

Panel Discussion

*Robert J. Barro**

Monetary policy controls nominal variables—in level form, the price level, monetary aggregates, the exchange rate, and nominal GDP; in rate-of-change form, the inflation rate, nominal interest rates, and growth rates of money, exchange rates, and nominal GDP. Monetary policy has uncertain, and usually short-lived and minor, influences over the main real variables, such as real exchange rates, real GDP, and real interest rates.

The central bank's principal mission ought to be to control nominal variables so as to provide for a stable framework within which the private economy gets accurate signals and can therefore make efficient allocations of resources. Within this context, a promising, but not fully articulated, guideline is price stability. Charles Goodhart and José Viñals point out that many countries have adopted this goal, but typically have not detailed its meaning. One well-defined objective is the minimization of departures of an index of the general price level from a prespecified path, which could be a constant. Alternatively, the central bank can manage its monetary instruments to hold down surprise movements in the price level, while simultaneously targeting a nominal interest rate. Either objective implies accommodating movements of monetary aggregates to shifts in money demand, but the forms differ in the prescribed reactions to past price-level errors.

One issue that arises in any program of monetary policy is the mechanism to ensure a credible commitment to a particular course of action. In the absence of such commitments, the central bank tends to respond, each time, to the value that it places on surprise increases in

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money and in the price level. Such increases may provide short-run stimuli to the real economy—to the extent that the expectational Phillips curve is valid—and surely provide public revenue if the government is a nominal debtor. In this last sense, nominal surprises are a form of capital levy, that is, a tax, *ex post*, on the assets that people accumulated based on prior expectations of policy.

If the monetary authority cannot commit itself to resist the temptations of nominal surprises, then one consequence is a high and variable rate of inflation. The economy's average real performance is likely to suffer, because the unpredictability of the price level interferes with the efficient allocation of resources.

Since the general nature of an ongoing monetary policy would be understood—for example, a tendency to be expansionary during recessions and contractionary in booms—it is unclear that attempts to use monetary policy to stabilize the real economy would succeed in equilibrium. This success does not materialize in some models that assume rational expectations and a simple form of the natural-rate hypothesis. Stabilization does arise in other models that incorporate rational expectations, including some presented at this conference. The key assumption here is that the government can react more quickly than the private sector when adjustments of nominal variables are required. This assumption conflicts with the usual and reasoned view that governmental action tends to be less efficient than private action, except in areas where failures of private markets are important. The source of market failure is often obscured in theoretical models by arbitrary assumptions about private mechanisms for adjusting prices. Perhaps the idea is that it is sometimes easier and clearer for the government to adjust one nominal instrument than for all private agents to change the nominal variables that they control.

One mechanism for implementing a commitment to price stability is the government's adoption of a formal rule of behavior. An example would be a promise to adhere to the gold standard or a fixed exchange rate. Other possibilities are a commitment to a particular plan for price stability or to a specific monetary rule. The seriousness of the government's commitment would, as in other policy areas, depend on its form. For example, simple promises of public officials differ from statutes, which differ from constitutional provisions. In any of these contexts, the weight of the commitment—that is, the penalty imposed on broken promises—likely depends on the social consensus about the importance of the transgression. For example, inflation surprises may be taken especially seriously in Germany because of the past experience with hyperinflation.

Another possibility, which is becoming increasingly popular, is to establish a central bank that is "guaranteed" to be independent of the government. The bank may come with a formal charter that commits it

to price stability or some related objective. Although the independence of the central bank from a sovereign government can never be complete, the degree of independence does vary across countries. Moreover, the empirical evidence for the developed countries suggests that institutional arrangements that provide for greater independence tend to generate lower average inflation without reducing real growth or raising unemployment. For a broader group of countries, a little evidence suggests that more central bank independence leads to lower inflation and higher real growth, perhaps because a more stable monetary framework promotes economic efficiency.

The personality of the central bank head may also matter within the context of a semi-independent bank. For example, an individual who detests inflation and cares little about unemployment is observationally equivalent to a person who is committed to low inflation. Such an individual can achieve good outcomes even if the expectational Phillips curve exists and even from the standpoint of an observer who cares deeply about the unemployed. Similarly, it can be desirable to choose a central bank head who places a lot of value on kept promises, someone who really means it when he or she commits to price stability no matter what.

The approach that stresses personality and character tends to give Paul Volcker and Alan Greenspan a lot of credit for the restoration of monetary credibility after the disastrous increases in inflation and nominal interest rates during the late 1970s. This approach also says that it will make a good deal of difference if appointments to the Federal Reserve Board, and especially to the chairman's position, are of softer individuals who are not strongly committed to low inflation. I did make this case in a recent *Wall Street Journal* column, but the argument has been challenged in a recent letter that I received from Milton Friedman. Milton says, in part,

I am much less confident than you that the personality of the Chairman of the Fed and his demeanor makes much difference except as it is itself a reflection of the President's attitudes. I believe that Volcker was successful in the early 1980s in ending inflation not because of his demeanor, not because of his personal character, but because Ronald Reagan did not object and backed him.

It is my conviction that when push comes to shove the President will always get his way regardless of who is running the Federal Reserve. If in late 1995 or early 1996 the economy is starting to look very shaky and threatening to interfere with Clinton's re-election prospects, I predict that we will have an inflationary monetary stimulus regardless of who is Chairman, regardless of whether Alan Greenspan is reappointed to another term or whether Alan Blinder becomes the Chairman. On the other hand, I also predict that if the economy continues to do very well, if its behavior along with low inflation

looks favorable for Clinton's re-election, there will be no such inflationary bursts, again regardless of who is Chairman.

I suppose that the key evidence I would cite for this conclusion is Arthur Burns. As you know, when he was named Chairman, I thought he was the right person in the right place at the right time as I wrote in the *Newsweek* column. I turned out to be wrong. It was not because Arthur was insufficiently dour; it was not because he did not understand what the effects of monetary growth would be. It was because President Nixon wanted badly to get re-elected and was willing to take whatever chances were necessary for that purpose. That was why Arthur went along with wage and price controls.

As indicated by the references to Arthur Burns, Milton has changed his views on the significance of the individuals who are the leaders of the Federal Reserve System. For example, in the *Monetary History*, Milton (and Anna Schwartz) argued that the death in 1928 of Benjamin Strong, the governor of the New York Fed, was an important contributor to the Great Depression. More generally, I think that monetary institutions place some constraints on the influence that any individual, whether the Federal Reserve Chairman or the President, can exert on outcomes. Probably economists can have their most productive influence by contributing to the effective design of these institutions.