The Relevance of Central Bank Independence: Challenges and Outlook

25th Anniversary of Independence of Central Bank of Mexico

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Why Central Bank Independence?

- Why shouldn’t the day-to-day activities of the central bank be run by the elected representatives of the people?

- Answer: with monetary policy the ***good stuff*** can happen quickly (stronger economy, better balance sheets), while the ***bad stuff*** (inflation, inflation expectations, foreign reserves crisis) happens in the longer run.

- The elected representatives of the people face periodic elections, and then their planning horizons shorten.

    - Can end up with too much of the ***bad stuff*** in the long run.

Two Thoughts on Central Bank Independence

- Evidence suggests central bank independence pays off:
  - Supported by classic cross-country evidence on measures of independence and measures of economic performance.
  - One of the big economic policy blunders of recent US economic history, the high US inflation of the 1970s:
    - Probably would not have happened under a more independent central bank.
- US history suggests that Central Bank Independence is Fragile.
  - Even with the right statutory support, in the end the defense of central bank independence depends on the bravery and fortitude of the central bank governor.

Need for Better Communication about Value of Central Bank Independence

- It would be most unfortunate if Central Bank Independence would fall victim to its own success.

- Some say: ”The purpose of central bank independence was to bring down inflation and, most important, inflation expectations. Now that inflation has been tamed, central bank independence is no longer necessary.”

- This is a foolish position.

    - In the 1930’s, after a tidal wave of bank runs, deposit insurance was implemented and the US commercial banking system has seen essentially no runs since then.

    - Everyone would agree that to get rid of deposit insurance because there have been no runs makes no sense.

Lessons from Three Recent Episodes in US

- Modern birth of Federal Reserve Independence: Treasury Accord
- William McChesney Martin
- Arthur Burns and the Great Inflation

Treasury Accord

- Independence of modern Federal Reserve, signed agreement on March 3, 1951.
    - Epic battle between the Federal Reserve and President Truman.
    - That the Fed `won’ the battle was a consequence of luck, and grit at the Fed.

- President Truman:
    - US was at war in Korea, which risked escalating and turning into WWIII.
    - Truman to Fed: be a team player and keep interest rate low.

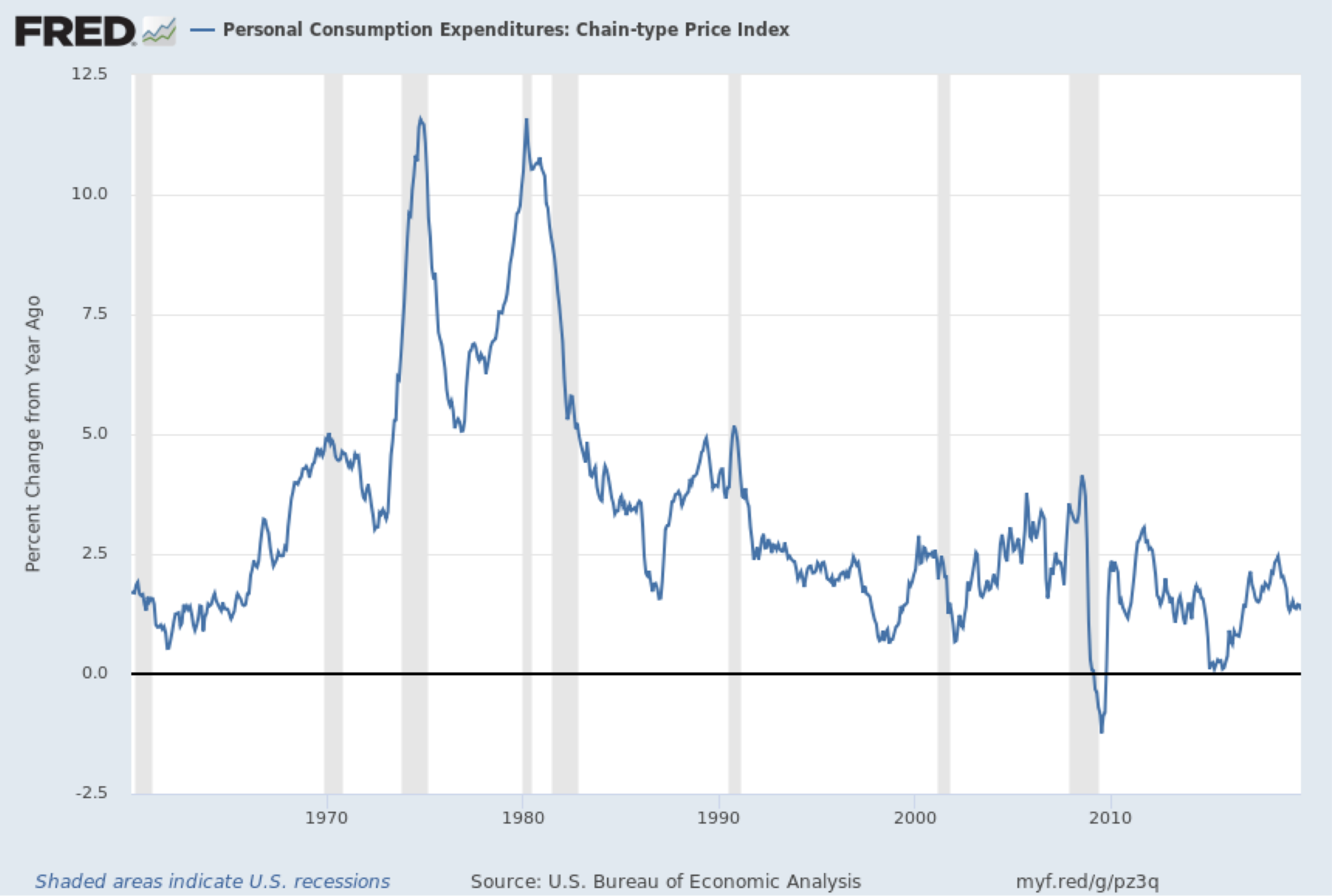
- Thomas McCabe (with support of Eccles), Fed Chair:
    - Feared high inflation if the Fed did what Truman demanded.

- The country was divided and dirty tricks were deployed.

- Even when the Fed `won’, it was not so obvious, since a Treasury official was installed as Federal Reserve Chair. (That `Treasury official’, Martin, turned out to be an excellent central banker).

Fed Chair William McChesney Martin

- Ran into trouble with President Lyndon Johnson in the 1960's.
- Johnson was fighting a war in Vietnam, passed a big tax cut, and wanted to pass his Great Society programs.
- Martin was worried about inflation and infuriated Johnson by raising interest rates.
- Johnson summoned Martin to his ranch in 1965.
  - "Martin, my boys are dying in Vietnam, and you won't print the money I need."
  - Johnson attempted to physically intimidate Martin.
  - But Martin would not back down.
- Johnson tried to fire Martin, but his attorney general advised against.


FRED
Personal Consumption Expenditures: Chain-type Price Index
Percent Change from Year Ago
12.5
10.0
7.5
5.0
2.5
0.0
-2.5
1970
1980
1990
2000
2010
Shaded areas indicate U.S. recessions
Source: U.S. Bureau of Economic Analysis
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The Beginning of the US Inflation

- It started in 1965.
- Martin did raise rates, but in retrospect it is clear that it was not enough.
- Perhaps, if Johnson had not been so insistent and the Fed were more independent, Martin might have nipped the `Great Inflation’ in the bud.

Arthur Burns

- Succeeded Martin.

- Burns repeatedly said that he was anguished by the high inflation.
  - His natural inclination was to raise rates.

- But, Burns faced strong political headwinds.
  - President Nixon.
  - Wright Patman: "**...the senselessness of trying to fight inflation by raising interest rates. Throwing gasoline on fire to put out the flames would be as logical.**"
  - Patman threatened that if Burns raised rates, Patman would see to it that interest rates would come under the control of the wage and price control board (*Time Magazine*, April 9, 1973).
    - Shocking example of *fragility* of central bank independence.

- Stop-go policy ensured that inflation expectations became entrenched.
  - The public got the message that stopping inflation was very hard.
  - As a consequence, the ultimate cost of eliminating inflation was very high.

Concluding remarks

- Central Bank independence is important and valuable.

  - The people must exercise ultimate control via their elected representatives.
    - But, they must do so by creating a framework and mandate.
    - Give central bank operational autonomy.
    - Central Bank must be held accountable for achieving its mandate.

  - Central Banks sometimes make mistakes and efforts should be made to learn from them.
    - Some mistakes were made by the Fed leading to the recent financial crisis.

- A source of concern is the *fragility* of central bank independence.
  - In the end, depends heavily on courage of central bank governor.