Monetary Policy Goals and Central Bank Independence *

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In recent years, a forceful body of academic literature has argued that central bank independence (CBI) is necessary to achieve and maintain price stability or low inflation. On the face of it, this view seems to confirm what most central bankers accept as an article of faith, namely, that they should have the autonomy to pursue policy objectives without being subjected to short-term political pressures, including intervention from other branches of government. At a more fundamental level, however, many aspects of recent CBI models are significantly removed from the realities of central bank policymaking. This paper focuses on two such aspects: the treatment of policy goals, and the issue of policymakers' inflationary bias.

1. Recent CBI studies

Most recent academic models of CBI assert that the sole, or at least the main, final goal of monetary policy is to maintain zero or low inflation.[1] Toward this end, so the model argument goes, central

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[1] For surveys of wide-ranging issues involved in central bank independence and reviews of recent studies, see Fischer (1994, 1995), Cukierman (1992, 1994) and Blinder (1995).

banks should be enshrined in a legal/institutional framework that would allow them a high level of immunity from short-term political pressures and independence from other parts of the government, and, at the same time, would provide them with the freedom to use their instruments to achieve price stability even at the cost of disregarding other objectives.

The empirical basis for establishing legal/institutional central bank independence is that many studies find a negative relationship, cross-sectionally, between inflation and measures of independence, at least for the industrial countries (see Fischer 1994, Cukierman 1992 and Cukierman *et al.* 1992). Some of these studies also find that independence is not significantly related to real economic growth, that is, independent central banks are able to maintain low average inflation without hurting growth (see, for example, Grilli *et al.* 1991 and Alesina and Summers 1993).

The theoretical case for CBI is based, to a large extent, on the view that policymakers are subject to a *systematic* inflationary bias. Most recent models of CBI attribute the systematic inflationary bias to the so-called dynamic or time inconsistency of monetary policy as theorized by Kydland and Prescott (1977) and Barrow and Gordon (1983). The time inconsistency refers to the gap between the optimal policies that would be announced by the authorities and believed by the public *and* the policies that would be carried out if, in fact, the public had acted on those beliefs or expectations. The time inconsistency arises because the authorities may not follow through if their announcements were believed and acted upon by private agents.

More specifically, according to the time inconsistency theory, the expectational Phillips curve creates a temptation for central banks to exploit the short-run tradeoff between inflation and unemployment. In practice, however, they can reduce unemployment only temporarily by surprising the private sector with more inflation than anticipated. In a rational expectations world, a time inconsistent policy is not "credible" because the public views policymaking as opportunistic and understands the authorities' temptations. And, as a consequence, monetary policy is not able to maintain a systematic wedge between actual and anticipated inflation. With no tradeoff between inflation and unemployment in the long run – vertical Phillips curve – policymakers' desire for short-term gains simply results in more inflation without additional growth and employment.

A major implication of recent CBI studies is that the establishment of legal independence eliminates the systematic inflationary bias by pre-committing central bankers to focus their instruments on price stability. A related implication is that, by ensuring the application of time consistent policies, CBI also offers the opportunity to improve the tradeoff between inflation and unemployment and enjoy a "credibility bonus". So far, however, empirical work offers little support for the view that CBI yields a credibility bonus or free lunch (see Fischer 1994 and Posen 1995).

2. Problems of CBI studies

The CBI models have made a useful contribution to policymaking by demonstrating that a high degree of independence from short-term political pressures is critical for achieving and maintaining price stability. Of course, this conclusion is not unique to recent CBI studies. Indeed, it is shared by a broad consensus of economists and policymakers. Nevertheless, empirical work within the context of these studies has highlighted the need for central bank independence. The rationale for such independence is that monetary policy operates with significant time lags and elected officials (politicians) may be more easily tempted by short-term gains at the expense of long-term benefits.

So far so good. But other aspects of most recent CBI models are more problematic. In particular, the treatment of policy goals and the assumptions about central bank inflationary bias are seriously flawed. The treatment of policy goals also causes problems for measuring central bank independence. The remainder of this paper focuses on these issues.[2]

2.1. *Policy goals*

Recent models of CBI do not include a significant degree of independence on policy goals. In fact, most of these models assume,

[2] Some recent studies have discussed other important shortcomings including, for example, the possibility of reverse causation between CBI and inflation, and the problem that legal independence may be quite different from actual independence.

explicitly or implicitly, the single-minded pursuit of inflation control as the *only* appropriate policy goal for central banks. In other words, CBI refers to fully constrained policy goals but unconstrained means or instruments to achieve those constrained goals.[3]

As a prologue to the following discussion, I want to emphasize the distinction between price stability as the *primary* monetary policy goal versus price stability as the *sole* monetary policy goal specified in terms of a numerical inflation target for zero or low inflation. The former allows policymakers, among other things, the discretion to deal with short-term priorities as demanded by circumstances, without losing sight of price stability over a longer period. It also may allow considerable scope for policymakers to interpret and give specific content to the broad legislative mandate as long as that mandate is consistent with maintaining price stability in an unmistakable way. In contrast, there is no room for discretion or interpretation in the latter notion; it is entirely driven by a fixed rule, and it does not accommodate cyclical stabilization of the economy and other short-term priorities. Note that greater rigidity of this notion relative to the other one reflects two aspects: the exclusive focus on price stability at the cost of other objectives, and the pursuit of a specific numerical inflation target.

The two notions of price stability as monetary policy goals are qualitatively different, and imply substantially different welfare costs for society. In recent years, something like the first notion has gained increasingly greater acceptance among economists, central bankers and the general public. The critique below is largely directed at the other, more rigid characterization of the central bank price stability task; some version of that characterization is incorporated in most CBI models.

Central bankers generally are not fond of multiple, and especially conflicting policy goals, although, in many cases, vague mandates with multiple objectives enhance their *de facto* power by allowing them discretion to provide specific interpretations of the ambiguities and to decide how to deal with the short-run tradeoff among conflicting objectives. While most central bankers would prefer more precisely defined policy goals, their notion of central bank independence is not likely to be driven by the single minded

[3] Fischer (1994, 1995) draws a clear distinction between goal independence and instrument independence.

pursuit of a numerical inflation target at all costs, with no role for them in choosing or even interpreting objectives over any time horizon, short or long.

Central bankers' preferences aside, it is entirely appropriate that, in a democracy, broad central bank policy goals be established by the legislative/institutional process and that the central bank be assigned only a limited role in setting those goals. But why should the legislative/institutional process impose price stability as the sole, or even the main, policy objective on central banks?

In principle, central bank independence implies the autonomy to pursue not just low inflation or price stability but also other important goals, such as high employment or growth, financial stability, and external stability. Indeed, most national economic goals have legitimate claims on central bank policy. But a central bank cannot achieve or even pursue all these goals simultaneously, given its policy instruments. So choosing a narrower set of appropriate central bank policy objectives is necessary.[4] What should be the basis for that choice?

In choosing central bank policy goals – regardless of whether the choice is made by the central bank or imposed on it by the legal/institutional process – two fundamental considerations are relevant: the workings of the economy and the role of monetary policy in it; and the political and social context of broader historical experience (see Akhtar and Howe 1991). These two considerations are pursued in some detail here.

No consensus exists among economists on how to specify the economy's structure and workings, and the role of monetary policy. Competing theoretical models offer markedly different implications for the role of money in the economy. But most economists generally agree that, in the long run, monetary policy primarily affects prices and that it has powerful effects on output and employment in the

[4] More narrowly and precisely defined policy goals are not inconsistent with the notion of an independent central bank, except if such a definition results in a rigid focus on a single objective eliminating central bank's interpretative role and its ability to establish appropriate short- and long-run priorities. Note that, in its purest form, the theory of economic policy argues that monetary policy can be effective in meeting only one goal. But with many more goals than instruments, this option is not available in practice. See Kindleberger (1995) and Volcker (1993) for more realistic perspectives on this issue. For a broad historical and institutional perspective on central bank functions, see Deane and Pringle (1995, especially chapter 8).

short run. In other words, monetary policy is neutral in the long run but not in the short run.[5]

If monetary policy has significant effects on employment and output, then it cannot aim exclusively at maintaining stable prices or low inflation rates on a period-by-period basis – say, on a quarterly, or annual basis – without inducing recessions or prolonged periods of weak economic activity. Given difficulties of forecasting the future path of prices and great uncertainties about the size and timing of monetary policy effects on the economy, focusing on inflation control alone is all but certain to increase the variability of real output (see, for example, Cecchetti 1995). The pursuit of a precise zero or low inflation numerical target is even more problematic since it runs the risk of aggravating and prolonging a weak economy, and possibly turning an ordinary weakness into a recession. Not surprisingly, therefore, all central banks attempt to stabilize, albeit to varying degrees, short- run or cyclical movements of output and employment.

Apparently, recent CBI models subsume financial stability – the basic function of central banks – under price stability. But if monetary policy has significant consequences for output and employment over periods lasting many years, this assumption is clearly unrealistic. In these circumstances, tightening monetary policy during a recession, as may be required at times under a numerical inflation target, would hardly seem to be the recipe for maintaining a stable financial environment. More generally, the single-minded pursuit of inflation control – whether defined as a numerical target for zero or low inflation or simply as no significant increases in the general price level – during periods of weak economic activity would lead to a more fragile financial environment, and may well cause financial shocks, disrupting the economy. Within that context, the exclusive focus on a precise numerical inflation target has the potential to turn small and moderate financial problems into larger shocks. Such an approach would seem to run the risk of damaging the very thing central banks

[5] In Milton Friedman's words: "In the short run, which may be as much as five or ten years, monetary changes affect primarily output. Over decades, on the other hand, the rate of monetary growth affects primarily prices" (1970, pp. 23-24). Note that Friedman's *static* long period ignores the significance of the dynamic output effects of monetary changes for long-run equilibrium. Those dynamic effects help explain, to some extent, why some economists question even the long-run neutrality of monetary policy. For review of the issues involved in the neutrality of monetary policy, see Patinkin (1992) and Tobin (1992).

are designed to protect – the safety and soundness of the money and credit system – and ultimately undermining price stability itself.

A stable financial environment requires much more than just maintaining zero or low inflation. It involves pursuing monetary policy actions that will minimize risks of financial shocks, while, at the same time, remaining consistent with long-run price stability. It also means dealing with actual and potential systemic risk in the financial system and containing various moral hazard problems for banks and other financial institutions in the context of a competitive financial environment.

With greatly increased integration and globalization of national financial markets, maintaining a stable domestic financial environment also demands that national policy actions be consistent with international considerations.[6] Given the high degree of interdependence of national financial policies and markets, no one central bank can have its way in the global marketplace. Consequently, in today's global financial environment, the effectiveness of a country's monetary policy to stabilize its own economy is closely tied to the interaction between domestic policy actions and international financial markets (see McDonough 1995).

In the long run, the pursuit of price stability may well be theoretically consistent with financial stability, but that pursuit, by itself, is clearly not sufficient for maintaining a stable financial environment during a given time period. Financial problems do occur in a low inflation environment; this is consistent with much pre-war experience and with the experience of the 1980s (see Kaufman 1994). History indicates that rising interest rates, even against the background of stable prices, can have significant adverse effects on asset values and liquidity of banks and other financial institutions. In considering the relevance of *the long run steady state stability conditions* for financial stability in the real world, one should keep in mind Keynes' admonition: "Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again" (Keynes 1924, p. 88).

The logic of all this suggests that the focus on price stability alone is unlikely to deliver a stable financial environment and that the

[6] Note that the financial stability function of central banks implies the lender of last resort role as well as an involvement in regulation and supervision. On the relevance of financial interdependence and globalization to central bank independence, see Solomon (1995 chapter 26) and Volcker (1993).

single-minded pursuit of a zero or low numerical inflation target could actually damage financial stability. A stable financial environment requires price stability. But it also needs to avoid repeated shocks to and breakdowns of financial markets and institutions. That means, ultimately, both price stability and a generally healthy economy, albeit with some cyclical fluctuations, are necessary to maintain a stable financial environment.

The broader historical social experience in the industrialized democracies seems to offer less clear implications for establishing central bank policy goals. On the one hand, the German experience with hyperinflation during the interwar period built a broad social consensus in favor of price stability, and as a consequence, the Bundesbank charter assigned the highest priority to "safeguarding the currency" (i.e. price stability) among monetary policy objectives. On the other hand, the law requires the Federal Reserve "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". This vague mandate seems to reflect, to some extent, traces of the influence of the Great Depression.

The inflation experience of the industrialized democracies in the 1970s and the 1980s garnered substantial public support for price stability. In part, this reflects greater recognition that, in a modern economy, even moderate rates of inflation – both anticipated and unanticipated – result in considerable social costs to the society (see Fischer 1994 for review of social costs). But there is no evidence that social costs would be smaller if central banks were to focus *exclusively* on price stability; on the contrary, social costs of that approach could well prove to be even larger.

Perhaps central bankers instinctively recognize that social costs of a long-term rigid policy focus on little or no change in the general price level would be not only very large but also quite difficult to manage in a political sense. Many of them talk in terms of noninflationary growth and not just inflation control. In recent years, while price stability has been the primary goal of monetary policies in the industrial countries, cyclical employment and output considerations have frequently influenced short-run policy actions. Even those countries that recently have pursued numerical inflation targets – such as Canada, New Zealand and the U.K. – have not sought to impose a permanently rigid design on policy goals.

There is certainly no compelling evidence that people want zero or low inflation at all costs. Politicians frequently make promises of more jobs and growth. In fact, in the United States, politicians and the public at large perceived low growth and poor job prospects as the key economic problems in the last three national elections. Against the background of relatively low inflation, the public has shown no significant appetite in recent years to aim economic policy at lowering inflation further, much less making inflation control the sole objective of monetary policy. Not surprisingly, legislative proposals in U.S. Congress to focus the Federal Reserve's mandate more sharply on price stability – e.g. the Neal Bill – did not attract enough support to even reach the House/Senate floor debate levels.

Where does all this leave us as far as central bank policy goals are concerned? Both economic theory and broader historical social experience indicate that the central bank mandate must include price stability as the key policy goal. They also suggest that the central bank should put greater emphasis on price stability relative to other goals, at least in the long run, that is, price stability should be the primary goal of monetary policy.

But neither the current state of economic knowledge nor the broader historical social experience justify making price stability or inflation control – whether defined as a precise numerical target or simply as no significant increases in the general price level – as the sole objective of monetary policy. Both sets of considerations militate against such a focus on monetary policy goals because of the implied social costs of short-run employment/output losses and financial instability problems.

This kind of narrow focus on policy goals can come only from looking at monetary policy as an abstract process far removed from the realities of policymaking. The idea that central banks can be free to focus exclusively and permanently on controlling increases in the price level without regard to the state of the economy and the financial system, and broad support from other branches of government and the public is not of this world. No democratic society is likely to institute a massive change in its central bank's charter based on a limited macroeconomic paradigm, which is not good enough even to pass the test of economic theory, let alone measure up to broader social considerations. There is a case, however, for tilting policy goals toward greater emphasis on price stability without relieving central banks of their responsibilities for short-run stabilization of the economy and for financial stability.

Goal independence and measurement of CBI

Problems of measuring central bank independence have been discussed in many recent studies (see, for example, Eijffinger and Schaling 1993 and Forder 1994). But, so far, measurement problems stemming from the treatment of policy goals in CBI models have not attracted much attention in the literature. The latter issue is the focus of comments here.

Empirical studies construct measures of CBI based on legal or statutory independence, which need not be the same as actual independence. Statutes do not cover all aspects of central bank behavior, and their implementation may be governed by unwritten institutional conventions. The implementation also may differ widely over time and among countries.

But even granting that legal independence is a good proxy for actual independence, there is no unique way to construct a CBI index; the outcome depends on the number of factors considered, weights for those factors and the procedures for aggregating them. Within this broad measurement context, the treatment of policy goals in the three widely used CBI indexes – Bade-Parkin (1988), Grilli *et al.* (1991) and Cukierman *et al.* (1992) – and their extensions suffer from at least two serious problems.

First, CBI indexes either exclude policy goals, or assign arbitrarily very low weights to them. Bade and Parkin specify no explicit weights for policy goals, only for whether the central bank is the *final* policy authority. Grilli *et al.* assign equal weights to eight different legal attributes, which include the statutory requirement that the central bank pursue monetary stability (i.e. price stability) among its goals. In their overall index, however, this weight may be cancelled if central bank policy formulation requires government approval. Cukierman *et al.* construct a CBI index based on a broad array of 16 legal variables, including the specification of policy objectives. Depending on the priority for price stability, policy goals in this index receive weights of zero (where stated objectives do not include price stability) to 15 percent (where price stability is the major or only objective and central bank has the final say).

Presumably, the Bade-Parkin type index considers legal specifications of independence on policy goals as unimportant to measuring the degree of CBI. In contrast, the measurement procedures in Grilli *et al.* and Cukierman *et al.* are consistent with constrained central bank goal independence. But neither offer any rationale for the actual weights assigned to policy goals. Why should policy goals matter so little relative to the means to achieve those goals? In the polar case where central bank independence includes both goal independence and instrument independence, the weights on legal specifications for both sides should be substantial, though not necessarily equal. But if independence refers to instrument independence to maintain low inflation or price stability, as is the case in recent CBI studies, the assignment of weights for policy goals becomes less clear. Note that any weighting scheme for price stability under this asymmetric definition of independence in fact assigns weight to *lack* of central bank goal independence.

A second fundamental measurement problem is that the treatment of policy goals in the existing CBI indexes is not consistent with a central bank policy mandate that could be justified on the basis of either economic theory or broader social considerations. In contrast to the more complex implications of the above discussion on policy goals, Grilli *et al.* (1991, p. 367) "identify independence with autonomy to pursue the goal of low inflation". Accordingly, they include only the low inflation objective in their index; the weight for other policy objectives is zero. Cukierman *et al.* consider price stability along with other objectives in constructing the index, but their weighting scheme also reflects fully constrained central bank goal independence. They score one point if price stability is the sole objective and the government cannot overrule the central bank; 0.8 for price stability alone; 0.6 for price stability and other compatible objectives; 0.4 for price stability and other potentially conflicting objectives; 0.2 for no specification of objectives in central bank charter; and zero for stated objectives which do not include price stability.

It is clear that the construction of CBI indexes in both Grilli *et al.* and Cukierman *et al.* reserves the highest weight for a central bank mandate with complete lack of goal independence, and gives no significant weights to policy objectives other than price stability. Moreover, the weighting schemes in both indexes, though somewhat different from each other, are arbitrary.

Overall, the existing CBI indexes are subject to serious shortcomings in their treatment of policy goals. Two of the three major indexes focus only on price stability, and assign arbitrarily low weights to policy goals relative to policy instruments. The third index ignores policy goals altogether.

2.2. *Inflationary bias*

Most recent models of CBI assume that policymakers are subject to a *systematic* inflationary bias because of the dynamic or time inconsistency of monetary policy. A broader issue is the existence of inflationary bias in the economic system due to both policy and non-policy sources. Here I deal with only the first issue.

The time inconsistency argument asserts that everyone, including the central bank, has rational expectations and knows how the economy works. The source of evil, as noted in the first section, is the short- run Phillips curve which creates a temptation for opportunistic policymakers to exploit the unemployment-inflation tradeoff. But since that tradeoff does not exist in the long run, it really cannot be exploited. Hence, the time inconsistent policies result in a systematic inflationary bias.

This theory of inflationary bias is deficient on both theoretical and empirical grounds.[7] On the theoretical side, the theory derives its forceful results from an entirely unrealistic assumption that the structure of the economy is known with certainty and that policymakers are able to hit their inflation targets on a period-by-period basis. Allowing uncertainty about the structure of the economy significantly alters the results: policymakers may not be able to hit their targets; they may not be able even to design rules and policies that work effectively; the public may not be able to distinguish between policy moves and random shocks, and between different types of policymakers; etc.

Another basic problem with this theory is that policymakers are assumed to target an unemployment rate that is inconsistent with the natural rate even though they know the structure of the economy. In the framework of the stipulated model, there is no inherent reason why policymakers should attempt to achieve such a low unemployment rate. They can simply aim at an unemployment rate that is compatible with the natural rate at which inflation is stabilized (see Englander 1991 and Blinder 1995).

Yet another significant problem with the time inconsistent theory is that the public is assumed to hold rational expectations about future events but policymakers are assumed to be less firmly grounded in rational expectations. In attempting to exploit the short-

[7] Englander (1991) presents a detailed review of these problems. See also Blinder (1995).

run inflation-unemployment tradeoff, policymakers feel they can fool most of the people for a long time even though they and the public have exactly the same information about the structure of the economy and their own policy preferences. This behavior cannot be justified on theoretical grounds; presumably, it occurs because policymakers' knowledge of the structure and policy preferences is overwhelmed by their susceptibility to short-term political influences. With central bankers holding less than fully rational expectations, the time inconsistency theory merely *assumes* that monetary policy is subject to a systematic inflationary bias. I can be forgiven for believing that central bankers are no less rational than the public.[8]

Turning to the empirical side, the time inconsistency theory of inflationary bias is consistent with relatively high inflation rates of the 1970s in most industrial countries. An alternative explanation for the prevalence of high inflation during that period is that the world economy experienced adverse shocks – two major oil price shocks, and the end of the Bretton-Woods system. Even so, however, one can argue that the theory in question explains the fact that central banks (and governments more generally) allowed those shocks to pass through into higher inflation.

This is plausible, but the pass-through of shocks into higher inflation is also easily explained without help from the time inconsistency view. Accommodation of higher inflation in the 1970s most likely reflected the state of economic knowledge about the inflation process. In particular, there was a widespread acceptance among economists of some version of the Phillips curve tradeoff and of the idea that welfare costs of low or moderate steady inflation rates were negligible. In fact, low levels of inflation were widely believed to be helpful in stimulating output and employment. Such views had considerable sway among politicians and the society at large. Against this background, policymakers were unwilling to accept the output cost of disinflation through much of the 1970s, and only gradually moved toward anti-inflationary policies.

Whatever conclusions one might reach about the 1970s, the time inconsistency theory of inflationary bias cannot be reconciled with longer economic history. After World War I, economic policies in the U.S. and the U.K. displayed a distinctly disinflationary bias:

[8] The assumption that the public holds rational expectations has been challenged on empirical grounds (see Englander 1991).

both countries disinflated to get back to fixed gold parities. In the post-World War II period, it is hard to make a case for systematic inflationary bias in U.S. monetary policy through much of the 1950s and the early 1960s when U.S. prices were essentially stable – between 1951 and 1965, consumer prices advanced, on average, about 1 1/3 percent per year while wholesale prices only rose about 2/3 of a percent per year. Since around 1980, monetary policies in the industrial countries have been consistently aimed at keeping inflation low or reducing it even further. Not surprisingly, these policies have caused, at times, sharp disinflations at high social costs. And yet, central banks in many industrial countries have exhibited strong willingness to continue disinflationary policies in the face of persistently high unemployment. Thus, monetary policies of the last 15 years or so, as noted by Blinder (1995), would hardly qualify as "grabbing for short-term employment gains at the expense of inflation".

Finally, it is worth noting that empirical studies have found little evidence to support the presumed major benefit of the time consistent policies, namely, that such policies result in lower output costs of disinflation due to the perceived credibility. The search for the credibility bonus has elicited much empirical work over the last 10-15 years – first, as part of the optimal monetary policy literature and, more recently, in the context of the CBI literature. So far, however, the credibility bonus has eluded most researchers.

Even if monetary policy is not a victim of the systematic inflationary bias attributable to the dynamic inconsistency, the economic system may be subject to other policy and non-policy sources of systematic inflationary bias. One such source of inflationary bias may be the fiscal aspects of inflation. Inflation acts as a tax in the economy and yields seigniorage revenues which could make the government more complacent about inflation than would be the case otherwise. Seigniorage considerations – broadly defined to include not just the real value of increases in high-powered money but also the revenue gains from unindexed tax brackets and from the devaluation of nominal public debt – may have played a significant role in accelerating inflation during the late 1960s and the 1970s as rising revenues helped finance increases in government spending (see Fischer 1994). Whether the economic system is subject to seigniorage and other non-monetary policy sources of inflationary bias, however, is beyond the scope of the present exercise.

3. Concludins remarks

By linking the performance on inflation to independence from political pressures, recent studies of central bank independence have made a useful contribution to policymaking. Particularly important in this respect is the empirical evidence that tends to confirm the inverse relationship between inflation and the degree of central bank independence. Given that monetary policy affects the economy with considerable time lags, it makes sense that central bankers should have the freedom to pursue policy objectives without being subjected to short-term political pressures.

But recent CBI studies are flawed in many respects and, consequently, their practical usefulness is quite limited. In most of these studies, central bank independence refers only to the use of instruments with little choice of policy goals, and it is also very poorly measured. Moreover, the underlying models are based on the faulty assertion that central bankers are somehow inherently prone to a systematic inflationary bias.

Perhaps the most serious problem with recent CBI studies is their extremely narrow focus on policy goals. More specifically, in these studies, central banks are given the autonomy to use their instruments for the single-minded pursuit of a zero or low inflation target, ignoring all other objectives in both the short run and the long run. This kind of simplistic and abstract view of policy goals cannot exist in the real world of democracies. Nor can it be rationalized on the basis of economic theory or broader social considerations.

The most fundamental function of central banks is to maintain a stable financial environment. That function requires price stability, but not the exclusive focus on controlling increases in the general price level at all costs. On the contrary, this paper argues that a rigid approach aimed at a numerical inflation objective could actually harm financial stability; history clearly offers no basis for assuming that such an approach will deliver a stable financial environment. From the perspective of central bank independence, the message here is that a broad legislative directive aimed at establishing price stability as the *primary* goal of policy is appropriate. This approach allows central banks to deal with short-run stabilization of the economy within the context of maintaining price stability. It is also the right approach when central banks confront a policy dilemma calling for judgement and discretion, rather than fixed rules. Such an approach is awkward and uncomfortable, but it is realistic.

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