NYU STERN
NEW YORK UNIVERSITY · LEONARD N. STERN SCHOOL OF BUSINESS

Central Bank Independence: More myth than reality

Paul Wachtel and Mario Blejer

Conference on
Financial Resilience and Systemic Risk
London School of Economics
January 30-31, 2019
Preliminary

Central Bank Independence (CBI)

One of the buzz words – sacred truths – of macroeconomics

Everyone is for motherhood, free trade and CBI

1. Where did the idea come from?
2. How did it come to be a sacred truth?
3. Is it the source of all good monetary policy?
4. Have circumstances changed since the crisis?
5. Was it ever really a fact?

CBI – earliest mention

Milton Friedman's 1962 –

Should there be an independent monetary authority?

"objective of a monetary structure that is both stable and free from irresponsible government tinkering" (p. 224).

Friedman considers three approaches -

- Commodity (gold) standard – not feasible
- CBI – "Never fully spelled out"
- A legislated mechanical rule

Where did it come from?
First mention - Friedman, 1962

- "[i]t seems to me highly dubious that the United States, or for that matter any other country, has in practice ever had an independent central bank in this fullest sense of the term*.* ***Even when central banks have supposedly been fully independent, they have exercised their independence only so long as there has been no real conflict between them and the rest of the government.*** Whenever there has been a serious conflict, as in time of war, between the interests of the fiscal authorities in raising funds and of the monetary authorities in maintaining convertibility into specie, the bank has almost invariably given way, rather than the fiscal authority. (p. 226-7)

- The irony of this first discussion of an independent central bank is that Friedman rejects it. He finds it intolerable "in a democracy to have so much power concentrated in a body free from any kind of direct, effective political control"

- Evidence from the memoirs of Emile Moreau, Governor of Banque de France who was critical (jealous) of Montagu Norman and Hjalmar Schacht who thought that they know what was best for the world.

Friedman, 1977

"...let us be done with the fiction that "independence" [of the Fed] is somehow or other a bastion against inflation. Let us put the responsibility for the rate of monetary growth--and therewith the subsequent inflation--squarely and openly on the Administration and Congress...let the Congress require the Fed to *achieve* specified rates of monetary growth within specified ranges of tolerance." Milton Friedman, Newsweek, 3 October 1977, p. 84.

SO, HOW DID CBI ENTER THE CANON?

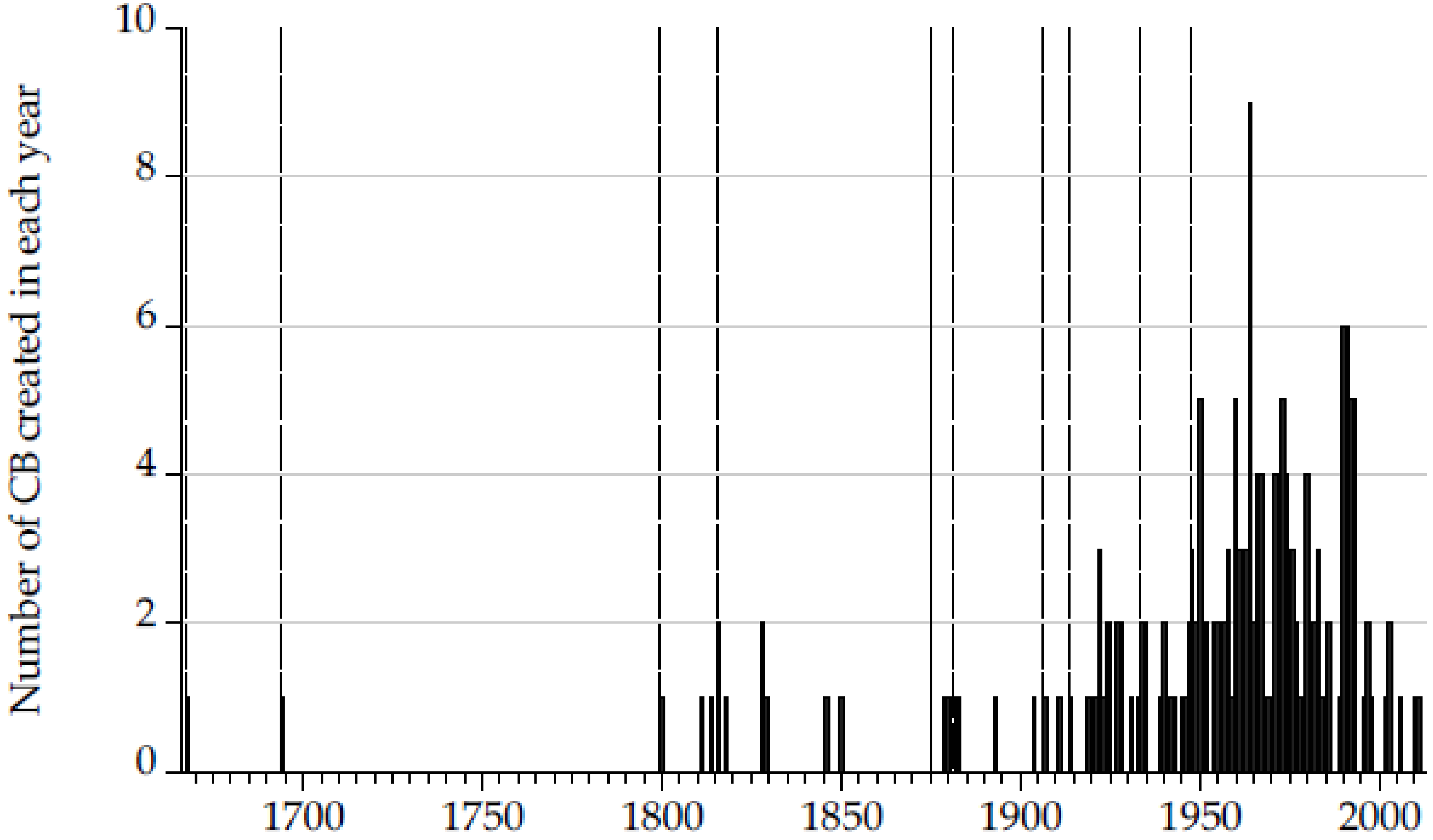
- Friedman notwithstanding – CBI with independence to act rather than policy chained to a rule – gained acceptance.
- As a perfect storm of four forces pushed CBI into prominence.
- The storm forces started to erode even before the crisis

The perfect storm –

1. Central bank laws and new central banks
    - Early central banks were often private, profit maximizing entities,
    - Public purpose only clear in 20th century – e.g. the 1935 Banking Act revisions to Fed governance
    - Emergence of central banks with monetary constitutions in many developed countries (post war); newly independent countries and monetary regimes (1970s-80s); establishment of about 30 central banks in transition world after 1989

2. Developments in macroeconomic modeling
    - Rational expectations augmented Phillips cures – only inflation surprises matter
    - Time inconsistency - Incentive for opportunistic policy maker to inflate for short run gain
        - Kydland and Prescott, 1977

Figure 2 Number of Central Banks Established



Bordo and Siklos, NBER 23847

The perfect storm – 4 forces

3. Inflation of the 1970s
   - Distrust of policymakers and sense that central banks with traditional governance structures failed
   - But secular disinflation may be due to technology and globalization rather than independent central bankers

4. Empirical evidence linking CBI and inflation
   - First reported in 1978 – Parkin and Bade in a conference volume on the Australian monetary system
   - Cukierman, Webb, Neypati (1992); Alessina and Summers (1993); and others.

1955-88
Average
Inflation

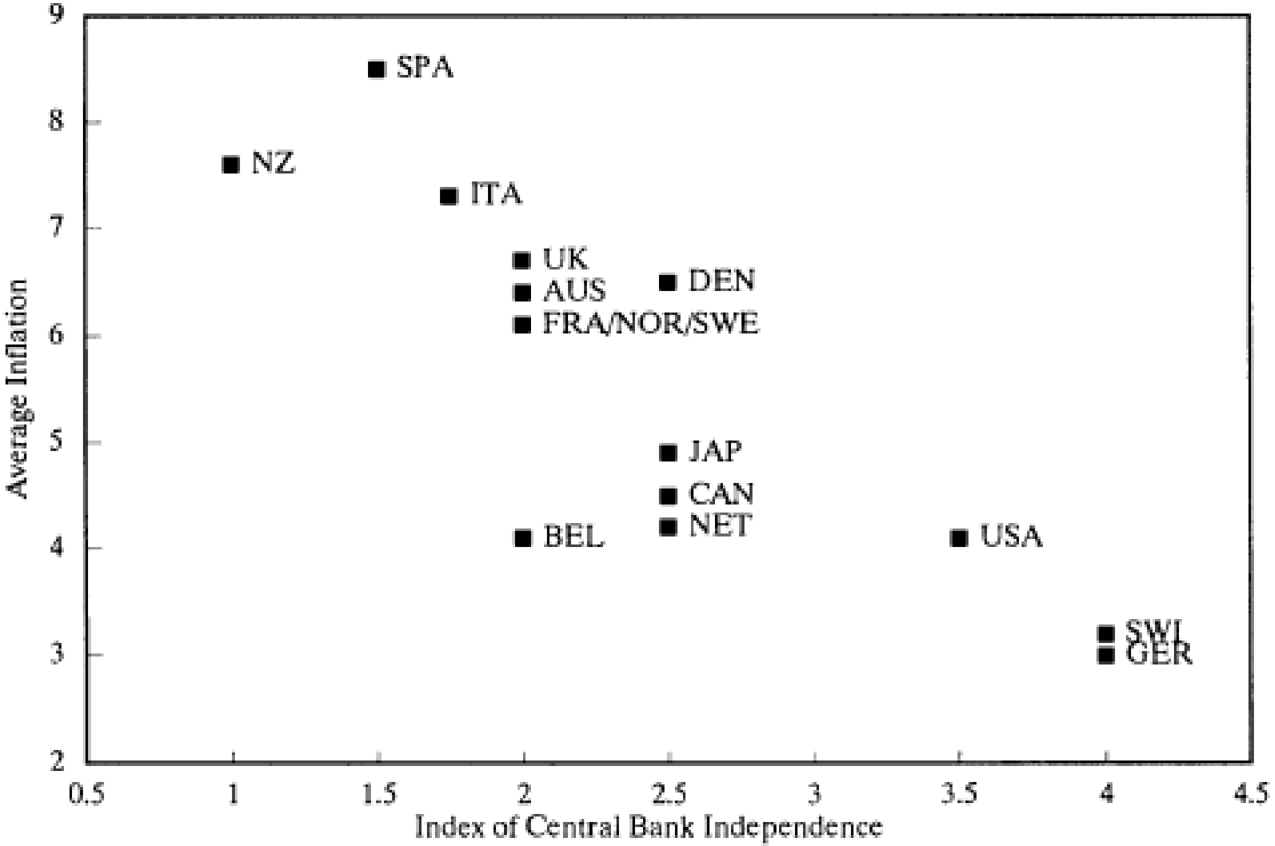


FIG. 1a. Average Inflation

Alessina and Summers, JMCB, 1993

Note on empirical evidence

- Sensitive to composition of information in CBI index
- Index weightings arbitrary
- Evidence strong for developed but not undeveloped countries
- Legal independence not the same as actual independence
- Endogeneity possible as central bank laws changed

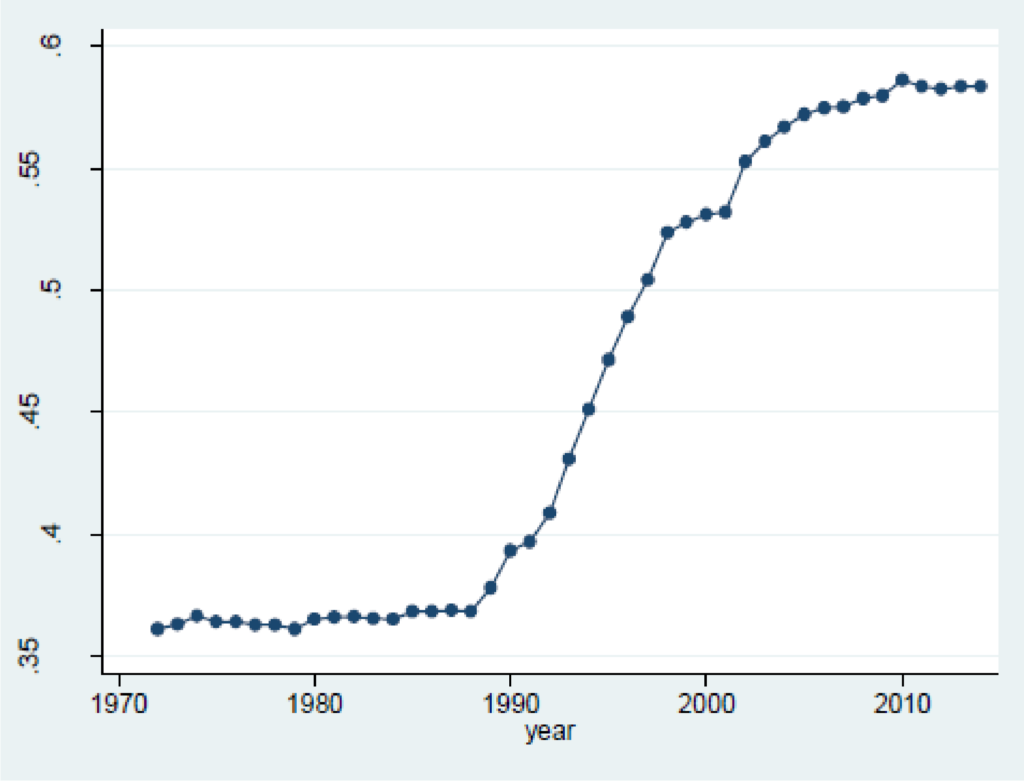
Empirical evidence does not have to be strong, perfect or even correct to be influential.

- See Wachtel, Credit Deepening: Precursor to Growth or Crisis? in *Comparative Economic Studies,* March 2018.

Central banks and governments bought into the idea of CBI.

Average measured CBI increased rapidly in the 1990s

Figure 2. Average CBI (all countries), 1970-2014



Jakob De Haan – Dubrovnik Economic Conference symposium
Comparative Economic Studies, June 2018.

Perception is that CBI.....

- insulates policymaking from political cycles and the temptation to pump up economic activity in advance of an election.

- protects against the temptation that governments have to finance their activities by printing money.

- gives the central bank the ability to ignore criticism and maintain policies that are consistent with its long-run objectives.

An unappreciated aspect of CBI – role in developing and emerging markets

- Externality from CBI on institutional culture
  - Institution building – rule of law based instituions
  - Professionalism
  - Respect for law
- International emphasis on CBI leads autocratic governments to respect the institution and the central banking law

Is good policy due to CBI or other things? At the same time ….

Explicit policy goals and targets introduced

- Inflation targeting

Transparency –

- Public awareness of policy
- Announcement of policy goals

- Accountability --
  - Requirement to report on performance
    - E.g. Monetary Policy Report to Congress
- Better Central Bank governance
  - Monetary policy committees

Idealized turn of the century central bank

An institution **independent** of government influence that determines monetary policy (policy interest rate, reserve availability) to influence market interest rates and credit supply in order to achieve price stability.

And, has no other function –

- financial regulation a separate issue
- Financial stability concerns – crisis and systemic risk – forgotten or at least it was assumed that major developed countries had solved the problem
- Macroprudential policy was not on anyone's mind
  - Though the BIS had used the term as early as the 1980s
  - Fed rejected suggestion that it monitor asset prices or lean against bubbles.

Idealized central bank disappears with crisis

- Innovative new lending programs in US and ECB
  - To support bank and non-bank financial institutions (e.g. money market funds)
  - Questionable collateral – lending might violate Bagheot dictum
  - To support specific firms – use of 13(3) authority in US to lend to non-banks in "unusal and exigent" circumstances
    - Fed avoided this – never used 13(3) before even when suggested (Chrysler bankruptcy in 1970, NYC bankruptcy in 1975, airline problems post 9/11)

- Innovative monetary policy in zero rate environment – QE

- Financial stability role / mandate of central banks.

CBI in the post crisis period

- CBI still unchallenged – at least directly
- But, worst financial crisis in 80 years took place after independent central bankers were handed the levers of policy
  - Prestige damaged
  - Can’t avoid some blame – unable to maintain stability
- Central banking community – ‘we avoided collapse’
  - But crisis response leaned on the help of regulators and governments
- Perhaps, central banks should not be so independent after all.

What is different now?

Three roles of a 21st Century Central Bank

1. Traditional monetary policy – for price stability and maximum sustainable growth
2. Lender of last resort to financial firms – with regulatory and supervisory role
3. Maintain financial stability with macro prudential tools

Where does CBI fit?

- Still needed for monetary policy
- Need to regulate, know the borrowers, be able to lend without stigmatizing borrower →requires some privacy
- But bailouts and crisis responses are fiscal decisions – requires political decision

New era – constrained independence

- Crisis lending responses often involve fiscal decisions
- Moreover, crisis monetary policy (QE) has distributional consequences for asset holders
- Do we hand <u>fiscal</u> and <u>distributional</u> issues – inherently political issues – to unelected, independent bodies?
- Central bankers seem to think that the issue will disappear with ’normalization.’ But, will public agree?

Idea of Central Bank Independence evolves

- The ideal independent central bank existed – maybe – for a generation from the 1990s to the crisis.

- However,

  Central banks have never been removed from political entanglements.

  There are many examples. Take a look at two

1. Fed and the President – The Accord

- Fed assisted war finance – long rate at 2½% - even as inflation emerged in post war period.
- Fed ready to raise rates in Korean War (high inflation, expanding deficit)
- Jan 1951 Truman meets with Board Chair and Secy of Treasury – announces that Fed would not move during conflict
- Marriner Eccles contradicts announcement in press
- Truman calls whole FOMC to White House
- Accord emerges March 1951
  - `Establishes policy independence
  - President did not think that it had it

2. The paradigm of CBI - Bundesbank

- CBI suited the political sphere with a clear objective to keep inflation low.
- Once CB and government objectives diverged – government won out
  - Bundesbank had to accede to government decision to convert ostmark for one DM.
  - Bundesbank had to accept the abolition of the independent currency that it was enshrined to uphold – as government joined Euro.

Conclusion

- Contemporary central bank is a complex institution with multiple roles that overlap with government / political responsibilities.
- CBI for the modern era needs to be sorted out. CBI is a more nuanced and complex concept than it seemed 30 yeas ago.
- As Friedman presciently noted over 50 years ago – central banks "***exercised their independence only so long as there has been no real conflict between them and the rest of the government***"
- CBI erodes if objectives diverge

Summary

- Emphasis on CBI stemmed from some coincidences in 1970s-90s
  - Establishment of monetary constitutions
  - Fear of inflation
  - Macro literature on time inconsistency
  - Measurement – indexes of CBI

- Central banks, governments and the public bought into an idealized version of CBI
- That was challenged by the crisis
- And was probably never true