The Politics of Monetary Policy

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Discussion

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Key developments

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Introduction

Chapter has two key goals

1. Summarize what we know

[we thought] "most of the basic issue about the conduct of monetary policy had been solved by … early 2000."

2. Ask how crisis changes what we thought we knew

Crisis changes what we thought we knew, or at least makes us far less confident about it. Two questions:

i) Did monetary policy cause the crisis?

ii) How should policy have responded?

Chapter looks across a number of topics on the politics of monetary policy focusing on these two questions

No easy task

Opening line: “Had we written this chapter before the summer of 2007 …”

For an October 2009 conference, it would have set a record for getting the paper to the discussant early

Timing of events put the authors in a tough spot, which they admitted it head on

It would have been nice had the authors had till 2011-12 to write this paper

Overview

Nice paper; Excellent idea of organizing the paper around these questions – what we knew pre-crisis; how does crisis change our views.

I want to organize my discussion a bit differently, starting with very general questions of what are the “political” issues in monetary policy and then examine what are the implications of the crisis for these issues

Main critique is that too little attention to issues the crisis raises (and too much review of things treated elsewhere)

I will also make some more specific criticisms, but I will try to keep this part short

A number of issues I won’t have time to talk about

Political Issues in Monetary Policy

1. **Protect central bankers from political pressure to inflate for short-term gain**

Set up "institutions" to protect against time inconsistency, that is, to *insulate* policymakers

2. **Should central banks have other goals?**

Financial stability

Common currency to achieve political unity

"Ownership society"

Is "Insulation" Undemocratic?

Nothing undemocratic about "Constitutionalism" – taking certain issues "off the table" to protect them from ordinary, everyday politics. But, which issue to take off the table?

Basic rights – freedom of religion, freedom of speech are constitutional guarantees

Society works better if we constrain decisions – monetary policy

Why not have an independent fiscal authority? Too many distributional issues

Of course monetary policy has distributional implications as well

TIC – some technical points

1. **Temptation to engineer surprise monetary expansion to reduce unemployment does not characterize central bankers in developed countries (Blinder, others)**

Rules, other institutions are meant not to protect Central Bankers from themselves, but from politicians

2. Protecting against temptation to inflate away nominal debt

There is work on debt structure to eliminate temptation: Persson, Persson and Svensson (1988); and refinement by Calvo and Obstfeld (1990) (also in my book)

3. "applicability of repeated game theory when a 'player' is a market expectation" (footnote 3)

As you've referenced it, I think there is a misunderstanding. This can be cleared up by distinguishing large versus atomistic agent

Rules versus Discretion

General issue of constraining monetary policy vs. allowing more flexibility

1. Firm policy rules, Central Bank Independence (CBI), and currency unions are not separate issues, but ***different*** degrees of constraint

   Moreover, already much work on pre-crisis models, views

2. What literature doesn't have is an organized discussion of central question – implications of crisis for re-examining how much discretion

Rules versus Discretion in Crisis

Should Central Bank have followed existing rules more tightly? – Taylor

Really hard to believe that low interest rates alone caused the crisis

Or, that lesson of crisis is return to strict Taylor or other rule

Hard to argue that the lesson of the crisis is to take away discretion to inject extraordinary liquidity

Implications of Crisis (cont.)

Do we conclude that policymakers should have more discretion or less?

Bottom line – The lesson of the crisis in terms of which direction to move is clear, but how much? And, how?

I think the models reviewed may not be very useful in giving answers

Consider, for example, escape clauses

1. Theory tells us how difficult it is to write contracts covering complex contingencies – but models of central banking consider very simple (highly unrealistic) contracts, escape clauses
2. Crisis should have taught us that the probability distributions attached to events were quite wrong and simple models of ε_t aren't going to tell us much about optimal policy.

Other Goals – Common Currencies

1. Euro – monetary union as another step toward greater political union

(Two CFA zones originally motivated by political goals)

2. Survival of euro not only makes common currency and ECB more politically popular, but also helps defend against critics that say monetary policy should not be sacrificed for political goals.

3. Alesina, Ardagna and Galasso (2009) –adoption of the euro has facilitated the introduction of structural reforms

Other Goals – Financial Stability

Charles Goodhart put it well – Absence of discussion in Bordo-Schwartz in previous Handbook was surprising. Now, it would seen as inexplicable

Even before 2007, discussion of extent to which CB should consider asset price dynamics and their implications in setting policy. Crisis surely strengthens this

Strong popular criticism of CB **not** considering financial stability. Doing something can bring political criticism; So, can not doing something

Before elections, central bankers try to be invisible, meaning sometimes accomodating shocks, so that interest rates don't rise. Both anecdotal and empirical evidence of a "dead spot"

Policy should not induce uncertainty in financial markets and make the crisis even worse

Goal of Financial Stability

To put it simply – **How much regulatory power should be given to CB?** This is a central question. It would have nice to see some treatment of this

Problem raised by proliferation of “exotic” instruments can’t be ignored

Nor, can we say that CB is not already a regulatory institution over some things

Other Goals – "Ownership Society"

Keep interest rates low to widen home ownership

Wide agreement that this was a BIG mistake

Clearly shows possible distributive effects of monetary policy (and hence pressures)

But increasing regulatory powers of CB (or some other agency) can increase distributive power of CB and thus pressure

Hence, in the next version of the Handbook a decade from now, the chapter on politics of monetary policy will probably include much more on distribution special interest group pressure on monetary policymakers

But, this paper is a very nice summary of what we know (and don't know) right now