Has the Financial Crisis Jeopardized the Fed's Independence?

By John H. Makin

Damned if you do, damned if you don't.

Judging from the response to the Fed's three-year battle against systemic financial collapse and the risk of deflation, it is difficult to escape the conclusion that financial crises and their aftermaths can pose greater challenges to central bank independence than the more traditional pain associated with combating inflation.

Prior to the financial crisis that began to unfold in 2007, it was received wisdom that central bank independence should largely be viewed in terms of the need to insulate the central bank from the political process that would tolerate higher-than-optimal inflation. Writing on central bank independence in 1993, Alberto Alesina and Lawrence Summers drew on the experience and literature tied to the inflationary 1970s and the epic Volcker win over inflation in the early 1980s to suggest that "delegating monetary policy to an agent whose preferences are more inflation-adverse than are society's preferences serves as a commitment device that permits sustaining a lower rate of inflation than would otherwise be possible." The requirement for political independence of the central bank was seen to be derived from "time inconsistency" whereby the median voter, as represented by politicians, would want to curb central bankers who impose economic pain by tightening monetary policy to lower inflation and inflation expectations.

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Paul Volcker

American Hero

The U.S. Congress did attempt to temper Federal Reserve independence by passing in 1978 the Humphrey-Hawkins bill that required it to target stable inflation and low unemployment. Humphrey-Hawkins, however, did not constrain **Paul Volcker,** who in 1980 allowed the Fed funds rate to rise above 20 percent by adopting tighter quantitative reserve targets and letting markets determine interest rates. Newspaper advertisements that protested Volcker's stringency—and potentially threatened Fed independence—showed the Fed chairman ripping intravenous tubes out of the body of a struggling economy and its unemployed workers.

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However, once the inflation rate had fallen from 15 percent in early 1980 to below 3 percent by 1983 while growth recovered, the case for low and stable inflation had been made. The "great moderation" was to follow with less volatility, steady growth, and low and stable inflation as a testament to the benefits of Fed independence.

By the time the Alesina and Summers article appeared in 1993, the independent central bank had come to mean economic stability and positive effects on growth that derived from two sources. First, more stable inflation meant lower inflation volatility that contributed to growth by lowering real interest rates (lower risk premiums) and stabilizing relative prices. Empirical evidence had supported the positive real growth effects of lower and more stable inflation. Second, the fear of unstable accelerating inflation that had grown up in the late 1970s as the Fed was trying ever-rising doses of easier money to push down the unemployment rate was buried.

The great moderation was seen by many as a beneficial byproduct of the Fed having abandoned the attempt to target real variables such as unemployment. The Friedman-Phelps natural rate hypothesis ruled, and the Fed was largely free in effect to focus on achieving low and stable inflation. Even the natural rate of unemployment (NAIRU, or non-accelerating inflation rate of unemployment) drifted downward during the 1990s, so that the threshold at which lower unemployment increased inflation risks was relaxed by Alan Greenspan.

Moving forward from the experience since 2008, the important thing to remember when gauging the negative response, and the rising threat to Fed independence that has grown out of the Fed's role in TARP and especially QE2, is the sharp and unpredictable change in the role required of the central bank during and after a financial crisis. The events in mid-2008 are highly instructive. Both the Fed and the European Central Bank were essentially thinking about the real economy and the need to remain vigilant against inflation threats even after the Bear Stearns crisis and just two months before the collapse of Lehman Brothers. The price of Brent crude oil reached $147 per-barrel in mid-2008, prompting the European Central Bank to raise interest rates by 25 basis points in July. Even after the frightening March 2008 collapse of Bear Sterns, the Fed at its June 25, 2008, meeting left the Fed funds rate target at 2 percent, citing diminished downside growth risk and upside risks to inflation.

In mid-2008, the Fed and the European Central Bank were still articulating monetary policy in terms of the traditional growth-inflation template. Financial instability, the paramount risk, was not much emphasized in public explanations of policy settings. The possibility that the risk of deflation rises sharply in a full blown systemic crisis was not a concern, especially for the European Central

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Bank. Its insouciant July 2008 rate boost seemed absurd to those in the financial sector who understood the exploding risk of systemic financial collapse during the summer of 2008.

With the benefit of hindsight, it probably would have been wiser for the Fed to have let Bear Sterns fail and warn other banks and investment banks to begin reducing their 30-to-40-times-capital leverage ratios, lest they be the next to fail.

After the September collapse of Lehman Brothers, the Fed had to embrace quickly the role of a central bank faced with systemic collapse. The Lehman-inspired panic caused a surge in the demand for liquidity that had to be accommodated by the Fed. After the financial bubble had collapsed, the need for liquidity was accommodated at the urging of the Fed by a surge in government borrowing undertaken to recapitalize banks and financial institutions. TARP was born. The Fed's active role in initiating TARP somewhat ironically has provided the basis for subsequent challenges to Fed independence based on the notion that the Fed is not answerable to the Congress and the voters. These criticisms have persisted even though it was Congress that had to approve TARP. For many Fed critics, in hindsight, the TARP plan advocated by Chairman Ben Bernanke bailed out the banks and left the taxpayers responsible for funding the huge $800 billion dollar-plus increase in government debt that TARP entailed.

There is much to criticize after the fact regarding the Fed's performance during the months leading up to the Lehman crisis. Adhering to its traditional inflation/growth mandate, even in June 2008, while failing to comprehend the rapidly building systemic financial crisis during the

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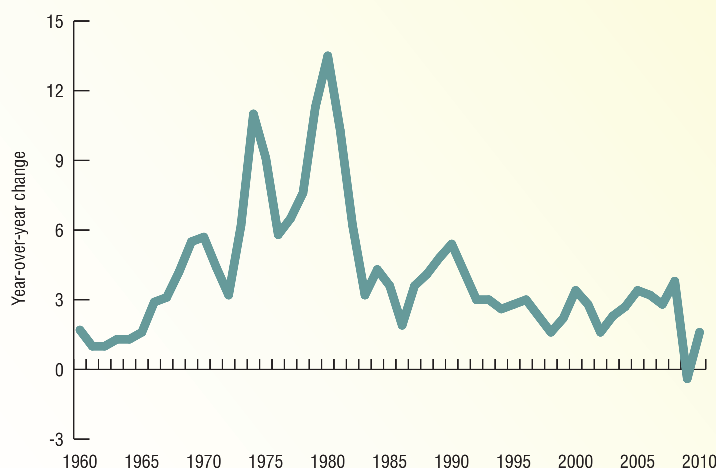
summer of 2008, was a huge mistake. It preordained the need for TARP and a bank bailout.

By September, with a huge surge in the demand for liquidity driven by rising counterparty risk that had already been seen during the Bear Stearns crisis, there was no bank or investment bank willing or able to purchase Lehman, that is to play the role that JPMorgan had played with Bear Stearns. Once Barclays backed out at the last minute as a possible buyer, Lehman's failure was unavoidable.

It is forgotten by many, including current Fed critics in Congress and many in the financial sector and the media, that a central bank has virtually no alternative in a systemic financial panic. If it does not accommodate the surge in liquidity demanded by the situation, the financial system will collapse. Without TARP, the loss of wealth and damage to the real economy would have been far worse than the $12 trillion of wealth losses experienced in the United States alone due to a collapse in real estate values and equities at the end of 2008.

By the time of the Federal Open Market Committee meeting on November 16, 2008, the Fed had reached the zero bound on the Fed funds rate. Citing risks to growth, the FOMC voted unanimously to move the Fed funds rate to zero. The stage was set for QE1 and QE2, which were driven by deflation risks, though such risks were not emphasized by FOMC members until the summer of 2010. Deflation would have set off a destabilizing rise in real interest rates and risked further financial damage and attendant weaker growth.



Though it was not anticipated at the time, the stage was also set for the barrage of criticism that accompanied QE2 when it enacted almost two years later in the face of a resurgence of deflation risks that had reemerged during the summer of 2010.

The deflation risks that drove the Fed's quantitative easing programs are not imaginary. The Federal Reserve Bank of San Francisco has developed a market-based method for measuring deflation risks. The San Francisco Fed's model shows a sharp surge in deflation risk, to a virtual certainty immediately after the Lehman crisis, and shows deflation risks surging back to 25–30 percent levels both in mid-2009 and early 2010.

As it turns out, the Fed's success in preempting deflation since 2008 has probably been the greatest source of threats to its independence. The fact that deflation has not emerged has undercut the Fed's claim that QE1 and QE2 were needed to preempt it. Further, QE2 was enacted just as a conservative Republican majority was being elected to the U.S. House of Representatives in November 2010. The Fed's decision to announce $600 billion of purchases of Treasury securities between the end of 2010 and mid-2011 led to a wave of protests. On November 17, 2010, the new Republican leadership in Congress sent an unprecedented letter of protest to Fed Chairman Ben Bernanke. After claiming that "the U.S. Federal Reserve must be free and independent from political pressures," the Republican leadership letter went on to assert that QE2 "introduces significant uncertainty regarding the future strength of the dollar, and could result both in hard-to-control, long-term inflation and potentially generate artificial asset bubbles that could cause further economic disruptions." The letter continued in a vein that suggested that the authors had forgotten the financial crisis, with a suggestion that "perhaps most damaging, we believe that QE2 is giving the impression that the Federal Reserve will keep making new and different attempts to boost the short-term prospects of the economy."

It is worth noting that when that letter was written, the year-over-year core CPI inflation rate, one of the primary mandates for Fed policy, had dropped to 0.8 percent down from 2.6 percent in 2006. (Year-over-year core CPI has since risen to 1.2 percent, still well below the Fed's mandated target of 1.5–2.0 percent.) At the same time, U.S. growth was on track at a 2.7 percent rate for 2010. But the Congressional Budget Office was soon to estimate that fiscal stimulus had accounted for about 2.7 percentage points—or all—of 2010 U.S. growth.

For its part, Congress, unknown to the Fed and most observers, was about to enact in December 2010 a second large fiscal stimulus package. That package included payroll tax cuts, another extension of unemployment benefits, and lower income tax rates, along with more generous expensing for capital outlays. The package, depending on how it is evaluated at the margin, produced $200–$300 billion in extra stimulus for 2011, thereby sharply boosting most growth forecasts for the coming year. It is hard to argue that the December 2010 stimulus package was anything other than an attempt "to boost short-term prospects for the economy," exactly the notion that the Republican leadership invoked to criticize QE2. Further, a glance at a chart of U.S. inflation (year-over-year CPI) suggests that widespread claims of a significant 1970s-scale inflation threat from QE2 were highly exaggerated (see figure).

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Kevin Warsh, a sitting Fed governor who had voted for QE2, wrote an opinion piece in the *Wall Street Journal* critical of the measure. "The Federal Reserve is not a repair shop for broken fiscal, trade, or regulatory policies." Fair enough and true. The Federal Reserve should not try to target the real economy. And, by emphasizing the risks of expanding the Fed's balance sheet and the potential for dollar weakness and higher commodity prices, Warsh was echoing post-QE2 criticism of the Fed emanating from many quarters, including the U.S. Congress.

To be clear, the Fed's performance between September 2008 and November 2010, when QE2 was announced, was sure to stir controversy. The Fed did bail out the financial system, although not having done so would very probably have meant financial collapse. Further, the Fed did stretch its mandate as it was forced to extemporize in the midst of a financial crisis. Indeed, the Fed was created in 1913 in large part to improve the means to address financial crises. While its role has evolved since then to its current dual-mandate framework, the problem it faced in the financial crisis remains essentially the same as in 1913 and the Great Depression. It would be dangerous to conclude from Congressional criticism of the Fed after QE2 that Congress or some other entity should determine the Fed's role in future financial crises.

One might ask whether QE2 ought to have been rescinded, as the e21 group suggested in its November 15, 2010, open letter to Chairman Bernanke. We do not know what the impact of a rescission of QE2 might have been. That said, the Congress did end up enacting a substantial increase in fiscal stimulus just a month after the surge in protest over QE2, suggesting that concerns about the sustainability of the U.S. economic recovery were not confined to the Fed, but rather were shared by some of its critics.

The challenge to Fed independence since the 2008 financial crisis and ensuing deflation threats arises from two primary sources. First, while the Fed so far has succeeded at preempting deflation and containing the damage in the financial sector, the bailout charge levied against the Fed could have been mitigated by the Congress with the passage of a financial regulatory reform bill that constrains the leverage available to depository institutions benefiting from federal deposit insurance available to their customers.

The second source of criticism of the Fed arises from the fact that it did act independently of Congress in unusual and *ad hoc* ways, including balance sheet expansion, TARP advocacy, and accommodation of insurance company AIG during the Bear Stearns crisis, in order to deal with the exigencies of a full blown financial disaster. The traditional independence granted to the Fed to combat inflation appears not to apply to efforts to contain financial crises and/or threats of deflation, because such efforts are not subject to Congressional oversight. "Low and stable inflation" requires Fed containment of both inflation and deflation threats. The fact that financial crises and deflation threats are unusual events means that necessarily controversial Fed efforts to address them have led to open calls for curtailing Fed independence. This is not withstanding the fact that the Fed's traditional mandate, an unemployment rate under 6 percent and core inflation between 1.5 percent and 2 percent, is still not being met.

Determining the way forward for Fed independence in the wake of the financial crisis is difficult. Serious Fed critics such as Kevin Warsh have a point when they say that the Fed should avoid persistently employing monetary policy to affect real variables like growth and unemployment. Most FOMC members and Fed staff would probably agree with that view. To put the same point another way, both monetary and fiscal stimulus measures produce only transitory positive effects on growth and employment. This is clear from the experience of the past several years and the transitory impact of the multiple fiscal and monetary stimulus packages enacted over that time.

The major benefit to the real economy of Fed independence arises from the believable Fed commitment to low and stable inflation that independence implies. That commitment, however, needs to include avoiding deflation as well as inflation, with the former being arguably more difficult to control and damaging than inflation, especially after a financial crisis.

The sharp criticism of QE2 by some over its potential inflationary effects may or may not turn out to be correct. That said, should the recovery falter due either to a stagflationary shock from higher oil prices or an unexpected move to U.S. fiscal stringency, the Fed will necessarily be slower to respond with a QE3 in view of the risk of further criticism from Congress and or dissents from some hawkish voting members of the FOMC.

There is no easy or obvious way out of this post-crisis dilemma for the Fed. Perhaps the best option is to embrace a single mandate of low and stable inflation to be achieved with a price-level target that implies a 1.5–2.0 percent inflation path and a commitment to respond symmetrically, acting to reduce inflation above that path and to boost inflation below it. Unemployment ought to be removed from the Fed's mandate since it is a real variable, one that is independent of changes in monetary policy over the intermediate to long run.

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The resulting single mandate should emphasize the Fed's obligation to combat both inflation and deflation while explicitly recognizing that avoiding deflation requires the Fed to move preemptively to manage systemic financial risk. As we have learned over the past several years and as Reinhart and Rogoff have reminded us, financial crises occur with distressing regularity. It would be ironic if an ultimately successful effort by the Fed to contain the deflationary fallout of the latest American financial crisis resulted in a reduction in its insulation from political control. ◆