

BY ANNA KOVNER

Resisting the Siren Song of Easy Money

In Homer’s “The Odyssey,” Odysseus has his crew tie him to the ship’s mast to resist the deadly temptation of the sirens’ song. A modern equivalent of this might be the screen time limits you set on your phone to help yourself limit any time wasting from scrolling in the face of algorithms designed to hold your attention. These are both examples of what economists call a commitment device — a mechanism by which you commit now to protect your future self from temptation. When the Federal Reserve was founded, the debate around its design took into account the siren song of easy money and enshrined central bank independence in its organization.

The economic theory of central bank autonomy is grounded in theories of time inconsistency. Politicians facing reelection may favor policies to boost short-term growth at the expense of long-term outcomes. Without a credible commitment to resist the temptation to stimulate the economy for short-term macroeconomic gains, the result is higher inflation. Even worse, the public understands what politicians want to do, and this expectation can lead to even higher inflation without sustainable real gains.

Knowing that they cannot commit to constraining their own behavior, politicians can create an institution that can take a long-term view, delegating monetary policy to an independent central bank insulated from short-term political pressures. The ability to commit to future behavior makes it possible to achieve outcomes that the elected government could not achieve on its own.

Theories supporting the independence of central banks are grounded in the real-world outcomes achieved by countries with these structures. Academic economists studied this topic in the 1990s by categorizing the independence of different central banks. They found that measures of independence are linked to lower inflation without worsening outcomes in the real economy (i.e., output and employment). It is true that the most spectacular cases of runaway inflation are found in developing countries with weak institutions, but evidence of this empirical relationship can also be found looking only within a sample of OECD nations. Greater independence, both legal and operational, delivers both lower inflation and reduced price volatility, on average.

Far from being undemocratic, U.S. central bank independence rests on deliberate choices made through the democratic process. In drafting the Federal Reserve Act of 1913, rather than concerns about elected politicians, Congress

was perhaps equally or more concerned with ensuring regional independence and limiting the influence of the federal government, Wall Street investors, and banks. When the Federal Reserve System’s governance was redesigned in the Banking Act of 1935, then-Fed Chair Marriner Eccles actually argued for the Fed and monetary policy to be controlled by the president. However, as the Act made its way through Congress, many experts and stakeholders who testified in Senate hearings argued for independence from the president, with then-Treasury Secretary Henry

Morgenthau going so far as to argue that the Fed should be like the Supreme Court. This *de jure* (in law) setting for independent monetary policymaking also requires a *de facto* (in practice) exercise, which evolved over the next decades, notably with the Treasury-Fed Accord of 1951. Indeed, debates around central bank independence are hardly new. Evidence of this is the fact that

there are over 100 references to the topic each decade since the 1990s in the hearings, speeches, and economics articles collected on the Federal Reserve Archival System for Economic Research (FRASER).

Independence, of course, comes with commensurate responsibilities. The Federal Reserve Act directs the Fed to promote “maximum employment, stable prices, and moderate long-term interest rates.” One of the advantages of independence is that a credible central bank has an easier time at balancing these goals, which may be in conflict if stimulating demand when seeking to increase employment leads to excess aggregate demand that pushes prices up. A credible central bank can convince businesses and consumers to expect stable prices, and those inflation expectations will anchor the responses in the economy to temporary shocks that lead to one-time price pressures or employment changes.

The Fed cannot rest on the democratic principles of its founding and goals set by politicians to act without accountability and transparency. The Fed serves the public by pursuing its assigned monetary policy goals transparently through regular reports to Congress, sharing its economic analysis and ideas with the public, and clear communication. Ultimately, independent monetary policy serves the American people by creating the conditions that support economic growth and stable prices. The best way to resist the siren song of easy money is to find ways to commit. **EF**

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