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Central Bank Independence and Financial Crises in History

Central bank independence is important because a central bank needs to be insulated from short-run political pressure in order to pursue its core mission of providing price stability. This involves the ability to tighten monetary policy at the expense of temporarily reduced real activity and increased unemployment without political interference. It is also crucial that the central bank is not forced to fund fiscal deficits in peacetime – that it be independent of fiscal policy. Finally a central bank has the important role of serving as a lender of last resort and independence from government influence can aid it in this pursuit.

The crisis of 2007/2008 has created considerable challenges for central bank independence. The Federal Reserve (and other central banks) have engaged in fiscal operations including credit policy(the extension of discount window lending to firms and markets other than commercial banks and the money market on the basis of risky collateral), bailouts of non bank financial institutions, and quantitative easing involving the purchase of risky mortgage backed securities and long-term Treasury securities. These actions have seriously threatened central bank independence and its crucial corollary credibility for low inflation. Are these developments novel? What does history tell us about central bank independence and financial crises? To answer this question I examine the record of the history of the Bank of England (one of the progenitors of modern central banking) before 1914 and the Federal Reserve since.

The Bank of England from 1694 to 1914

The Bank of England established in 1694 was a private institution with a government charter. Its original mandate was to purchase and help market government debt. It was not initially set up as a central bank but it gradually evolved in that direction (Bordo, 2008; Flandreau et al., 2009; Grossman, 2010). The Bank of England like the Swedish Riksbank founded in 1664, engaged in private banking activities. Be-

cause it held the deposits of other banks, it came to serve as a bankers bank facilitating transactions between banks and providing other banking services. It also became the repository for many banks because of its large reserves and extensive correspondent network. These factors eventually allowed it to become the lender of last resort in the face of a banking panic. In other words it became willing to provide emergency cash to its correspondents in times of financial distress. Also of great importance, the Bank played a crucial role in maintaining long term price stability by

following its charter and maintaining the convertibility of its notes into gold at a fixed price, i.e. adhering to the gold standard.

Learning to be an effective crisis manager involved a lengthy and painful process for the Bank and its independence was often compromised. Moreover, its independence often acted as a barrier to effective crisis management. There were two problems. First, before the passage of the Bank Charter Act of 1844, the government used the threat of revoking the Bank's charter when it periodically came up for renewal to pressure it to bail out the bill market on numerous occasions against its wishes (Calomiris, 2010) . It also forced the Bank to suspend the convertibility of its notes into gold in 1797 at the outset of the Napoleonic wars and to issue fiat money. Second, actions by the Bank itself worsened financial crises on several occasions (1825, 1837, 1847, 1857). The Bank as a profit making institution acted in its own interest to protect its gold reserves and did not provide liquidity to other banks and to the money market. In the face of severe criticism, the Bank adopted the responsibility doctrine proposed by Walter Bagehot, which required the Bank to subsume its private interest to the public interest of protecting the banking system as a whole. The Bank began to follow Bagehot's rule which was to lend freely on the basis of any sound collateral offered, but at a penalty rate to prevent moral hazard. The Bank learned its lesson well. No banking panics occurred in England after 1866 (at least until the run on Northern Rock in September 2007).

During the classical gold standard era from 1880 to 1914 the Bank of England adhered to the credible nominal anchor of gold convertibility and served as an effective lender of last resort. Its experience (as well as that of the Banque de France and the Reichsbank) served as a model for later central banks, especially the Federal Reserve System, established in 1914.

The Federal Reserve from 1914 to 2009

The Federal Reserve was established in 1914 primarily to deal with the periodic banking panics which frequently jolted the U.S. economy throughout the 19th century. The banking panics reflected two problems: first serious structural deficiencies in U.S. banking, a system based on unit banks (branching was prohibited) and a prohibition on interstate banking; second the absence of an effective lender of last resort, after the rejection of the charter of the Second Bank of the United States in 1836 the country had no authority resembling a central bank. The Federal Reserve System was set up to overcome these problems. Twelve regional Federal Reserve banks coordinated by the Federal Reserve Board in Washington were empowered to use their discount rates to adhere to the gold standard, to accommodate the "needs of trade" and to act as a lender of last resort to the member banks.

The Federal Reserve Act gave the institution a considerable amount of independence from the fiscal authorities. The Reserve banks could set their discount rates based on the demand by member banks to discount eligible paper. Government securities were not included in eligible paper (this was changed in 1931) so that the Fed, unlike the Bank of England in its early history, was not created to be a central bank to finance short-run government revenue shortfalls. However, the Fed was not completely independent, the Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Board.

World War I changed the picture considerably. The System quickly became involved in war finance, absorbing short-term government securities at low pegged rates and marketing war bonds, and by 1917 became an engine of inflation. Once the war ended, it took the Fed two years to regain its independence during which it fueled two more years of inflation.

In the 1920s the Fed carried out an independent monetary policy based on the Burgess Rieffler doctrine – a variant of the real bills doctrine – (Meltzer, 2003) in what Friedman and Schwartz (1963) termed "The High Tide of the Federal Reserve". But then its flawed real bills perception of the stock market boom (as a harbinger of inflation) led it to tighten policy to kill the boom triggering a recession in August 1929 and the Wall Street crash in October. Disaster followed in the next three years when the Fed failed to use its open market policy to offset a series of banking panics. Its performance reflected a mistaken reliance on the real bills doctrine and an endemic structural split between the Federal Reserve Board and the Reserve banks (Friedman and Schwartz, 1963; Meltzer, 2003). Indeed the Fed's poor performance in the Great Contraction of 1929-33 led Milton Friedman to propose in a 1962 essay that the Fed be made a branch of the Treasury for the purpose of following his famous k-percent rule.

In reaction to the Great Contraction the Fed was reorganized in the Bank Acts of 1933 and 1935. In theory the 1935 Act solidified the Fed's independence by removing the Secretary of the Treasury and the Comptroller of the Currency from the Federal Reserve Board and centralizing control in the new Board of Governors. However, as Meltzer (2003) points out, although the Fed in theory had the trappings of a powerful central bank ("Independent within the government") in practice it was subservient to the Treasury gold policy and a low interest rate peg from the mid 1930s to 1951. The one episode when the Fed used its policy indepen-

dence was in 1936–37, when it doubled reserve requirements in a mistaken attempt to mop us excess reserves in the commercial banking system. This action led to a serious recession in 1937/38.

From 1941 to 1951 the Federal Reserve was completely subservient to the debt management policies of the Treasury and during World War II became an engine of inflation initially by lending to commercial banks on the collateral of government securities at a preferred rate below the official peg and later by directly purchasing Treasury securities.

By the end of the 1940s some Fed officials, concerned about inflation, pressed for the institutional independence to raise rates. From 1949 to 1951, there was growing conflict between the Treasury arguing for bond market stability and the Fed urging higher rates to stem inflation. The conflict ended with the famous Fed-Treasury Accord on February 26 1951, which gave the Fed the independence to conduct its own interest rate policy.

In the 1950s under Chairman William McChesney Martin the Fed followed sound monetary policies within an economic environment under the Eisenhower administration which emphasized budget balance, price stability and the Bretton Woods peg to gold at USD 35 per ounce. During this period until the 1970s there were no banking crises as the banking system had become highly regulated after the Depression and was also protected by deposit insurance.

The Fed's independence came increasingly under challenge beginning in 1965. Mounting pressure from the Treasury and the Johnson administration to coordinate monetary and fiscal policy and to follow "even keel" policies under which the Fed would hold Trea-

sury bond prices steady to aid funding operations reduced the Fed's ability to raise rates to ward off inflationary pressure. During this period Keynesian views and belief in the Phillips curve tradeoff between inflation and unemployment gained dominance within the Fed and the U.S. government. In December 1965, after the Fed had raised the discount rate to stem incipient inflationary pressures and mounting gold losses, President Johnson verbally attacked Chairman Martin (Meltzer, 2010). For the rest of his tenure as chairman, Martin was increasingly acquiescent to the Administration's demands and inflation momentum kept building up.

The Fed's performance in the 1970s under chairman Arthur Burns and later G. William Miller was abysmal. The Fed lost its will to tighten sufficiently to completely offset the buildup in inflationary expectations for fear of the political costs of rising unemployment. Indeed Burns caved in to political pressure from President Nixon to avoid tightening and raising unemployment and thereby jeopardizing the Republicans chances in the election of 1972 (Hetzel, 2008).

By 1979, inflation had reached double digit levels. In August 1979, President Carter appointed a well known "inflation hawk". Paul Volcker, as Chairman of the Federal Reserve. Volcker raised the federal funds rate by 7 percentage points between October 1979 and April 1980, the largest increase in Fed history. This tightening combined with consumer credit controls in the spring of 1980 led to a sharp recession. The Fed then shifted to an expansionary policy in July 1980 but in the face of a resurgence of inflation the Fed began to tighten again in May 1981. The FOMC policy reversal and acquiescence to political pressure in 1980 was widely viewed as a signal that the Fed was not committed to achieving a substantial decline in inflation.

The second and more durable round of tightening succeeded in reducing the inflation rate from about 10% in early 1981 to 4% in 1983 at the cost of a very prolonged recession (Bordo et al., 2007). The second Volcker shock, which was supported by the Reagan ad-

ministration succeeded in breaking the back of inflationary expectations. It also augured a new era of Fed independence after a 20 year hiatus. During the subsequent Great Moderation period from 1984 to 2006 the Fed demonstrated its credibility to commit to low inflation as seen by its willingness to raise the funds rate sharply in the inflation scare of 1994.

Since the financial crisis of 2007/2008 the Fed's independence has again been challenged with echoes of the 1940s, 1960s and 1970s. In 2007 and 2008, the Fed worked closely with the Treasury to set up a number of discount window credit facilities to alleviate the credit crunch. Such quasi fiscal facilities provide credit directly to firms the Fed deemed most in need of liquidity and exposed the Fed to the temptation to politicize its selection of recipients of its credit. In addition, the Fed's balance sheet ballooned with the collateral of risky assets including those of non banks and an insurance company AIG. These assets were in part backed by the Treasury. Thus, the Fed abandoned its traditional "Treasuries Only"policy and exposed its balance sheet to credit risk (Goodfriend, 2010). The Fed also worked closely with the Treasury to stabilize major banks with capital injections and stress testing. Moreover, the purchase of mortgage backed securities and long term Treasuries in 2009 (quantitative easing) combined monetary with fiscal policy. Finally a sense of déjà vu was evident in the close cooperation between the Chairman of the Fed and the Secretary of the Treasury in their appearance before Congress requesting financial rescue funds in the fall of 2008. All of these moves have compromised the Fed's independence.

Lessons from History

From this brief survey of the histories of the Bank of England and the Federal Reserve several policy lessons can be discerned.

First, central bank independence can be helpful in dealing with financial crises. This was the case in Western Europe during the classical gold standard era. The Bank of England and its counterparts in Western Europe as publicly chartered banks of issue, effectively maintained a credible nominal anchor and served as an effective lender of last resort to the financial system. They operated in a rules based regime.

Second, based on the experience of the Federal Reserve in the interwar period, central bank independence can be harmful if it is based on a flawed policy doctrine or a structurally flawed institution.

Third, serious financial crises can compromise central bank independence. This was the case with the Bank of England in the crisis of 1797 and especially during the recent crisis where the Fed has lost much of its independence and will need to struggle to regain it. It is an open question whether the Fed needed to abandon its "Treasuries Only" policy and purchase long-term Treasuries and mortgage backed securities, whether it needed to follow credit policy and engage in credit allocation, whether it needed to bail out non bank financial institutions or to follow the "too big (and too interconnected) to fail" doctrine? Or whether a different approach to the crisis could have preserved its independence and hence assured its credibility for low inflation. One possibility would have been for it to follow highly expansionary monetary policy from August 2007 throughout 2008 (the Fed held policy too tight through much of 2008 hence

aggravating the downturn (Hetzel, 2009)), and let the Treasury deal with all the bailouts and selective credit allocations by itself. Likely the Fed would have hit the zero nominal bound in 2008 and would have had to engage in quantitative easing involving the purchase at least of long-term Treasuries to attenuate the recession. Thus in the end it might have not been possible for the Fed to completely separate itself from fiscal policy actions but it may have gone a lot farther than it did in that direction.

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