

Central Bank Independence

Implications in a Global Macroeconomic Environment

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Frederick Langley

Faculty Advisor: Dr. Katie Baird



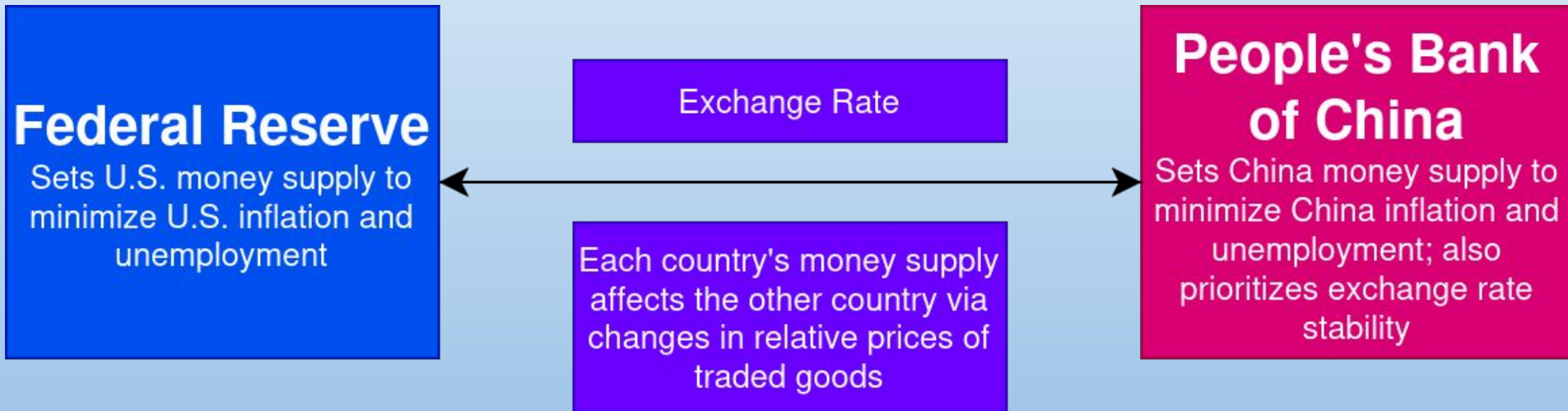
Motivation

- Federal Reserve independence has faced unprecedented political pressure in recent years
- United States monetary policy affects global trade and asset flows
- In a multipolar world, financial dynamics must be reconsidered



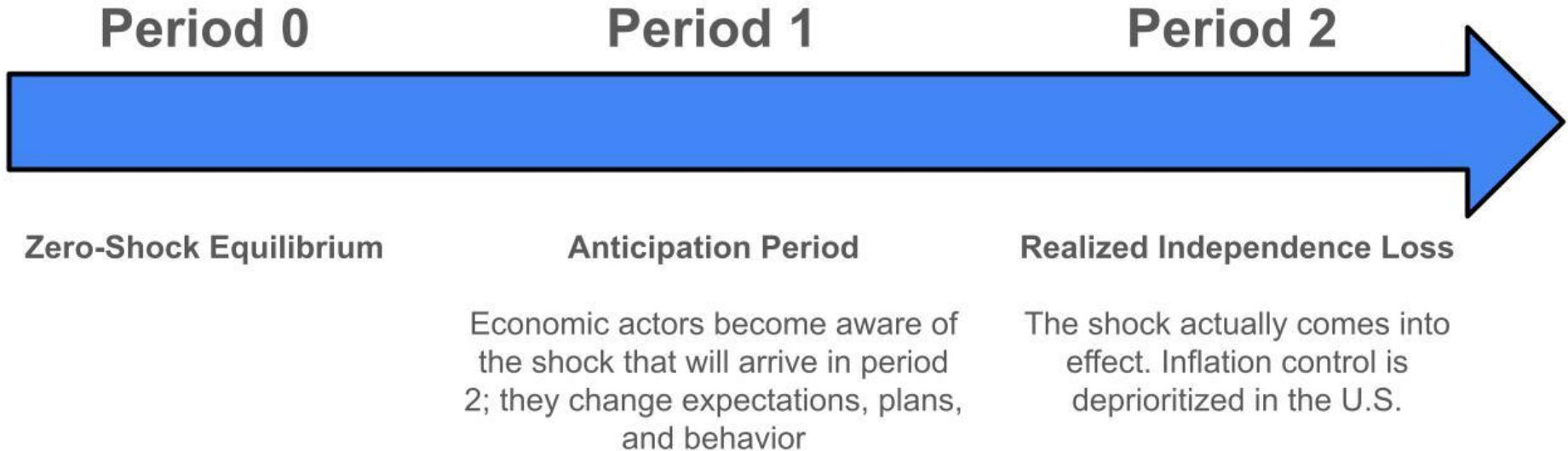
The Framework

Each country sets monetary policy according to fixed objectives





Timing of Shocks





Central Bank Strategic Interaction

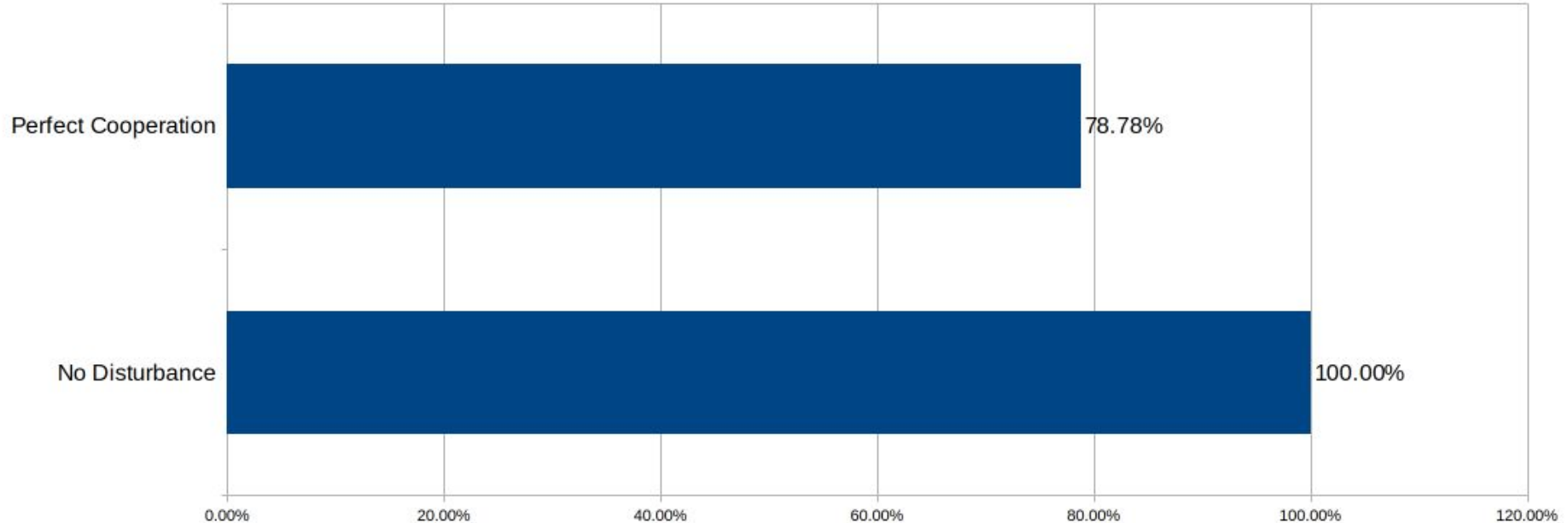
- In period 1, expectations create inflationary pressure, causing the Fed to contract money supply
- This affects China via the exchange rate channel, leading the PBoC to contract
- This interdependence leads to suboptimal outcomes. At the Nash equilibrium, both central banks over-contract in period 1, and over-expand in period 2

Cooperation As A Solution



The two central banks could collaborate, internalizing the exchange rate externality

Cumulative (Discounted) Value of All Periods Relative to Nash





Robustness and Limitations

- Robust to a number of parameter values
- Two-country simplification
- Reduced form macroeconomic model rather than fully derived microeconomic behavioral foundations
- Illustrative rather than empirical calibration
- Does not determine how cooperation would actually emerge or be enforced



Policy Implications

- Erosion of central bank independence creates international economic instability
- Cooperation gains can be large; institutions that facilitate coordination are valuable
- Cooperation gains can be asymmetric, which has feasibility implications



Conclusion and Future Direction

- Changes to central bank independence have implications on a global scale
- Future research could investigate the effect of uncertainty, the viability of cooperation, and the effect of exogenous shocks on the model
- Empirical work to ground the model more firmly in reality would be valuable



Key References

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