Central Bank Independence

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Introduction

Central banks in most developed countries have **some** independence.

Goals are prescribed:

- price stability and full employment

Implementation is up to the Fed

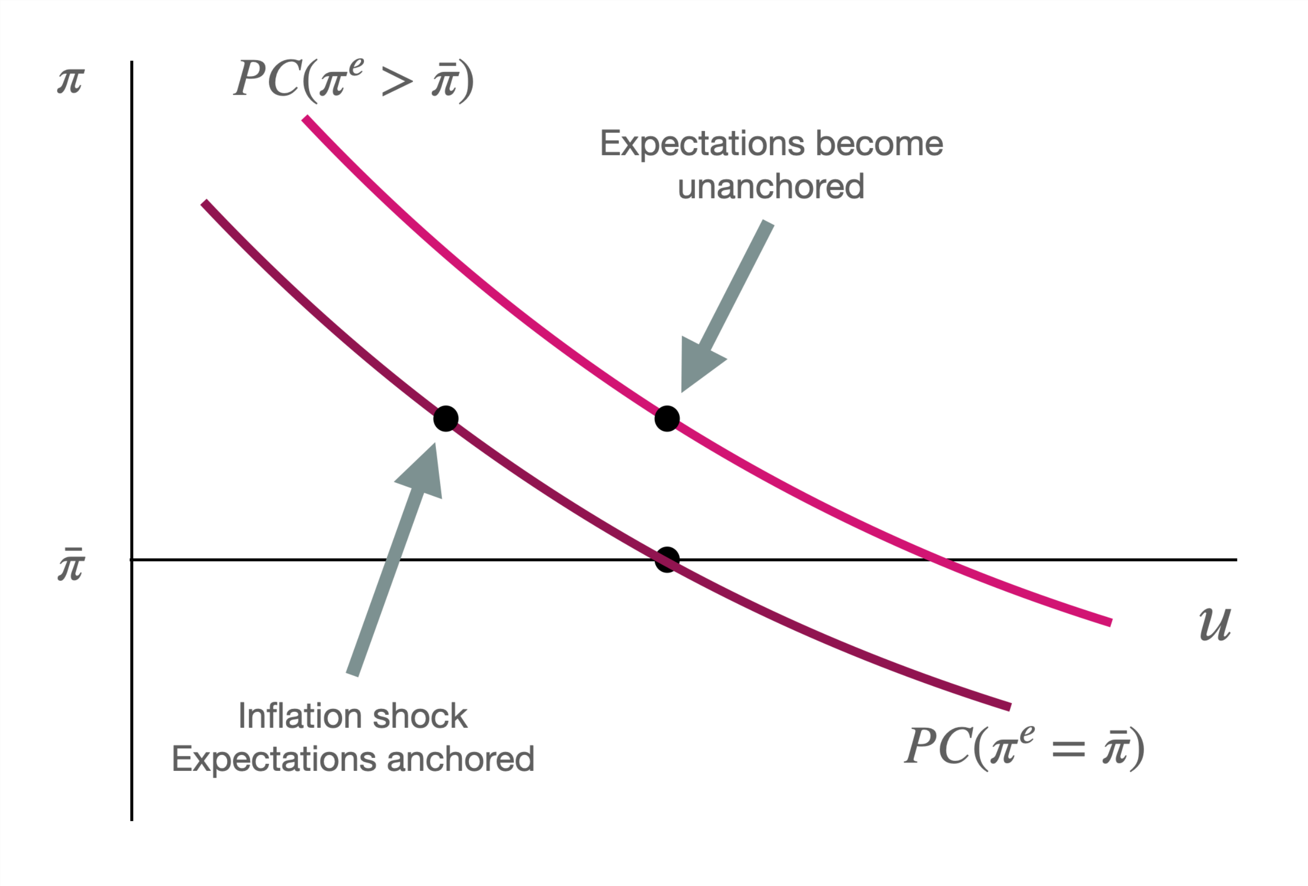
- Fed governors are senate confirmed
  but then serve 14-year terms (or not any more ...)

Tools are limited

- buy and sell (mostly) bonds
- set a few interest rates

Why this arrangement?

1 Independence as a Commitment Device



Expansionary monetary policy
=>
Move along the PC

Does the PC shift?

The Fed benefits from anchoring inflation expectations.

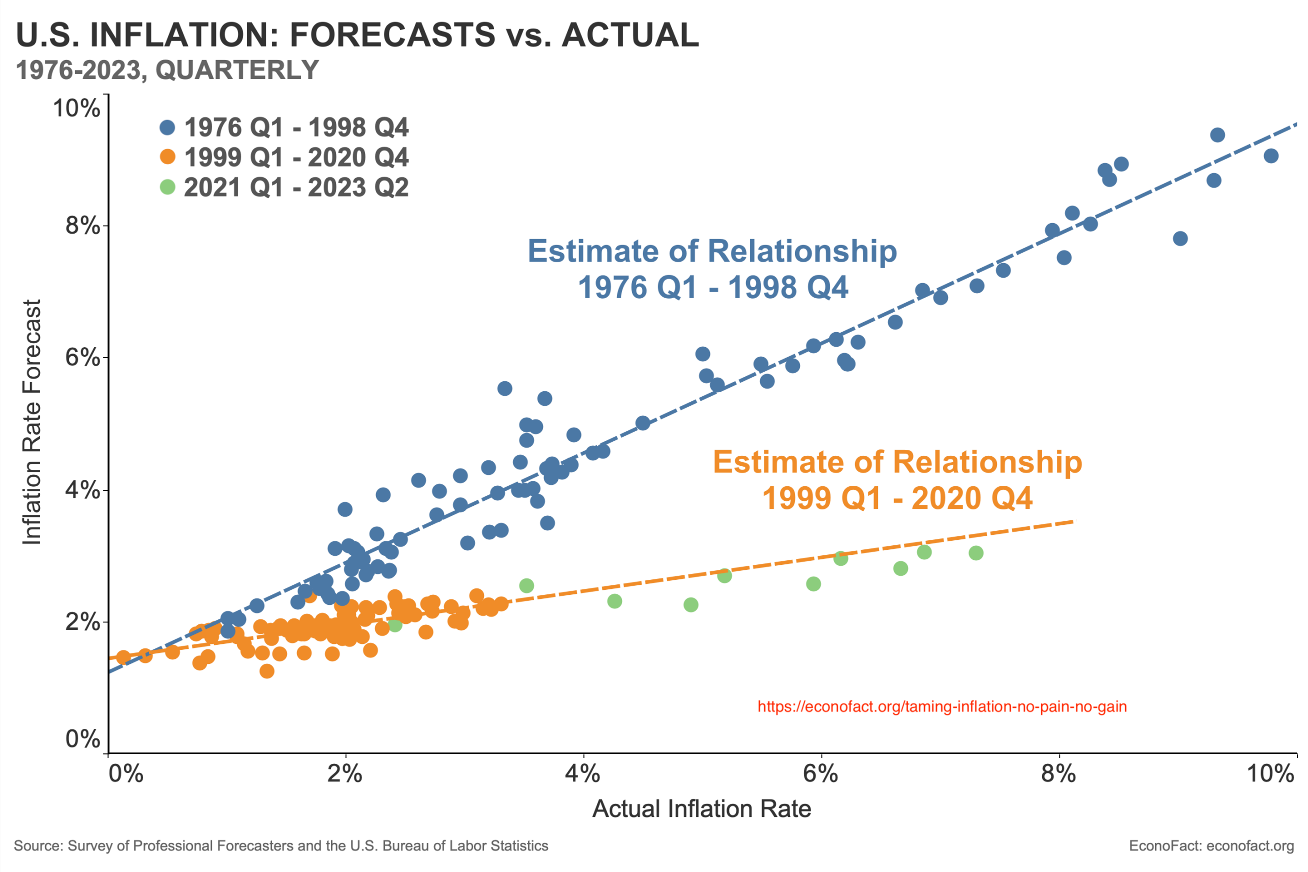
Anchored:

- Rising inflation does not move expectations much.
- Fed can tolerate high inflation for a while.

Not anchored:

- Rising inflation moves expectations.
- After a shock, bringing down inflation expectations is costly.

1.1 Lessons from the Philips Curve



Anchored inflation expectations

$\Longrightarrow$

Rising inflation does not move expectations much.

1.2 How to anchor expectations?

The problem: The Fed cannot commit.

An easy way of anchoring: **write inflation into law**

- But that's too rigid

How can the Fed convince the public that it will keep its promises?

Without commitment: Need to build a **reputation**.

That requires giving up short-term gains for long-term gains.

That requires a policy maker with a **long time horizon**.

1.3 What if the Fed is not independent?

Politicians with **short horizons** take over.

Temptation to run the economy "hot" before the next election.

- Pay the inflation cost later.

Political business cycles

- This is how the 1970s inflation got started.

Over time, inflation expectations become unanchored.

Monetary policy loses its power.

- When the Fed needs to move along the Philips curve, it starts to shift right away.

1.4 Fiscal Commitment

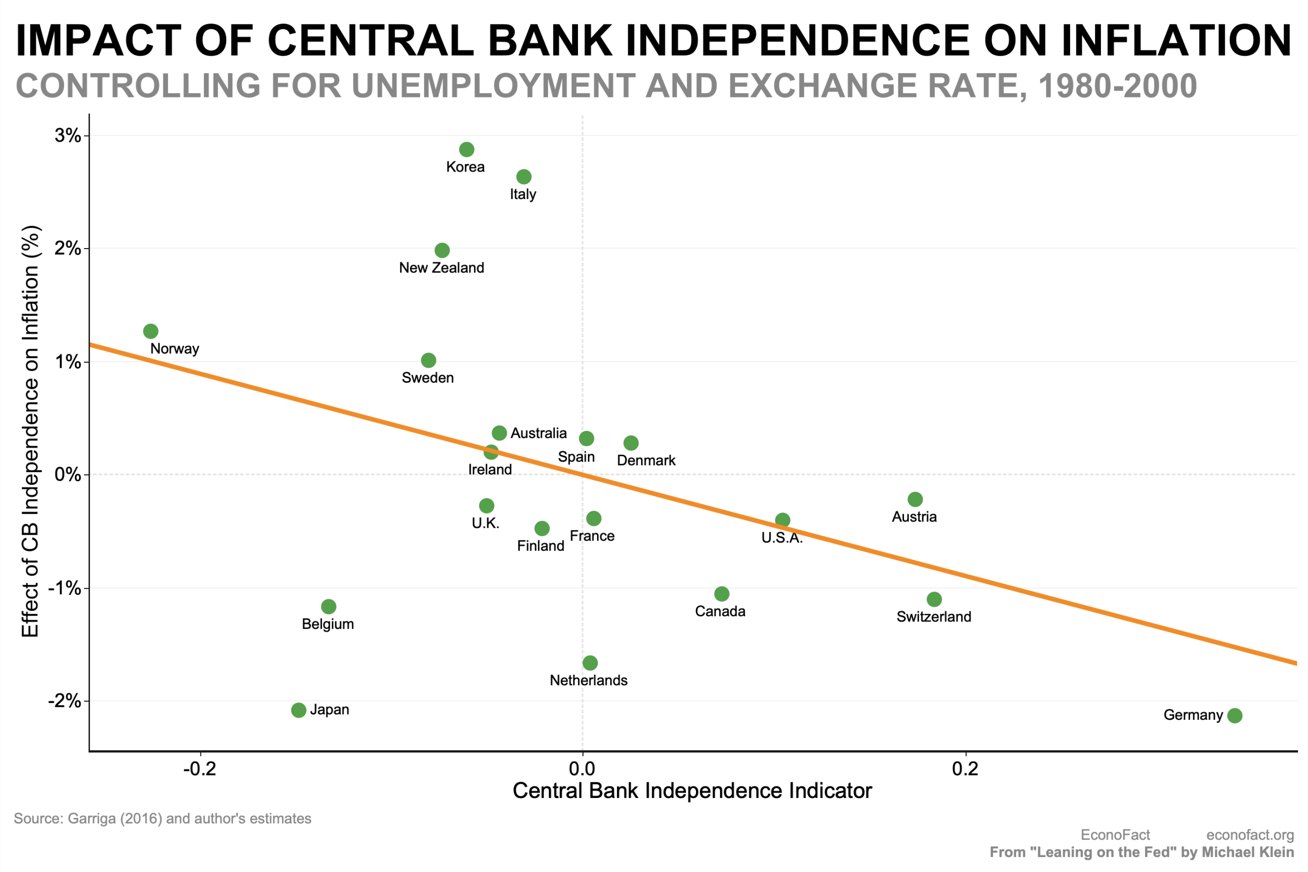
The temptation:

- Run deficits before the next election.
- Let the Fed finance the deficits by buying bonds.
- Pay the debt cost later.

Most high-inflation episodes stem from fiscal deficits financed by printing money.

An independent Fed **commits** the government to be (more) fiscally responsible.

1.5 Fed Independence and Inflation



Fed independence

$\Longrightarrow$

Lower inflation

Source: Econofact

1.6 Downsides of Fed Independence

Lack of accountability

- Congress cannot correct Fed mistakes

The Fed may focus too much focus on price stability and neglect employment.

- A common complaint about the ECB

The Fed can finance government debt, if it wants to

- QE effectively has done this.

1.7 Summary

Monetary policy is effective when **inflation expectations are anchored**.

Anchoring is achieved by building a **reputation**.

That requires a policy maker with a long time horizon.

- an independent Fed

But there can be too much indepdenence.

And not all Fed actions benefit from independence.

- e.g., bank supervision

1.8 Reading

John Cochrane: Central Bank Independence, June 2025

- A nuanced discussion of the pros and cons of Fed independence.