Independence and Accountability of Monetary and Fiscal Policy Committees

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Motivation

How do different degrees of independence and accountability for monetary and fiscal policy as well as of interaction between these two kinds of macro-management influence economic outcomes?

1. Delegation of monetary and fiscal policy to independent but accountable non-elected expert committees.

2. Potential to enhance policy credibility and effectiveness.
Outline

1. Motivation
2. The Basic Model
3. Key Results
4. Concluding Remarks


**Basic Model I**

**Economy**

\[ y^D = ad - b(i - \pi^e) + \epsilon, \quad y^S = y^N + c(\pi - \pi^e) + \varepsilon, \]

\[ y \equiv y^D = y^S \]

**Government, MPC and FPC**

\[ L^G = \frac{\gamma_{\pi}^G}{2} (\pi - \pi^*,G)^2 + \frac{\gamma_y^G}{2} (y - y^*,G)^2 + \frac{\gamma_d^G}{2} (d - d^*,G)^2 \]

\[ L^M = \frac{\gamma_{\pi}^M}{2} (\pi - \pi^*,M)^2 + \frac{\gamma_y^M}{2} (y - y^*,M)^2 \]

\[ L^F = \frac{\gamma_d^F}{2} (d - d^*,F)^2 + \frac{\gamma_y^F}{2} (y - y^*,F)^2 \]
Independence and Accountability: Monetary Authority

\[ Z^M = \theta^M L^G + (1 - \theta^M) L^M \]

\[ = \theta^M \left[ \frac{\gamma^G_y}{2} (y - y^{*,G})^2 + \frac{\gamma^G_\pi}{2} (\pi - \pi^{*,G})^2 + \frac{\gamma^G_d}{2} (d - d^{*,G})^2 \right] \]

\[ + (1 - \theta^M) \left[ \frac{\gamma^M_\pi}{2} (\pi - \pi^{*,M})^2 + \frac{\gamma^M_y}{2} (y - y^{*,M})^2 \right] \]

\[ W^M = \alpha (L^G + C^M) + (1 - \alpha) Z^M \]

\[ = \left[ \alpha + (1 - \alpha) \theta^M \right] L^G + (1 - \alpha) \left( 1 - \theta^M \right) L^M + \alpha C^M \]
Independence and Accountability: Fiscal Authority

\[ Z^F = \theta^F L^G + (1 - \theta^F) L^F \]
\[ = \theta^F \left[ \frac{\gamma_y^G}{2} (y - y^{*,G})^2 + \frac{\gamma_\pi^G}{2} (\pi - \pi^{*,G})^2 + \frac{\gamma_d^G}{2} (d - d^{*,G})^2 \right] \]
\[ + (1 - \theta^F) \left[ \frac{\gamma_d^F}{2} (d - d^{*,F})^2 + \frac{\gamma_y^F}{2} (y - y^{*,F})^2 \right] \]

\[ W^F = \alpha (L^G + C^F) + (1 - \alpha) Z^F \]
\[ = \left[ \alpha + (1 - \alpha) \theta^F \right] L^G + (1 - \alpha) (1 - \theta^F) L^F + \alpha C^F \]
Basic Model II

The order of events is assumed to be as follows:

1. The form of accountability is determined and goal and/or instrument independence is granted to the MPC and the FPC.

2. If there is goal independence, each institution chooses its target, the inflation rate and the budget deficit, respectively.

3. The private sector forms rational expectations about the inflation rate and assumes a linear rule for the interest rate and the budget deficit.

4. The supply and demand shocks are realized and observed.

5. The MPC and the FPC set the interest rate and the budget deficit, respectively, resulting from their optimization.

6. The Government checks whether any overriding, as part of the accountability mechanism, has to take place.

7. Inflation, output and the budget deficit are realized.
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Results

Four dimensions of *ranking* the policy regimes: trade-offs

1. inflation expectations
   (strongest anchoring)

2. actual inflation
   (shock stabilization, target level, deviation from target)

3. actual output
   (shock stabilization, target level, deviation from target)

4. actual budget deficit
   (shock stabilization, target level, deviation from target)
Results: Inflation Expectations

A regime that implements optimal macroeconomic policies where inflation expectations are anchored on target among those considered in the model is one with a fully independent non-elected MPC whose decisions are explicitly guaranteed not to be overridden by, and in the latter sense unaccountable to elected politicians.

Provided that monetary policy is delegated to a fully independent and unaccountable MPC, delegation or not of fiscal policy to an unaccountable FPC being similarly independent does not matter for inflation expectations in the model.

All considered mechanisms for policy making without accountability modeled as an override clause dominate the corresponding contracts with accountability in the above sense along the dimension of anchoring inflation expectations.
Results: Output Level

*Without accountability:* The output level is the same for regimes with dependent monetary policy (as well as independent MPC) regardless whether fiscal policy is dependent or not. With dependent MPC, the output level is closer to normal output under the given assumptions about preferences of policymakers. In the general case with partially independent committees and with equally shared responsibilities, the output level is intermediate between the polar regimes.

*With accountability:* In case of overriding, the output level in regimes with in/dependent MPC is the same regardless of the degree of dependence of the FPC. The output level with dependent MPC is closer to normal level compared to the output levels in all other regimes.

If comparing the cases with and without accountability, regime without accountability and dependent MPC produce the same output level as the resp. regimes with accountability. For all other regimes, the relationship between the output level in cases with and in cases without accountability is ambiguous.
Summary of Results: Inflation

For anchoring inflation expectations (ex ante) or containing the effects of cost-push shocks on actual inflation (ex post), we reach an unambiguous conclusion in terms of the optimal regime:

- A fully independent MPC whose decisions are explicitly guaranteed not to be overridden by elected politicians is the regime to implement to anchor inflation expectations on target.

- Once monetary policy is delegated to such an expert committee, delegation or not of fiscal policy as well to a parallel independent FPC does not matter in terms of anchoring inflation expectations and actual inflation.

- All considered mechanisms for policymaking without accountability, modeled as an override clause, dominate the corresponding incentive contracts with accountability in terms of anchoring inflation expectations and actual inflation.
Summary of Results: Output

For determining the output level close to normal, we do not reach unambiguous conclusion in terms of the ordering of the regimes:

- Output is closest to normal if the MPC is dependent and the Government overrides the FPC decision.

- If the committees decide, the structure of the result is the same as if the government steps in but the target gaps for output and inflation receive the opposite sign.

- However, the highest stabilization of supply shocks occurs if the government determines monetary policy, in case of overriding or dependent MPC.
Conclusion

What we can conclude from our theoretical exercise is that

- if the priority is to manage inflation and inflation expectations, a society should opt for independent monetary policy which is not constrained by the threat of its decisions being overridden.

- If, on the other hand, a society would prefer to mitigate the fluctuations of output and employment, policymaking by expert committees should be additionally constrained by accountability mechanisms such as override clauses or similar in effects.