

Discussion of “Is Optimal Monetary Policy Always Optimal?”*

Athanasios Orphanides

Massachusetts Institute of Technology

A burgeoning part of the monetary policy design literature posits that optimal monetary policy is the solution to a constrained optimization problem where the monetary authority has the discretion to minimize a social welfare function, taking the economy and other policies as given. In their paper “Is Optimal Monetary Policy Always Optimal?” Troy Davig and Refet Gurkaynak (henceforth, DG) argue convincingly that the solution thus attained may fail to deliver the desired outcome.

The key insight is that any economy is characterized by multiple inefficiencies and multiple policymakers with possibly conflicting objectives, not necessarily coinciding with the social welfare function. As a result, designing policy under the false assumption that the central bank is the “only game in town” has undesirable side effects that induce inefficiencies. For example, political considerations may introduce elements other than the social welfare function to the objectives of fiscal policy. In this environment, optimality cannot be attained unless the different policies in question are jointly examined and formulated. Designing “optimal policy” is a question of the optimal mix of various policies (e.g., monetary, fiscal, regulatory, structural) for which different policymakers are responsible. The problem of “optimal policy” is not the same as the problem of “optimal monetary policy,” and equating the two yields flawed conclusions both for what monetary policy *can* do and for what it *should* do.

*This note is based on the discussion of the paper by Troy Davig and Refet Gurkaynak, “Is Optimal Monetary Policy Always Optimal?” which was presented at the IJCB and RBNZ conference “Reflections on 25 Years of Inflation Targeting,” Wellington, New Zealand, December 1–2, 2014.

In game-theoretic terms, monetary policy that optimizes social welfare taking the policies of all other policymakers as given converts the central bank to a follower in a Stackelberg equilibrium. This overburdens the central bank and, according to DG, treats monetary policy as the “residual claimant of all policy” which changes the incentives and behavior of other policymakers. Social welfare suffers, and indeed outcomes are potentially worse than might be possible to attain with monetary policy formulated in a different fashion than by optimizing social welfare taking other policies as given.

Questioning the foundations of the so-called optimal monetary policy literature brings to the foreground some questions of importance on the twenty-fifth anniversary of inflation targeting: What tasks should be delegated to an independent monetary authority and how narrow or broad should the mandate of monetary policy be? Should price stability be the primary mandate of monetary policy or should multiple goals be assigned to the central bank? Does this assignment achieve good results for overall social welfare in a democratic society? Should a central bank be expected to do more than simply focus on its legal mandate?

The paper makes such a convincing case that one could take issue with the title. Arguably, the question should be: “Is ‘Optimal’ Monetary Policy *Ever* Optimal?” to which the answer is obviously “No!” There are, of course, numerous reasons why the so-called optimal monetary policy literature fails to deliver on its promise and risks offering false policy advice. Indeed, we have little of the knowledge required to even properly discuss and evaluate what is optimal. Optimality is most often discussed in highly abstract mathematical models that we know with certainty fail to capture reality. Ignorance of the structure of the economy is tackled with inadequate approximating models, and yet questions of the robustness of the approximation are infrequently acknowledged. In addition, we are ignorant of the relevant preferences whose knowledge is pre-supposed for formulating a social welfare function that is meant to be optimized. In a finite lifetime, an individual generally has limited knowledge even of his or her own preferences, and the uncertainty is not necessarily resolved over one’s lifetime. And potentially conflicting interests among individuals and among policymakers suggest pervasive non-cooperative behavior at many levels.

The discussion raises a number of broader institutional design problems that are useful to acknowledge in evaluating policy: How

should tasks be delegated to different policy institutions in a democracy? How can a central bank best contribute to society? Should objectives be limited to what is feasible to achieve and what a policymaker can be held accountable to? How much discretion should be encouraged or tolerated? Is it sufficient to delegate the task to “independent” authorities with “good intentions”? How can adherence to the institution’s mandate be enforced?

More fundamentally, the discussion takes us back to questions pertaining to the classic debate on rules vs. discretion: Should a central bank be allowed to pursue what the policymaker thinks is “best” based on his or her understanding of social welfare in a discretionary manner? How do we limit harmful discretion if the policymaker is allowed to do what appears to be “best”? How do we solve the basic problems of dynamic inconsistency and moral hazard that can result from harmful application of a central bank’s discretionary powers? If a “central planner” or a “benevolent dictator” is the solution to organizing society, where are they to be found among humans?

One reason these questions arise is due to the multiplicity of goals that a central bank could contribute to attain, at least in principle. If we were to draw a list of declining importance on various goals, we would likely have a consensus that price stability should be first. Price stability ought to be the central bank’s primary task, an objective that should be in its purview to attain with reasonable success with monetary policy. Financial stability could be seen as a second important task, but one for which the central bank would need to coordinate monetary policy with regulatory policy and fiscal policy. Beyond these two objectives, the goals become increasingly more tenuous as monetary policy becomes less and less important relative to other policies such as fiscal, structural, growth, and social policies. Should “economic stability” be a key objective of monetary policy? How about “maximum employment,” which is presently one of the Federal Reserve’s statutory mandates? How about “widely diffused well-being”? If we are willing to entertain pretty much anything on such a list, we could include fiscal transfers to failed institutions in the mix, a goal that could be particularly appreciated by politicians during a crisis.

Accounting for these broader issues, it may be fruitful to reformulate the question posed by DG as follows: From an institutional design perspective, can we expect good outcomes if the central bank acts as the “residual claimant of all policy”? That is to say, when

it comes to monetary policy, are good intentions enough? Intentions at a central bank may be good—to achieve what is “optimal” for society where all other institutions and policymakers may prove inadequate. This bears some resemblance to the question regarding central planning. In theory, central planning works. But the real question is whether it works in practice. Two examples of practical experience relating to monetary policy are instructive—the United States in the 1930s and New Zealand in the 1980s.

Consider first the following description of the objectives of the Federal Reserve, as described by the Board of Governors in 1939:

The purpose of Federal Reserve functions, like that of Governmental functions in general, is the public good. Federal Reserve policy can not be adequately understood, therefore, merely in terms of how much the Federal Reserve authorities have the power to do and how much they have not the power to do. It must be understood in the light of its objective—which is to maintain monetary conditions favorable for an active and sound use of the country’s productive facilities, full employment, and a rate of consumption reflecting widely diffused well-being. (Federal Reserve Board 1939)

The intentions to achieve “widely diffused well-being” may have been noble and the Federal Reserve Board had considerable discretionary power with which to set policy. Did the Federal Reserve manage to come close to maximizing social welfare during the 1930s? Hardly! The 1930s marks the worst decade in the performance of the institution.

Consider next the 1980s in New Zealand. Reflecting on the decade, prior to the introduction of inflation targeting in New Zealand, former Governor Don Brash noted: “The legislation under which we operated required us, in formulating our advice, to have regard for the inflation rate, employment, growth, motherhood, and a range of other good things” (Brash 1999). Intentions may have been good. The Reserve Bank had wide discretionary powers at its disposal. Did good intentions and the discretion to do the right thing deliver good outcomes? Hardly! Indeed, discretionary actions attempting to deliver “optimal” policy failed in New Zealand during the 1980s, the very failure that gave rise to the inflation-targeting framework as an alternative.

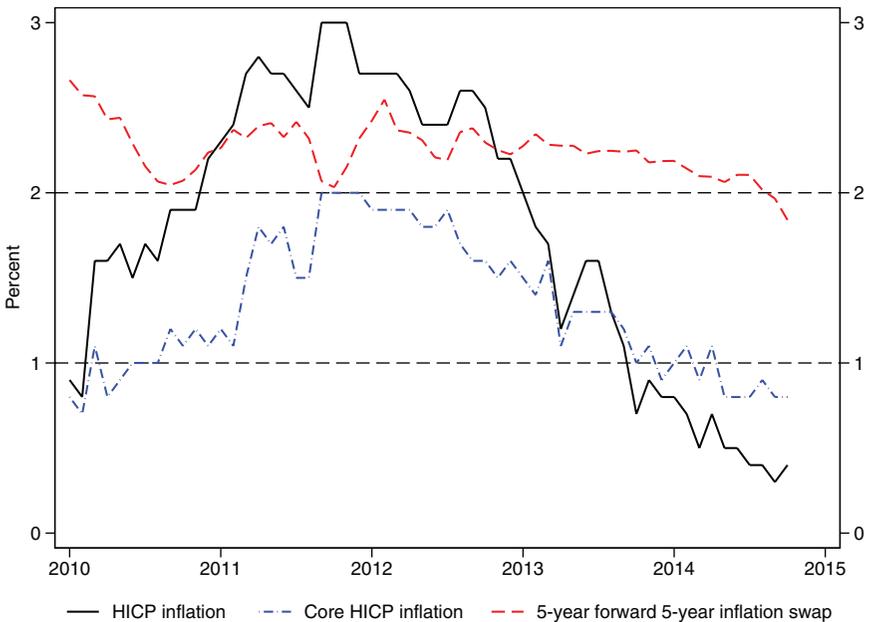
The inflation-targeting framework, as pioneered in New Zealand, has been a success precisely because it liberated monetary policy from the mentality that it should be “optimal.” Inflation targeting refocused policy to a single primary objective that is feasible for monetary policy to attain—price stability. Some may consider this goal too modest for a central bank, but the performance of New Zealand as well as other countries that adopted inflation targeting generally suggests that this modest approach can be more successful for delivering what matters for economic welfare than alternative approaches.

The very success of inflation targeting creates the temptation to reinterpret the inflation-targeting framework as “multiple goal targeting” aiming to be “optimal.” Indeed, some academic researchers use the qualifier “flexible” to describe what they consider to be a variation of inflation targeting that delivers “optimal” policy. But this is a false promise. The risk is that the very success of inflation targeting may once again make the central bank responsible to support “employment, growth, motherhood, and a range of other good things.”

More generally, one solution to the problem highlighted by DG is the adoption of narrow mandates and strict rules. Narrow mandates and rules are essential for successful institutional design in democracies. In assigning tasks to an independent agency, society tries to solve problems of human nature: dynamic inconsistency and moral hazard. As long as discretion is encouraged, with multiple conflicting objectives, the problems remain. Narrow mandates and rules are needed to protect society from harmful discretion. In a democracy, no unelected and unaccountable policymaker should be or act as the residual claimant of all policy.

The tendency to improve upon the achievable outcomes that result with narrow mandates must be checked. Current policy debates around the world highlight some risks of the temptation to overreach. Consider the Federal Reserve. Dissatisfaction with the pace of improvement in labor markets in the aftermath of the Great Recession has apparently led to new guideposts, including discretionary assessments on concepts such as labor force participation. Does the Federal Reserve have the legitimacy to define and try to attain what it believes is the “optimal” level of employment or labor force participation? Does the Federal Reserve advance “social

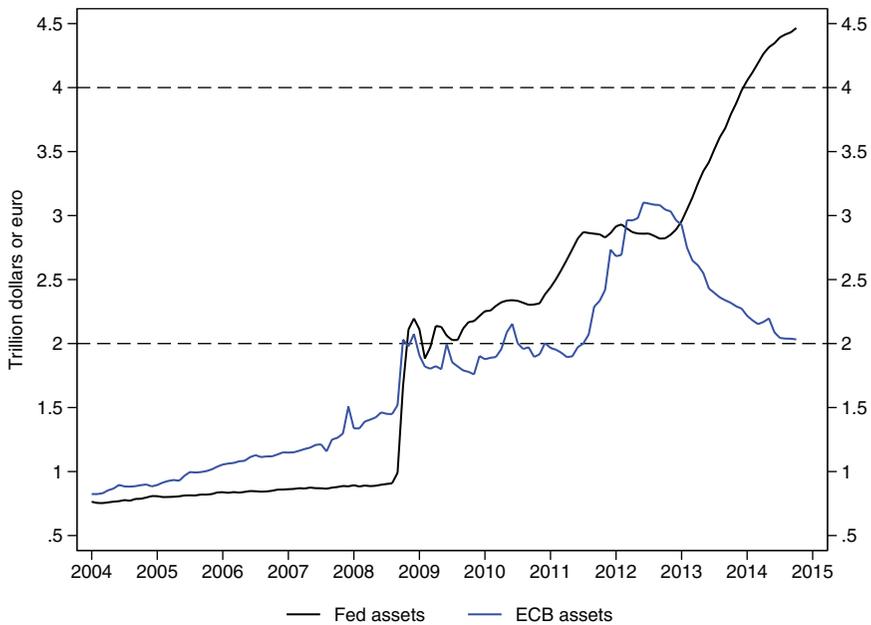
Figure 1. Inflation and Inflation Expectation Measures for the Euro Area



welfare” by taking on these tasks? The Federal Reserve may feel obliged to undertake such tasks in the absence of more forceful structural policies by the government. Then again, the expectation that the Federal Reserve might attempt to improve labor market inefficiencies, albeit not necessarily with positive results, may be exactly what induces government inaction.

A more peculiar but also potentially objectionable situation is currently observed in the case of the European Central Bank (ECB), the central bank of the member states of the euro area. The ECB has found itself in an impossible position due to the mismanagement of the euro-area crisis by euro-area governments, leading to policy decisions that are incredibly difficult to justify in terms of its narrowly defined mandate of price stability (Orphanides 2013, 2014a, 2014b). As of December 2014, the ECB has let inflation and inflation expectation drift significantly below its price stability for some time (figure 1). Resistance to the indicated monetary policy

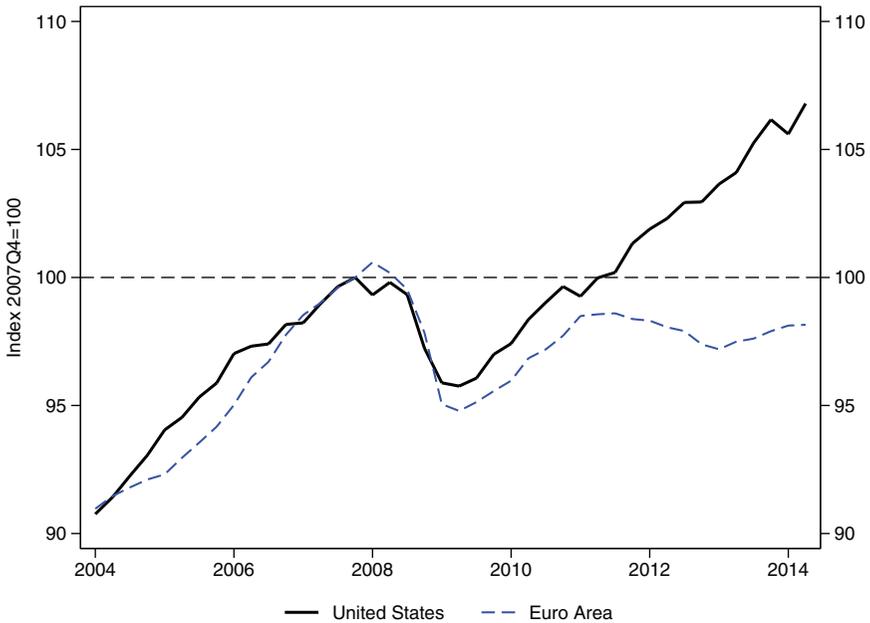
Figure 2. Central Bank Balance Sheets for the United States and the Euro Area



has appeared with numerous justifications. On December 4, 2015, a member of the Governing Council was quoted by Reuters as arguing: “Extremely low interest rates caused countries’ willingness to implement structural reforms to tail off.”

A question on this occasion is whether the ECB has the democratic legitimacy to let harmfully low inflation persist, as a means to encourage governments to adopt policies that might (in the ECB’s judgment) ultimately benefit the euro area. This is highly dubious. And yet this is an argument that has been advanced as a justification for the continuation of tight policy by the ECB, as can be gauged by a comparison with the Federal Reserve. With policy interest rates effectively at the lower bound for both the Federal Reserve and the ECB, the size of the balance sheet has been a useful indicator of policy action. The comparison of the two balance sheets, figure 2, shows that by this measure the ECB has been tightening policy from

Figure 3. Real GDP in the United States and the Euro Area



Notes: Index: 2007:Q4 = 100.

mid-2012 to the end of 2014, while the Federal Reserve kept drastically easing. To be sure, it is not entirely clear if this difference can be attributed to the effort by the ECB to create incentives for the governments to take actions towards resolving the euro-area crisis. And whatever the discretionary policy being followed, the intentions may have been good. Nonetheless, easier monetary policy would have certainly contributed positively to higher real GDP in the euro area. Judging from the comparison with the United States shown in figure 3, the indicated monetary policy easing alone might have been a more certain positive contribution to the euro area than any discretionary deviation meant to provide incentives to governments to do structural reforms.

Returning to the question of whether any institution should take the role of a central planner, it is instructive to recall that there is a reason communism failed. In theory, central planning can work.

In a complex society populated with humans, with all their biases and flaws, the notion of an “optimal” equilibrium that would be supported by a benevolent dictator or central planner is unattainable. Conflicting and competing interests dominate the landscape of human interactions. Institutions bound by rules are needed to protect against losses from the resulting non-cooperative game. We cannot expect the central bank or any other institution to “solve” all of the associated problems. Central banks with a broad mandate to “do good” never deliver optimal outcomes but bring about the undesirable consequences of discretion. A solution is to insist that central banks have narrow mandates and are bound by clear rules that strengthen transparency and accountability. Ultimately, such an institutional structure may be second best but may well represent the feasible optimal point for social welfare.

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