Central Bank Governance Issues

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Presentation at the Riksbank Conference on Rethinking the Central Bank's Mandate

June 4, 2016

Charge

To discuss:

- Central bank independence, now and in the future
- The scope of the objectives given to central banks

Central Bank Independence

- Research and experience show value of CBI for good economic performance.
  - Time consistency
    - applies to monetary policy proper
  - Trade off between price stability and output stability
    - Implies flexible IT or dual mandate
- But granting independence to a public agency in a democracy, requires

  a limited purpose & *strong accountability*.

From Limited Purpose to Multi-Purpose Institutions

- If purpose is broadened, rationale for independence weakens
  - Close connection between financial stability and monetary policy, - LOLR
  - But financial regulatory activities can be in less independent agencies
- Independent multi-purpose institutions escape checks & balances
  - Inappropriate interventions and poor economic performance
  - Interventions in particular sectors or in credit allocation
    - US Consumer Financial Protection Bureau—with oversight of payday loans
- Reform? legislative appropriation for regulatory activity in central bank
- Future? If central banks do not keep to a limited purpose, they will be seen as too powerful and will lose independence

Independence is Not Enough

- Large shifts to & away from rules-based monetary policy
  - 1970s: accompanied by high inflation and high unemployment.
  - 1980s, 1990s, early 2000s: improvements in price & output stability.
  - Move away from rules-based policy circa 2003-2005 followed by Great Recession & Not-So-Great Recovery.
  - Nikolsko-Rzhevskyy, Papell, Prodan provide statistical evidence
- Shifts occurred without change in *de jure* independence.
  - Numerical indices: Crowe and Meade (2007).
  - But closely correlated with shifts in *de facto* independence:
    - Meltzer (2009), Goodfriend (2012), Issing (2012)
    - Independence sometimes taken away; sometimes given away.
- Policy implication: Encourage more rules-based policy by reforming the objective, or the mandate, given to the central banks.

Monetary policy gets more predictable, inflation targets, rules-based

From "Has the Fed Gotten Tougher on Inflation?" The FRBSF Weekly Letter, March 31, 1995, by John P Judd and Bharat Trehan of the San Francisco Fed

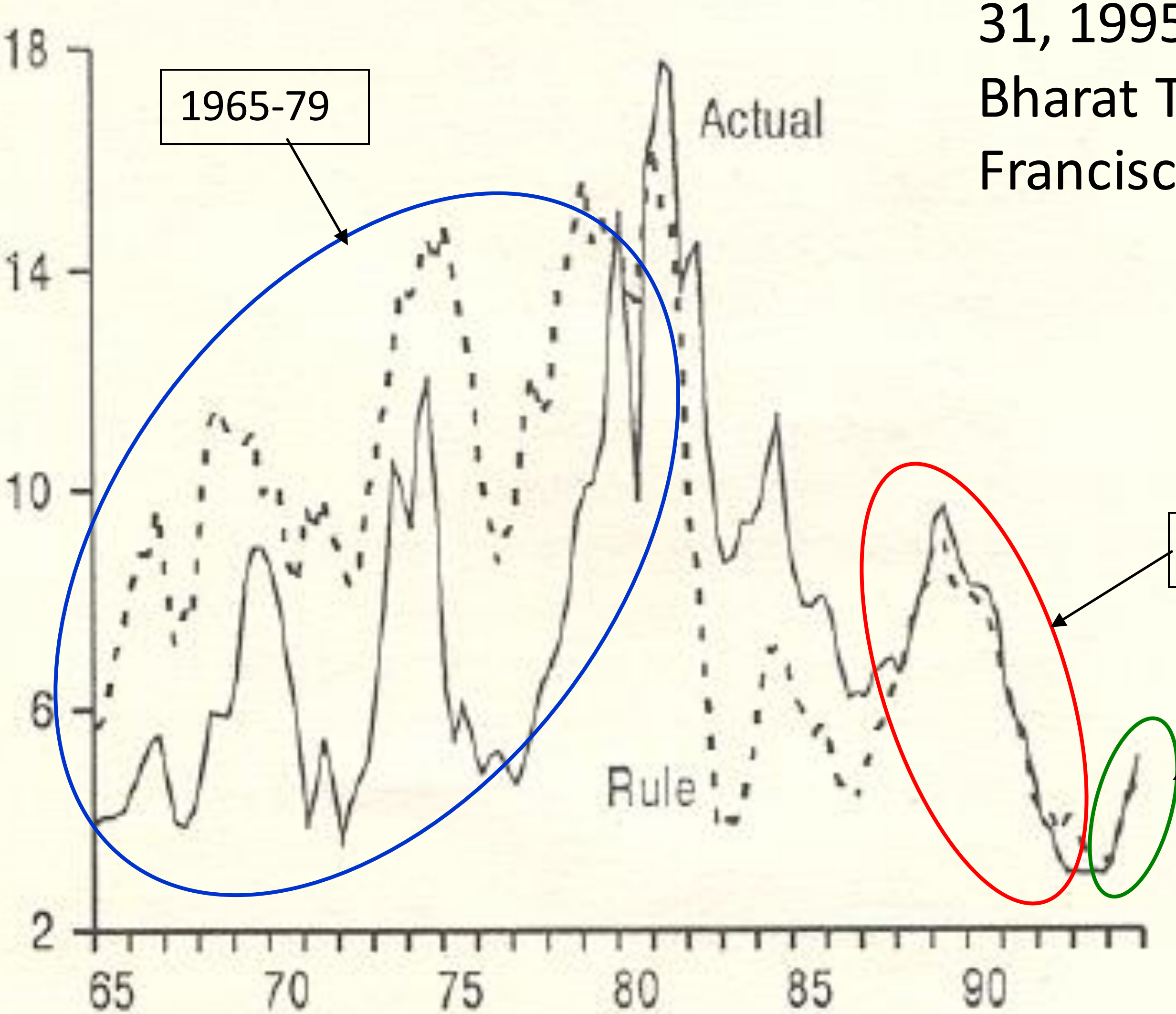
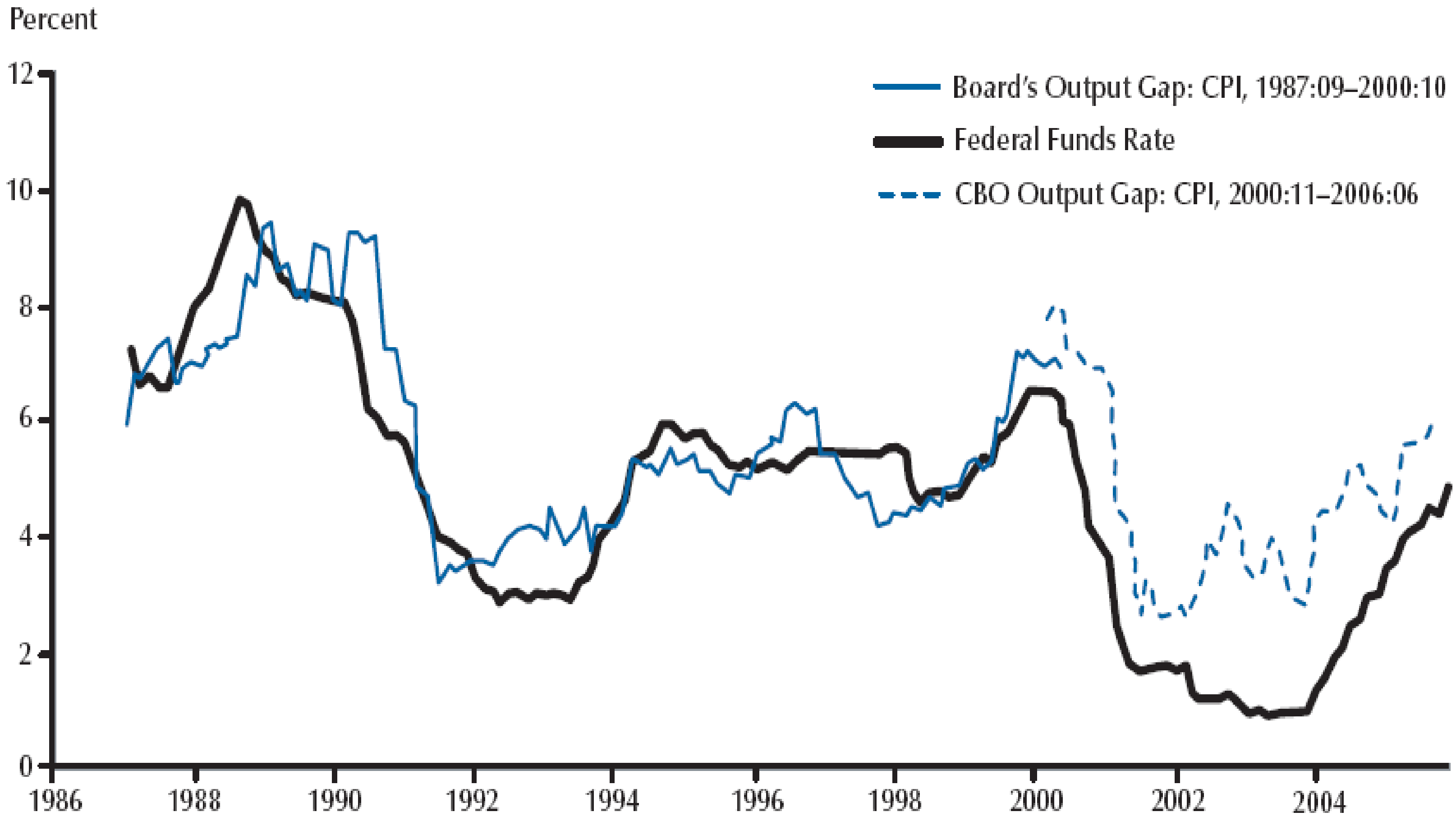
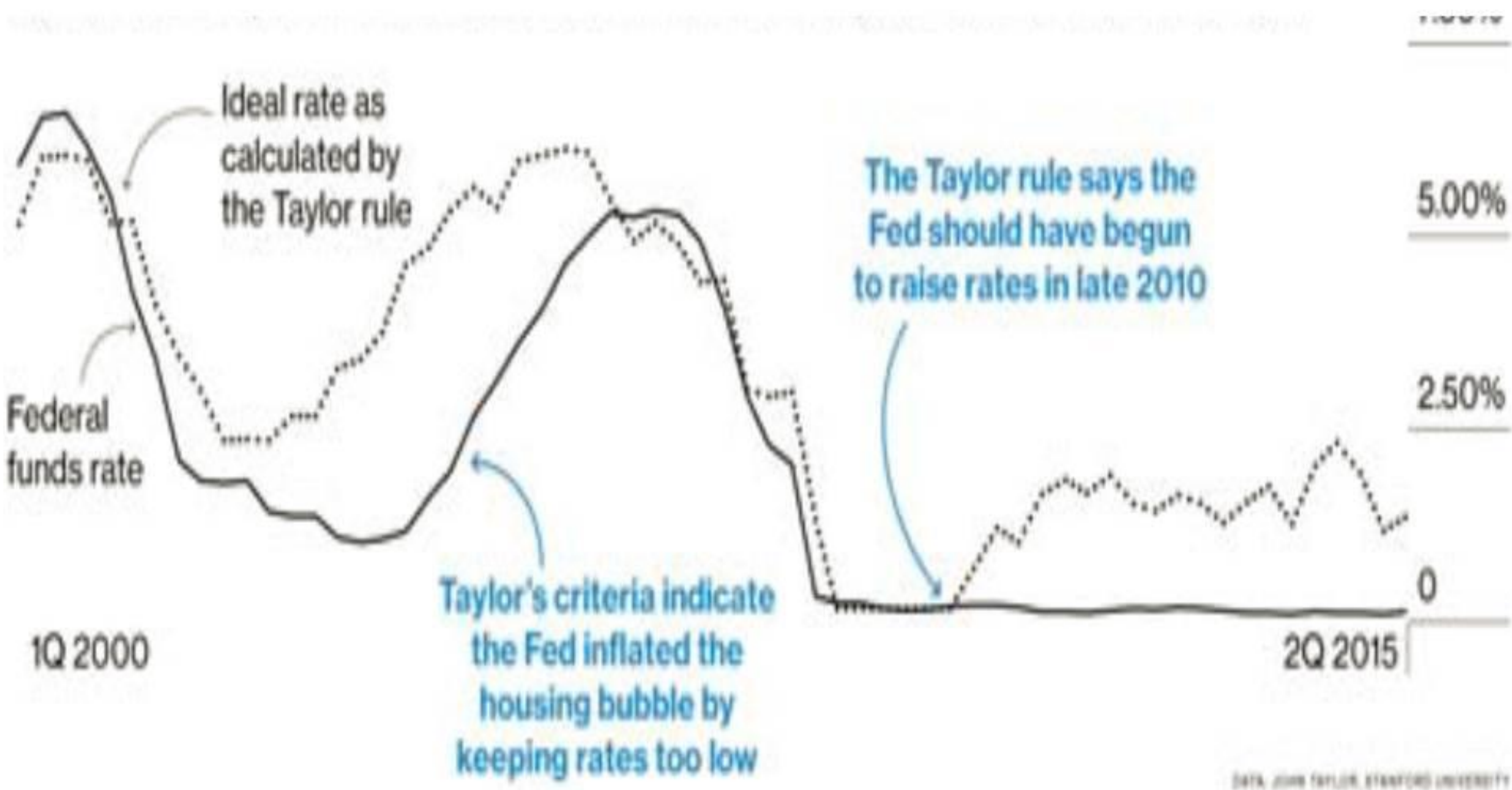
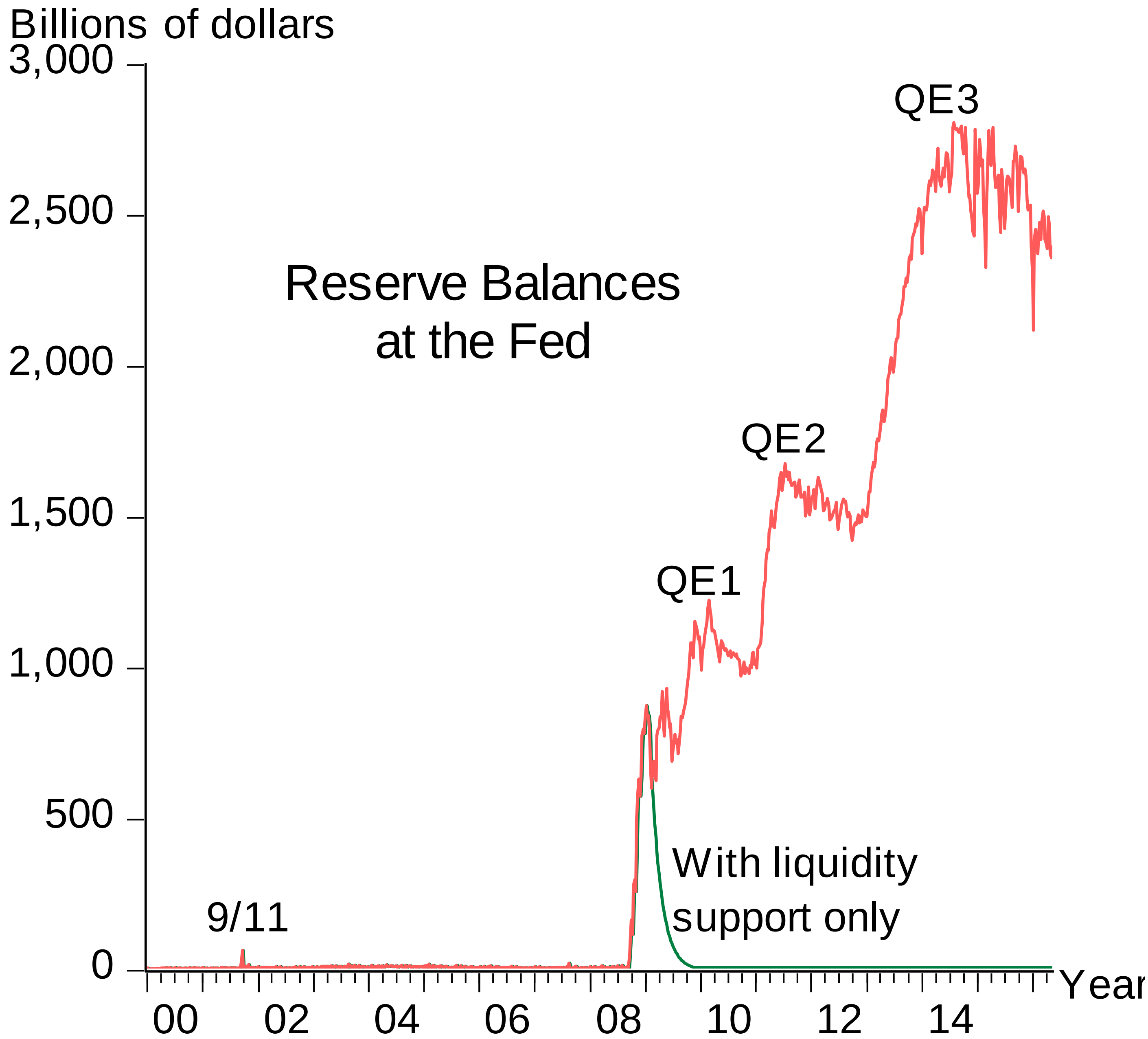


Chart from Fed, St. Louis *Review,* William Poole (Jan/Feb 2007) Showing Shift Back Toward Discretion

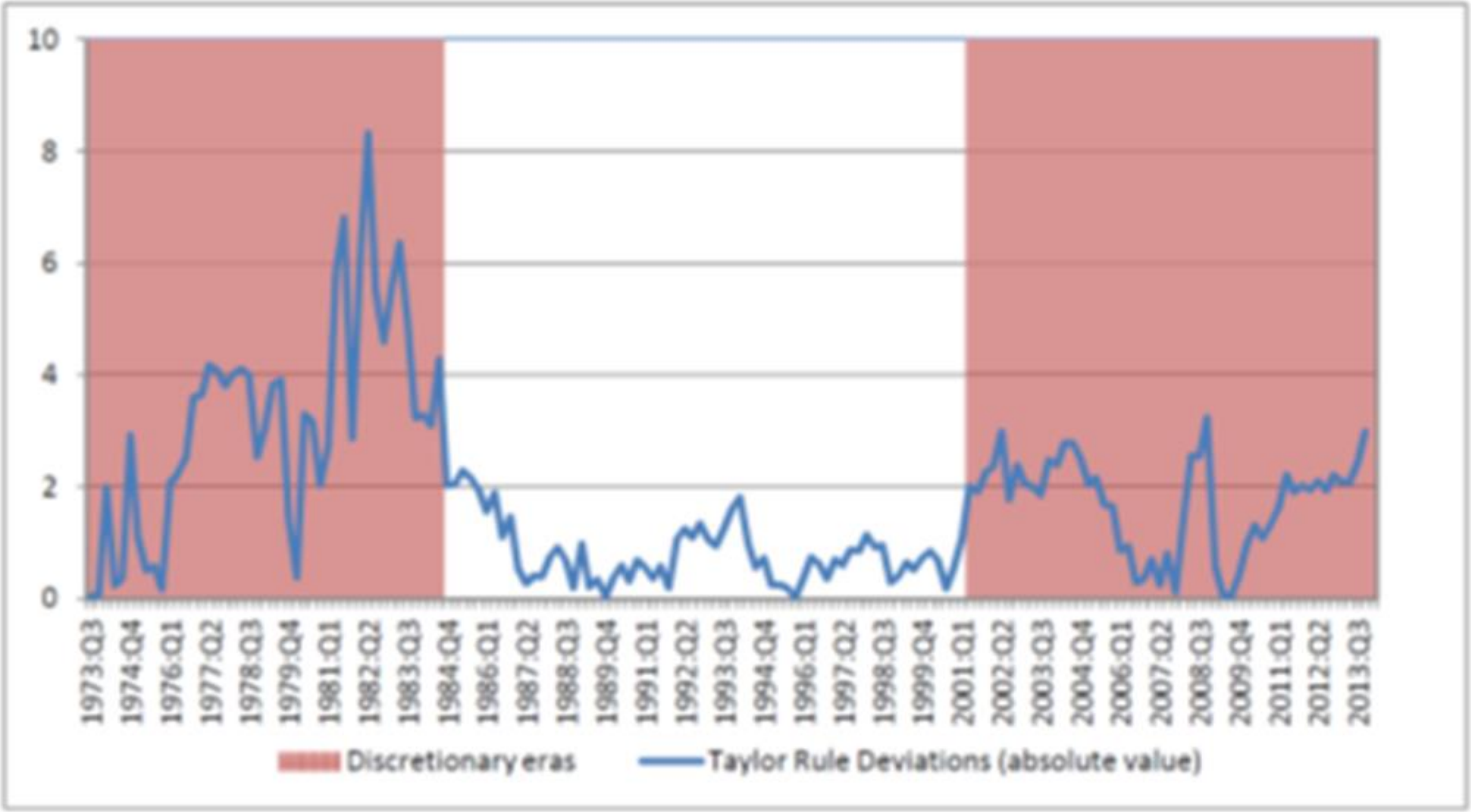
Greenspan Years: Federal Funds Rate and Taylor Rule
(CPI $p^* = 2.0$, $r^* = 2.0$) $a = 1.5$, $b = 0.5$

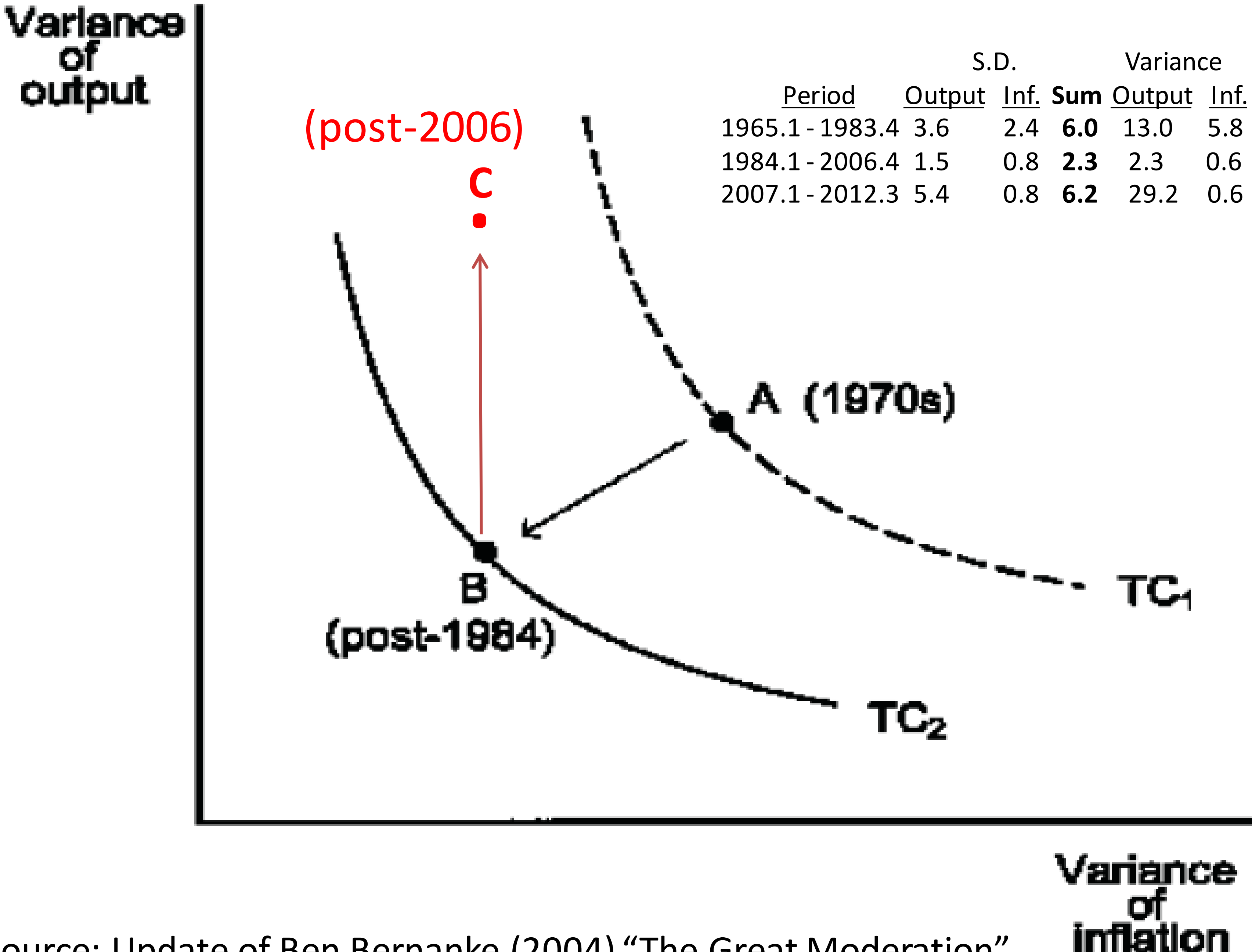



Ideal rate as calculated by the Taylor rule
Federal funds rate
The Taylor rule says the Fed should have begun to raise rates in late 2010
Taylor's criteria indicate the Fed inflated the housing bubble by keeping rates too low
5.00%
2.50%
0
1Q 2000
2Q 2015
DATA: JOHN TAYLOR, STANFORD UNIVERSITY


Billions of dollars
3,000
2,500
2,000
1,500
1,000
500
0
Reserve Balances
at the Fed
QE3
QE2
QE1
9/11
With liquidity
support only
00
02
04
06
08
10
12
14
Year

Historical analysis (Meltzer) and statistical tests (Nikolsko-Rzhevskyy, Papell, and Prodan) agree that when policy is rules-based performance is better

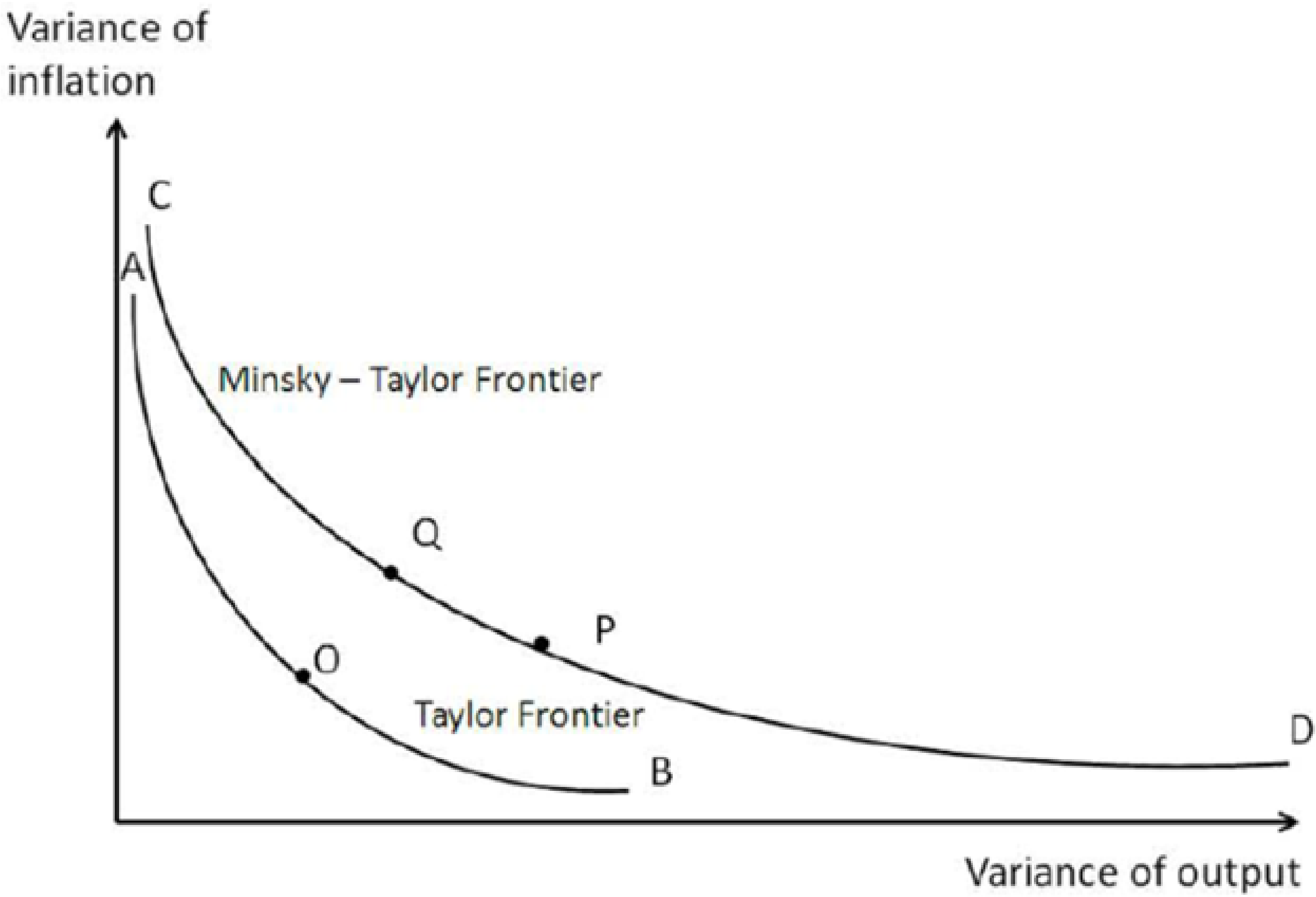




Period	S.D. Output	S.D. Inf.	S.D. Sum	Variance Output	Variance Inf.	Variance Sum
1965.1 - 1983.4	3.6	2.4	**6.0**	13.0	5.8	**18.8**
1984.1 - 2006.4	1.5	0.8	**2.3**	2.3	0.6	**2.9**
2007.1 - 2012.3	5.4	0.8	**6.2**	29.2	0.6	**29.8**

Source: Update of Ben Bernanke (2004) “The Great Moderation”

Alternative View: Curve Shifted for Other Reasons



Source: Mervyn King's Stamp Lecture (2012)

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The Scope of the Objective Given to Central Banks

- Deepen rather than widen
  - Do not need more goals
  - Need a strategy to achieve the existing goals,
    - With details about the rules-based policy for the instruments.
- How to achieve the reform?
  - Fed's statement is called "Longer-Run Goals and Monetary Policy Strategy"
  - ECB's statement is called "Strategy"
  - But these statements say little about the strategy for the instruments of policy

Policy Rules Legislation

- Requires central bank to report its strategy for the instruments.
  - Suggested such legislation in 2010
  - Now written into a bill which passed the U.S. House in 2015
  - Similar bill passed out of committee in U.S. Senate
- Would require that Fed "describe the strategy or rule of the FOMC for the systematic quantitative adjustment" of policy instruments.
  - Central bank's job to choose the strategy and how to describe it.
  - Could change its strategy, but it would have to explain why.
  - For concreteness, requires Fed to compare strategy to "reference rule."
- Precedent for giving such an objective to the central bank.
- Central bank would not be chained to any mechanical rule or lose its independence.
- What about uncertainty about output gap, effective lower bound on interest rate, changes in the equilibrium real interest rate? Even more difficult for discretion

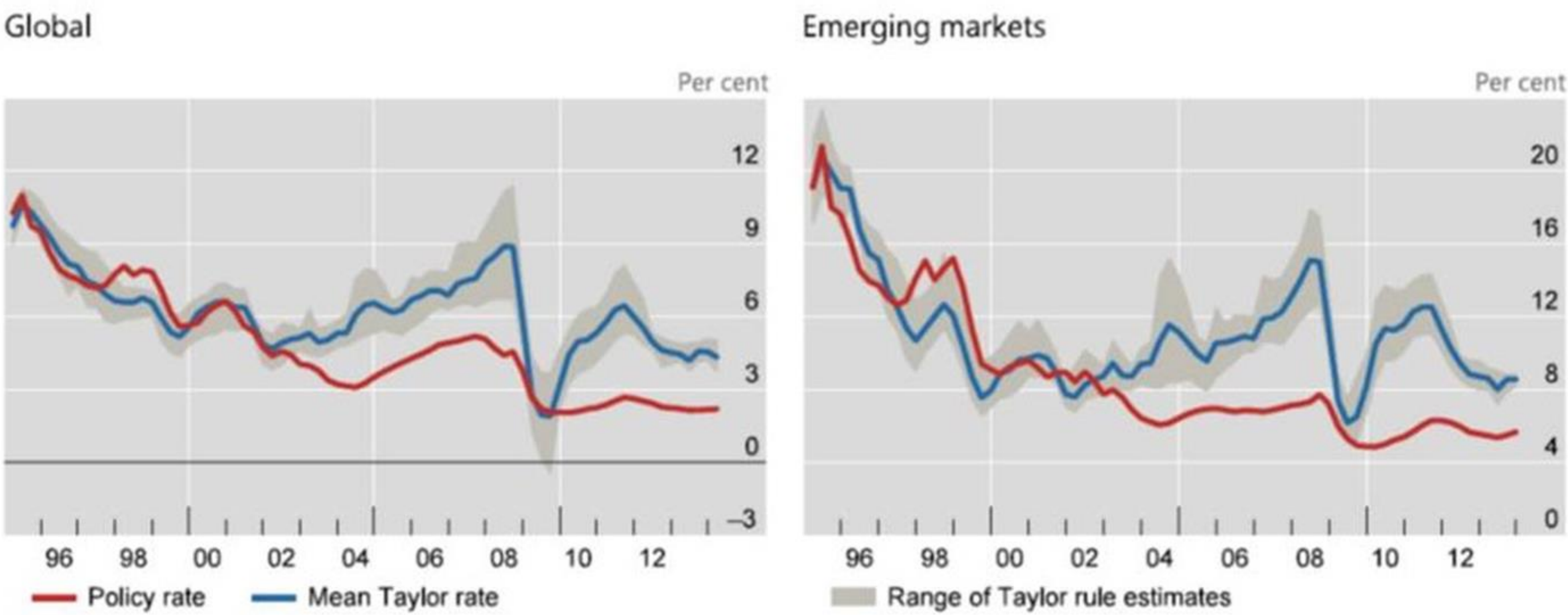
Forecast Targeting Legislation?

- Rather than a policy rule for the instruments, the legislation could require the central bank to report its *forecast targeting* strategy
  - Woodford (2012):"Forecasting Targeting as a Monetary Policy Strategy"
  - Example $$(\pi_{t+h,t} - \pi^*) + \phi x_{t+h,t} = 0$$
  - Dual to the same problem, like first-order condition & decision rule
  - As with the policy rule legislation one must write it into legislation without impinging on central bank independence
  - The central bank would decide on forecast targeting approach and how to describe it
  - Policy evaluation method of Svensson (2012) could be used
- Perhaps would meet requirement in existing bill!
- Much deeper than "constrained discretion" where all one has are goals & policymakers do whatever it takes
- Constrained discretion is an appealing term, but it does not induce rules-based policy as the term suggests.

International Considerations

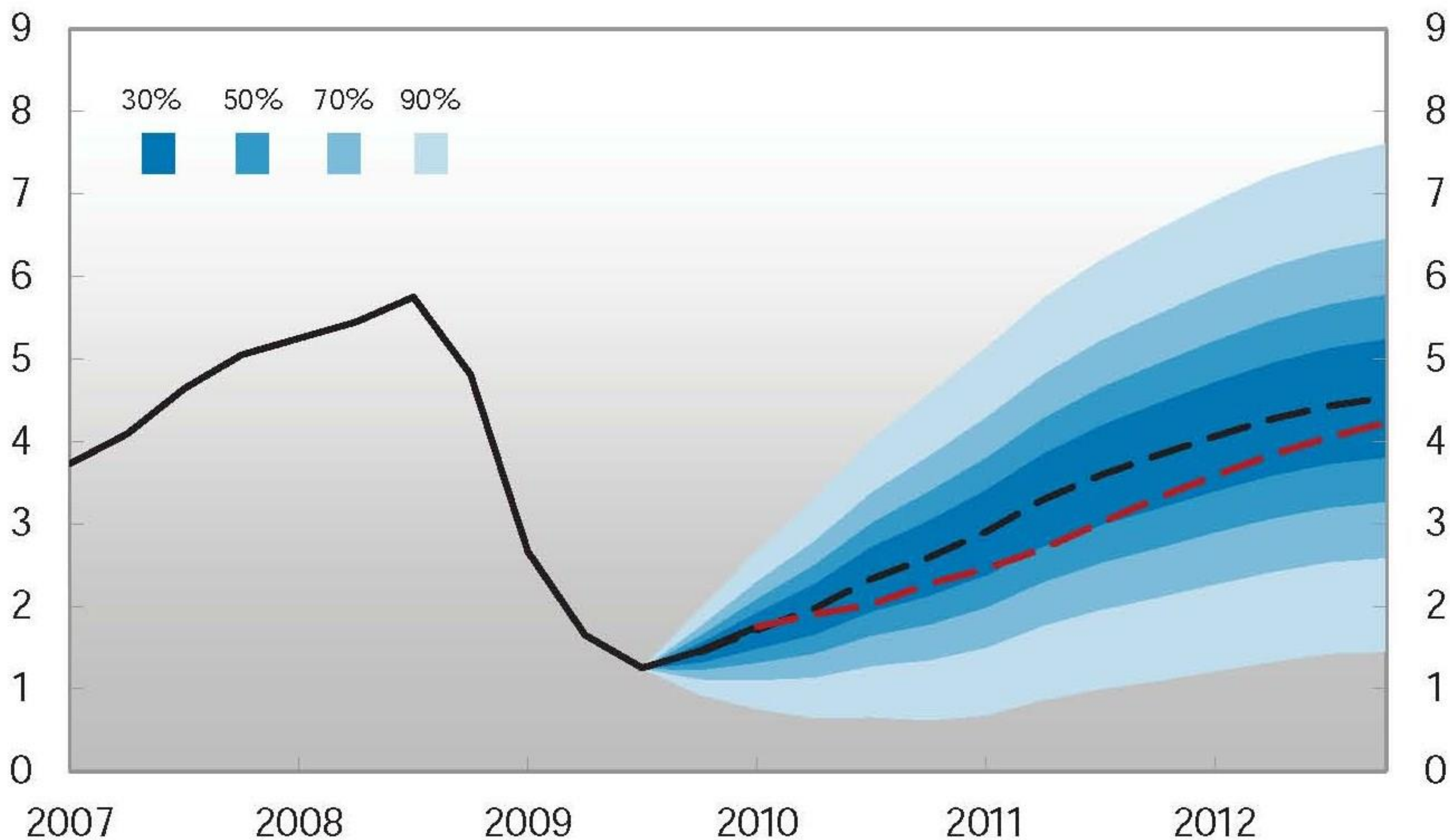
- The deviations from rules-based policy spread.
- Central banks tend to follow each other.
  - Low interest rates in large countries are followed by low interest rates in other countries, trying to fight off currency appreciations.
  - QE begets QE
- So international monetary system has drifted away from a rules based system.
- International economic performance has been poor.
  - Huge swings of capital flows, increased volatility of exchange rates, and disappointing economic growth

Policy rates compared to Taylor rules[1] Graph 2



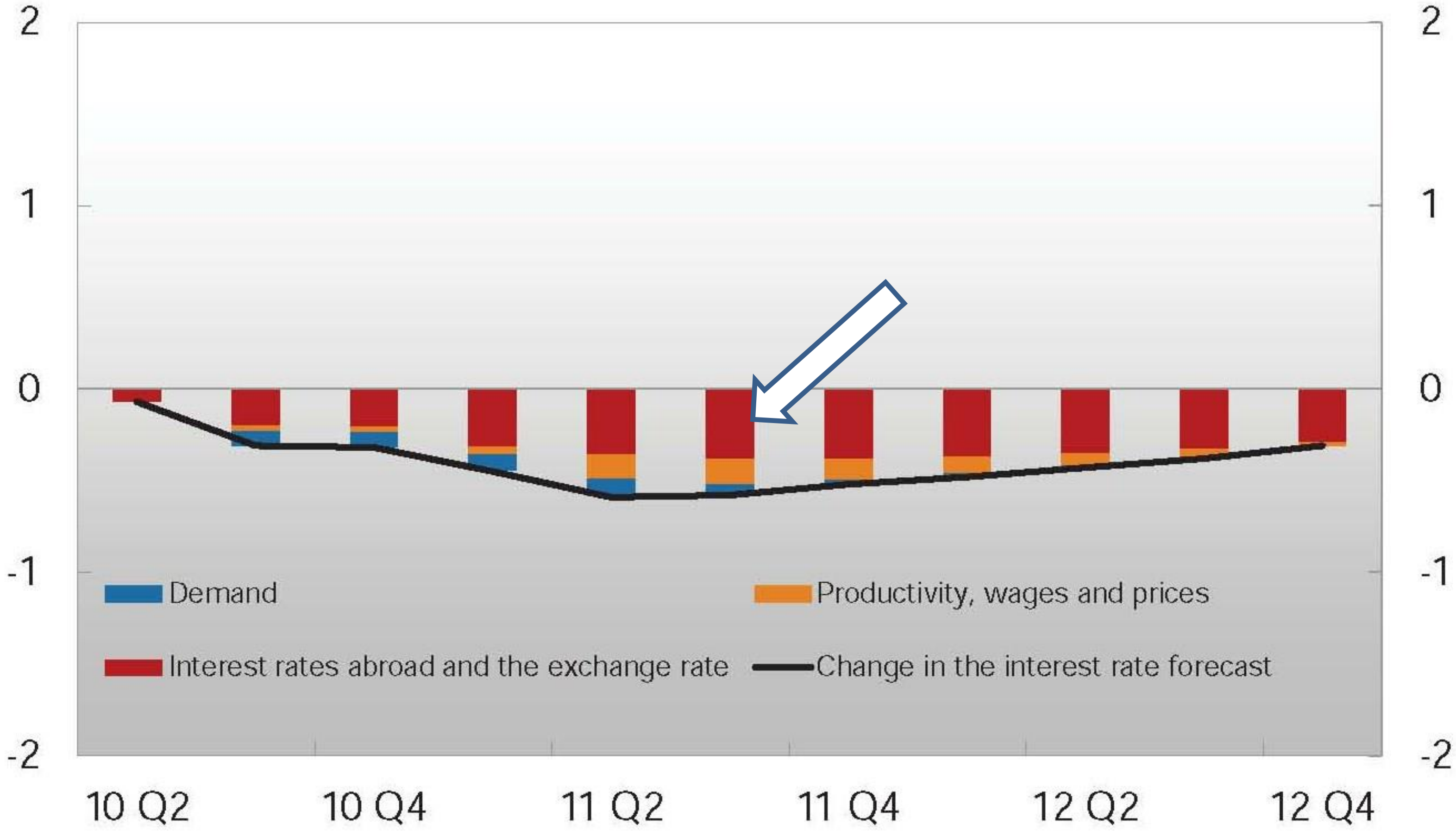
Source: BIS, Shin

A cut in the Norges bank policy rate (black line to red line)…

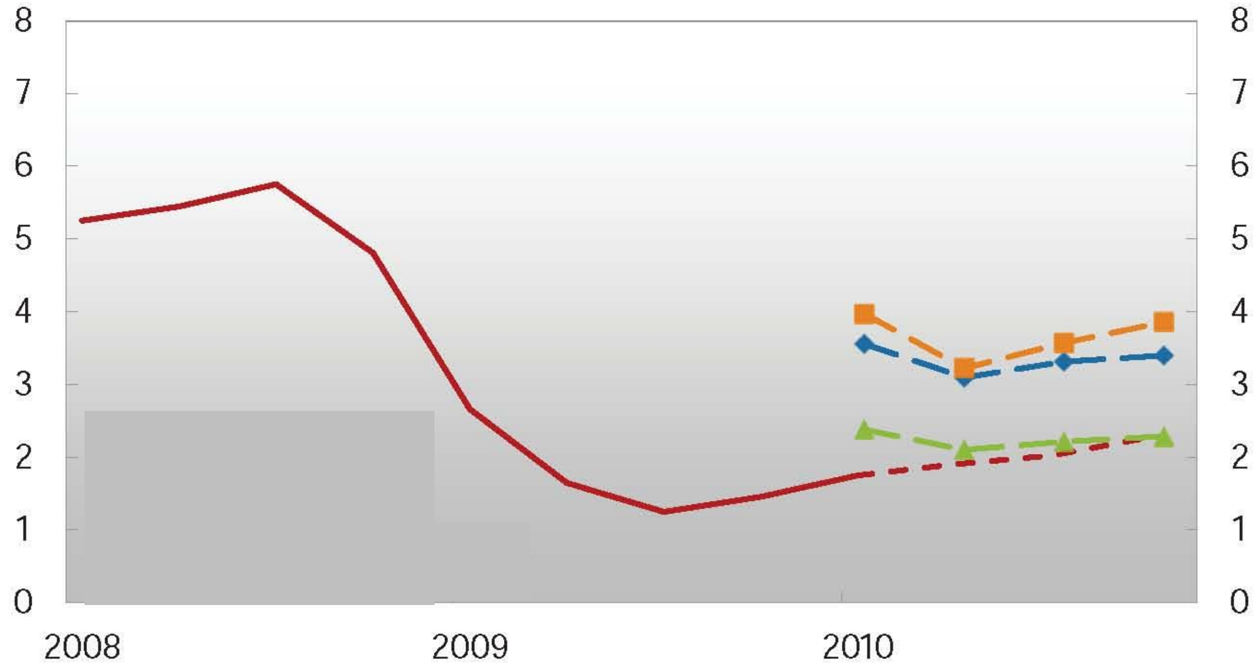


Source: Norges Bank

….because of interest rates were cut abroad.



Source: Norges Bank

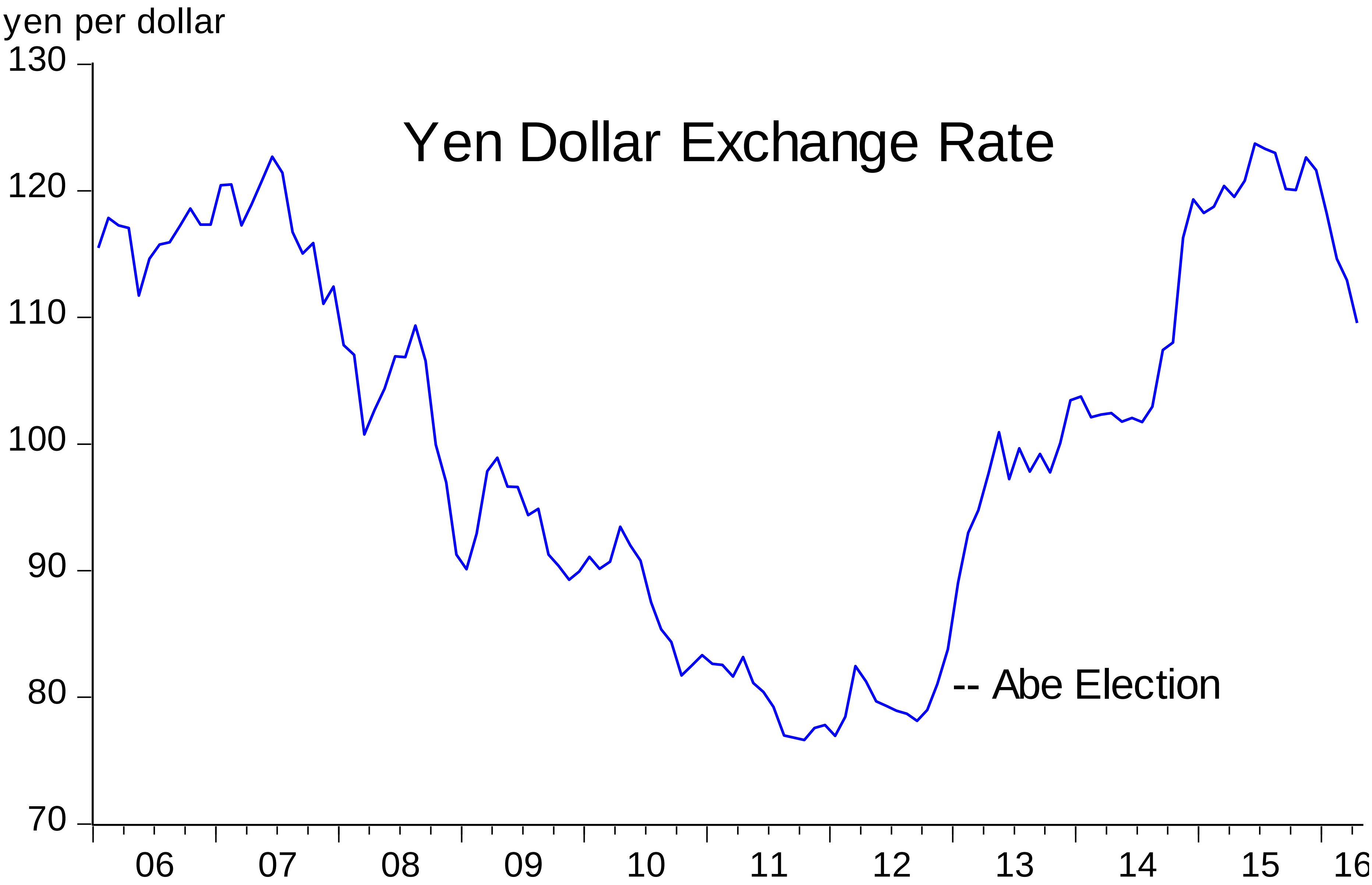


Taylor Rule

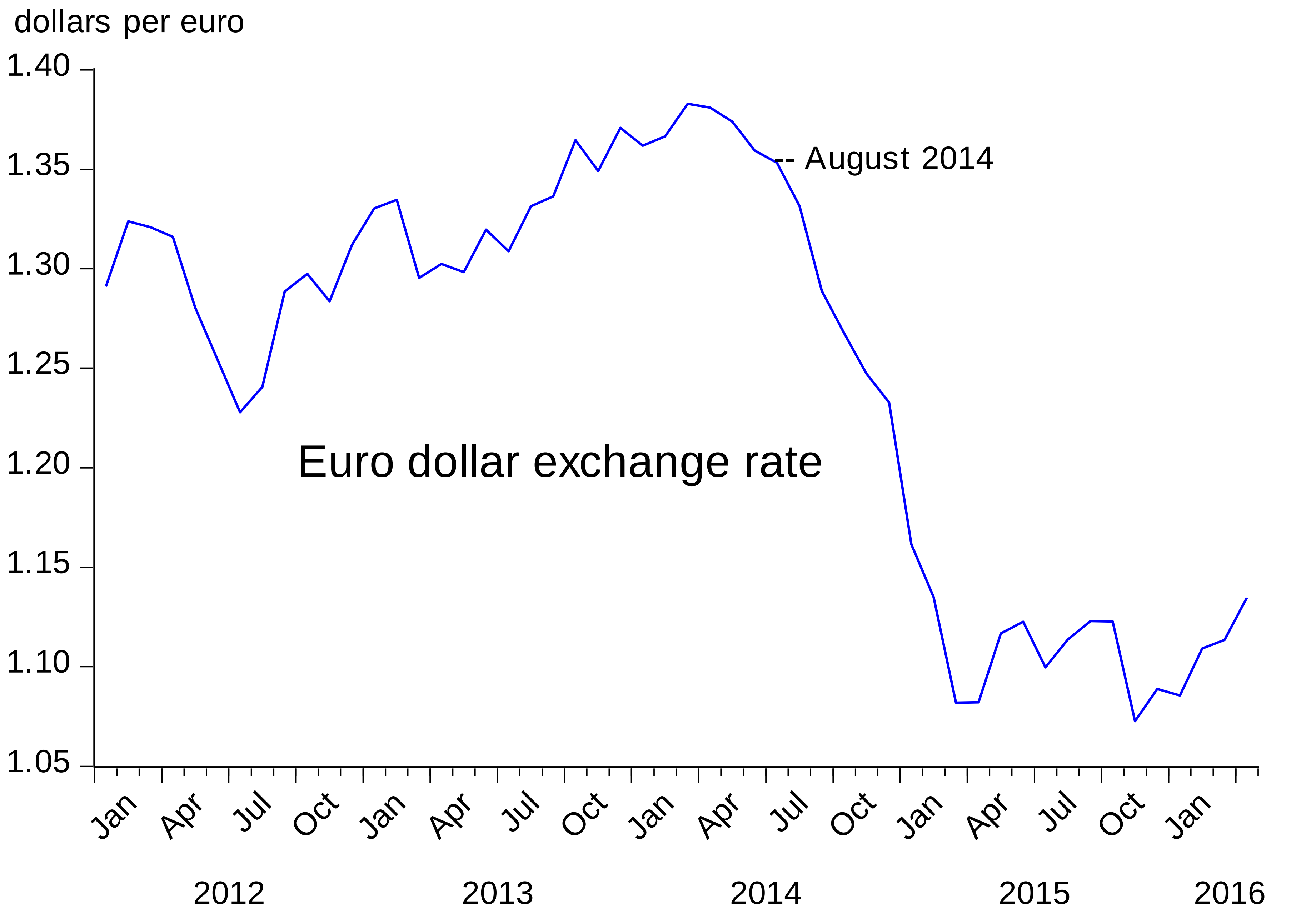
Key Policy Rate

Rule with external interest rates

Growth rule



yen per dollar
Yen Dollar Exchange Rate
-- Abe Election
130
120
110
100
90
80
70
06
07
08
09
10
11
12
13
14
15
16



dollars per euro
1.40
1.35
1.30
1.25
1.20
1.15
1.10
1.05
-- August 2014
Euro dollar exchange rate
Jan
Apr
Jul
Oct
2012
2013
2014
2015
2016

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- International economic performance has been poor.
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Calls for International Monetary Reform

- Jaime Caruana: global instability shows need for reform
- Paul Volcker: "the absence of an official, rules-based, cooperatively managed monetary system has not been a great success."
- Raghu Rajan:"what we need are monetary rules that prevent a central bank's domestic mandate from trumping a country's international responsibility."
- This proposal: A rules-based international monetary system built on policy rules in each country
  - Research (old and new) shows it will work well even with capital mobility and flexible exchange rates

Specific Proposal

- Countries forge an international agreement:
  - each central bank describes and commits to a monetary policy strategy for the policy instruments.
- Important lessons from previous international monetary agreements: 1945, 1973, 1985
- Given many calls for reform, now is a good time.
- Need for a transition to more rules-based policy.