CENTRAL BANKING IN THEORY AND PRACTICE. BY ALAN S. BLINDER. CAMBRIDGE, MASSACHUSETTS: THE MIT PRESS, 1998

Richard Layard, in the Foreword to this short volume, states that in this series of lectures[1] Alan S. Blinder "argues powerfully that central banking can only be conducted effectively within a proper intellectual framework." It will come as no surprise to readers of this journal who are familiar with the work of Professor Blinder that his intellectual framework is not one that fellow travelers of either the Chicago or the Austrian[2] Schools will find convincing. However, the book is a must read. The author presents an excellent summary of the recent mainstream debates on the role of a central bank and the conduct of monetary policy and provides a framework for monetary policy that ignores all the lessons, both historical and theoretical, provided by the calculation debate. The author's stellar academic and professional credentials and a self-professed comparative advantage in the theory and practice of central banking (Blinder 1998, p. 2) make his perspective on central banking and monetary policy one which critics, especially Austrian economists, should respond to, not ignore.

Keleher (1998) presents two competing approaches in the recent debates about the role of government in policy coordination. Blinder's intellectual framework fits clearly into the second approach presented by Keleher. As described by Keleher (1998, p. 305) this policy framework "relies more heavily on centralized, public sector decision-making. . . . Relevant information and knowledge are assumed to be readily available for centralized policymakers to execute this strategy; acquiring appropriate information does not pose much of a problem for macropolicymaking." Central bankers and other macroeconomic policymakers can and must "fine tune" the economy. As summarized by Layard (1998, p. ix), Blinder's central-bank policy "must be based on dynamic optimization, where each year we select a plan for now and for the future that will produce the best available time-path for output and inflation."

The strength of the book is that Blinder concisely and clearly presents a framework by which a central bank can, in his opinion, "manage to keep the economy walking the full-employment tightrope without letting inflation accelerate."[3] Blinder is even "up to a point persuasive."[4] But what is never clearly established, in either theory or practice, is why such a framework would be successful.

---

[1]The Lionel Robbins Memorial Lectures given by Alan S. Blinder in 1996.

[2]See Yeager 1997.

[3]The quote is from an article by Blinder "The Economic Myths that the 1980s Exploded," *Business Week* (November 27, 1989): 22.

[4]Henderson (1987), in a review of Blinder's *Hard Heads Soft Hearts,* is the source of this comment on the Blinder rhetoric.

The Quarterly Journal of Austrian Economics vol. 1, no. 4 (Winter 1998): 89–92

The argument is presented in three steps. The first chapter (lecture), presents a practical framework for implementing "the classical targets-instruments approach." In the second lecture, Blinder (p. 2) addresses what are logically the next questions once one accepts the feasibility of the targets-instruments approach: "What policy instrument should the central bank use? And should it attempt discretionary policy at all, rather than relying on a simple rule?" The last chapter is devoted to normative and positive aspects of central-bank independence. Who should be the *central planner* and how or should the central planner be constrained? This review will focus primarily on the issues raised in lecture one.

After presenting the basic outline of the general targets-instruments problem, in the first lecture, Blinder suggests several shortcomings to the approach: model uncertainty, lags, need for forecasts, choice of instrument, and the choice of the objective function. Or as Blinder (p. 6) succinctly puts it, "[A] curmudgeon could summarize the problems with applying the Tinbergen–Theil program as follows: We do not know the model and we do not know the objective function, so we cannot compute the optimal policy rule." But despite these obstacles "we" must do something. The alternative of a truly unhampered market is unthinkable. Such "know-nothingism is not a very useful attitude."[5]

How then does an active central bank overcome this conceivably difficult if not insurmountable information problem? Blinder's intellectual framework for the proper conduct of monetary policy should remind Austrian economists of the socialists' market answer to the calculation debate. We can overcome the information and lag problems by using several models and "don't ever trust any one of them too much." Set a clear policy over time—"today's monetary policy decision must be thought of as the first step along a path." Use trial and error as feedback in the planning mechanism in two ways. First, following suggestions made by William Brainard, compute the optimal policy responses "and then do less." And second, "[A]t each stage the bank would project an entire path of future monetary policy actions, with associated paths of key economic variables. It would, of course act only on today's decision." If things evolve as expected, follow the projected optimal policy plan. Surprises would be responded to in "obvious ways." Policy should be based on preemptive strikes and policy-making should be by committee. Such a framework should "build in natural safeguards against truly horrendous mistakes."

The second lecture continues the argument for active central monetary planning in much the same vein. There exists no information problem that is not easily swept away. There exists no criticism of central-bank activism that is not wrong. On the choice of an instrument the "scholarly literature was worthwhile and intellectually fascinating. But in the end, real-world events, not theory, decided the issue." Monetarism is dead. "The death of monetarism does not make it impossible to pursue a monetary policy based on rules. But it does mean that the rule cannot be

[5]This listing of potential information and knowledge obstacles to central planning followed by dismissal is typical of Blinder's method of rhetoric. Following a discussion (which is quite good) of the problems of econometric modeling, Blinder (p. 8) concludes, "Yet what are we to do about these problems? Be skeptical? Of course. Use several methods and models instead of just one? Certainly. But abandon all econometric modeling? I think not." Or see his (p. 38) dismissal of the Friedman rules argument, "In all honesty, we must admit there is at least an outside chance that Friedman could be right."

a money-growth rule."[6] The instrument, if by default, is an interest rate. The problem: which rate? Or as Blinder (p. 30) reminds us, "In other words, the interest rate that the central bank can control doesn't matter (much), and the rates that really matter cannot be controlled." Policymakers seem, again, to face "a devastating conundrum." But again things, for the planners, "are not as bad as they appear."

Policy should be guided in the long run by the neutral interest rate. But despite the use of a familiar term, beware. This neutral rate is not the unhampered market rate of Mises, Hayek, or Wicksell. As defined by Blinder (p. 32) this rate is "the interest rate that equates GDP along this steady-state IS curve to potential GDP." Blinder's neutral rate is "difficult to estimate and impossible to know with precision." A perfect policy instrument for the intellectual framework outlined in the first lecture! The time inconsistency problem is deftly handled in a similar manner. Estimate and target the natural rate of unemployment. Again a market equilibrium concept becomes an operational concept for policymakers, not a market restraint on discretionary policy-making.[7]

The final chapter presents an excellent summary of the literature on central bank independence, but even here Blinder adds his own unique twist. While "central bank independence is a fine institution that ought to be preserved where it exists and emulated where it does not," Blinder (p. 75) adds, "I have also argued that modern central banks ought to assert their independence from the financial markets just as vigorously as they assert their independence from politics. The United States Congress, for example, did not delegate the authority 'to coin money [and] regulate the value thereof' to the bond market; it delegated it to the independent technocrats at the Federal Reserve." The technocrats at the Federal Reserve are the *benevolent despots* of a monetary economy—"tracing out the effects of alternative policy choices, and preaching the message of what effects are good."[8] No political ties, constitutional rules, or market outcomes should prevent these elite of the elite from promoting the *public interest*. This is certainly not an intellectual framework that leads one to ask "What has government done to our money?"

Blinder, like most advocates of discretionary monetary policy, chooses to ignore two fundamental principles of economics and monetary theory. "What makes us rich is an abundance of goods, and what limits that abundance is a scarcity of resources: namely land, labor, and capital. Multiplying coin will not whisk these resources into being." And "we see that while an increase in the money supply, like an increase in the supply of any good, lowers its price, the change does not—unlike other goods—confer a social benefit."[9] Blinder's framework also never addresses ethical problems of the redistribution of purchasing power that follows a monetary injection—the money creation benefits early recipients at the expense of later

[6]The death announcement may be premature. See Timberlake 1993 (p. 361). "Consequently, monetarism as an official central-bank policy had neither failed nor succeeded. It simply had never been tried."

[7]If the terms neutral rate of interest and the natural rate of unemployment are used in the original meanings, a policy of targeting these rates is "no" policy. These are market phenomena. No central bank may be the best monetary policy.

[8]See Brennan and Buchanan 1981 (p. 20).

[9]See Rothbard 1990 (p. 33).

recipients of the newly created money. Recognition of these principles leads one to look for a broad based intellectual framework for analyzing monetary institutions and policies—an intellectual framework that includes not only sound monetary theory, but also sound ethics and political theory.

Keleher's (1998) preferred framework for monetary policy provides a clear alternative to Blinder's framework. The role of government in this policy approach is based on a constitutional approach to policy. Monetary and other policies and institutions should be aimed at establishing "those institutions and structures that enable the price system to work most efficiently and to promote certain policy rules, standards, and legal conventions."[10] Economists need to remove the *blinders* imposed by the benevolent despot image of policymakers and argue strongly for constitutional restraints on money. Such restraints should, as pointed out by Brennan and Buchanan (1981, p. 21), "guard against dangers that should seem real and obvious enough once they are pointed out—even to a 10-year old!" Blinder's short book should remind critics of the importance of agreement on the necessity of a monetary constitution as a prelude to meaningful monetary reform. As Brennan and Buchanan (1981, p. 65) put it over twenty years ago, "Our charge is: Let us first agree that a monetary constitution is necessary *before* exhausting our energies in debates over the precise content of this constitution! Otherwise, the ship may sink while we debate which lifeboat to use."

JOHN P. COCHRAN
Metropolitan State College of Denver

REFERENCES

Brennan, H. Geoffrey, and James M. Buchanan. 1981. *Monopoly in Money and Inflation: The Case for a Constitution to Discipline Government.* London: Institute of Economic Affairs.

Dowd, Kevin, and Richard H. Timberlake, Jr., ed. 1998. *Money and the Nation State: The Financial Revolution, Government, and the World Monetary System.* New Brunswick, N.J.: Transaction Publishers.

Henderson, David R. 1987. "A Liberal Economist's Case." *Fortune* (November 9). P. 185.

Keleher, Robert E. 1998. "Global Economic Integration: Trends and Alternative Policy Responses." In Dowd and Timberlake, ed. 1998. Pp. 305–29.

Rothbard, Murray N. 1990. *What Has Government Done to Our Money?* Auburn, Ala.: Ludwig von Mises Institute.

Timberlake, Richard H. 1993. *Monetary Policy in the United States: An Intellectual and Institutional History.* Chicago: University of Chicago Press.

Yeager, Leland B. 1997. "Austrian Economics, Neoclassicism, and the Market Test." *Journal of Economic Perspectives* 11, no. 4:153–65.

[10]Austrian monetary and business cycle theory are compatible with this approach.