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LESSONS LEARNED AND CHALLENGES AHEAD

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*Part Three - Central Bank Independence and Accountability in a Democracy*

**Moderator:**

DAVID WESSEL  
Director, The Hutchins Center on Fiscal and Monetary Policy  
Senior Fellow, Economic Studies

**Presenter:**

DONALD KOHN  
Senior Fellow, The Hutchins Center on Fiscal and Monetary Policy  
The Brookings Institution

**Discussants:**

CHRISTINA ROMER  
Garff B. Wilson Professor of Economics  
University of California at Berkeley

KENNETH ROGOFF  
Thomas D. Cabot Professor of Public Policy and  
Professor of Economics  
Harvard University

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MR. WESSEL: So, can I ask the people who aren't going to the restrooms or the coffee pot to take a seat so we can move right into the next session, and we don't crowd Chairman Bernanke.

One of the consequences of the financial crisis has been an enormous increase in the prominence of the Federal Reserve, and with that, enormous increase in the criticism of it, and political backlash to a perception that, basically, the Fed bailed out Wall Street, and Main Street got screwed.

Now, Ben Bernanke said on "60 Minutes," "I didn't set out to save Wall Street, I set out to save Main Street. But in order to save Main Street, I had to save Wall Street" -- which is logically true and about twice as long as the attention span of the average American -- not in this group, of course.

So, to think about where the Fed's independence stands, and the political risk to it, we asked Don Kohn, who's a colleague of mine here at Brookings but, of course, was for a long time at the Federal Reserve -- at the end of his career, vice chairman of the Federal Reserve. And then we're going to discuss that with Christy Romer from Berkeley, who was in the Obama administration, the Council of Economic Advisors, and Ken Rogoff, at Harvard, who has done a lot of things but, most notably, has written a lot about what happens to economies in the wake of financial crises, which turns out to be a really interesting and relevant question.

Don.

MR. KOHN: Thank you, David.

So, as you noted, questions about the attitudes, and the attitudes of people toward central bank independence, and the role of the Fed in the democratic

society, I think happened, raised by the extraordinary actions that the Fed took around then, after the crisis, and also by the new regulatory responsibilities its gotten for systemic risk, as we were discussing in the last panel.

So the issue I tried to think about are what are the risks that Congress will try to make changes in the nature of the arm's-length relationship of the Fed to short-term political pressures? This is a really important question.

Logic, history strongly suggest that a less independent central bank is less likely to achieve its objectives, particularly it's price stability objective. And I also suspect that a high degree of independence will be necessary for the Federal Reserve, or any other central bank, to achieve its financial stability objectives.

I think I'd like to begin with two useful -- what I think are useful distinctions about independence. One is the distinction between goals and instruments. This is partly due to Stan Fischer-right, Stan? -- and the paper you wrote with Guy Debelle, about differentiating goal independence and instrument independence. I think the general paradigm is that, in a democracy, goals are and should be set by the elected representatives of the people, but the instruments should be set by the central bank, with considerable independence, with a very substantial arm's-length relationship, or arm's-length distance between their decisions on the instruments to achieve these goals, the settings of those instruments, and short-term political pressure on those instruments.

Central banks need to be held accountable for outcomes -- whether they hit the goals -- rather than the inputs, how they're basically achieving them. Now, accountability does include the need to explain as clearly as possible how the

instrument settings relating to achieving goals, but it's ultimately the goals the central bank should be held accountable for.

I think a second distinction to make in thinking about independence, and the degree of independence of a central bank or other government entity, is between monetary policy and regulation. In the case of monetary policy, there's a clear rationale for considerable instrument independence: lags in the policy effects, the tendency for economic cycles to be longer than political cycles -- in the United States those are about two years long, the political cycles, between elections -- have meant that when instrument settings respond to these shorter-term political pressures, there is too much emphasis on short-term output gains in employment, and insufficient attention to the longer-run inflationary consequences of pushing on the output-employment side.

I think the regulatory-accountability nexus is much more complex and difficult on the -- or the independence-accountability nexus is much more complex on the regulatory side. The goal of financial stability is not so easily measured for democratic accountability purposes. We kind of know, after the fact, when it's not achieved, after there's a crisis. But it's hard, unlike inflation and employment, it's hard to measure as you're going through.

In the U.S., responsibility for financial stability is split among a number of agencies. Requiring cooperation among those agencies. Regulation and supervision clearly affect the distribution of profits and credit, not just the overall levels of output and credit. So there is a potential for fiscal consequences if the financial stability regulation isn't done right -- as we saw in the last few years. And these are inherently more political decisions, I think, than the instrument settings for monetary policy.

In the U.S., we've had a bifurcated system, in which the Federal Reserve had considerable independence for its monetary policy instrument settings, but much less independence in the regulatory side because of its need to cooperate with these other agencies.

I must say, with the macroprudential regulation, I think a high degree of instrument independence will be required. Macroprudential regulation will be another form of taking away the punch bowl as the party gets going. And we saw, in the lead-up to the last crisis, there was considerable political resistance, even to the small steps that the regulators were taking to try and make the system safer in the early 2000s.

I do think that the threats to monetary policy instrument independence are higher than normal right now. There are a number of reasons for this. As David mentioned, and others have talked about, actions around the crisis eroded the public support for the Federal Reserve. And in my paper there are some charts of confidence in the Federal Reserve -- "a lot" and "a little." And, unfortunately, the "a lot" of confidence has been declining, and the "little" has been rising.

There's a perception that the fed didn't see, or didn't try hard enough to address the building vulnerabilities in the crisis. The supplying of liquidity was deemed a "bailout." There was little recognition in the sort of classic function of a central bank in a crisis to supply liquidity, to stop runs and fire sales. There was confusion among the elected representatives between spending and lending. They saw the Fed's lending, and they characterized it as "spending." And there was this perception -- as David mentioned -- of helping Wall Street, not Main Street. So the actions of the Federal Reserve in the crisis, -- in my view, completely justified and necessary, and in keeping

with classic central banking -- were not really well appreciated, both in the Congress and by the public.

And then in the recovery, of course, some actions have been perceived as distorting asset prices, favoring the rich, one hears, penalizing virtuous savers. And the tepid recovery has raised questions about the efficacy and the relative costs and benefits of the unconventional monetary policies that the Fed has followed.

So I think there's been a hit to the reputation of the Fed -- unfortunate but true.

I think the second issue is that the whole discussion of the Federal Reserve and Federal Reserve policy has been caught up in this very polarized political discourse that we've been experiencing in this country these days. In the paper, there's a chart of Democrats and Republicans, and their support for the Fed, and you can see that polarization shifting and switching, and getting worse over time.

A very disturbing, in my mind, example of this was the discussion at Republican primaries, presidential primaries, who would "fire" -- quote-unquote -- Ben Bernanke fastest. And it was also disturbing to me when the Congressional -- the Republican Congressional leadership wrote a letter to the Federal Reserve trying to dictate their portfolio choices. This is a direct interference, or an attempt to interfere in an instrument setting.

And then there were the votes against Ben Bernanke when he was reappointed, and Janet Yellen, more recently -- the number of votes and the party affiliation, I think you can see the polarization affecting the Fed.

The third issue that I think is worrisome is that, while many of these objections so far have centered on worries about inflation, and perception of an overly accommodative Fed, I think the pressure on independence will only intensify as the Fed exists from its unconventional monetary policies. Tightening is always unpopular with many politicians, who want more emphasis on jobs -- that's why independent central banks are created, so they didn't overemphasize that. And this time, after such a long period of high unemployment, I think the tightening issues will be questioned even more.

Exit will be complex, with many steps. It will be hard to explain. There will be plenty of opportunities for second-guessing. Exit will have fiscal consequences, raising the cost of borrowing for the fiscal authorities, and reducing, perhaps eliminating, the payments from the Fed to the Treasury at the same time, and that will also increase the focus in the Congress on this.

Fourth, macroprudential policy is mainly the responsibility of the Fed and, to a considerable extent, I think this is a terrific addition to the rule book here -- it will allow monetary policy to concentrate on jobs and inflation -- but it could also meet political resistance. It gives the Fed more exposure to pressure. It could easily be tightening both policies at the same time.

So I think the threats to the potential for -- the threats to independence are substantial here. I do think that worries about these threats should not deter the Federal Reserve from doing what it sees to be the right thing. I think the best defense of instrument independence is success at meeting your objectives. Exiting too soon because you're worried about what people were saying, and thereby sending the

economy down into recession, or preventing it from recovering, or waiting too long because you're worried about the political backlash of your exit will undermine your independence over time, because you won't be meeting your objectives.

So the best defense of the current degree of independence is doing well -- coupled with continued effort to explain what the Fed is doing, and why it's doing it. In my paper, I have a very nice quote from Ben Bernanke, talking about the importance of transparency to defending independence.

Right now, the main immediate threat to Fed independence, or to the degree of Fed independence, seems to be the backing for a Government Accountability Office audit of monetary policy. This would not be a good idea, in my view. To be clear, this isn't an audit about the accuracy of the financial statements, this is about studying the efficacy of policies. GAO audits everything about the Fed in this regard, all the policies of the Fed, but monetary policy. And this difference was established in the late '70s. Congress, who are opposed to Fed actions will use the audit to argue, at a minimum, for delaying, perhaps exit, from unconventional monetary policies, pending a GAO study.

Now, the Fed doesn't have to wait for the GAO study. It doesn't have to adhere to the GAO recommendations. But this will be an additional pressure point that moves the needle in the wrong way, when exit will require preserving independence to contain inflation, and it would be a bad signal to the financial markets, and it would undermine what I think has been this very useful distinction between independence for monetary policy, and independence for regulation policy.



So, I think it's important to debate this in a democracy, but I certainly hope that there is no action that would significantly undermine or reduce the independence of the Federal Reserve from where it is right now.

MR. WESSEL: Thank you, Don.

I should mention, in introducing Christy, that these academic issues, or these historical issues, you've studied academically for some time. So --

MS. ROMER: All right.

MR. WESSEL: -- is the Fed in as much trouble as Don thinks?

MS. ROMER: Ahh -- maybe. But I think, maybe, for different reasons than Don suggests.

So, you know, I think the first thing to say -- Don is always so wise and balanced, that it is a delight to read anything that he writes. And I have this overwhelming sense that I should just say I agree with him, and shut up.

But, so I --

MR. WESSEL: But, fortunately, you won't.

MS. ROMER: But I can do the next best thing, which is to say I agree completely with what he said about the fundamental importance of central bank independence, and the threats to the Fed, but maybe for, as I said, a different reason. And I think that that somewhat different perspective on why central bank independence matters maybe gives you a different sense of where the threats are coming from.

So, in his paper, actually, Don gives kind of a classic case for central bank independence, which is politicians have a short-term outlook, they just want to win elections, and so if you let them control monetary policy, they're going to pump up the

economy before an election, and that's going to tend to cause inflation. And, in contrast, if you delegate monetary policy to an independent central bank, they can take a longer-run view, and then you get less of these problems, you get less inflation.

I think the reason that -- I'm skeptical of that story for a couple of reasons. One, the number of people that have tried to look for a political business cycle, and evidence that politicians do pump up the economy before elections, by and large, can't find them. I guess, with the exception, with the one exception, and not at all surprising exception, of Richard Nixon, that doesn't seem to be really what politicians do.

And if you doubt my skepticism about this usual story, I mean, I just point out the bizarre situation that we find ourselves in today -- which, in both the United States and Europe, politicians seem to care a lot more about inflation than central bankers do right now, and a lot less about the short-run state of the economy than central bankers seem to.

Finally, probably my most compelling reason for not believing that sort of story about politicians and independent central bankers have different time frames, really just does come from history. And that is, if you look back over, certainly, U.S. history, but I'd say in many other countries, when have we made mistakes? When has inflation gotten too high? When have we done other things wrong? By and large, it's not been particularly correlated with central bank independence, it's been correlated with ideas. And when we go wrong is when we have screwy ideas about how the economy operates.

So, what all this leads me to is the sense that the main reason or rationale for central bank independence is expertise; that, by and large, we want to delegate our

monetary policy to an independent central bank because we think they'll do better, because monetary policy is really hard -- especially at the zero lower-bound, as John Williams' very nice paper from this morning gave us a sense.

And just as you wouldn't want to delegate, you know, the -- you wouldn't want Congress telling your physicist how to build your nuclear arsenal, you don't want Congress telling the monetary policy-makers how best to achieve price stability and maximum employment. So I think we want monetary policy made by experts because we expect the outcomes to be better.

Okay, so if I'm right that the main reason for central bank independence is expertise, because we want a monetary policy made by experts, I think that suggests sort of -- this is coming back, I think this is actually sort of where Don ended up -- that the biggest threat to independence is bad monetary policy decisions. Because then the central bank loses their main argument for independence: that they're better at it than other people.

And one reference in Don's paper, to Japan, I found it a little hard to parse. So, I couldn't quite tell if he was perhaps lamenting that the democratically elected government had replaced the governor of the Bank of Japan, and strong-armed more expansionary monetary policy. I think, in my view, 15 years of deflation had caused the Bank of Japan to lose its right to claim superior expertise.

I think an even more compelling example probably comes from the 1930s. In the Great Depression, I think the Federal Reserve thought it was taking actions that were consistent with what was written down in the Federal Reserve Act, and yet their policies were failing miserably. And I think, in that situation, it's only natural that central

bank independence comes into threat. At some point, accountability has to involve more than just the central bank providing information about why they're doing it. At some point, if they're failing dramatically, elected officials should, in fact, take appropriate actions to fix the situation.

So, if the biggest threat to Fed independence is for policy, I end up exactly where Don is, which is the biggest counter to that threat is good policy. And so, as Don points out, if the Fed or some other central bank doesn't take actions that it knows to be correct, or thinks to be correct, because they're afraid of how Congress will react, that's just going to be a disaster. That is, in fact, going to tend to lower their independence rather than strengthen it. Or -- I had exactly the same analogy that Don had: the best defense against the threat to independence is an offense in the form of good policy.

Finally, let me just end up and sort of agree with the last point that Don made: his concern about political partisanship. But, again, I think I take it in a little bit of a different direction.

I think the thing that worries me most about rising partisanship is kind of the flip side of that, which is a decreasing support or belief in the value of expert opinion. And we see this not just with monetary policy, but with fiscal policy, with climate policy -- you name it -- I think we're seeing this across the board.

And so, I think some of the decline in the support for experts, certainly on monetary policy, can be countered by the Federal Reserve doing an even better job of explaining why their doing -- compelling testimony, all of those things. And I think here's where Chairman Bernanke, I think, has made great strides. And I think the greater transparency of the Fed under his watch, I think, will be one of the lasting contributions.

But I think the battle needs to be fought much more broadly -- by the press, by academics, by ordinary voters. And I think it's fabulous we have the Hutchins Center, because I think that's going to be another voice fighting for the importance of expert opinion. Because I think only if we reestablish the value of expertise and evidence-based policy-making, can we squelch what I see as sort of the fundamental challenge to Fed independence, and actually to good policy-making, more generally.

MR. WESSEL: So, in an era where everything has to be boiled down to a 140-character tweet -- I can't quite count if I can do this right -- so the point is: independence, but only for intelligent central banks.

MS. ROMER: That's a fine tweet.

MR. ROGOFF: Well, let me pick up where Christy left off, of saying that, you know, in this world where debates become increasingly partisan -- and I wouldn't just say "expert opinion," but, in general, the center has been just destroyed and drowned out -- it's a pleasure to be here at the founding meeting of the Hutchins Center, which aspires to have nonpartisan analysis.

I agree, maybe more broadly, with Don's paper than you did, Christy -- although I accept the points you made. It's a very understated paper, but he expresses some pretty horrific concerns about what can happen --

MR. WESSEL: You have to work on this, Don --

MR. KOHN: I'm sure with your help, David, get that journalistic --

MR. ROGOFF: If I can, you know, blend it in with the Williams paper that we had earlier, it sort of very candidly admits -- again, in an understated way -- that economists know less than they thought they did in understanding business cycles,

especially today. And I would go to, absolutely we need to look more at history.

There's been everything focused on a couple decades which don't tell us that much.

The models -- they actually, it's not that they don't have financial markets, that they have perfect financial markets, that nothing can ever go wrong, and then you don't have to study them. And, of course, they're the core of the problem that's going to take us a long time to fix.

And then, the interplay of this involves the non-linearities. Yes, graduate students are studying this. No, they won't have the answer in the next 5 to 10 years.

And so we exist in this world of tremendous uncertainty, where we won't know if monetary policy had it right. Ben Bernanke wrote his 1983 paper about the Great Depression, it was, you know, 50 years later, there was a big rethink of what we should have done.

And so I certainly come down on the side of having central bank independence as being very important, expertise as being very important. It is an environment where it's very difficult to preserve.

Let me just finish on a couple points, understanding the Chairman is about to walk in.

Certainly, I do think institutions, forecasting, needs to be re-calibrated to that. As John pointed out in his paper, we live in a world where we may have cycles more like we had before World War II, something more often than we used to, and where we see them around the world. And Carmen Reinhart and I have certainly emphasized this point also. And then that may mirror back into inflation-targeting

regimes, how you want to design institutions, which were fine-tuned for this more benign environment that we had before the crisis.

And let me, lastly, say that there was discussion about monetary policy, fiscal policy, where it could have been inadequate. I think some of that was based on the forecasts' not being correct.

I have to say my biggest disappointment in the policy response to the financial crisis has not been in either of those. It's really been in structural reforms. Where is our third arrow? Where are the reforms that are going to generate, you know, more long-term growth in the United States?

Simpson-Bowles, I think, had some good ideas about tax reform. Didn't happen. Dodd-Frank has 30,000 pages, when you do all the legislation, but I think it's missing high equity ratios, and such.

And, of course, having more infrastructure investment is something that all economists seemed to agree on all along, but it didn't happen nearly to the extent we have.

So, certainly these are problems that need to be studied holistically, and present challenges, because the Fed gets blamed for everything.

MR. WESSEL: Ken, thank you.

Ken -- well, that's definitely true. And that's good, because if the Fed doesn't get blamed, then the press gets blamed.

So, Don says the evidence is central banks have to be independent, because otherwise we get a lot of inflation because the politicians are short-sighted. Christy says it's a nice thought, but it's not supported by the evidence.

Do you have a side in this?

MR. ROGOFF: Well, I mean, I think I tend to think that -- I mean, of course it's better to have expertise than -- the Federal Reserve made mistakes in the Great Depression because they had almost no expertise. But if you ask any central banker, there are 99, or maybe 999, pressures for lower interest rates compared to higher interest rates. And I think something I'd echo in Don's paper is that, you know, if you think that there were complaints about the policy now, wait until you see when the Fed has to tighten.

MR. WESSEL: All right.

MS. ROMER: Actually, could I just -- could I disagree with that for second? Which is -- I mean, listen to some of the pressure coming out of Congress today. I think there's maybe -- I'm sure there will be pressure on that direction when the Fed tries to raise rates, but there's a lot of people in Congress that are saying, that are champing at the bit for the Fed to tighten, to certainly dial back a lot on extraordinary measures.

So, I'm not -- I actually think the pressures may be more balanced than you two think.

MR. KOHN: Although my experience, sitting behind chairmen for about 30 years, was there were many more Congressmen arguing for lower rates, or not raising rates than were arguing for raising them.

MS. ROMER: I think that gets back to this "maybe the world has changed." I think we have to be a little careful not to be fighting the last wars, and to know where the pressures are today.



MR. WESSEL: Maybe this time is different? Is that --

MS. ROMER: Maybe this time is different.

MR. WESSEL: We have time for a couple questions.

Peter Fisher, here.

MR. FISHER: Have we got a mic?

MR. WESSEL: It's coming.

MR. FISHER: Peter Fisher, of BlackRock, Dartmouth and BlackRock.

A question for all of you, but Don in particular: Is a GAO report really the right place to draw the line? Can any of the four people up there point to an irresponsible GAO report that incited Congress to go off in an irrational direction? Is that really -- aren't there more important places to try to draw the line on central bank independence than a GAO audit function?

MR. KOHN: So, I don't -- I haven't studied GAO reports, and agency responses to them. I don't think the GAO, a GAO report would be a disaster for central bank independence. But I do think it does move the needle a little bit. It would be used by Congress as a tool against the Federal Reserve. And mostly my concern, still -- I mean, I agree with what Christy says about expertise, and things have shifted -- will be that the concerns will be more intense when they start raising rates.

And it's not a big deal. And, as I said, the Fed can just ignore the GAO, and ignore the call for the report. But I just see it moving in the wrong direction, even if it's not a big deal.

That wouldn't -- you know, there would be other things that might be proposed that I would see moving it even in worse -- even by more. But it just seems like the wrong direction, at the wrong time.

MR. WESSEL: Andy?

MR. LEVIN: So, I just wanted to connect --

MR. WESSEL: Please tell us who you are.

MR. LEVIN: Oh, sorry -- I'm Andy Levin, from the IMF.

To connect it up to the previous discussion -- it seems like between goal independence and instrument independence, there needs to be something maybe we could call "strategy" and "contingency planning."

And one way to think about this -- which, again, is very consistent with "this time is different," sort of -- but in normal times, you may have a doctor that you see occasionally, and if you, you know, think he's doing a good job, you keep going to the same doctor. And, if not, you switch. That would be kind of goal -- you know, the goal is to be healthy, and the instrument is the doctor kind of figures out, you know, what to do, on a regular basis.

When you're in unusual circumstances, like your child is sick and may have to have surgery, you'll want to consult much more closely with the physician, maybe with multiple physicians, and talk through the strategy -- which type of surgery, what other sorts of treatments could be appropriate -- and be much more involved in those decisions.

Now, when it comes to the actual date of the surgery, in the operating room, of course, the doctor and the other assistants have to be able to use the scalpels,

and, you know, decide how the surgery is going to take, and those sort -- so there is a level of instrument independence.

But I think these distinctions of what we're seeing today in the political world -- and so, in that sense, again, maybe this is a direction that Don can expand, in consultation with David, in thinking how to communicate this to the public. Because I think we've been in a situation the last five years that's more like a sick child, where the parents are very, very concerned, and where there are tough decisions -- which surgery, and what are the risks, and so forth.

MR. KOHN: So, I think -- I agree, it's very -- part of the accountability -- it's not so clear cut. And, especially in the case of the Federal Reserve, where the Congress has given very vague goals -- maximum employment, stable prices -- and it's been up to the Federal Reserve, and they've done a good job, particularly in the last few years, defining those goals a little better so they can be held more accountable for them.

But the strategy -- they've also done more about defining the strategy.

So, I completely agree that consulting -- part of the accountability is consulting on the strategy, explaining how the strategy is supposed to achieve the objectives, what the risks are on either side. And I think, under Chairman Bernanke, the Fed's made huge strides in that direction.

But will there be challenges for Chair Yellen? You bet. And more to be done.

So, that communication and consultation is definitely part of preserving independence.

MR. WESSEL: We have time for one more, if there's one. Way back there.

SPEAKER: I'm (inaudible) from the IMF. I have a question for any of the panelists. And it's related to whether central bank independence is viable in an environment of, let's call it, "fiscal dominance." We could cite a number of examples in emerging markets. I don't want to talk about the U.S., what could happen in the future.

But the question is, is central bank independence viable in an environment of fiscal dominance?

MR. WESSEL: Ken? Why don't you -- just define "fiscal dominance" first.

MR. ROGOFF: If the government's desperate for money, they'll make the central bank do what it wants. So, of course, the answer is no. I mean, but this is a matter of degree.

So, you know, certainly, governments can be creative in dealing with their debt problems in lots of ways, short of pressing the central bank into inflation. And they can go through a long menu of options -- which, again, Carmen Reinhart and I have written about.

But, yes, you know, if it's bad enough, that happens. I don't think we're talking about that in the United States nearly yet.

MR. WESSEL: Thank you.

Well, with that, join me in thanking our panelists. (Applause.)