

The Rationale for Independent Monetary Policy

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1. Introduction

Recently there has been a great deal of media discussion concerning the independence of the Federal Reserve in its role as the designer and implementer of monetary policy. In this outpouring of words there has, however, been little if any explicit discussion of the *rationale* for central bank independence. This absence is extremely unfortunate, for it makes little sense to discuss the desirability of central bank independence, and the design of alternative arrangements for providing and insuring—or modifying—such independence, in the absence of an understanding of what it is supposed to accomplish and how it is expected to do so. In the present paper, I will argue that a crucial aspect of monetary policy is a systematic discrepancy in the times that elapse after policy actions before the observance of real and monetary effects. This discrepancy lends an inflationary bias toward policy efforts that is more pronounced, the more impatient is the policymaker. Finally, I compare current monetary practices with those specified by the U.S. Constitution, and indicate how the intentions promoted by the Constitution could be fulfilled under today's fiat money monetary institutions.

2. Response-Time Discrepancy

There is, no doubt, more than one line of argument for central bank (CB) independence. Nevertheless, I will focus on one particular rationale, presuming that other members of the SOMC will be discussing others.¹ The simplest way to describe the one that I have in mind is as follows: When the CB eases policy—i.e., making monetary conditions more stimulative and aggregate demand stronger—the socially desirable

¹ A limitation of my discussion is that it will focus on monetary policy, as distinct from any regulatory duties.

effects arrive more promptly than do the undesirable effects. That is, there will normally be effects that can be thought of as expansions (relative to what would have prevailed in the absence of the policy change) of output and employment that will begin to occur within two or three months. Then after one or two years there will also occur upward pressures on the inflation rate. If instead the policy action is one that tightens policy, rather than loosening it, there will be relatively prompt reductions of output and employment, followed in a year or so by reductions in the inflation rate. Now, it is the case that most economists, congressmen, commentators, and citizens consider expansions in the level of employment and output to be desirable and consider increases in the inflation rate to be undesirable. Accordingly, if monetary policy is required to be politically acceptable, there is a tendency for policy to be more expansionary and inflationary the more impatient is the policymaker—the shorter is his effective time horizon.

What is it in the workings of the economy that creates this difference between the speeds with which output-employment and inflation responses occur? There is, unfortunately, some disagreement among monetary and macro economists about the exact nature of the “transmission mechanism” from policy actions to outcomes; indeed, I have argued in the past that this issue represents the weakest link in our models of the economy.² There is, however, essentially no disagreement as to the existence of the asymmetry. Builders of “Classical,” “Keynesian,” “New Classical,” “New Keynesian,”

² See, for example, McCallum (2002, pp. 84-85). Incidentally, I hope that readers will not be inclined to the opinion that all “models” are useless; that policy should not be based on analysis with models. Since any systematic understanding of the workings of the economy amounts to a model, that opinion amounts logically to a belief that it is hopeless to take any position regarding systematic aspects of economic behavior. For example, a belief that rapid money creation typically leads to inflation logically stems from the adoption of some—perhaps seriously incomplete—model.

“Real Business Cycle,” “Austrian,” and “Minskyian” models all share this agreement, as do the proponents of both highly structured dynamic-stochastic-general-equilibrium (DSGE) methods and also non-structural vector-autoregression (VAR) approaches.

By far the most widely-held position among mainstream economists, however, is that the lagging aspect of inflation-rate effects, relative to output effects, stems from some form of “stickiness” of nominal prices and/or wages—some sluggishness in the price adjustment mechanism. This type of behavior is at the heart of New-Keynesian (NK) approaches, reflecting J.M. Keynes’s emphasis on models with precisely that feature (i.e., models in which prices do not adjust at all “in the short run” with all adjustment taking place in quantities). But it is also central to the “monetarist” analysis of Milton Friedman (and, e.g., Anna Schwartz, Karl Brunner, and Allan Meltzer) and to its current-day counterpart in the “New Neoclassical Synthesis” as described by Goodfriend and King (1997).³

3. Implications

Let me now return to the main point. While I usually dislike use of the term “policy implications,” I believe that the above-mentioned discrepancy in adjustment speeds is such that it becomes crucial for the agency that makes decisions on monetary policy to be so situated that it is capable of taking appropriate account of effects of its policy actions on events in the medium and distant future, without being dominated in its thinking by concerns pertaining to the more immediate effects. This does not mean that the monetary policy maker should care only about the very distant future; it does mean that the monetary policy maker should not be excessively concerned about the present and very near future. Instead, the policy maker should be able—and likely—to make

³ See, for example, Clarida, Gali, and Gertler (1999), McCallum (2002), and the textbook of Walsh (2003)..

decisions that reflect concern for the well-being of the economy over the entire future.

What is the nature of monetary policy behavior that is, over long periods of time, desirable for the behavior of a nation's economy? All the various schools of economic thought mentioned above agree that from a steady-state ("long run") perspective monetary policy has a decisive effect on the inflation rate and little or none on the level of output or employment.⁴ With higher inflation rates, moreover, larger fractions of total output must be used in the process of conducting transactions, because at higher inflation rates households and firms rationally choose to hold smaller money balances and consequently are forced to use more transaction-facilitating resources (e.g., "shopping time"). The best monetary policy from a steady state perspective is, accordingly, to keep inflation at a very low rate—near zero or perhaps even slightly negative.⁵ Political pressures could interfere, of course, but from a purely technical economic point of view it should be relatively easy for a central bank to keep inflation near to such a target rate.

The rationale for central bank independence, accordingly, is that a central bank that is given the assignment of conducting monetary policy for the benefit of economic performance over the indefinite future, and given considerable insulation from the day-to-day political pressures, has the possibility of conducting its business in a manner that accomplishes the most that monetary policy can provide.

It will be objected by some readers that the foregoing argument, by focusing on steady-state relationships, omits cyclical considerations that monetary policy should be concerned with. It is not necessarily the case, however, that policy ignores the role of cyclical fluctuations. The central bank's monetary rule can include responses to output

⁴ And certainly none on the sustained growth rate of output or employment.

⁵ That the "optimal" inflation rate, under simplified but illuminating assumptions, is slightly negative was recognized by Friedman (1960) and made famous in the title essay in Friedman (1969).

and/or employment conditions as well as inflation rates. What is important is that the central bank behaves according to a policy rule rather than reacting on an ad-hoc basis to current conditions; the rule can be activist and can respond to output growth or output gaps as well as inflation, but the rule needs to be maintained over all phases of the business cycle.

4. Recent Proposals

In light of the arguments developed above, one should not be happy about recent proposals, coming from the U.S. Congress, regarding the Federal Reserve. Among the most important are proposals that the presidents of the regional Federal Reserve Banks be appointed politically or be excluded from voting on monetary policy. Both of these proposals are designed in recognition of the fact that the regional Bank presidents are generally more hawkish on inflation, and more insulated from the current political pressures in Washington, D.C., than are the members of the Board of Governors.

Another is a proposal that the policy actions of the Fed be “audited” by an appointed board—appointed presumably by Congress. Under these proposals, and others that have been put forth formally or just discussed, the proposed institutional changes designed so as to reduce the independence of the Fed, by making it *more* “responsive” to current political pressures.⁶ In light of what is argued above, such changes would represent moves in precisely the wrong direction. They would tend to increase the short-sightedness of monetary policy actions, to increase inflation without improving average

⁶ The bill introduced by Senator Dodd on March 15 would have the President of the New York Fed, by far the most important operationally of the regional banks, appointed by the President of the United States. The bill would also move regulation of medium and small sized commercial banks from the Fed to another agency, thereby drastically reducing the influence of the regional banks and, accordingly, shifting influence to officers appointed in a more highly politicized manner. This is, accordingly, a change in precisely the wrong direction, according to the argument above.

employment rates, and generally to worsen the macroeconomic prospects for the U.S. economy. What, then, should be done?

5. Properly Designed Independence

In my opinion, and in the opinion of others who have studied the matter more thoroughly (e.g., Timberlake, 1989), the Constitution of the United States rather clearly specifies that the nation's monetary system should be based upon a metallic standard, not a fiat arrangement, for the only monetary provisions in the Constitution read as follows: "The Congress shall have power ... to coin money, regulate the value thereof and of foreign coin, and to fix the standard of weights and measures" (Art. I, Sect. 8) and "No state shall ... coin money, emit bills of credit; make any thing but gold and silver coin a tender in payments of debts ..." (Art. I, Sect. 10).⁷ Now, I do not believe that we can or should now attempt to return to a gold standard—or to a silver or bimetallic standard—for the decisions of the Supreme Court in the "Legal Tender Cases" of 1870-84 put the U.S. on a paper (fiat) standard in a manner that would apparently require a constitutional amendment to reverse.⁸ *Nevertheless*, the essence of the Constitution's instructions could be recreated today in the context of our paper money system, and in a manner that would be entirely in the spirit of the case for central bank independence. In particular, the provisions of the Constitution were clearly designed to prevent ongoing changes in the purchasing power of the medium of exchange. Given the absence of publically available data on comprehensive price indices in those days—or even any form of rapid communication among offices in different cities—the specification of a fixed metallic standard was the only means known to the authors of providing a semblance of price

⁷ Article 8 also says that Congress shall have the power to "borrow money on the credit of the United States," but that provision pertains to fiscal policy, not monetary arrangements.

⁸ Again, see Timberlake (1989).

level stability.⁹ That the “value” specified by this standard was to be adjusted very infrequently (if ever) was, it seems clear, implied by the expressions “to coin money” and “regulate the value thereof” appearing in the same sentence as that pertaining to establishment of standards for weights and measures. Given today’s technology, however, near-constancy of the value of the medium of exchange could be provided by congressional specification of a comprehensive price index, rather than the price of gold, that the monetary system should keep at a constant level over time. That is, Congress should designate a price index and assign the Federal Reserve the technical task of keeping the associated inflation rate equal to (or at least close to) zero.¹⁰ This would provide the United States with a monetary standard, and would specify the Fed’s duties in such a way that the Fed would have monetary policy independence, which would then be used in meeting the standard specified, in accordance with the Constitution, by the Congress.

⁹ In simpler words, the authors believed that a gold (or silver or bimetallic) standard was the most effective device for maintaining the purchasing power of money and preventing inflations or deflations that would be unfair to either creditors or debtors.

¹⁰ In choosing the index and setting the target inflation rate, the Congress should of course take advantage of professional expertise in such matters, which would (I believe) correctly involve considerable discussion with officials and economists of the Federal Reserve system. It might be argued that the Fed’s role would be to adopt a policy rule, for adjustment of a policy instrument (an interest rate or monetary base growth rate), that would be intended to price level stability over a period longer than the intermeeting span.

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