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Monetary Policy and the Independence Dilemma

Recently there has been a great deal of commentary arguing that the Federal Reserve needs more oversight and greater transparency. This has culminated in a number of legislative proposals designed to constrain the Fed's freedom of action in monetary policy and other spheres. One prominent example is the bill proposed in the House of Representatives entitled the Federal Reserve Accountability and Transparency Act of 2014, or the FRAT Act for short. Much of the debate surrounds the Federal Reserve's policy actions during and following the global financial crisis and recession. But the deeper issue of oversight and independence of central banks in democratic societies is not new; on the contrary, it has been a contentious one for the past century. In the broader historical context, recent proposals are not unique to the current situation but instead represent the latest chapter in a long-running debate in the United States and around the globe.

In this talk, I will delve into the question of central bank oversight and independence, examine some of the solutions that have been tried in the past but ultimately failed, and then turn to approaches that have proven more successful. I'll conclude by considering how the lessons from the past apply to the current debate about how to enhance the oversight and transparency of the Federal Reserve. Throughout I will focus on monetary policy and not address payments systems, regulation of financial institutions, or other activities of central banks. At this point, I should emphasize that the views expressed here today are entirely my own, and do not necessarily reflect those of others in the Federal Reserve System.

The independence dilemma

Why has central bank oversight and transparency been so contentious? The independence dilemma stems from the enormous power central banks have to create money essentially out of thin air. Wielded judiciously, this power can foster economic prosperity and stability. However, it can also be misused as a short-term fix for governments to meet financing needs by printing money or to stimulate the economy before an election. Such misuse can undermine economic stability and fuel runaway inflation. The resulting longer-run damage may only be felt years or decades in the future, well outside usual political time frames.

To avoid the temptation of opportunistic money creation, modern governments have generally delegated the day-to-day operation of monetary policy to an independent central bank. This independence means that policymakers are free to focus on the technical aspects of their task, removed from direct political influence. This arrangement, however, creates a new problem: Who tells the central bank what to do, if not the government? Thus, the dilemma: Successful monetary policy necessitates both an arm's-length relationship to the political process and oversight by elected officials. The search for balance at the horns of this predicament has been at the heart of central bank debates and reforms over the past century.

Two broad approaches have been taken to solve the quandary. In both cases, the overarching goal is the same: economic prosperity and stability. The difference is in the degree of operational latitude afforded the central bank. The first, more restrictive, approach is to delegate an operational mandate stipulating that the central bank achieve a specific intermediate goal. A legislated target for the growth rate of the money supply is one example of an operational mandate. The second approach is to delegate an overall economic goal, such as low

inflation, and let the central bank determine how to best achieve its goal with the tools at its disposal.

Operational mandates

In the past, central banks were typically given an operational mandate. This choice reflected a strong desire to limit the discretionary power of central banks and to provide a nominal anchor, that is, a stable value of money. Operational mandates were thought to be highly predictable, accountable, and transparent, and able to provide the basis for longer-term economic stability, at the cost of short-term flexibility and discretion. However, as I will discuss in more detail, operational mandates have been beset by a string of failures rooted in this very lack of flexibility to deal with changing economic conditions and crises. After each failure, a new operational mandate framework has been introduced that, while an improvement over the prior one, still proved prone to breakdown under economic and political stress.

The classic example of an operational mandate is the gold standard. Under the gold standard, monetary policy is completely subordinate to the fixed price of gold at a legislated level. Many countries followed the gold standard before World War I and in the period between the wars. The gold standard represents the most extreme form of oversight and transparency. The central bank has little freedom of action or decision and is therefore unable to take potentially harmful actions on its own—or, for that matter, *any* actions on its own.

History has shown that this inflexibility and the subservience of monetary policy to fluctuations in gold supply and demand contributed to economic crises and depressions. The gold standard's inability to cope with economic stress is reflected by its frequent curtailment during times of war and crisis. In fact, so often was it suspended that deviations from the gold

standard routinely became the norm, rather than the exception. The inherent lack of flexibility in the money supply was blamed for contributing to the depth of the downturns experienced by many countries during the 1930s.[1] Moreover, although the gold standard system was transparent in terms of the operational mandate, its execution was far from transparent in practice, as accounts of central bank dealings during the gold standard period illustrate.[2]

The failure of the gold standard led to a new type of operational mandate, the fixed exchange rate regime. Under this system, the central bank is required to maintain the value of the domestic currency in relation to that of a foreign currency. As with the gold standard, predictability, accountability, and transparency were considered paramount virtues. The most famous example was the Bretton Woods system, in which foreign currencies were pegged to the U.S. dollar. A fixed exchange rate system is somewhat less rigid than a gold standard and is far less subject to the particularities of gold supply and demand. Nonetheless, it puts a straitjacket on a central bank's ability to set monetary policy attuned to domestic economic conditions, since policy is beholden to the exchange-rate peg. As a result, monetary policy is less able to counter cyclical swings in the economy.

Once again, history has shown that fixed exchange rate systems perform very poorly and are often abandoned during periods of severe economic stress or crisis. Although some smaller economies, such as Denmark and Hong Kong, have successfully operated with exchange-rate pegs, other regimes have not stood the test of time. The Bretton Woods system collapsed in the early 1970s and the European Exchange Rate Mechanism faltered in the early 1990s.

[1] Eichengreen 1992.
[2] Ahamed 2009.

The string of failures associated with the gold standard and fixed exchange rates led to other proposed operational mandates, including monetary targets. Monetary targeting is most often associated with Milton Friedman's proposal to have the money stock grow at a constant rate irrespective of economic conditions.[3] In theory, monetary targeting has the benefit of being predictable, accountable, and transparent while providing a stronger automatic stabilizer for the economy than earlier, more rigid regimes. For example, if the economy heats up, demand for money balances rises, driving interest rates up, which slows the economy and reduces inflation pressures.

However, in practice, monetary targeting has proved an unreliable and overly restrictive framework. In particular, changes in the financial system have caused the relationship between money demand and the economy to shift in unexpected ways. As a result, a fixed growth rate of the money stock can have unpredictable implications for economic growth and inflation. Following on the theoretical insight of William Poole, in a world where money demand is hard to predict, it is preferable to use the interest rate as the primary policy instrument rather than money supply.[4] This is what central banks around the world have done, leaving monetary targeting by the wayside.

Goal mandates

In light of the string of past failures of various forms of operational mandates, many countries have settled on a very different approach to deal with the issues of oversight and independence. Instead of stipulating an operational target, they set high-level economic goals and delegate to the central bank the authority to decide how to best achieve them. Under such a

[3] Friedman 1960.
[4] Poole 1970.

goal mandate, the central bank is held responsible for achieving its objectives and is typically required to regularly report on its progress and the steps it is taking. This framework stresses the predictability, accountability, and transparency of the main economic goals of policy, rather than operational actions.

An early entry in this category is the mandate under which the Federal Reserve has operated for the past 38 years. The Federal Reserve Reform Act of 1977 states: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Somewhat confusingly, this sentence combines elements of both operational and goal mandates. The operational mandate aspect is captured by the reference to long run growth of monetary and credit aggregates, hearkening to a monetary targeting regime. The goal mandate is specified as the ultimate objective of monetary policy. Later in this paragraph, the tension between the two approaches is resolved clearly in favor of the goal mandate: "Nothing in this Act shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions." Although the description of the goals is left somewhat vague, the Federal Reserve filled in this gap by issuing a statement describing the longer-run goals and policy strategy in greater detail.[5]

The Act of 1977 also demanded a greater level of oversight and transparency regarding monetary policy. It stipulated that the Fed would consult with congressional committees at

[5] Board of Governors 2015.

semiannual meetings concerning "objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates for the upcoming twelve months, taking account of past and prospective developments in production, employment, and prices."[6] The Full Employment and Balanced Growth Act of 1978 added a requirement that the Fed issue semiannual reports to Congress in conjunction with these meetings. The semiannual meetings and reports continue to this day.

Other countries have taken the goal mandate framework considerably further. Some 25 years ago the Reserve Bank of New Zealand introduced a new goal mandate framework called inflation targeting.[7] Since then, dozens of countries have adopted some form of inflation targeting. The cornerstone of this approach is that the central bank—often in consultation and in formal agreement with the government—assumes responsibility for inflation being, on average, near a numerical target. It is important to note that, although the inflation goal is front and center, inflation-targeting central banks also recognize a role for stabilizing economic activity—what is often referred to as "flexible inflation targeting."

The inflation-targeting framework also features clear communication of the central bank's policy strategy and the rationale for its decisions, with the goal of enhancing the predictability of the central bank's actions and its accountability to the public. This is generally done in regular public reports with detailed analysis of the economic outlook and policy strategy and decisions.[8] Indeed, some governments require the head of the central bank to issue a public

[6] Federal Reserve Reform Act of 1977.
[7] Leiderman and Svensson 1995, Bernanke and Mishkin 1997, Bernanke et al. 1999, Kuttner 2004.
[8] See, for example, Norges Bank 2014.

letter when the inflation goal is missed, explaining why the target was not achieved and what is being done to rectify the situation.[9]

Although the legal and institutional structures of inflation-targeting frameworks differ across countries in their particulars, they share the following: a clear delegation of goals to the central bank, regular formal reporting on the attainment of these goals to the public, and a requirement to explain what the central bank is doing to best achieve its goals. As a testament to the effectiveness of this framework, countries with inflation goal mandates have generally kept inflation low and stable over the past few decades, even in the aftermath of the global financial crisis.[10]

Back to the future: Monetary policy rules as an operational mandate?

Although many countries have found that a goal mandate coupled with strong oversight and transparency works much better than past operational mandates, some commentators argue that the problem has not been with the notion of an operational mandate per se, but with how it has been implemented. They accept that the gold standard, fixed exchange rate, and monetary targeting are flawed, and argue that a more sophisticated operational mandate is needed—one that is more flexible at dealing with changing economic conditions but still puts a meaningful constraint on the central bank.

The latest proposed operational mandate is that the central bank should, under most circumstances, follow a fixed mechanical monetary policy rule such as the Taylor rule.[11] This is the basic idea underlying the FRAT Act. According to many standard monetary policy rules, the

[9] See, for example, Bank of England 2015.
[10] Williams 2014a.
[11] Taylor 1993.

real (inflation-adjusted) federal funds rate depends on a few macroeconomic variables: specifically, the utilization gap—the difference between the level of economic activity and its normal, full-employment level; the inflation gap—the difference between the inflation rate and its target level; and the normal, or "natural," rate of interest. Like other operational mandates, this proposal places a high value on predictability, accountability, and transparency and aims to limit the discretionary decision making of the central bank.

This approach has several advantages over previous operational mandate frameworks in terms of macroeconomic performance. First, a monetary policy rule makes clear the central bank's longer-term inflation goal, which is an integral part of the rule itself. This clarifies the communication of policy goals and actions. Second, a properly specified policy rule incorporates the fundamental principle ("Taylor principle") of monetary policy that the nominal interest rate needs to rise more than one-for-one with an increase in inflation as a necessary condition to achieve the desired level of inflation in the long run. Third, a policy rule incorporates systematic and predictable counter-cyclical responses to economic conditions consistent with economic theory and a wide range of economic models.[12]

Research has shown that a policy rule is likely to be superior to other operational mandates like the gold standard, fixed exchange rates, and monetary targeting.[13] In model simulations of typical economic fluctuations, an optimally designed monetary policy rule can come very close to the first-best achievable outcomes.[14] As a result, central banks around the world consult monetary policy rules in preparing forecasts, analyzing risk scenarios, and

[12] Taylor and Williams 2011.
[13] Bryant, Hooper, and Mann 1993.
[14] Levin, Wieland, and Williams 1999, 2003; Levin et al. 2006.

studying alternative policy strategies. At the Federal Reserve, monetary policy rules have been a regular feature of monetary policy analysis, briefings, and discussions for the past two decades.[15]

There is no question that monetary policy rules provide an invaluable tool for research and practical policy considerations at central banks. Nonetheless, before one rushes to institute a policy rule operational mandate, there are substantive issues and open questions that need to be addressed. Three are particularly relevant: the treatment of unobserved variables such as the natural rates of economic activity and interest, the zero lower bound on interest rates, and the specification of the rule itself.

An important element of most monetary policy rules is the dependence on unobservable measures of the normal, or "natural," levels of economic activity—such as real gross domestic product or the unemployment rate—and interest rates. In principle, these natural rates change over time in unpredictable ways and are therefore subject to considerable uncertainty.[16] Under a policy rule mandate, would the estimates of the natural rates be set by statute or by the central bank? Would they change over time as economic circumstances change or would they be fixed? These are not purely academic questions. Following the most recent recession, estimates of both the natural rate of output and interest have been subject to dramatic shifts, which would have sizable effects on the appropriate setting of policy according to standard monetary policy rules.[17] If the mandated policy rule uses outdated or inappropriate measures of natural rates, economic performance will suffer. On the other hand, allowing the central bank to freely choose natural rate measures would significantly loosen the constraint on policymaking. In the extreme, any deviation from the mandated rule could be defined away by a shift in the estimated natural rate.

[15] Williams 2014c.
[16] Orphanides and Williams 2002, Laubach and Williams 2003.
[17] Williams 2014b, 2015.

A second issue is the zero lower bound on nominal interest rates that limits the ability to lower interest rates during periods of economic downturn or very low inflation relative to the prescription of a monetary policy rule. During the recent U.S. recession, standard monetary policy rules prescribed negative nominal interest rates, but this was unattainable.[18] In the end, the Federal Reserve and other central banks turned to unconventional means to provide the missing monetary stimulus. These measures, including asset purchases and explicit forward policy guidance, are outside the realm of standard monetary policy rules. In such circumstances, which are very likely to occur again in the future, a policy rule mandate will be silent. Moreover, research shows that the very presence of the zero lower bound argues for deviating from a standard policy rule around times when the constraint binds, as the central bank aims to make up for lost monetary stimulus.[19]

Third, although there has been a great deal of research about the properties of well-performing monetary policy rules, there is, as yet, no consensus about the best specification of such a rule. Different models imply different best rules. In addition, in the presence of the zero lower bound or uncertainty about natural rates, the best performing rules can be very different from those designed absent these features.[20] In those circumstances, mechanically following one type of standard policy rule designed to work well under one set of assumptions can yield very poor economic outcomes when those assumptions are violated.

Where do we go from here?

I have argued that the independence dilemma has been with us for a very long time. Despite the best intentions, attempts to solve it through an operational mandate have proven

[18] Board of Governors 2009, Rudebusch 2009, Williams 2009.
[19] Reifschneider and Williams 2000.
[20] Orphanides and Williams 2002, 2006; Reifschneider and Williams 2000.

fruitless in the past. Although a policy rule operational mandate is unquestionably superior to past operational mandates, such an approach is subject to a number of issues and questions. First and foremost, what rule should the central bank follow? One lesson from the history of operational mandates is that what looks good in theory often fails to deliver when circumstances change in unpredictable ways. Particularly in situations of economic stress or crisis, operational mandates have proven to be ineffective and have often been abandoned.

Given the challenges for an operational mandate to succeed, a potentially more promising approach to address the independence dilemma may be to look to the experiences of inflation-targeting countries, where the principle of enhancing accountability and transparency within a goal mandate framework has proven to be very successful.

Thank you.

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