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Are rules and boundaries sufficient to limit harmful central bank discretion? Lessons from Europe

Athanasios Orphanides [*,1]

MIT Sloan School of Management, E62-481, 100 Main Street, Cambridge, MA 02142, USA

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ABSTRACT

Marvin Goodfriend's (2014) insightful, informative and provocative work explains concisely and convincingly why the Fed needs rules and boundaries. This paper reviews the broader institutional design problem regarding the effectiveness of the central bank in practice and confirms the need for rules and boundaries. The framework proposed for improving the Fed incorporates key elements that have already been adopted in the European Union. The case of ELA provision by the ECB and the Central Bank of Cyprus to Marfin-Laiki Bank during the crisis, however, suggests that the existence of rules and boundaries may not be enough to limit harmful discretion. During a crisis, novel interpretations of the legal authority of the central bank may be introduced to create a grey area that might be exploited to justify harmful discretionary decisions even in the presence of rules and boundaries. This raises the question how to ensure that rules and boundaries are respected in practice.

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Marvin Goodfriend's (2014) insightful, informative and provocative work explains concisely and convincingly why the Fed needs rules and boundaries. Fundamentally, I agree with the concern Goodfriend identifies and the reasoning he provides. The concern is a serious one. As he points out in the "Introduction": "The lesson from the Fed's first century is that wide operational and financial independence given to monetary and credit policy subjects the Fed to incentives detrimental for macroeconomic and financial stability" (pp.1–2). Once this is acknowledged, it becomes clear why we should strive to improve the current framework. Rules and boundaries are needed to avoid conflicting and sometime impossible demands on the central bank that lead to bad economic outcomes.

Goodfriend's paper recounts examples that raise concern regarding both monetary policy and what is called credit policy, a term used to describe lending facilities such as the provision of emergency liquidity assistance (ELA).

On monetary policy, Goodfriend brings back the ghosts of the Great Inflation era. In the absence of clear rules, and with a muddled objective that simultaneously instructs the Fed to achieve maximum employment and price stability, the Federal Reserve faces the risk of excessive influence by the shifting balance of public concerns for inflation and unemployment. The risk is that monetary policy becomes dominated by short-term considerations, which makes monetary policy a source of instability, worsening both unemployment and inflation outcomes.

* Tel.: +1 617 324 4051.
E-mail address: athanasios.orphanides@mit.edu

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This is very much a current concern. Following a painful recession in the aftermath of the recent crisis, short-term dissatisfaction with elevated unemployment has created incentives for the Fed to overemphasize maximum employment as a policy objective. The Federal Reserve's decision 2 years ago to adopt a framework where monetary policy was explicitly guided with reference to a numerical threshold for the unemployment rate was quite troubling for anyone familiar with these risks and the troubled history of the Federal Reserve. I consider it a positive development that the Federal Reserve has reversed its earlier decision and has dropped this explicit guidance.

On credit policy, the key issue is that some of the actions in which the Federal Reserve gets involved, including during the recent crisis, are effectively equivalent to fiscal operations. In a democracy, however, fiscal operations should not be within the purview of the central bank. In a democracy, elected government is assigned the responsibility to spend public resources and faces the accountability for fiscal policy. The risk, in the case of credit policy, is that the central bank's independence can be abused to take actions and make decisions outside its scope of competence and accountability. Goodfriend reaches the controversial conclusion that: "The Fed's very independence, the ambiguous boundary of expansive Fed credit policy itself, would exacerbate the financial panic in September 2008 that would produce the Great Recession" (p.11). Whether the ambiguity of the Fed's credit policies and the actions taken in 2008 exacerbated the Great Recession is something I believe will be under discussion for generations, similar to the study of what happened in the 1930s. I am not ready to draw a definite conclusion on this point but I find the issue of great concern and, as will become clear later, a concern that applies to other central banks as well. Similar to the case of monetary policy, the issue is that even a central bank that may generally behave in a systematic fashion has tremendous discretion on numerous actions. This discretion entails costs. If it is feasible to redesign the system to ensure that discretion is limited by better rules and stricter boundaries so that central bank policy cannot add instability to the economy, this should be pursued.

Marvin Goodfriend goes on to identify the governance problem associated with an independent central bank and describes principles meant to solve the problem. "Congress bestows Fed independence only because it is necessary for the Fed to do its job effectively. Hence, the Fed should perform only those functions that must be carried out by an independent central bank. The problem is to identify the limits of independence on credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury" (p. 20).

The broader institutional design problem is about what a central bank should be doing and how its effectiveness can be safeguarded. The issue can be framed with questions: How can a central bank best contribute to society? What should the central bank's objectives be? How much discretion should be encouraged or tolerated? Is it sufficient to delegate the task to "independent" authorities? How can an independent central bank be held accountable?

The ideal institutional design of the central bank is a long standing problem. Broad agreement has been reached on the desirability of delegating central bank tasks to independent authorities. But this may not be enough. Goodfriend argues for the need to impose additional boundaries and constraints. Even then, one may question if this is sufficient to solve the problem.

The question goes back at least to the 1936 discussion on "Rules versus Authorities" by Henry Simons: "Our problem is that of defining an adequate monetary system based on simple rules and of finding the way toward such a system" (Simons, 1936, p. 4). The risks emanating from discretionary power left to governments was identified already a century earlier by David Ricardo. In his 1824 *Plan for the establishment of a National Bank*, Ricardo identified the problem of letting governments control paper money (Ricardo, 1824): "It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it; and that, on any occasion when it was pressed for money to carry on a war, it would cease to pay coin, on demand, for its notes; and from that moment the currency would become a forced Government paper. There would, I confess, be great dangers of this, if Government—that is to say, the Ministers—were themselves to be entrusted with the power of issuing paper money."

Ricardo proposed independence as the solution: The central bank should be governed by individuals "entirely independent" of the government's Ministers who "should never, on any pretence, lend money to Government, nor be in the slightest degree under its control or influence." However one reads Ricardo's proposed solution, it is easy to identity why Goodfriend's examples of fiscal operations undertaken by the independent Federal Reserve during the crisis are a cause of concern.

What should the scope of central bank objectives be? There is wide agreement on some tasks: price stability, economic stability, financial stability. These are legitimate objectives reflecting what any stability-oriented central bank should be concerned with. But there is disagreement about additional objectives, and this is why some central banks end up with muddled mandates and ambiguous responsibilities. Should "maximum employment" be a central bank task? How about "widely diffused well-being"? Or "fiscal transfers to failed institutions"?

These are additional objectives that quite often government and the public expect central banks to be involved in. These additional objectives are responsible for the conflicts Goodfriend identifies as counterproductive. Consider the notion of "widely diffused well-being." Shouldn't this be an objective we should want all authorities to aim at? Isn't this what we would like to achieve in a democratic society? Certainly, widely diffused well-being is a desirable social objective, much like maximum employment. The question is whether it is a legitimate central bank objective. Going back to 1939, in the first edition of the Federal Reserve's *Purposes and Functions*, we find the following characterization of the central bank's objectives (Federal Reserve Board, 1939): "The purpose of Federal Reserve functions, like that of Governmental functions in general, is the public good. Federal Reserve policy cannot be adequately understood, therefore, merely in terms of how much the Federal Reserve authorities have the power to do and how much they have not the power to do. It must be understood

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