The Futility of Central Banking

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From Anguish to Triumph and Back

It has been more than three decades since Arthur Burns (1979) gave his famous Per Jacobsson lecture on "The Anguish of Central Banking." In it he declared that

> the persistent inflation that plagues the industrial democracies will not be vanquished—or even substantially curbed—until new currents of political thought create a political environment in which the difficult adjustments required to end inflation can be undertaken.

Coming from a recently retired Fed chairman, this was a remarkable statement. It amounted to an admission that the Fed was quite incapable of performing its most fundamental task, and that the problem was, not any lack of material means on the Fed's part, but simply the will to do what needed doing given political incentives then at play.

Just over a decade later, Paul Volcker (1990) felt able to answer Burns' pessimism by making "The Triumph of Central Banking?" the title of his own Per Jacobsson lecture. Volcker went so far as to speak of a "renaissance" of central banking—an era of newfound accord between central banks and governments, in which the former were allowed to exercise scientific control over money, unconstrained by pressure for fiscal accommodation.

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To his credit Volcker understood that the triumph of which he spoke might prove ephemeral. Hence, the question mark in his lecture's title. Volcker warned that

> a conclusion that central banks happen to be in relatively good repute today isn't the same thing as convincing evidence that those institutions have now, in fact, equipped themselves to assure greater price and financial stability in the years ahead. To make that case will require something more lasting than a demonstration that, at one perceived point of time, they could squeeze a good deal of inflation out of the system. Nor is one exceptionally long period of economic expansion—a period that followed a deep recession—conclusive.

What's more, Volcker said, "Even the partial victory over inflation is not secure."

Alas, Volcker's warning proved all too prescient: reports of the passing of monetary mismanagement were indeed premature. We now know that the "triumph of central banking" was but one successful campaign in a war comprising an almost uninterrupted sequence of monetary calamities—from the post-WWI inflationary binge to the Great Contraction of the 1930s to the present subprime boom and bust. And that one undeniable success is now less secure than ever.

Perhaps no central banker will ever be so bold as to give a Per Jacobsson lecture on "The Futilty of Central Banking." Yet the time has come for someone to speak on that topic. For it should now be clear, in case it wasn't long ago, that central banks generally, and the Federal Reserve in particular, not only are unable to prevent financial and monetary catastrophes, but are unable to resist pursuing policies that inadvertently help to *cause* such catastrophes.

Central Banks Are Inherently Discretionary

One might reply that central banks' many failures have been, not failures of central banking per se, but failures of *discretionary* central banking that might have been avoided by commitment to the right sort of monetary rules. But plausible as this view may appear, I believe it to be mistaken. For insofar as it takes the presence of a central bank for granted, the very idea that a choice exists between monetary rules and monetary discretion is misleading. The truth is rather that central banks are inherently discretionary institutions or, more precisely, that central bankers cannot resist exercising discretion. Like a married bachelor, a rule-bound central banker is a contradiction in terms, for both the background of central bankers and the incentives they confront, combined with the inescapable imperfections of even the most carefully crafted of monetary rules, will inevitably tempt them to tinker with the money stock.

Thus the classical gold standard, a rule-based monetary arrangement that made possible an unprecedented interval of global monetary stability, was doomed once its enforcement was placed in the hands of central banks, the very presence of which was destabilizing, and even long-standing commitments to maintain established currency parities were of no avail once central bankers faced a choice between honoring those or meeting the emergency fiscal demands of their sponsoring governments.

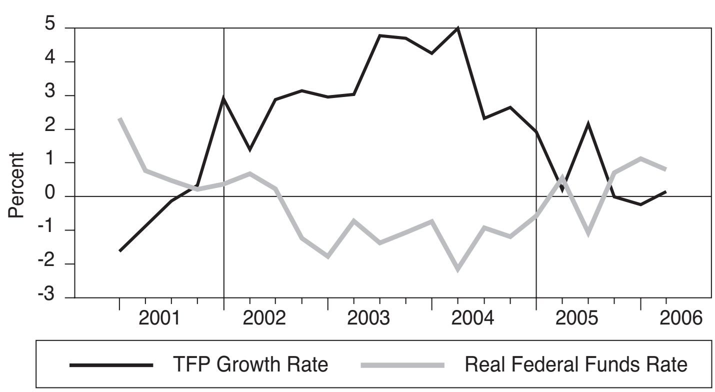
The point is illustrated just as effectively by the Fed's conduct during the recent crisis. Between the 1980s disinflation and the dot-com crash, the Fed could boast of having overseen a period of overall monetary stability unprecedented in recent experience. The so-called great moderation seemed to amply justify Volcker's tentative conclusion, made not long following its onset, that central bankers had triumphed after all. But it represented as well a triumph, albeit inadvertent, for proponents of monetary rules, for it was using evidence from this period that John Taylor was able to show that the Fed had been conducting policy largely *as if* it had been adhering to a relatively simple monetary rule, calling for it to adjust its federal funds rate target in a systematic manner in response to observed changes in the rate of inflation or deviations of output from its sustainable long-run value. What's more, Taylor (2008) has shown more recently that, had the Fed continued to follow the same "Taylor Rule," much of the post-2001 housing boom, and consequent bust, might have been avoided.

Surely of all possible monetary rules none could be easier for central bankers to stick to than a rule derived ex post to conform to the pattern of their own past discretionary decisions, and especially so if the same administration remained in place. Moreover, not long after

Taylor published his findings the Fed began explicitly to consider his rule in its deliberations. Yet the Fed was unable to resist making a substantial ad hoc departure from the rule in the wake of the dot-com crisis. Instead of raising its fed funds target in response to growing signs of recovery from the bust, as the Taylor Rule would have required, the FOMC found ways to rationalize keeping the rate low.

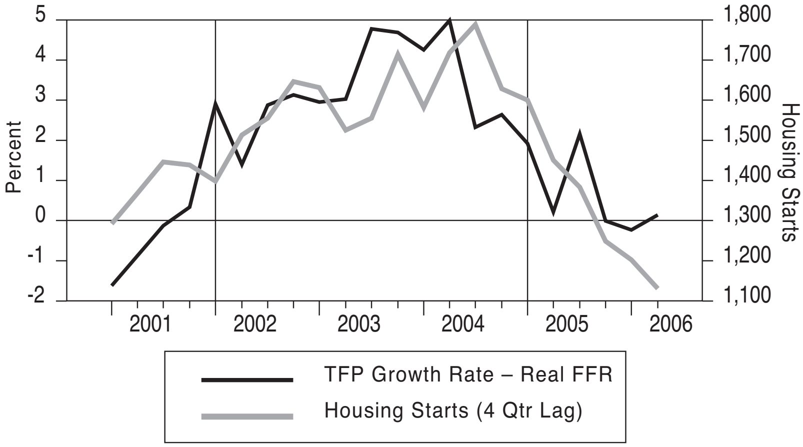
In particular, the FOMC treated an ongoing surge in productivity as a reason for further delaying a return of the fed funds rate from 1 percent to its long-run average (for the inflation rate prevailing at the time) of about 3 percent. They did this, moreover, despite the fact that a productivity growth surge generally implies a higher than average "neutral" funds rate. Instead, they reasoned that the surge, by putting downward pressure on prices, would allow them to depart from their normal policy without sparking inflation. Figure 1 shows the relationship between the rate of productivity growth and the real fed funds rate during the periods in question, while Figure 2 shows the relation between the "productivity gap" (defined as the difference between the rate of total factor productivity growth—a rough-and-ready proxy for the "neutral" real fed funds rate—and the actual real fed funds rate) and housing starts.

FIGURE 1
Prodctivity Growth and Monetary Policy



Source: Beckworth and Selgin (2010).

FIGURE 2
The Productivity Gap and Housing Starts



Source: Beckworth and Selgin (2010).

In short, the FOMC saw productivity gains as an opportunity to keep revving up the credit engine without risking a speeding ticket. That doing so might ultimately cause parts of the economy to overheat, and eventually to fail, does not appear to have occurred to it.

The point of the story is not simply that the Fed erred, but that it erred by departing from a relatively tried-and-true (though certainly imperfect) formula, using clever but misguided reasoning to justify doing so, and that such misguided innovation is inevitable, given the Fed's constitution. More to the point, it is inevitable that an FOMC, consisting of expert monetary economists, simply cannot be expected to set that expertise aside in making policy, as if it consisted of so many mere clerks. And the same is true for all central banks today. Nor is this failure to adhere to rules as a mere matter of policy the manifestation of political pressure or of a more subtle "time inconsistency" problem, as some writings have suggested. Those factors also undermine central banks' ability to adhere to self-imposed rules, to be sure. But the main problem these days is more prosaic than that. It consists of nothing more than the monetary authorities' perfectly well-meaning yet ultimately misguided desire to use their heads.

Separation of Monetary and Financial Regulatory Powers

While it is relatively easy to point out Fed errors after the fact, it is very hard to find fault with the FOMC's deliberations, taking the committee's charge for granted. Those deliberations reveal, in the case of the recent cycle at least, no caving in to pressure from the Treasury or intent to deceive the public. The arguments of committee members, if sometimes mistaken, appear well-intentioned and consistent with a desire to act in accordance with the Fed's official mandate.

The real problem, as I have noted, is not the particular way in which the FOMC determines policy but the committee's inherently discretionary nature; and the only way around it is to rule out discretionary decisionmaking altogether, through institutional change that would amount to doing away with the Fed altogether, in spirit at least if not in name.

A number of countries have managed to do this in recent years either by establishing currency boards or by dollarizing. But these reforms can hardly address the problem of unwanted monetary discretion in the management of the major currencies on which they depend, including the U.S. dollar. What is needed in the United States is a reform that would, in essence, replace the FOMC with a management arrangement based on a constitution similar to those on which orthodox currency boards are based, but stipulating that the *sole* purpose of the "Monetary Rule Enforcement Agency" is to manage the supply of base money in strict accordance with some simple monetary rule. The authority should have no other powers, just as no other authority should have the power to manipulate the monetary base; and its employees should be more policemen than pilots, chosen for their integrity and willingness to enforce the monetary constitution rather than for their presumed ability to supply expert advice regarding desirable ad hoc changes in the course of monetary policy. Finally, financial regulatory policy and financial rescues (to the extent that the last are undertaken at all) should be the responsibility of separate agencies, and so would have to be handled without the least hope of support from the Monetary Rule Enforcement Agency's printing press.

Besides being essential to the strict maintenance of a monetary rule, the proposed separation of the power of base money creation from that of financial firm regulation and support would also help to reign in implicit guarantees that presently threaten to further undermine financial system safety. Alas, it is also precisely opposite to what the White House has proposed in its current financial reform plan. That plan would substantially enhance the Federal Reserve's role in regulating and rescuing financial firms, thereby further complicating its original mission of managing the money supply, while appearing to reward it for having mismanaged that supply in the recent past.

The Market Can Help

Although even strict adherence to the Taylor Rule would have been better than the Fed's actual ad hoc approach to managing the money supply, there are other monetary rules that would be better still. This should come as no surprise, since (as has been noted) the Taylor Rule was developed, not as an ideal, but as a rule approximating the Fed's actual (and imperfect) monetary policy decisions throughout the much of the Greenspan era.

An alternative monetary rule—nominal GDP targeting—has much to recommend it. Under that rule, the monetary authority adjusts the monetary base in response to changes in the growth rate of nominal spending, with the goal or maintaining a steady growth rate. The money stock is thus made to grow more rapidly when the real demand for money holdings increases, and less rapidly when that demand declines. A nominal GDP growth target is for this reason intuitively appealing, because it does not require any monetary response to movements in variables like the rates of unemployment and inflation, which movements are not always a reflection of monetary shortages or surpluses.

So long as the overall flow of spending remains stable, then whatever may ail the financial system, it is not a general lack of dollars or liquidity, and any tampering with the supply of dollars is likely to cause problems of its own. Of course, regulatory bureaucrats might prefer to have the extra leeway for emergency lending that recourse to the monetary printing press would give them. But far from being a reason for objecting to a strict nominal GDP targeting regime, this is proof of the need to keep regulators at arm's length from those responsible for the regime's enforcement.

The Bank of England supposedly employs nominal GDP target—though it does so without being bound to do so in any fashion; and economist Scott Sumner has for some time proposed a scheme, called nominal GDP futures targeting, in which speculators in the open market play a crucial role in implementing and enforcing the monetary authority's rule (see Sumner 1989 and 1995). The details of the scheme are too involved to list here. Its main virtue is that it significantly reduces the discretionary element in monetary base adjustments aimed at implementing the nominal GDP rule, and thereby comes close to making the monetary supply adjustment process an entirely automatic one, largely free from any reliance on bureaucrats' judgment.

Sumner's scheme thus satisfies a general principle upon which any sound scheme of monetary control must be based—namely, the scheme ought to work in concert with market forces. Central banks have generally forsaken this principle, acting as if the market could play no positive role in helping them to achieve monetary stability. But that attitude is seriously mistaken. History supplies important examples of stable monetary systems that were based entirely on competitive market arrangements; and while the existence of fiat monetary standards means that monetary control can no longer be entirely market based, it does not follow that market institutions cannot assist the process.

Sumner's plan suggests one way to employ such institutions. Another is to get the government out of the paper currency business, so as to allow the monetary authority to focus on regulating the supply of bank reserves. Commercial banks should be encouraged to supply their own paper notes, as they did in the past; the public in turn can be encouraged to make greater use of electronic forms of payment, which have many advantages besides. By supplying paper currency at public expense, the present arrangement complicates the problem of monetary control while perpetuating an archaic means of payment.

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