Monetary Policy Independence, Governance and Policymaking

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Hot Issue in U.S.

- Trump has violated Rubin rule that a President should not comment on current monetary policy
- Legislation (passed or proposed) to control Fed actions
  - Dodd-Frank Act of 2010 (passed) which restricts Fed lender-of-last resort lending
  - Ron Paul "End-the-Fed" bill to have GAO audits of Fed (Federal Reserve Transparency Act of 2015, passed by House only)
  - Financial Choice Act of 2017 which subjects Fed to GAO audit if Fed deviates from Taylor rule (passed by House only)

Types of Independence

- Goal Independence
  - Objectives of monetary policy set by central bank
- Instrument Independence
  - Monetary policy instruments set by central bank

Goal Independence

- In a democratic society, central bank should be goal dependent if possible
  - Objectives should be set by government, but may be more difficult in a congressional system in which the legislative branch is separate from executive branch
  - Also objectives may be hard to quantify or have technical elements that are beyond scope of politicians
    - For example, government might set the inflation target, but cannot describe what weight to put on output gaps versus inflation gaps in objective function

Goal Independence

- In U.S., Federal Reserve Act is so general that in effect, the Fed sets its own goals
  - This is undesirable and can create tension between the central bank and the government
- Other countries with parliamentary system, such as Sweden, objective (inflation target) is set by Parliament in consultation with central bank
  - Not only is this goal dependence more democratic, but it promotes buy in by government so fiscal and other policies are more likely to support monetary policy objectives

Instrument Independence

- Strong arguments for instrument independence
  1. Time inconsistency problem: Discretion leads to temptation to renege on optimal plan to exploit short-run tradeoff between unemployment and inflation
     - Problem does not come from monetary policymakers as in Barro and Gordon (1983), but from politicians who are short sighted (Mishkin-Westelius, 2008)
     - Instrument independence enables policmakers to resist political pressure to renege on optimal plan
  2. Monetary policy effects have long lags, so policy has to focus on longer horizons than politicians
  3. Evidence finds better outcomes with instrument independence
     - Current example of Turkey illustrates what happens when central bank is not independent

Instrument Independence Requires Accountability

- With high accountability more support for instrument independence
  - Example of granting to instrument independence to Bank of England in 1997 because inflation targeting made BOE more accountable
- Low accountability can lead to loss of instrument independence

Accountability Requires Transparency

- Transparency involves better communication
  1. More accessible documentation of policy (e.g., Inflation Reports, with bells and whistles and simpler language)
  2. Speeches
  3. Press conferences
  4. Testimony to Congress or Parliament
  5. Meetings with politicians and their staff to explain policy
  6. Appropriate oversight (periodic, scheduled evaluations by independent experts as in Sweden, but not GAO-type audits at request of politicians)