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Central Bank Independence – a Victim of the Crisis

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Introduction

Over the past twenty years central bank independence has been embraced enthusiastically almost worldwide. Led by New Zealand, where monetary policy had been politicised in the sense of being used for short term political advantage with damaging effects for the economy, the idea that giving the central bank responsibility for and control over monetary policy would lead to better monetary performance caught on almost worldwide. More and more countries gave their central bank independence. Some countries, indeed, did it as a way of demonstrating the intention to be monetarily responsible – that was the declared intention of, for example, the Labour government that took office in Britain in 1997.

Economists by and large supported this endeavour. A substantial number of studies (e.g. Bade and Parkin (1987), Masciandaro and Tabellini (1988) and Alesina (1988 and 1989)) were published demonstrating that low inflation was associated with central bank independence, and theoretical work by Barro and Gordon (1983a and b) and subsequently Cagan (1986) and others showed that there were reasons to expect this association.

But in the wake of the financial crisis which started in the past decade but is still with us, albeit somewhat abated, central banks seem to have moved, or been taken, closer to government. The ECB is buying up government debt without apparent regard for the effect the extraordinary growth of its balance sheet is likely to have on future inflation. So, too, is the Bank of England. Indeed, that institution seems to disregard not only future inflationary dangers but current inflationary outcomes, and has become the main buyer of British government debt. And the US Federal Reserve, although it never had a clear inflation mandate, has certainly and admittedly for the foreseeable future stopped paying heed to inflation at all.

Our view is that this should not be a surprise. We would argue in fact that central bank independence never has and never can survive a crisis. We make this point by use of economic analysis, and support it by evidence drawn mainly from Britain – because of the length of its central bank's history – but not exclusively from there. Indeed, we suggest that there can not really be such a thing as a truly independent central bank.

The Argument

Most economists who have written on central bank independence took it for granted that what it meant was clear, and sought how to measure it. There was of course no doubt that independence meant freedom to conduct monetary policy. But was this freedom totally unconstrained?

Freedom to take policy decisions seemed an obvious concept, and that was taken as being clear and detailed enough to be satisfactory for the purpose at hand. In a much earlier paper, however, one which concluded by recommending not central bank independence but a monetary rule as the best guarantee of price stability, Milton Friedman(1962) devoted some time to considering the meaning and inevitable corollary of independence.

He writes, "The device of an independent central bank embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to- day plaything ....of the current political authorities". (p178)[1] Then he went on "A first step in discussing this notion critically is to examine the meaning of 'independence' of a central bank. There is a trivial meaning that cannot be the source of any dispute about the desirability of independence. In any kind of bureaucracy, it is desirable to delegate particular functions to particular agencies."(p 179) At this point Friedman gives the example of the Bureau of Internal Revenue as an "independent bureau" within the US Treasury. As he said, "This is simply a question of expediency and of the best way of organising an administrative hierarchy." (p179)

What he called a more basic meaning of independence is that "...a central bank should be an independent branch of government coordinate with the legislative, executive, and judicial branches, and with its actions subject to interpretation by the judiciary"[2].(p179)

That is the meaning which most writers have implicitly applied to the concept of an independent central bank. Friedman was concerned about the democratic accountability of such an institution. But these were not his only grounds for rejecting the proposal. Independence might, he said be "only a matter of words" if the bank's authority were narrowly defined and its policies tightly specified. This takes us to the point where the importance of his discussion for the present study becomes clear. If the central bank is to be independent in the sense in which, say, the judiciary is independent, then it requires a set of instructions to follow just as judges require a set of laws to implement. Further, as is desirable with laws (but not always attained) the instructions must be sufficiently clear that the legislature's intentions are either carried out, or, if they are not, it is clear that they have not been.

Friedman reviews three proposed solutions for the problem of ensuring that so long as government is responsible for money it can not by debasement abuse that responsibility. He considers the following three solutions: an automatic commodity standard; an independent central bank; and a rule binding the conduct of policy. An automatic standard, such as gold,

[1] All page references to this Friedman article are to the1968 reprint.

[2] Recently both the ECB and the Bank of England have had their actions reviewed by the judiciary, albeit over very different issues.

has tended to develop towards a "mixed" system with a substantial fiduciary component. Further, it is not now feasible: "....the mythology and beliefs required to make it effective do not exist". (p 177)

Many advocates of an independent bank recognise the current impossibility of a commodity standard, and view an independent bank as an alternative way of getting price stability. Hence, together with the widespread acceptance that inflation is not desirable, we have central banks given instructions to focus on maintaining some measure of price stability.

The Reserve Bank was given a clear statutory objective - to maintain stability in the general level of prices. (Reserve Bank Act 1989, s8) New Zealand has a floating dollar. There are provisions for the Bank to intervene in the foreign exchange market - but such interventions can occur only on the basis of a written *and published* directive. There are no limits on the central bank's ability to finance the government. It may seem curious that there be no restrictions on debt monetisation, particularly as New Zealand had in the past experienced inflation because of such monetisation. Legislation against this was, however, thought to be both unnecessary and undesirable. Unnecessary in view of the full-funding commitment the Government had previously adopted. Undesirable because it could constrain actions undertaken for, say, liquidity management or in the course of a lender of last resort operation.

There is much detail in the Act that we have omitted, but the above describes the main aspects.[3]

Unlike the situation in many countries after the crisis, no changes took place in New Zealand to the act governing the central bank[4]. This reflects several factors, and it is not possible to separate them. There was no widespread financial crisis in New Zealand – there were substantial problems, but in one part of the finance sector only, and that a part outside the remit of the Reserve Bank. (See Mayes and Wood, 2012.) But worth emphasising is that the Reserve Bank had a constitution which actually encouraged it to think about financial stability and the role of lender of last resort. That was, explicitly, the reason that there were no restrictions on Reserve Bank purchases of government debt. Hence the specification of the Reserve Bank Act had been such as to make the institutions it produced more robust. It did not however deal with all eventualities. This can be seen by considering the recent (almost) worldwide crisis.

Banking crises can be of two types, although they rapidly merge into one another. The classic banking crisis is that which Lender of Last Resort evolved to deal with – a sudden surge in the demand for liquidity by the entire banking sector.[5] The New Zealand Act was consciously

[3] More details can be found in Knight, R. L. (1991)
[4] Nonetheless, towards the end of 2012 the opposition parties in the New Zealand parliament tabled a Bill to add further objectives in the US style to the RBNZ's inflation mandate. It failed by one vote, with voting along party lines.
[5] See Wood (2000) for a detailed description of the evolution of Lender of Last Resort.

framed both to direct the attention of the Reserve Bank to the possible need for this operation and to allow it to take place.

But there is another type of banking crisis, much rarer in the whole run of recorded banking history but one that has occurred twice in comparatively recent years – one due to a shortage of capital not in one bank but across all or most of a banking system. This was the source of Japan's banking problems and also the original difficulty in the recent crisis. (See e.g. Lastra and Wood, 2010.)

There is no provision in the Reserve Bank Act to deal with a "capital" crisis. It was not there because it was thought such crisis could never happen, nor was its absence due to a desire to allow banking system failure under such circumstances. Rather it was due to no more than lack of complete foresight, and thus the inability to write a complete contingent contract dealing with all possible states of the world.

And that is fundamental problem. It is impossible to design a contract so complete that nothing ever happens to require its being rewritten, thereby letting the government of the day tame or at the least reshape the central bank. That is the basic reason for almost every financial crisis leading central banks into the arms of government, for assistance, relaxation of law, or some other form of support or guidance. This point is supported by examples in the following section of this paper.

The Evidence

Some historical experience in two of the world's major central banks, the Bank of England and the Federal Reserve, illustrate many aspects of the problems we discuss.

The Bank of England was founded in 1694 out of the needs of the state to finance war. In return, the Bank was given a charter from the state that gave it a privileged position in banking in the country. The renewal of the charter clearly rested on the Bank's satisfying the state's requirements. And so began a relationship of dependency. The state needed the Bank and the Bank relied on the state for its privileges. When the Bank's charter was renegotiated in 1697, for ten years, it was given protection from competition from rivals; and its position was strengthened further in the renewal of 1708 when a fresh loan was required from the Bank. On that occasion other banks were restricted to six partners or fewer, and the Bank was given a monopoly of note issue in joint stock banking, in effect a joint stock banking monopoly. The Bank's position depended on its fiscal usefulness to the state.

Britain was at war for more than half of the years between 1688 and 1815 and the closeness of the relationship between Bank and government grew ever stronger. The state needed finance for war and the Bank either provided it or organised it, so that by the end of the eighteenth century the government saw the Bank as an essential component of its war finance programme. In the wars with France at the end of the eighteenth century the government would take bills in large volumes to the Bank for discounting. The Bank would put up a show of resistance but there was no question of it not complying with the state's wishes.

Government then rewarded the Bank for its co-operation in wartime by giving its notes de facto legal tender status in 1811 (de jure in 1816). In the world after the Napoleonic wars the Bank's fiscal usefulness was in decline and so the case for the monopoly in joint stock banking was eroded, and it was soon abandoned.

In the nineteenth century the Bank's independence was still limited. In the first place the Bank's essential function was management of the gold standard and so it was heavily constrained by the rules of the gold standard and particularly so after these were redefined in the legislation of 1844. The main objective was to maintain convertibility of the currency into gold and the main control instrument was the short-term interest rate. The interest rate was made effective by discounting bills and, increasingly as time passed, by open market operations. These were all things the Bank became expert in and it was left to get on with the job without political interference.

However, a financial crisis that involved a scramble for cash presented a serious problem. In the crisis of 1825 the government instructed the Bank to pay out to the last penny. Instruction was needed as it was feared the still privately owned bank might otherwise have looked after its immediate profits due either to insufficient heed to the long term or to caution over its own survival. The 1844 legislation made it difficult for the Bank to perform its key role in a crisis, that of lender of last resort. The act needed to be suspended and that required a letter from the Governor to the Chancellor seeking the necessary exemption. That happened in the crisis of 1847 and again in the crisis of 1857. Then again at the height of the Victorian boom in 1866 crisis struck again in the famous case of Overend Gurney. The Chancellor agreed that it was, 'requisite to extend their discounts and advances upon approved securities, so as to require issues of notes beyond the limit allowed by law.' But he continued: 'No such discounts or advance, however, should be granted at a rate of interest less than 10 per cent, and Her Majesty's Government reserve it to themselves to recommend if they should see fit, the imposition of a higher rate.' (Quoted in Fetter. See also Gregory.)

So when crisis struck the rules were such that government again dictated how the Bank should behave. Fetter concluded for the nineteenth century, 'the Bank and the Government ... continued the fiction of official independence' (Fetter p.280).

That was true again in 1914. At the outbreak of war in August 1914 there was a major crisis. The Governor was invited to a meeting in Downing Street and told to sign a statement and to promise the Bank must act on the direction of the Chancellor. Cunliffe, the governor, initially refused to sign and had the support of the Bank. But some face saving was allowed and Cunliffe agreed to comply.

For the interwar years the Bank of England was of the view that it should be 'operationally and institutionally distinct from government' regarding this as independence, but 'it should accept Treasury control of policy'. In the 1930s Montagu Norman told a meeting of Commonwealth bankers, 'I am an instrument of the Treasury'. Following the Great Depression when the blame fell on bankers, both central and commercial, their room for manoeuvre became further circumscribed.

It is often assumed (or asserted) that after the Bank was nationalised by the Labour Government in 1946 everything changed and the Bank thenceforth became a subsidiary of the Treasury. But in fact very little changed. While there were complex drafting requirements to specify the functions, powers, and purposes of the new public corporations being formed after the war, in the case of the Bank this was unnecessary because there was 'never any question that it should not continue doing what it had been doing for a very long time'. (Chester, p. 196.)

The Radcliffe Committee that was established to enquire into the nature of the monetary system was particularly concerned to bring the Bank to heel and have the Treasury clearly dictate the terms. The question of Bank Rate setting was partly one of principle and partly symbolic. The Bank took a strong line from which it never deviated: this was an operating rate and only the Bank knew which way it should be moving. This was largely accepted by government. The Bank delegated its power to set Bank Rate to the Governors, with the Chancellor giving formal approval to any change. And that was essentially what happened. The Bank would, primarily for external reasons, decide that a change in the rate was required. It would notify the Treasury of their view and expect to have the decision rubber-stamped. There are some isolated examples of disagreement for political reasons or for timing but generally these simply took the form of the Treasury suggesting a delay of a week or some such trivial alteration.

Across the period from the 1950s to 1980 the Bank operated with considerable freedom, what it liked to think of as independence[6]. Its principal function of defending the exchange rate was restored. Bank Rate was regarded as primarily of use for external purposes. And movements in Bank Rate were not merely executed but determined by the Bank. Whenever there was a developing threat to sterling the Governor would tell the Chancellor that a rate change was proposed on a particular date. The Chancellor's reply was simply stamped 'approved'. The relative freedom began to come under serious pressure in the 1970s following the loss of the explicit exchange-rate target and when monetary targets were in place monetary policy was increasingly politicised and politicians and civil servants had a simple number which they wanted to see met or be told why it was not.

From the Bank of England's foundation a dependent relationship with government was accepted. Since the country was at war more often than it was not between 1688 and 1815 and the state needed funds it needed the Bank and the bank depended on the state for its privileges. In the nineteenth century whenever crises flared, under the gold standard the Bank needed government approval to act in the necessary way and that came with conditions. In the first half of the twentieth century war dictated much of what happened when again the Bank responded to the needs of the state. There was a brief period after the Second World War when another exchange-rate target was in place when the Bank enjoyed relative freedom of action but that all came to and end in the debacle of the 1970s. The next attempt at restoring some independence in 1997 has lasted only so long as there was no crisis.

[6] See Capie (2010)

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When the Federal Reserve was founded in 1914 financial stability was its chief focus and it was intended that the bank be independent of political influence. It was founded after a long period of peace but war broke out soon after and the Fed was almost immediately involved as the Treasury's banker. (Further, indicating another level of independence, the twelve district banks were free to operate independently of each other.) The Federal Reserve Act was quickly amended so that banks could borrow from the Fed using government securities as collateral. Inflation followed but the Fed could not raise its discount rate without Treasury approval. So it did not get off to a good start in terms of either independence or inflation control and it took some years after the war before it returned to its intended path of being an independent institution. In the years after the War and particularly following the recession of 1920-21 the Fed discovered open market operations and the Open Market Investment Committee was established. The New York Fed became the dominant bank under the leadership of Benjamin Strong.

Hardly had the post-war adjustment taken place before new problems confronted the Fed, at the end of the 1920s, and its actions and its failures to act resulted in the Great Depression. (Friedman and Schwartz, 1963) Following the Great Depression and the criticisms, subsequent and sometimes consequent, that were made of banks and central banks the Federal Reserve Act was again amended, by the Emergency Banking Act of 1933. That Act, amongst other things, gave the President powers to regulate credit, whatever that may mean. But calls for greater reform were strong and a new Banking Act was designed, for implementation in 1935. Initially the principal aim had been to provide a small but flexible monetary authority with its independence restored. The vague mandate that the Fed had been given in 1913 was preserved in the 1935 Act. And in the 1930s if the Fed did not stay in line with the Treasury's wishes it was readily brought back into line by the Treasury acting through the new Exchange stabilisation fund or other Treasury accounts. Meltzer (2009) is critical of the chairman of the time, Marriner Eccles, who, he said, failed to defend the Fed's independence under Roosevelt.

In any case within a matter of a few years there was war again and in war the Fed was obliged to support the prices of government securities. It was an instruction in time of crisis. Tensions arose immediately between the Treasury and the Fed, with the Treasury seeking low rates to support the sales of bonds for war finance. In 1942 Federal Reserve banks were authorized by government to buy government securities directly from the Treasury. The dangers this gave rise to remained in place for years after the war. Throughout the period of low interest rates commercial bank reserves grew hugely and the inflationary dangers rose with them.

These tensions between the Fed and the Treasury over interest rates came to a head in 1950 and there broke out what has been called the 'greatest battle in the history of central banking' (Davis 2012). Sproul of the New York Fed was sufficiently worried after the outbreak of the Korean War in 1950 to force the issue. In what he saw as a dangerously inflationary situation

he thought it was time to exercise some independence. So the Board of Governors announced rate increases and indicated they would take further action if required to restrict credit.

The turning point came in January 1951. There was a special meeting between the FOMC and the President. That meeting was a direct consequence of an instruction by the Treasury to the Fed to buy government bonds at a specified price. The Treasury released a public statement after the meeting that suggested that the Fed would do as it was told. This so enraged Eccles, still a board member though a former Chairman that he broke confidentiality rules and gave the press the Fed's record of the meeting. The Fed's record had suggested no such thing. Discussions then began in earnest between the parties. These led to the Accord of March 1951. The Chairman (McCabe) resigned soon after and his replacement was William McChesney Martin Jnr., the Treasury assistant undersecretary, who had conducted the meetings on the Accord. This might have looked like a cynical Treasury move but subsequent events indicate otherwise. Some see the Accord as the turning point in the Fed's history, the point at which it became a truly independent central bank. How true that is will continue to be debated. What it does for our purposes is remind us of how fragile independence can be. When any kind of emergency appears the dangers are that the response to these circumstances will be legislation that seems at the time entirely appropriate to the problem. But it then weakens the central bank's position when normality is restored. Although Martin went on to become the longest serving Chairman of the Fed, and is generally credited with maintaining the Fed's independent position, he still held a slightly ambiguous view of independence. He liked to repeat the words of Sproul that the institution should be, 'independent within government not independent of government'. Does that match Friedman's favoured definition of independence? It might, but then it might not.

Conclusion

So, just as the second section of this paper showed that the inability to write complete contingent contracts ensures that independence is compromised in a crisis, the previous section demonstrates one route by which that compromising occurs – emergency legislation whose scope after the crisis turns out to be greater than had been realised at the time.

Reactions to the recent crisis may turn out to be an example of that; but whether they are or not, they certainly exemplify how a crisis can thrust a central bank into the arms of its government.

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