Monetary Stability and the Independence of the Federal Reserve Bank

Monetary stability is essential for countries to thrive. A stable currency reduces uncertainty about the future price level, allowing businesses to make long-term investment decisions without worrying about the negative impact of unexpected spikes in inflation. This is in turn boosts economic growth via higher investment spending.

Central banks are supposed to guarantee monetary stability. They are responsible for maintaining the purchasing power of money over time. In order to fulfill this objective, monetary authorities need to have a certain degree of independence from political power: the more independent a central bank is, the more efficiently it will achieve its price-stability objective.

One way to reinforce the independence of monetary authorities is to appoint a renowned economist as head of the central bank. Except for Donald Trump, who nominated a non-economist to chair the Federal Reserve, all U.S. presidents since 1987 have followed this practice. The aim was to convey the message that the Fed is an independent organism led by experts and free from political pressures.

Yet this strategy hasn't always worked. A recent paper explores the transition of former Fed chairs Arthur Burns, Alan Greenspan, and Ben Bernanke from academia (or business, in the case of Greenspan) to policymaking. The authors conclude that the economic views Burns, Greenspan, and Bernanke held prior to their leap into the political arena changed considerably after taking over the Fed's chair. In all three cases, political pressures pushed them to express opinions or make decisions that were at odds with their previous opinions.

Let's take the case of Arthur Burns. When he was appointed to the Fed, Milton Friedman, a former student of his, praised the decision noting that "for the first time in history [the U.S. will] have a monetary framework for stable economic growth." Friedman's optimism didn't last long. In a *Newsweek* column a few months later, he lamented the change in Burns, declaring, "It is disheartening to observe so tough-minded, so independent, and so knowledgeable a person as Arthur Burns conform to this pattern so soon after becoming chairman of the Fed."

Friedman's disappointment stemmed from Burns' change of mind about the causes of inflation and the role of the Fed in reducing inflationary pressures. One year before his appointment, Burns wrote that "the basic cause of the wage-price spiral that we have lately been experiencing … is mainly the result of the excessively rapid creation of new money."

Yet, as the Fed's Chairman, Burns blamed inflation on special factors that were pushing costs and wages up. As a result of his misdiagnosis of the causes of inflation, Burns pursued an excessive expansionary monetary policy under pressure from Congress and President Nixon, doubling the inflation rate between 1970 and 1974.

Similar examples can be found during Greenspan's mandate. For instance, Greenspan supported the bailout of thrift institutions in 1989 and Long-Term Capital Management in 1998 despite having warned about the moral hazard of bailouts when he was President Ford's economic advisor.

In contrast, Bernanke's policies during his tenure as chairman were broadly in line with his academic views. As an academic, Bernanke argued that the 'zero lower bound' – a situation in which central banks cannot stimulate the economy by cutting interest rates because these are already at zero – didn't represent a problem to monetary policymakers as the Fed can always resort to non-conventional tools to affect price-level expectations. As chairman, Bernanke didn't hesitate to use one of these alternative tools (quantitative easing) in the aftermath of the 2008 Financial Crisis.

But not everyone agrees. Bryan Caplan, a former student of his, notes that Bernanke used to be skeptical about "the power of government to mitigate economic crisis." However, he worked hand in hand with government during the 2008 economic turmoil; a partnership that ended up dramatically expanding the role of fiscal and monetary authorities.

Political pressures sometimes play a role in shaping the decisions of central bankers. Yet it would be absurd to think that any change of opinion stems from the influence of politicians on monetary authorities. As with any other social scientists, economists can change their previous opinions for reasons unrelated to politics. But given the importance of monetary policy, central bankers should be shielded from the pernicious influence of the political game.

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