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The Taylor rule and the appointment cycle of the chairperson of the Federal Reserve

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Abstract

We estimate a forward-looking Taylor rule on a meeting-by-meeting basis using real-time forecasts for the Volcker and Greenspan chairmanships. We find that under Volcker the Fed responded countercyclically to inflation but had no significant response to the output gap. Under Greenspan, the Fed responded countercyclically to both inflation and the output gap. We then test the hypothesis that monetary policy varies systematically with the appointment cycle of the chairperson of the Fed. During both the Volcker and Greenspan chairmanships, we find that in the five-meeting periods prior to renomination, the Fed becomes significantly less responsive to the macroeconomy. Further, under both Volcker and Greenspan, we find evidence that the Fed raises its inflation target in the periods prior to renomination.
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1. Introduction

The Federal Reserve is designed to operate independently of political pressures. Some studies, however, have found that monetary policy varies systematically across the electoral cycle. To the extent that this is true, monetary policy could be the source of what has come to be called the political business cycle, a situation where political events influence macroeconomic cycles.

Studies that seek to find a monetary source to the political business cycle are far from conclusive. Gamber and Hakes (1997) cite over 20 of these studies and suggest that about half find evidence

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of a monetarily induced political business cycle while about half do not. Drazen (2000) surveys the political business cycle literature from both economics and political science, and concludes that fiscal policy is the driving force behind the political business cycle with monetary effects being the result of monetary accommodation of fiscal policy.

Regardless of the source of the literature, a common thread in nearly all political business cycle research is the focus on the election cycle as the source for the variation in political influence on macroeconomic policy. In this paper, however, we shift the focus of the search for a monetary source to the political business cycle from the president's election cycle to the appointment cycle of the chairperson of the Federal Reserve. We suggest that because the chairperson can be reappointed to consecutive 4-year terms within his or her term on the Board, there may be an incentive for a self-interested chairperson to accommodate political pressures in the later portion of the chairperson's term in order to increase the probability of reappointment.

For the chairperson's appointment cycle to have an impact on monetary policy, there must be enough institutional flexibility within the Fed for the chairperson to exert an independent influence on monetary policy. There is substantial evidence that, indeed, this is the case. Hakes (1990) finds structural break points in the Fed's reaction function that are associated with a change in the chairperson of the Fed. Following this study, it has become common for researchers to model each chairperson's subperiod separately when estimating monetary policy rules (Judd & Rudebusch, 1998). Other studies seek to measure precisely the proportion of influence of the Fed chair in monetary policy decisions. Havrilesky and Gildea (1994) survey former FOMC members and find that 60–80% of the policy decision lies with the Fed chair. Chappell, McGregor, and Vermilyea (2001) measure the chair's proportion of the monetary policy decision to be about 50%. Additionally, there exists anecdotal evidence suggesting that there is a disproportionate influence of the chairperson in monetary policy decisions (Greider, 1987; Woodward, 2000). We argue that if the chairperson can independently influence monetary policy, then there may be an incentive for a chairperson, with at least some self-interest, to engage in a monetary policy in the periods prior to reappointment that would increase the probability of reappointment.

Based on this idea, this paper tests the hypothesis that monetary policy varies systematically with the reappointment cycle of the chairperson of the Fed for the Volker and Greenspan chairmanships. A priori, different outcomes are possible. In the periods prior to reappointment, monetary policy might become more responsive to real output and less responsive to inflation. Alternatively, monetary policy might become generally less responsive to the macroeconomy in the periods prior to reappointment if the chair were attempting to appear nonpolitical during this sensitive period.

In this short paper, we estimate a Taylor-type monetary policy rule to test the hypothesis that monetary policy differs in the periods prior to the reappointment of the two most recent Fed chairmen. We estimate the Taylor rule in a manner similar to Orphanides (2001) by employing a forward-looking model with real-time data. We improve upon Orphanides by estimating the model on a meeting-by-meeting basis, as opposed to a quarterly basis, for both the Volcker and Greenspan chairmanships. For the Volcker chairmanship, we find evidence that monetary policy was less responsive to inflation prior to his reappointment. For the Greenspan period we find that the Fed is less responsive to the output gap in the periods prior to his reappointment.

2. Model and data

The Taylor rule (Taylor, 1993) is the best known of the simple monetary policy rules—rules that suggest that the monetary authority sets its policy instrument in response to a small number

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