

Central Bank Independence and Credibility During and After a Crisis

Unlike my distinguished fellow panelists, I am not the head of a central bank. So I take my marching orders from the conference organizers. In this case, they asked me to ruminate on the extent to which central banks' *independence* and *credibility* have been affected by their actions during the crisis. So that's what I'll do.

Historical note

But first, I can't resist an historical note that illustrates how times change. The first paper at the first Jackson Hole symposium (in 1982) was entitled, "Issues in the Coordination of Monetary and Fiscal Policy." I'm one of the few people on earth who know that little fact--because I wrote the paper.¹ I mention it now because that title sounds similar to what I was asked to talk about today. But back in those days, the key issue was the apparent *lack of coordination* between monetary and fiscal policies, thought of as two arms of stabilization policy. Concretely, tight money and loose fiscal policy—one restraining the economy, the other pushing it along--were thought to be giving us the “wrong” policy mix in the early 1980s.

Nowadays, the question is whether there has been *too much* coordination between monetary and fiscal policy, not too little; whether the close cooperation between central banks and Treasuries² has compromised central bank independence; and whether, therefore, this

¹ Alan S. Blinder, "Issues in the Coordination of Monetary and Fiscal Policy," in *Monetary Policy Issues in the 1980s*, Federal Reserve Bank of Kansas City, 1983, pp. 3-34.

² Many countries have Finance Ministries rather than Treasuries. I'll stick to the American-British usage.

close cooperation should end promptly. If I may paraphrase Ronald Reagan, it's: *Mr. Bernanke, put back that wall.*

I am tempted to say that the recent crisis *forced* central banks and Treasuries to work closely together. But to be more neutral about it, let me just say that the crisis *induced* them to work closely together. That seems to be an indisputable fact. But some people applaud it, others view it as inevitable under the circumstances, and yet others see it as troubling, if not downright dangerous.

For example, my friend Allan Meltzer, another participant in that first Jackson Hole conference, has been sharply critical of what he views as the Bernanke Fed's squandering of the Fed's hard-won and fragile independence. He wrote in a 2009 Hoover book that:

Chairman Ben Bernanke seemed willing to sacrifice much of the independence that Paul Volcker restored in the 1980s. He worked closely with the Treasury and yielded to pressures from the chairs of the House and Senate Banking Committees and others in Congress.³

Notice that Meltzer wrote those fighting words in 2009. I don't know in which month, but given publication lags, it might have been while the crisis was still raging.

My view is quite different. To me, close cooperation between the central bank and the Treasury in a crisis is both *inevitable* and *desirable*. And in this particular crisis, it was both essential and salutary. The trick is how and when the Treasury and the central bank disengage after the crisis ends.

Two different problems

³ Allan H. Meltzer, "Policy Principles: Lessons from the Fed's Past," in J. Ciorciari and J. Taylor (eds.) *The Road Ahead for the Fed* (Hoover: 2009), p. 13.

I'm pretty sure no one in this room questions the importance of maintaining a high degree of central bank independence in normal times. I also think that at least most of us recognize that the bright line between the functions of central banks and the functions of Treasuries necessarily gets blurred and perhaps breached during dire emergencies. Think of waking up on the morning of September 16, 2008, for example. Should Ben Bernanke not have taken Hank Paulson's call?

So I'd like to think through the nature of central bank-Treasury cooperation in three different settings: (1) during a serious financial crisis; (2) during the aftermath of such a crisis, when the economy may be staggering and monetary policy may be unconventional; and (3) in normal times, when monetary policy is conventional. For the US, I'm thinking roughly of (1) as the acute crisis period from September 2008 through about April 2009, (2) as the years since then, and (3) as the way things were before the financial crisis--and will be again one day.

Let me dispose of (3) quickly. Under normal circumstances, with the central bank practicing garden-variety monetary policy, the line between the Treasury and the central bank *on monetary policy* should be bright, and as inviolable as possible. But let's remember two things we all know but sometimes forget: First, central banks don't normally have as much independence in their non-monetary-policy activities, such as bank supervision. The doctrine of central bank independence basically applies to monetary policy. Second, the main rationale for central bank independence is that politicians, with their short time horizons, have weak incentives to reduce inflation or to keep it low. Because politicians facing elections would have a "natural" tendency to inflate too much, we want monetary policy controlled by independent technocrats with long time horizons.

In a financial crisis

Lots of things change in a crisis. One of them is the time horizon. When the issue becomes how to get through to the weekend with your financial system still functioning, the hangman's noose concentrates the mind wonderfully—and not on the long run. The central bank's vaunted long time horizon evaporates, temporarily replaced by the same time horizon the Treasury has—which is short. That makes cooperation more natural.

Second, and related, the principle objective of the central bank changes. It's no longer fighting inflation, which may be unnecessary or even counterproductive if a slump is imminent, but rather holding the financial system together. That's also the Treasury's overriding goal. The combination of urgency and overwhelmingly common interests virtually cries out for cooperation, even though central banks and Treasuries have different operating styles, capabilities, legal authorities, institutional concerns, and prejudices. Each has its comparative advantages, and two can do the job better than one.

Third, cooperation is necessary to calm nervous or panicky financial markets. The need for coordinated action has operational, political, and psychological dimensions. Only the central bank has unlimited means—and the ability to deploy them quickly without legislative approval. But the Treasury is needed for political legitimacy, for cover. And few things could be worse in a crisis than seeing the central bank and the Treasury at loggerheads. The two authorities need to present a united front to jittery markets, and maybe also to a jittery legislature. In fact, having *two* agencies working hand-in-glove is not enough in countries where bank supervision and/or

deposit insurance are in different hands; all the relevant authorities should be on the same page.⁴

A fourth reason for close cooperation is that the central bank may be drawn into what are called *quasi-fiscal operations*. Think about the adjective. The term *quasi-fiscal* tells you immediately that the neat separation between monetary policy and fiscal policy has gone by the board. Modest-sized lender-of-last resort operations along Bagehot lines are one thing. If the collateral is really good, they don't resemble appropriations. But massive lending and/or asset purchases involving possible losses start looking like backdoor spending, or at least putting taxpayer money at risk—that is, like *fiscal* policy. This resemblance has not gone unnoticed in the US, the UK, or the Eurozone.

Fifth, when it comes to deciding which financial institutions shall live on with taxpayer support (e.g., Bank of America, Citigroup, AIG,...) and which shall die (e.g., Lehman Brothers violently, Bear Stearns peacefully), political legitimacy is critically important. The central bank needs an important place at the table, but it should not be making such decisions on its own. If the issue becomes politicized, as is highly likely, the Treasury, not the central bank, should be available to take most of the political heat—even if the central bank provides most of the money. That's part of what I meant by having different comparative advantages.

Finally, in worst-case scenarios, the central bank's accounting solvency might come into question. The Federal Reserve never came close to such a situation; but if it had, the Treasury would have had to backstop it. Should the ECB suffer large losses on its portfolio, which ECBers

⁴ In the case of the U.S. in 2008, several actions by the FDIC were instrumental in bringing the crisis to an end.

will tell us is impossible, the constituent governments will have to stand behind their central bank. Unfortunately, there are 17 countries, and they don't all think or act alike.

That's a lot of reasons to cooperate, and you can probably think of others. My conclusion is that, in a crisis, preserving strict central bank independence is neither possible nor desirable.

In the aftermath

Once the dust has settled on the acute stage of the financial crisis, the economy is likely to be weak, if not in a deep recession. The country's major financial institutions are also likely to be sick, or nationalized, or both.

Many of the considerations listed above carry over into the post-crisis period, especially if the central bank has hit the zero lower bound (ZLB) on nominal interest rates and is relying on unconventional monetary policies like large-scale asset purchases. Inflation is not likely to be a major concern then, unless there has been a currency crisis and a large depreciation. Markets will still be jittery. The legacy of the emergency quasi-fiscal operations will still be with us; indeed, new ones may be in train. In severe cases, the central bank may be worried about its balance sheet.

It's likely to be a difficult environment, with the macroeconomy needing stimulus but monetary policy weakened by the ZLB and fiscal policy possibly hamstrung by large budget deficits and accumulated debt. In principle, both monetary and fiscal policy should remain expansionary—and explicit coordination should not be necessary. But fiscal policy may turn (or be forced to turn) in the wrong direction, and monetary policy may be a spent force.

Speaking about spent forces, since much of the FOMC is here, let me point out that there is one nominal interest rate that is *not* constrained by the ZLB. That's the rate the central bank

pays on excess reserves, which can be made negative. In fact, several central banks have done so at times and, so far as we know, that did not destroy capitalism in their countries. The ECB now pays zero interest on reserves, and there is at least talk of going negative. Yet at the Fed, even going back to zero, where it was for 95 years (!), is viewed as a frightening prospect. And going negative is unthinkable. For the life of me, I can't understand why.

That's the end of my commercial, which I've made at greater length elsewhere.⁵ Now back to our regularly-scheduled discussion.

During the difficult post-crisis period, the central bank should be gingerly disengaging from the Treasury and gradually re-establishing its independence. Fortunately, much of that will happen automatically—which is one reason why I don't lie awake at night worrying about this. Once the crisis is gone, the central bank will naturally focus again on monetary policy proper, rather than on emergency rescue operations. The number of live-or-die cases to be decided will dwindle, perhaps to zero. Emergency lending against dicey collateral will probably end, too.

You may have noticed that this brief description of setting (2) seems to characterize the position of today's Fed pretty well, but the position of today's ECB not so well. That illustrates a general point: How quickly disengagement can or should occur will depend on the circumstances. If financial stability has been substantially restored, the central bank should be able to separate its monetary policy from financial stability concerns, and re-assert its independence regarding the former. I think that happened smoothly in the United States. While they don't invite me to FOMC meetings, I don't see any evidence of attempted encroachment on the Fed's traditional turf by the Treasury. That's less true in Europe, where the ECB still faces

⁵ Cf. Alan S. Blinder, "How Bernanke Can Get Banks Lending Again," *The Wall Street Journal*, July 23, 2012.

a potential crisis of major proportions, is worried about major bank failures, and is contemplating more highly-unconventional, quasi-fiscal operations.⁶

What about credibility?

If you were listening, rather than reading your Blackberries, you may recall that my assignment included central banks' independence *and credibility*. But I have spoken so far only about independence. There's a reason, and this is my last point.

When people worry about crisis-induced damage to a central bank's credibility, they generally mean that the emergency actions in the crisis and its aftermath may call the central bank's anti-inflation resolve into question. For example, in the US today, a small but vocal minority of economists, some of whom are in this room today, worries out loud that the huge buildup of Federal Reserve assets and bank reserves sow the seeds of future inflation.

To my mind, this is a misuse of language. Credibility means *believability* and *trust*. You build it by matching deeds to words.

Promising and then delivering low inflation is one important aspect of central bank credibility, to be sure. But it's only one, and it is pretty clear that the Fed has retained it. On the day I wrote these notes in my Princeton office, the spread between 10-year nominal bonds and 10-year TIPS, which are based on CPI inflation, was 2.3 percentage points. Making a 30 basis point deduction to translate from CPI inflation to PCE inflation, which normally runs lower, the market's implicit inflation forecast matched the Fed's 2 percent PCE target *exactly*. In August 2008, before the Fed began to blow up its balance sheet, the corresponding inflation forecast was 2.2 percent. Not much erosion there!

⁶ The ECB announced such policies just a few days after the symposium.

But as I said, anti-inflation credibility is just one aspect of credibility. Promising to do “whatever it takes” to stop a financial meltdown in the United States (as Ben Bernanke did in 2008) or to preserve the euro (as Mario Draghi did about a month before this symposium), *and then delivering on your promise*, is at least as important. A central bank that handles a financial crisis well should find that its success builds credibility for the future, even if that credibility is not explicitly about inflation fighting.

Dealing effectively with a crisis requires not only smart policy actions, but a high degree of transparency and extensive communication. The public, the markets, and the politicians are entitled to especially full, clear, and coherent explanations of any unusual or unprecedented policy measures. Remember, credibility is built by matching deeds to words. Montague Norman famously said a central bank should “never explain, never apologize.” Montague Norman was wrong.