the overlords of the formal financial system. Where this legislative or statutory power is transformed into real power, i.e. the ability to make other financial institutions and transactors behave as the central bank intends, then central banks become the dominant institutions imbued with the capacity to shape, guide and determine the structure of the financial system and the course of general economic activity. The potential influence of central banks also derives from their status within the hierarchy of public sector economic agencies. They are regarded as the centre of expertise in finance and macroeconomics if not in the entire field of economic development. Their close working relationships with international financial institutions, particularly their policy intermediation between those institutions and the political directorate add weight to their advice.

These potential sources of power and prestige are not always manifest and are not always permitted expression. In Guyana, the central bank has since 1970 been marginalized by the political directorate which has established more powerful and influential economic agencies elsewhere in the state system. Furthermore, although there is room for debate about the exact degree of the diminution in the status and influence of the Bank of Jamaica since 1977, it is evident to informed observers that this Central Bank no longer enjoys the status and wields the power characteristic of its 15 years of existence.

On the whole, Caribbean central banks do exercise power and do have enormous prestige. They are subject only to the authority of the political directorate to whom they are legally answerable and from whom they may receive directives. The reality, as distinct from the constitutional formality, of political control and accountability is the subject matter of this paper. It proceeds on the premise that performance accountability is desirable and enquires into the problem of making accountability meaningful. The implicit viewpoint that central banks do not necessarily know best, are not error-free, and may have social preferences which should not necessarily prevail in a democratic society may seem somewhat heretical to those who espouse the independence of central banks from the political system e.g. Blackman (3) and Worrell (30).

THE CONCEPT OF PERFORMANCE ACCOUNTABILITY

The concept of performance accountability pertains to achievement or non-achievement of economic goals assigned to central banks. It is to be sharply distinguished from financial accountability which deals with rectitude and efficiency in the use of funds. A central bank is accountable for its performance if through a set of systems and rules it can be made to answer - rewarded, penalized, praised or censured - for achievement or non-achievement of goals.

There are several elements in this definition of performance accountability. These include (i) the identification of central banking goals or objectives; (ii) the identification of performance indicators; (iii) attribution; (iv) and the system or rules for answerability. Each is analyzed in turn.

GOALS, OBJECTIVES AND THE CENTRAL BANK'S PREFERENCE FUNCTION

The first major difficulty in performance accountability is encountered with the evaluation of central banking performance. To evaluate performance, one must first identify the goals or objectives pursued. Several broad objectives can in fact be easily established from the enabling legislation of the central banks. Blackman (3) lists these as:

1. The preservation of the internal value of the currency
2. The preservation of the external value of the currency
3. The promotion of economic development
4. The promotion of a healthy financial system
5. The development of capital markets

The difficulty arises primarily because not all statutory objectives have the same importance or weight in the central bank's scheme of things at any point in time or over any defined interval of time. For instance, it cannot be concluded that capital market development featured importantly among central banking objectives in Barbados during the 1970s or among the members of Organization of Eastern Caribbean States during the early part of the 1980s. Similarly, one would be hardpressed to sustain the argument that the Bank of Guyana or the Bank of Jamaica sought actively to preserve the internal and external value of their national currencies during the 1980s. Generally speaking, the social preference function of central banks as a formal representation of their goals and objectives is not time invariant or uni-valued.

The central bank's social preference function may not correspond with that of the political directorate, statutorily defined objectives, or with the community's social preference function. One issue which then arises is which set of weighted objectives is the appropriate set for performance evaluation of the central bank e.g. the objectives they are required to pursue or the ones they actually pursue? The notion that central banks may have quite separate and distinct preference functions from their political masters and the general public is readily understood from the perspective of bureaucratic theory. Within this paradigm, central banks are viewed as bureaux which are concerned with prestige and self-preservation and this may lead to a distinctive ordering of objectives by a central bank (Acheson and Chant, 1). If there are indeed differences between the preference functions, then one cannot conclusively infer policy failures from divergences between exogenously i.e. politically determined objectives and actual outcomes. What may appear to be policy failure may merely reflect the central bank's pursuit of an internally determined different set of objectives.

Matters may be further complicated by deliberate central bank strategies of goal concealment. The less explicit or identifiable are central banking goals and objectives, the weaker is the empirical basis for criticism and the smaller is the scope for political efforts at ensuring convergence between the central bank's preferences and the society's preferences. As a bureau, it is in the central bank's interest to provide as little information as possible and to be as vague as possible about policy objectives and their relative ranks or ordering. Mystification may be good defensive and interest promoting strategy (Acheson and Chant, 2; Chant and Acheson, 9).

Given the possibility of divergent objectives and of mystification, it is essential that society and the political directorate develop the capability of discerning the "true" as distinct from "stated" objectives or goals of central banking policy. However, the ability to identify the "revealed preferences" of central banks is not an easy task.

REVEALED PREFERENCES OF CENTRAL BANKS

A strand of the economics literature offers a solution to the problems which might be posed by the failure of central banks to state their true intentions. The 'revealed preference' approach pioneered by Reuber (19) and Wood (27) has its roots in the theory of optimal economic policy developed by Theil (23). The approach infers the policy intent by working backwards from knowledge of the policy actions, given a known structure of the links between policy actions and policy outcomes. Motive is deduced from action. A formal variant of this approach may be usefully sketched as follows:-

Let the central bank's preference function be the quadratic:

(1) $$U = (Y - Y^*)' \; W(Y - Y^*) + (X - X^*)' \; Z(X - X^*)$$

Where Y^* and X^* are vectors of desired values of the objective variables Y and the central bank's instrument variables X, and where W and Z are relevant matrices of weights representing the unknown preferences of the central bank.

Assume that the central bank operates with a truncated policy model of the economy linear in the policy instruments:

(2) $$Y = AX$$

Where A is a matrix of reduced form coefficients.

Then assuming that the central bank optimally chooses the values of the instrument variables, we get (by solving the first order conditions for maximum U) the optimal reaction function of the central bank

(3) $X = X^* + Z^{-1} A' WY^* - Z^{-1} A' WY$

The optimal reaction function provides quantitative evidence on the contribution of changes in the objective variables to changes in the policy instruments by the central bank. In this sense, the policy preferences of the central bank are revealed by its policy actions. For example, suppose that a 10% monetary expansion is known a priori to cause a 3% growth in employment, a 10% price level increase, and a 8% deterioration in the foreign reserves. Furthermore, suppose that starting from a situation of zero per cent changes for all three objective variables i.e. employment, price level, and foreign reserves, employment drops by 3%. If the central bank then expands the money stock by 10%, one would infer from the monetary expansion that the central bank attached greater social value to the employment objective than to the stability of the internal value of the currency and the balance of payments.

However, there still remain pitfalls in the revealed preference approach. Cognizance has to be taken of the possibility of covert policy action. In addition, the value of the approach is contingent upon knowledge of the economic structure or policy transmission mechanism.

POLICY EXTERNALITIES

Kane (13) pointed to possibility of unintended consequences of policy actions. Where the variable affected are within the central bank's preference function, these effects are likely to be incorporated in subsequent policy reformulation. When they fall outside the preference function, they are an externality. Analogous to the incorporation of externalities in social cost-benefit analysis of investment projects, it seems advisable to incorporate the unintended effects of policy actions in the performance appraisal of central banks. This means that the review of goals and achievements must go beyond the statutory or declared objectives of the central bank and should encompass consideration of spillover effects on variables not within the set of statutory or declared objectives.

PERFORMANCE INDICATORS

Public economic objectives are often stated in terms that lead to imprecision and lack of clarity with respect to measures of achievement. In other words, it is not often clear what are the appropriate performance indicators. Consider for instance, objectives such as "economic development", "capital market development", and "promotion of a healthy financial sector". Economic development admits numerous performance indicators: growth of national income on an aggregate or per capita basis over some specific period; stability of incomes; the degree of employment; self-sufficiency (variously measured); etc. The problems of indicators with respect to capital market development can be exemplified by the following set of questions: Is capital market development measured by the number of institutions? The volume of instruments traded? The pattern of investment financing?

Similar definitional issues arise with respect to the policy objective of a healthy financial system. How many institutional failures does it take to make a financial system unhealthy? Does it depend upon how much wealth is lost or on how pervasive is the damage? Even apparently simple cases like preservation of the internal and external value of the currency turn out to be tricky because of choices with respect to relevant reference period and the acceptable degree of change and deviance.

If there are no clear-cut performance indicators or if there is scope for reasonable differences in the choice of performance indicators, then one can be fairly sure that there will be major difficulty in reaching agreement on the quality or effectiveness of central bank performance even if there was an agreed identification of the set of policy objectives.

ATTRIBUTION

Attribution or assignment of responsibility for performance outcomes presents perhaps the most difficulty in making central banks accountable. One reason is the less than full information available on central bank actions. Chant and Acheson (9) argue that bureaux will prefer covert to overt methods. "By use of covert methods, combined with a skillfully created mythology, the management of any bureau can increase its immunity to critical investigation" (pg. 109). Covert actions will also appeal to central banks because of "the broad range of initiatives implicit in their use." Chant and Acheson indicate that, depending upon the instrument chosen, a central bank may obfuscate its powers or crucially delay knowledge of its powers. They go on to argue that a central bank can influence the overall covertness of its monetary policy by a judicious combination of instruments. "Sole

reliance on any given instrument leaves a central bank vulnerable because only one signal is provided of the Bank's actions. On the other hand, combination of several instruments used in different degrees and even in different directions at the same time makes interpretation of the central bank's actions much more difficult and provides a degree of covertness unobtainable by exclusive reliance on any instrument." (Chant and Acheson, 9, pg. 110).

A second reason is that the central bank is often not the only bureau with official responsibility for policy goals. For instance, the goals of economic development and capital market development in the Caribbean are also the responsibility (partial at least) of other economic bureaux such as the Ministry of Finance and the Ministry of Planning and of some legislative bureaux. Responsibility is diffused in most cases. Diffusion of responsibility provides opportunities for blame shifting among the several bureaux and may thereby reduce their separate accountability.

Thirdly, each of the statutory objectives of central banking policy is a complex function of variables, all of which are not endogenous to the central bank. In such circumstances, it can be argued that goals were not achieved despite the best efforts of the central bank. An interesting example is the case of general price level stability. Only monetary reductionist models of the open macroeconomy would insist that the rate of inflation is a single-valued function of the domestic money stock. More complete causal models would allow for the influence of foreign prices and money wage rates. The latter two variables are exogenous to the central bank. If increases in either variable exert upward pressure on aggregate prices independently of any change in the nominal money

stock, it would be difficult to sustain the argument that monetary policy caused inflation, although it is readily understood that subsequent increases in the money stock would validate the inflation induced by foreign prices or by nominal wage rates. This example shows the potential for ambiguity in interpretation of cause and effect and the difficulty it creates for attribution. There are many cases of course where no such ambiguity exists and where it is clear that the central bank does not have full control. For example, the failure of financial institutions may be due to the absence of adequate regulatory power or to a generalized recession in the economy or in a particular sector. Friedman and Schwartz (12) and Bourne and Graham (4) demonstrate that ex ante sound loans can become unsafe ex post because of deep economic recession.

There is a fourth reason which is closely related to the third one, namely that there is not always much technical consensus on the mechanisms of the economy. Differences in technical judgements lead to different appraisals of central bank performance and to varied perspectives on the issue of attribution. Many examples may be adduced but it is perhaps sufficient to refer to the cases of the demand for money, the aggregate savings function, and the aggregate investment function. The demand for money function is a key relationship in macroeconomic models. Monetarists believe that there exists a stable relationship between the demand for real money balances and real income so that changes in nominal money balances generate changes in aggregate expenditures, aggregate prices and the balance of payments. A recent Caribbean example of such a monetarist model is contained in St. Cyr (22). In the monetarist schema, interest rates have at best a weak and distant effect on the demand for real money balances so that the effects of money stock

changes are not transmitted through financial markets. Keynesians in contrast believe that interest rates are a major influence on the demand for real money balances and that monetary effects on aggregate expenditures, aggregate prices and the balance of payments are transmitted via financial markets. The Caribbean empirical studies on real money demand functions reported in Bourne (5) provide a menu of estimates of the income and interest rate parameters, giving rise to a lack of consensus on the empirical magnitude of the relationships.

The savings function is another major macroeconomic relationship. It plays a central role in short-run stabilization analysis and policy as well as in long-run economic growth and development. It is common practice to specify the savings function with some income variable and interest rate as its arguments. The development economics literature often adds other variables such as the dependency ratio and foreign savings. A variety of empirical specifications are reported in Bourne (4), Ekanayake and St. Cyr (10) Ramsaran (17) Watson (24), and Watson and Ramlogan (25). Here, too, the empirical evidence is conflicting. With respect to the influence of interest rates on domestic savings in Trinidad and Tobago, Watson (24) reports a coefficient of 2261.9 for one specification and 2459.9 for another specification. Watson and Ramlogan (25) report interest rate coefficients of 0.641, 0.653, 1.27, and 1.22 for varying specifications of a Trinidad and Tobago savings function in which the savings ratio is the dependent variable, and estimated coefficients of 2143.8, 2276.1 and 2865.6 when the net national savings is the dependent variable. On the basis of these two studies alone, the policymaker and the policy analyst have considerable latitude with respect to the savings model they may choose.

The empirical evidence on the aggregate investment function is also inconclusive. Studies by Worrell (29), Bourne (5), and Ramlogan and St. Cyr (16) lead to quite different conclusions about the strength of monetary and financial influences on aggregate investment. Even a single study on a single country e.g. Ramlogan and St. Cyr (16) presents a variety of results. Thus Ramlogan and St. Cyr (16) present five different statistically significant (but perversely signed) coefficient estimates for their credit variable, and similarly for their output variable. Coefficient estimates are not identical across model specifications.

The main conclusion of this section, therefore, is that it is extremely difficult to attribute credit or blame to central banks even within their statutory realms of responsibility because their actions may be covert, other public sector agencies share responsibility with them in vaguely defined terms, important causal variables might be exogenous to the central bank's set of policy instruments, and the underlying model of the pertinent economic process may be unclear and debatable.

PROVISIONS FOR PERFORMANCE ACCOUNTABILITY

There is hardly any constitutional or other formal provision for performance accountability in Caribbean central banking. The Trinidad and Tobago Central Bank Act is characteristic of the status quo. It stipulates that the central bank shall keep the Minister of Finance informed of monetary and banking policies pursued or intended. It permits the Minister to issue general directives to give effect to the monetary and fiscal policies of the government. It also requires a copy of the Central Bank's Annual Report to be laid before Parliament. Although the laying of the Annual Report in Parliament provides an

opportunity for parliamentary review and debate on central bank performance, this rarely happens. Furthermore, when questions are raised they tend to be focussed on alleged breaches of statutory restrictions on central bank credit to the government, rather than on the central bank's macroeconomic and financial sector management performance.

The United States is sometimes cited as an example of how performance accountability might be formally achieved. The Federal Reserve System must report to Congress. Furthermore, the Chairman and the Governors of the Federal Reserve Board are required to appear before the Banking Committee and the Joint Economic Committee. Thus in theory "Congress can provide a highly visible forum for criticism of the System". Woolley (28 pg. 133). There is considerable skepticism, however, about the effectiveness of congressional supervision. Reagan (18 pg 298) asserts that the "issue of FRB accountability to Congress is a false one and should be exposed as such." Skaggs and Wasserkrup (21) claim that the information provided to Congress at quarterly oversight hearings is insufficient and inadequate. Woolley (28) points to the inadequate technical background of members and to the limited staff resources of the oversight committees as well as the lack of sustained interest as further constraints.

From a Caribbean perspective of little or no performance accountability of public sector agencies, it would still be useful to adopt the US system of congressional supervision. At the minimum, it would serve to focus parliamentary attention on macroeconomic policy and on the role of the central bank in the conduct of that policy. Routine requirement of parliamentary review would galvanize wider public interest and discussion because issues raised in parliament tend to be widely reported by the national communications media and thereby command public attention.

These formal provisions for performance accountability could be reinforced by the development of a better technically equipped media and local intelligentsia, and by publication of good quality current affairs journals with reasonable coverage and periodicity.

A QUESTION IN LIEU OF A CONCLUSION: SHOULD CENTRAL BANKS BE ACCOUNTABLE?

Performance accountability of central banks is closely related but not identical to the question of central bank independence from the political system. It is therefore perhaps useful to conclude by re-examining the premise on which this paper was constructed. There is a large international body of opinion in favour of independent central banking. Similar views have recently been advocated in the Caribbean by Blackman (3), Worrell (30), and with some qualification by Farrell (11). Expert opinion has not always supported the desirability nor the reality of central bank independence. For instance R.S. Sayers categorically states: "The authority of the state over the central bank is always necessarily absolute. All that is open to question is the extent to which the sovereign body should detail its commands to the central bank - for the monetary laws are such commands" (20 pg. 65). Cairncross concludes at the end of his survey of relations between the Bank of England, the Treasury, and Parliament that "The British experience has been that there is no alternative to a close working relationship with each preserving its independence of judgement but with the responsibility for major decisions resting inevitably on the government of the day." (8, pg.71-72). Edward Kane's summary conclusion on the Federal Reserve System is definitive: "The Fed is approximately as independent as a college student whose room and board is financed by a parentally revocable trust fund. Some conflict will

be tolerated, but the limits of the benefactors patience must always be kept in mind." (Kane 14, p. 329). Furthermore, the abrupt departure of Mr. Pohl from the Presidency of the Deutchse Bundesbank in Germany after his loss of a major policy issue with Chancellor Kohl at the very least raises a question about the reality of the much proclaimed independence of the Deutsche Bundesbank.

It has been observed that "virtually all those who advocate independence, do so because they want the central bank to pursue, or at least to be able to pursue, fundamentally different objectives from those pursued by the rest of the government." (Bryant 7, pg. 320). Fortunately, this has not proved possible in modern democratic societies.

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