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Central Bank Independence: More Myth then Reality

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Central Bank Independence: More myth than reality[1]

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Central bank independence (CBI for short) became one of the buzz words of modern economics about 30 years ago. It remains the cornerstone for monetary policy discussions and central banks around the world espouse its importance. In this paper we address two questions: first, how did this come about and second, is it true?

CBI emerged as a widely held tenet of policy makers as a result of four disparate influences. First, the inflationary episodes of the 1970s led to a great deal of dissatisfaction with central banks which were blamed for allowing it to happen. There was a strong feeling that central bank organization, governance and policy making needed to be rethought. Second, central banks were being established or re-established in many countries, in developed countries, ne

wly independent countries and lastly in the transition countries. In every instance the role and position of the central bank in government structures needed to be defined. Third, the rational expectations revolution in macroeconomics led to major changes in thinking about the role of monetary policy. Lastly, initial empirical investigations suggested that countries with more independent central banks seemed to experience less inflation. By 1990 or so, there four

[1] Earlier versions of this paper were presented at the Colloquium on "Money, Debt and Sovereignty"Université de Picardie Jules Verne, Amiens, France, December 11-12, 2017; the XXVI International Rome Conference on Money, Banking and Finance LUMSA University, Palermo, Italy, December 14-16, 2017; the Conference on Financial Resilience and Systemic Risk, London School of Economics, London, January 30-31, 2019; and the Center for Advanced Studies on the Foundations of Law and Finance, Goethe University, Frankfurt, Germany, May 20, 2019.

influences came together with the almost universally held conclusion that central banks should be independent of political influence.

As a result, the idea that CBI is an essential principle of proper central banking is often taken for granted. In this essay we will take a closer look. First, we will look at the origins of the idea --- how did it emerge as one of the accepted truths of economics. Second, we will look at the expanded role of central banks in the post crisis era which calls for a reexamination of CBI. Third, we will look at the relationship between governments and central banks and discover that independence is often exaggerated. Central banking has never been above the political fray.

<u>History of an idea</u>

The earliest mention of CBI that I have been able to identify is Milton Friedman's 1962 essay titled "Should there be an independent monetary authority?" Friedman states that the central bank should be organized with the "objective of a monetary structure that is both stable and free from irresponsible government tinkering" (p. 224). He considers three organizing structures beginning with a commodity standard which he dismisses because a fully automatic standard is not feasible in a complex banking system; the Classical Gold standard never truly existed and recall that Friedman was writing at a time when gold still had some monetary functions.

He then turns to the proponents of an independent central bank and notes that "so far as I know, these views have never been fully spelled" (p. 224) which leads me to suspect that the term independent central bank originates with Friedman. A central bank exists with "a kind of monetary constitution" which specifies its objectives and tools and establishes a bureaucracy to carry out the mandate. An independent central is one whose mandate to achieve responsible control of monetary policy is unaffected by anything the government might do. An independent central bank would "not be subject to direct control by the legislature" and presumably the executive as well. In Friedman's argument, a completely private sector central bank like the pre-war Bank of England might have such characteristics although Parliament could always revoke its charter, just as government could change the underlying monetary constitution for an independent central bank. Regarding independent central banks, Friedman avers:

> "[i]t seems to me highly dubious that the United States, or for that matter any other country, has in practice ever had an independent central bank in this fullest sense of the term. Even when central banks have supposedly been fully independent, they have exercised their independence only so long as there has been no real conflict between them and the rest of the government. Whenever there has been a serious conflict, as in time of war, between the interests of the fiscal authorities in raising funds and of the monetary authorities in maintaining convertibility into specie, the bank has almost invariably given way, rather than the fiscal authority. (p. 226-7)

The irony of this early discussion of an independent central bank is that Friedman rejects it. He finds it intolerable "in a democracy to have so much power concentrated in a body free from any kind of direct, effective political control" (p. 227).[2] On a technical level, Friedman is concerned with the dispersal of authority between the central bank and other parts of the government, the dependence of the independent central bank on strong personalities and the tendency for bankers to dominate the independent central bank.

Friedman believed that an independent central bank ("wide discretion to independent experts" (p.239)) is not the answer. Instead he prefers legislation that specifies the rules for the conduct of monetary policy and restricts discretion.[3] Rules maintain public control through the legislative process and insulates policy from the diurnal whims of politicians. Friedman became a powerful proponent of rules as seen for example:[4]

> "….let us be done with the fiction that "independence [of the Fed] is somehow or other a bastion against inflation. Let us put the responsibility for the rate of money growth – and therewith the subsequent inflation—squarely and openly on the Administration and Congress….let the Congress require the Fed to achieve specified rates of monetary growth within specified ranges of tolerance." *Newsweek,* October 3, 1977, p.84.

The arguments in favor of an independent central bank began to crystallize in the 1980s after a decade or more of traumatic inflationary experience which put a spotlight on central bank policy making and its failures.[5] Banaian, Laney and Willett (1986) discussed the emerging political economy literature on CBI. CBI became the focal point of discussions of central bank practice for four reasons.

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[2] His proof by example is based on his interpretation of the memoirs of Emile Moreau, Governor of the Banque de France. Moreau derisively or perhaps jealously depicts Montagu Norman and Hjalmar Schacht as contemptuous of democracy and firmly believing that they knew what was best for the world.

[3] For a brief discussion see https://www.stlouisfed.org/publications/regional-economist/january-2003/rules-vs-discretion-the-wrong-choice-could-open-the-floodgates . Also pp. 64-67 of the House Committee on Financial Services, Comprehensive Outline for a summary of recent views http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf

[4] The quote is found in Parkin and Bade (1978), a rarely cited paper, published in an Australian conference volume, which is the earliest empirical treatment of CBI. The idea of policy rules took a back seat in the 1980s and 1990s and later as CBI became the ascendant and dominant approach to central banking.

[5] Friedman did not change his view that independence does not provide an adequate incentive to pursue monetary stability (see Friedman, 1982) even as theory and evidence to support CBI was accumulating.

First, the emphasis on independence can be understood in the context of the development of central banks generally. Although there are examples of central banks that have been around for a long time (the Rijksbank was founded in 1668 and the Bank of England in 1694), most central banks are of more recent vintage (e.g. the Federal Reserve in 1914; the Bank of Canada in 1934). Moreover, in many countries the institutions that functioned as a central bank did not have a formal definition of its role and relationship to the government codified until the mid-20th century. Further, in the post war period, many newly independent countries established central banks and had to define their relationship to the central government and planning mechanisms. Thus, there was considerable interest around the world regarding, to use Friedman's phrase, the monetary constitution.

Second, developments in macroeconomic modeling in the 190s and 1970s such as the natural rate of unemployment and the expectations augmented Phillips curve had implications for what a central bank can accomplish. Kydland and Prescott (1977) and Barro and Gordon (1983) introduced a rational expectations framework where deviations from the natural rate are associated with inflation surprises. A policy maker could temporarily bring the unemployment rate below the natural rate by surprising the public with a policy expansion. A related literature on political business cycle suggested that elected policy makers might take advantage of policy surprises to secure re-election (see Drazen (2000) for a summary of the early literature and the contributions by William Nordhaus and Alberto Alessina).

In summary, the macro theory arguments are twofold: (i) CBI insulates policymaking from political cycles and the temptation to pump up economic activity in advance of an election; (ii) CBI protects against the temptation that governments have to finance their activities by printing money.

Imagine that a central banker announces a low inflation policy which leads economic agents to form expectations and make decisions consistent with the policy leading to a low inflation full employment equilibrium. The policy maker who is keen to lower unemployment has an incentive to renege on its commitment with an expansionary monetary policy that reduces the unemployment rate. Of course, this opportunistic policy maker will quickly lose credibility and its ability to control inflation will quickly erode.

The fact that an opportunistic policy maker can temporarily achieve a low unemployment rate provides the basis for the time inconsistency problem. The policy maker facing an election will have an incentive to introduce an expansionary monetary policy that will reduce unemployment in the short run. The fact that the effect will be temporary and that in the long run – presumably after the elections - there will be an increase in inflation and unemployment will return to the natural rate is not of concern. Since the dynamics of unemployment and inflation effects are different, the elected official has an incentive to follow a short run policy.

The third reason is the inflationary experience of the 1970s. Inflation was economically disruptive, politically unappealing and hard to eradicate. It was appealing to blame central banks and to suggest changes in their governance as a solution. Time inconsistency and generally the temptation to monetize deficits were acknowledged as serious problems and reasons to take policy decisions out of the hands, at least directly, of elected officials and put them into the hands of an independent policy maker.

Finally, the rise of CBI to prominence was driven by empirical work that defined and measured central bank independence and looked at the relationship with inflation. As mentioned earlier, Parkin and Bade (1978) were the first to measure CBI as indicated in central bank laws but they only examined 12 major countries and their results did not attract much attention. A few additional papers looked at the relationships but with similarly small samples, rudimentary measures of CBI and uncertain results (see Parkin, 2013, for an overview). Cukierman, Webb and Neyapti (1992) attracted more attention with their results based on detailed data on the characteristics of central banks for 72 countries for the entire post-war period. Their work went a long way to canonizing the notion that more independent central banks do a better job at controlling inflation.

The empirical relationship is complex and some authors challenge the accepted wisdom (see de Haan, 2017, and Parkin, 2013, for references). First, the construction of indexes of independence involves arbitrary weightings regarding the relative importance of central bank characteristics and how to measure the extent of independence conveyed by different values. Second, the results are often sensitive to the composition of the sample; the negative relationship is strong among developed countries but not among undeveloped countries. Third, the measures of legal independence might have little to do with actual independence. The latter is hard to measure; survey responses or the tenure (or turnover) of central bank governors are commonly used. Fourth, CBI can be endogenous, reflecting the influence of a strong (anti-inflationary) financial sector or associated with strong, accountable, transparent democratic institutions in advanced countries. Acemoglu et al (2008) show numerous instances where central bank reforms were put in place after or as inflation subsided. Finally, the relationship is complicated over time as many countries have responded to the canonization of CBI by changing their central bank laws. Central banks are far more independent now than they were in the 1980s (Crowe and Meade, 2007).

From the very start the proponents of CBI were aware of these shortcomings and tried to address them. However, it is interesting to note that the empirical evidence is rather shaky for a relationship that has been extremely influential to policy makers and thinking about monetary policy. Econometric results can be important even when they are weak.[6]

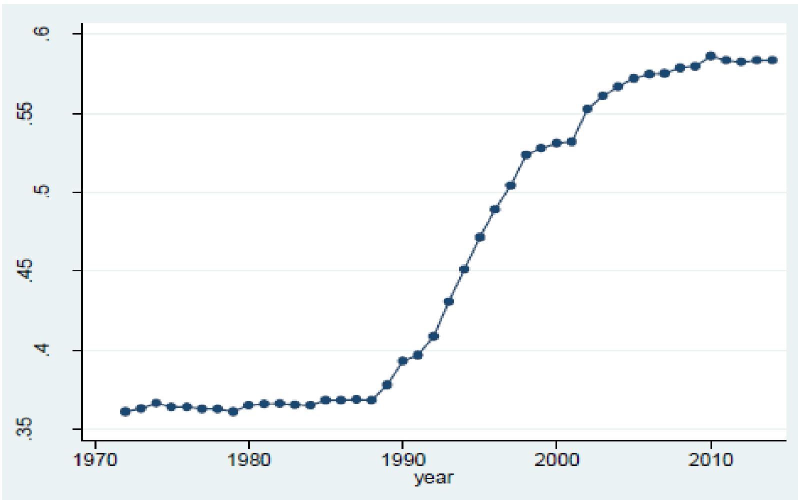
The compelling case for CBI also influenced governments around the world. In the 1990s the mean CBI index around the world rose rapidly and substantially as seen in the figure from de

[6] Another such example (Wachtel 2018) is the empirical work on the finance-growth nexus. It dates to the early 1990s and changed the way economists think about the influence of the financial sector on growth. The panel data studies were very influential but in many respects – appropriateness of the measures, sensitivity of the results, and lack of causality – not very strong results.

Haan (2017). The index is based on characteristics of the central bank legislation and policy procedures.

In summary, CBI moved to the forefront due to four factors – a) interest in central bank legislation and constitutions; b) reaction to high inflation; c) macro theoretical developments and d) the empirical evidence. All of these came together to build a universally convincing case that CBI is essential to constrain political influence and provide sound monetary policy. By the turn of the century there was a strong consensus view among economists, central bankers and governments in support of CBI. Central bankers found that CBI gave them the ability to ignore criticism and maintain policies that are consistent with long-run objectives.[7]

Figure 2. Average CBI (all countries), 1970-2014



Source: De Haan (2017)

Central bank independence today

The arguments regarding CBI are focused on the monetary policy role of central banks which only emerged in the post-World War II era as economists began to understand the importance of interest rates and credit aggregates to the macro economy. Historically, central banks, including some that were private sector entities, were explicitly agents to carry out government policy (Parkin and Bade, 1978). This would be true of the Bank of Japan, the Netherlands' Bank. Other independent central banks, including the Swiss National Bank and the Bank of England, did not establish their statutory independence until recently.

[7] For a central banker's explanation of the importance of independence, see Timothy Geithner, "Perspectives on Monetary Policy and Central Banking," March 30, 2005, a speech given at the Central Bank of Brazil, a country that has suffered the consequences of non-independence https://www.newyorkfed.org/newsevents/speeches/2005/gei050329 .

The traditional view of central bank functions is associated with the 19th century British journalist, Walter Bagehot, who articulated the idea that a central bank should act as the lender of last resort to the financial system. By providing liquidity, the central bank can prevent crises and preserve stability. For example, the Fed was established as a lender, to use discounting to maintain financial stability ("furnish an elastic currency" in the words of the legislation). The lending functions of the Federal Reserve and other central banks diminished in importance through the latter half of the 20th century as macro monetary policy became the focus and new policy tools were developed.[8] By the end of the 20th century, central banks were primarily associated with the macroeconomic policy role. However, the financial crisis of 2007-2009 brought a renewed emphasis on the lender of last resort function and the use of central bank lending to ensure financial stability.

The financial crisis caused central banks to rediscover the importance of their original function as the lender of last resort, to add new financial stability goals and tools such as macro prudential regulation, stress tests and monitoring systemic risk. In practice, financial stability has been added to the dual mandate of the Federal Reserve. How is CBI affected by this expanded, post crisis role of central banks?

The Bagehot dictum is that the lender of last resort facility is for solvent but illiquid institutions that can provide collateral. Access to the lender of last resort by insolvent institutions introduces an element of moral hazard, as banks would count on a bailout facility being available. Further, lending to an insolvent borrower does not end its need for support, and it can subordinate private creditors in any bankruptcy. These concerns were clear to Bagehot years ago, but are hard to maintain in contemporary crisis situations where it can be difficult to determine whether an institution is insolvent or merely illiquid. Moreover, the choice to support a possibly or potentially insolvent institution involves difficult judgments regarding when support is needed to avoid a costly systemic crisis.

There are three complex and closely related central bank functions: (i) setting monetary policy to attain its goals of price stability and maximum sustainable growth; (ii) providing a lender of last resort facility to financial institutions, which leads to an involvement with regulation and supervision; and (iii) maintaining the stability of the financial system as a whole. Historically central banking started with (ii), Bagehot's lender of last resort. It was almost forgotten in the calm of the post war period as central banks emphasized (ii), monetary policy. However, the lesson of the crisis is that all three are relevant.

CBI developed in the context of (ii), monetary policy making. How does it fit with the other functions? The lender of last resort function is a banking function. The central bank is lending to a customer, and just like any bank, it needs to know its customers. Thus, the central bank has

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[8] The eminent monetary historian, Anna J. Schwartz, concluded in 1992 that "A Federal Reserve System without the discount window would be a better functioning institution," p.68. The Fed did not follow her advice but took several steps in the 1990s to strengthen the discount window and encourage bank borrowing.

a role in bank supervision partly because it should be familiar with the condition of its potential loan customers. Further, it should be able to maintain some secrecy regarding lending so that solvent banks that access the discount window are not stigmatized or subject to runs. To conduct its banking functions, particularly in a crisis, the central bank needs to operate independently and out of the public eye.

However, when a systemic crisis looms, lending can go beyond Bagehot's dictum and represent a decision to bail out or at least support financial institutions in jeopardy of failing. In that case, the lending is a form of government support or an expenditure for specific activity. Bailouts are a fiscal decision, a government expenditure which should be subject to political oversight or input. In fact, the crisis responses of the Fed, the Bank of England, and the ECB among others included fiscal decisions and extensive cooperation between the independent central banks and their governmental partners.

Crisis responses challenge CBI and bring the central bank closer to the government in two ways. First, as just noted, a bailout can involve a fiscal decision which is the purview of the political structure. Second, bailouts, other crisis responses and macro prudential policies designed to maintain stability all involve distributional implications. Particular activities – loans to this sector or that – or particular institutions will be affected differently. Such asymmetries fall in the realm of political decision makers.

The 2007-9 crisis experience challenged the holy grail of CBI (de Haan, 2017). The crisis responses placed limits on CBI although there has been no formal retreat in the indexes that measure CBI. Governments rather than independent central banks were the primary decision makers in crisis responses including the use of TARP funds in the US, the takeover of Northern Rock and RBS in the UK. The ECB was established in the heyday of CBI and Article 130 of the Maastricht treaty enshrines a very formal conception of the bank's independence. However, the role of the ECB expanded in two significant ways during the crisis – it was a given a role in bank supervision and a role in providing financial assistance to certain member states. The expanded role calls for a redefinition of independence (see Mersch, 2017) and suggests that CBI might not be immutable but evolutionary.

As a consequence of the crisis experiences, discussion of the principles of central bank governance has moved away from CBI and now emphasize goal setting, transparency and accountability.[9] It could well be that independence is not important if these other features are in place. Another reason why CBI might be less important in the post crisis environment is that low inflation makes time inconsistency less relevant.[10]

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[9] See for example Chairman Powell's speech "Finanical Stability and Central Bank Transparency, May 25, 2018, https://www.federalreserve.gov/newsevents/speech/files/powell20180525a.pdf

[10] Thanks to Vedran Sosic for pointing me to comments by Lawrence Summers at http://larrysummers.com/2017/09/28/central-bank-independence/. However, low inflation may not be permanent.

For monetary policy, the line between CBI and the role of government was helpfully drawn by Debelle and Fischer (1994) who introduced the distinction between goal and instrument independence. The goals of the central bank are the prerogative of the political establishment. CBI then means that the central bank should be able to decide how to use its policy instruments in order to attain those goals. Simply speaking, Congress set down the goals of stable prices and maximum feasible employment and the Federal Reserve sets the Federal Funds rate and other policy instruments in order to attain the goals.

As we have seen, the financial crisis added, implicitly if not explicitly, a third goal – financial stability. In this case, the goal is harder to define operationally and the relationship to instruments is less well understood. Some stability actions – a bailout – are one-off decisions which involve a political decision and some involve policy tools – e.g. for macroprudential regulation – that are still being developed. The implication is that financial stability goal involves close interaction between the independent central bank and the government; CBI cannot be cleanly separated from the country's political institutions.[11]

With all our admiration for CBI, central banks are part of the government and have always been involved in the give and take of politics. It is silly to pretend that there is an ideal of CBI that sets them apart. This was a lesson of the financial crisis but, interestingly, it was always true. The idealized version of CBI was not really descriptive of the world that even the most independent central banks inhabit.

In order to examine the history and future of CBI, it will be useful to distinguish between a narrow and broad form of CBI. The narrow form relates to the monetary policy role of the central bank. The government sets the objectives of the central bank (e.g. price stability) and gives the central bank the mandate to choose instruments and use them to pursue the objective without interference from government authorities. A broader form of CBI relates to the ability of the central bank to pursue all its objectives without government interference. We will find that it is not uncommon for governments – now and then – to interfere with narrow CBI, macro monetary policy making. Nevertheless, the formal structures that create narrow CBI have not changed since the crisis. On the other hand, as already described, central bank activities have expanded, particularly in pursuit of a financial stability objective, and maintaining broad CBI that encompasses these activities is probably not possible.

Myths of Central Bank Independence

In this section we take a look at experiences of the US Federal Reserve which illustrate how closely tied up central banking, even macro monetary policy making, has been with political institutions.

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[11] For an early recognition of this in the political science literature see Goodman (1991).

The Federal Reserve and the President.

Although the Federal Reserve System is not one of the oldest central banks, it is one of the oldest with a clearly defined 'monetary constitution' that specifies its role. The 12 regional Federal Reserve Banks were established in 1914 as private entities with weak oversight from the Washington DC based Board of Governors. Independence was reinforced in the 1930s with the establishment of the FOMC and the removal of the Secretary of the Treasury from the Board. Although the Fed's formal independence is clear, most every post-war President has tried to influence its decision making.[12]

It took several decades for the Fed to develop its monetary policy role and it made serious missteps during the Depression. Independence was not considered during World War II when everyone agreed that the role of the Fed was to assist in war financing with low interest rates. The Fed was subservient to the Treasury and it continued to peg long term interest rates at 2½% even as inflation accelerated in the post war period. Low interest rates were popular and the policy record indicates that the Treasury was in charge; the Fed had little will or interest in resisting. Conflict emerged during the Korean War when inflation reached high levels as the prospect of large deficits loomed. The Fed was ready to react to inflation concerns, tighten policy and assert its legislated independence.

In January 1951, President Truman called in the Chair of the Federal Reserve Board and the Secretary of the Treasury for a meeting and announced afterwards that Fed had agreed to support the president and the stability of government securities through the war. Further, the Treasury added that interest rates would not change for the duration of the conflict. A virtual war erupted between the Fed which thought that its powers had been usurped and the executive. A few weeks later, Truman called the entire FOMC into the White House for a meeting. The war was fought in the press, fueled in part by Marriner Eccles (a former Board chair who kept his seat on the board when Truman appointed a successor) who released his notes of the meeting and contradicted the announcements (KC Fed, 2012).

The debate ended in March 1951 with the Fed-Treasury Accord. It was an agreement affirming that the Fed would assure the government's ability to finance the war and at the same time minimize the monetization of the debt. The Fed took this to mean that it was free to conduct monetary policy to combat inflation. The Accord was a singular event that affirmed the independence of the Fed. However, it is important to note that President Truman did not view the Fed to be independent despite its monetary constitution.

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[12] The statutory independence of the Fed was unusual at the time. Many central banks were agents to carry out government policy (Parkin and Bade, 1978). This would be true of the Bank of Japan, the Netherlands' Bank and others. Other independent central banks such as the Swiss National Bank and the Bank of England di not establish their statutory independence until well after World War II.

The Accord did give the Fed its operational independence but it by no means ended Presidential interference with the conduct of monetary policy. Tax cuts and spending on military operations in Vietnam led the Fed to raise interest rates in December 1965 which angered President Johnson. He called the Board chair and other officials to his Texas ranch to criticize monetary policy. Although the Fed stood its ground, the President did not readily accept CBI and tried to influence policy making (Fessenden, 2016).

An important instance of political influence over Fed policy involves President Nixon and Board Chairman Arthur Burns. Burns was a prominent academic economist and a Republican activist who managed Nixon's 1968 campaign. He remained close to Nixon after he was appointed chairman of the Board of Governors. Monetary policy was expansionary in 1970 and 1971 and the economy grew rapidly in 1972 while inflation was temporarily restrained by wage and price controls which had been introduced in August 1971. Nixon was reelected by a wide margin in November 1972.

Even at the time observers wondered whether the loose policy was an effort to insure Nixon's reelection or just an incompetent policy (or an honest misjudgment regarding the effects of price controls), see Cukierman (2010). The discussions were clarified when the Nixon tapes of White House conversations were released. Abrams (2010) finds several conversations showing efforts by Nixon to influence Burns. Although it is impossible to tell whether Burns' policy decisions were determined by electoral considerations, it is clear that the President made every effort to influence the Federal Reserve.

A close relationship between the President and his advisors and the Fed chairs continued into the Greenspan years at the Fed. Interestingly, the direction of influence may have reversed. Greenspan used his intellectual clout, political savvy and unparalleled reputation to influence Presidents.

Direct interactions between the President and the Chairman of the Board of Governors continue today. President Trump has made repeated public criticisms of the Fed in recent months. Using Tweet, he commented on December 24, 2018 after an increase in the Fed Funds target that "The only problem our economy has is the Fed." More specifically, on April 30, 2019:

> Our Federal Reserve has incessantly lifted interest rates, even though inflation is very low, and instituted a very big dose of quantitative tightening. We have the potential to go...up like a rocket if we did some lowering of rates, like one point, and some quantitative easing. Yes, we are doing very well at 3.2% GDP, but with our wonderfully low inflation, we could be setting major records &, at the same time, make our National Debt start to look small!

It is impossible to judge whether these recent efforts to influence policy making have any effect on the FOMC discussions. It is clear that Trump follows some of his predecessors by having little confidence in CBI.

Congress and the Fed.

There does not appear to by any time in the post war era where the Fed has not been subject to Congressional criticism including threats to take away its independence. Criticism of the Fed has come from the left and from the right but there has always been criticism of policy and the structure of the central bank. It is impossible to judge whether the criticism, introduction of restrictive legislation and threats have influenced policy but it does pull the Fed off its perch of independence and into politics. The discussion is unrelenting and it is hard to imagine that the Fed is impervious to political winds around it. Binder and Spindel (2017) tally 879 pieces of legislation on the Fed introduced since 1947 and observe that the frequency varies with economic conditions. For the most part, Congress does not take any action but criticism makes it more difficult to conduct policy and erodes public trust.

Wright Patman, a populist Texas Democratic, spent a long career in the House of Representatives berating the Federal Reserve for keeping interest rates too high (KC Fed, 2012). More substantive criticism came from, Hubert Humphrey in the 1970s. Humphrey was a liberal Democratic Senator from Minnesota and Presidential candidate who sought to place monetary policy under closer, even direct, Congressional supervision, because he thought that the Fed paid too little attention to the full employment mandate set out in 1946.[13]

With the US economy suffering from stagflation, there was considerable interest in Congress to do something or at least to have the Fed do something. Although, there was not sufficient support for any legislative change a “concurrent resolution’ (H. Con. Res. 133) in 1975 declared (without any legal force) that the Fed should report its policy moves and money supply targets to Congress regularly; this was the first move towards accountability.

Criticism of the Fed’s inability to control inflation and the intellectual ascendancy of monetarism led to some legislative changes in 1977. First, the dual mandate (maximal employment and stable prices) was formally established and second, the Fed was required to report regularly to Congress regarding its policymaking. Prior to that, the Fed, like other central banks, largely operated in secret. Secrecy about short-term intentions—and even about actual policy changes—was thought to preserve the Fed’s discretion and influence over financial markets.

The Reform Act of 1977 increased Congressional oversight by requiring the Fed to “consult with Congress at semiannual hearings about the Board of Governors' and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates for the upcoming twelve months, taking account of past and

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[13] It is ironic that in the 1970s, the most liberal wing of Congress was eager to control the Fed, while 40 years later, it is the rallying cry of the most conservative elements. In fact, populist elements on both sides of the aisle—from Rand Paul to Bernie Sanders—are often critical of the Fed’s independence.

prospective developments in production, employment, and prices." Congress specified a policy approach, a monetarist emphasis on growth targets and formalized accountability for the first time. However, it went on to add "Nothing in this Act shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions."[14] A year later, the Humphrey Hawkins Act called for a broader written report, the semiannual Monetary Policy Report to Congress on both monetary policy and macroeconomic performance. These reports continue today, long after the legislated requirement expired (in 2000) and monetary growth targets were abandoned.[15]

Another element of Congressional oversight introduced in the 1977 Reform Act was that it made the President's designation of the Chairman and Vice Chairman of the Federal Reserve Board (from among the Governors) subject to Senate confirmation and introduced a four-year term. This tied the appointment of the leading policymakers to the political cycle as was just illustrated in the US. Unlike his predecessors for several decades, President Trump declined to reappoint a Board chair originally selected by the previous President.

These 1970s reforms were a reflection of Congressional criticism and a desire to rein in or take control of the Fed. However, the steps taken did not reduce formal Fed independence in any significant fashion. Of greater consequence were the changes that started a trend toward greater transparency. Increased transparency and accountability are now viewed as important features of policy making. Transparency and communication are the modern hallmarks of good central banking, perhaps more so than independence.[16]

Congressional criticism of the Fed shifted across the aisle around the turn of the century. The gadfly of note was Ron Paul, a Republican Congressman from Texas, who wrote a book called succinctly, *End the Fed*, and ran for President on that issue. His support for legal challenges to the constitutionality of the independent central bank, introduction of a gold standard and Congressional audits of all policy making activity were not taken seriously by many. Nevertheless, they may well have been influential; Paul's anger at the Fed resonated with many during the financial crisis.

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[14] Section 2A of the Act from https://www.govtrack.us/congress/bills/95/hr9710/text.

[15] The act required the Fed to report money supply target growth ranges to Congress which to excessive focus on money aggregates at just the time when confidence in the efficacy of the monetarist approach was waning

[16] The Fed itself did not start moving towards greater transparency and improved communication until the 1990s. It was only in 1994 that the Fed began to announce the numerical value of its Fed Funds rate target and only in 2011 that the Board Chair began to hold a press conference after the Federal Open Market Committee (FOMC) meeting. The FOMC now regularly publishes forecasts for key economic variables, along with projections for the policy interest rate.

After the crisis, the landmark 2010 Dodd-Frank Act introduced extensive changes to financial regulation but did not change the way monetary policy is conducted. Early drafts of the Act included adding a goal—maintaining financial stability—to the dual mandate but it is not part of the act. However, the Act introduced new Fed functions and responsibilities that make such a goal implicit, and the Fed's own mission statement does include "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets." [17] On the other hand, Dodd-Frank placed severe limits on the ability of the Fed to use its lending authority in response to crisis. Thus, it limits CBI with regard to the Fed's financial stability goals.

The Fed made vigorous use of its lending authority as the financial crisis unfolded, some of under its emergency lending authority, Section 13(3) of the Federal Reserve Act, which then stated that "In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may …" lend to just about any institution.[18] In the crisis the Fed used 13(3) for some of its broad-based lending programs and for tailored assistance to four firms that the Fed considered too-big-to-fail. These four instances generated a great deal of controversy about the willingness of the Fed to bail out Wall Street.[19] Even some in the Federal Reserve were uncomfortable with the use of 13(3) lending authority to support too big to fail institutions. Charles Plosser (2010, p.11), then the president of the Philadelphia Fed, argued that "Such lending should be done by the fiscal authorities only in emergencies and, if the Fed is involved, only upon the written request of the Treasury."

The negative public reaction to the Fed's 'bailouts' resulted in provisions in Dodd-Frank designed to restrict the use of section 13(3) emergency lending which had been very open ended.[20] This was a significant reduction of CBI, albeit with regard to crisis response rather

[17] https://www.federalreserve.gov/aboutthefed/mission.htm

[18] Federal Reserve Bank of Minneapolis, "Lender of More than Last Resort," 2002. https://www.minneapolisfed.org/publications/the-region/lender-of-more-than-last-resort
This unusual lending authority was added to the Federal Reserve Act in the Depression, subsequently repealed, and then reinstated in 1991. The lending authority was not used in the post-Depression era until the Fed invoked section 13(3) in connection with the purchase of Bear Stearns in March 2008.

[19] The proper scope of emergency lending by the central bank and whether it should extend to nonbank entities is a difficult question that has been the subject of much debate, see Labonte (2016).

[20] The Dodd-Frank Act requires that emergency lending to nonbanks go only to those participating in a broad-based program. The provision was specifically designed to prohibit the extension of credit to individual nonbanks. It also introduced some external oversight of Fed lending. The original provision only required the approval of not less than five members of the Board of Governors, while Dodd-Frank requires prior approval by the Secretary of the Treasury. In addition, the Act requires reporting to Congressional committees within seven days of the use of 13(3) and allows for Government Accountability Office (GAO) auditing.

than monetary policy. Proponents of Dodd Frank argued that other provisions mitigated the restrictions on emergency lending such as the Financial Stability Oversight Council. Significantly, FSOC is chaired by the Treasury Secretary and includes, in addition to the Chair of the Federal Reserve Board, other financial sector regulators and an independent member appointed by the President. The awkward structure of FSOC runs the risk of delaying and politicizing decision making—just the opposite of what would be desirable in a crisis. In the Trump administration, FSOC has removed the SIFI (systemically important financial institutions) status of several banks and non-banks thereby weakening the new Dodd-Frank safeguards. Whether the crisis response mechanisms work or not is yet to be seen but it is clear that crisis response has been pulled back to the political world; it is not the exclusive purview of the independent central bank.

The Fed was also criticized for the secretiveness of its actions during the crisis. As a result, Dodd Frank also requires full public disclosure, with a time delay, of the terms and details of *all* Fed transactions. While transparency is valuable, the detailed disclosure policies (even with a lag) might inhibit the Fed's willingness to use its lending authority in a crisis.

Dissatisfaction with an independent central bank did not end with the passage of Dodd-Frank. Until the 2018 election Texas Republican, Jeb Hensarling chaired the House Financial Services Committee. Under his leadership the House of Representatives approved the Financial CHOICE Act which warrants a close look even though there is no current likelihood that it will move forward in the current Congress.

From start to finish, the CHOICE Act provisions that relate to monetary policy reflect an anger at the Fed's history and practice (see Wachtel, 2017). There is an underlying motif that the Fed consistently does the wrong thing and needs to be admonished and controlled; it is an institution that cannot be trusted. Short of replacing it with some other institution, the Act attempts to place monetary policy on a short leash and under a degree of scrutiny that will clearly compromise the independence of policymakers. The independent central bank would be subject to constant detailed oversight from Congress and the executive branch that is designed to influence policy and limit CBI.

Although the CHOICE Act does not change the goals of monetary policy, it provides detailed instructions regarding the choice of policy targets and how the appropriate target value for the policy instruments should be determined. The CHOICE Act provisions would both restrict the Fed's independence and constrain its flexibility to respond to economic conditions.

All previous legislation has been consistent with the principle that Congress sets the objectives of policy (the central bank does not have goal independence) and the central bank determines how best to achieve the goals (instrument or operational independence). The CHOICE Act takes a drastically different approach; it specifies a fixed reference rule as a benchmark for assessing monetary policy and introduces complex procedures for GAO (Government Accountability Office) and Congressional oversight of the Fed's policymaking or adherence to that rule. The Act specifies the well-known Taylor Rule as the determinant of the policy interest rate and the legislation includes data definitions and coefficients as if an economics research paper is being presented in legislative language. The act proposes to assess Fed performance against the reference rule (the legislated Taylor Rule) in a way that would diminish the Fed's incentive to set policy optimally.

There is a long history of economists who support the use of policy rules for monetary policy. Our discussion began with Milton Friedman's disdain for central bank independence; he was arguing for a rule and would probably support this legislation. A rule provides the public with a context for understanding policy decisions and interpreting the intermediate-term objectives of policy. A publicly known rule makes the central bank's objectives clear and shows how it will use its policy targets to achieve those objectives. Importantly, a rule also helps the policymaker to maintain a stable policy designed to achieve long-term objectives. In an ideal world, the rule guides policy and provides the public with a full understanding of policy decisions, thus enhancing economic stability and confidence. Monetary policy should be systematic, predictable and focused on its long-run objectives; a rule can be useful as part of the communication strategy.

CBI in the US cannot be taken for granted. Presidents have tried to influence the Fed and Congress seems to be perpetually at odds with the idea of CBI.

Bundesbank and CBI

The Bundesbank is often viewed as the paradigmatic example of CBI. However, central bank functioning in post war Germany was controversial and the Bundesbank was not established until 1957 and its independent role evolved over time. However, a look back suggests that the issues are more nuanced. First, the ability of the Bundesbank to maintain a hard-nosed anti-inflationary approach to monetary policy is less a reflection of its independence and more a reflection of national values (driven by earlier bouts with inflation) and the concomitant political consensus for price stability.

Moreover, I will provide three examples where government objectives and central bank policy diverged and in each case the government policy, made for political reasons, wins out. First, the decision to convert the ostmark into DM at a parity of one-to-one was made by the government and resisted by the central bank. Second, the decision to provide extensive support for the French Franc in 1992-93 in the form of loans and swap agreements reflected a political decision to stay on the path to a single currency rather than allow central bank independence to prevail.

CBI in Canada

James Coyne, Governor of the Bank of Canada from 1955 to 1961 was opposed to the expansionary fiscal policies pursued by the Diefenbaker government (Siklos 19xx). He both publicly criticized the government and refused their appeals for lower interest rates. The government thought that elected officials should determine economic policy, including monetary policy. The 'affair' involved a public dispute with the Finance minister regarding the Governor's pension which led to his resignation. The Coyne affair did result in clarification of the central bank – government relationship which preserved independence in monetary policy making.

In the recent financial crisis, the central bank had to work with the government to provide adequate backstop liquidity. The bank relaxed its collateral requirements for lending to financial institutions by providing guarantees for losses.

Macro pru in Belgium

The Belgian National Bank introduced instruments for macro prudential regulation. In 2016, in response to some concerns in an analysis by the ESRB, the bank decided to increase bank capital charges on certain mortgage loans. As is often the case macro pru policy actions have distributional consequences, falling in this case on certain parts of the housing sector. The government objected to the policy change and forced a reexamination of the issue which ultimately resulted in a compromise. The episode is a typical example that broad CBI often fall away when we consider sector specific macro prudential rule.

Conclusion

CBI is like comparative advantage or the role of money in inflation, part of the accepted wisdom of modern economics. It attained that elevated status around 1990 and led to an idealized view of central banking. The ideal central bank was an institution that was free of any political influence so it could use monetary policy instruments to pursue price stability or an inflation target. Our discussion shows how this idealized view arose and then shows how unrealistic it is.

The idealized view was thrust forward by four developments in the 1970s and 1980s. First, central banks of most major economies were unable to curb the inflationary outbursts in the 1970s associated with oil price shocks. Second, the macro literature developed a firm theoretical basis for understanding time inconsistency and why governments might exhibit an inflationary bias. Third, central banking laws were being introduced in many countries, some times for the first time (in newly independent countries and emerging markets) and sometimes being modernized as central banks moved from a private sector role to a clearly defined relationship to the government. Finally, characteristics of central bank organization and governance were used to construct indexes of CBI which seem to correlate with inflation experience. Although, the simple correlation of more CBI with less inflation seemed to provide the finishing touch on the canonization of CBI. Governments around the world took note of these developments and legislated changes to give central banks more independence were common through the 1990s.

CBI came into prominence at a time when the monetary policy functions of the central bank were paramount and other roles receded into the background. However, the regulatory, lending and stability functions of the central bank came to the forefront very quickly during the financial crisis. The modern central bank is a more complex institution whose responsibilities overlap with other government functions; central bank efforts to avoid a systemic crisis might involve fiscal or expenditure decisions and have distributional implications that are political in nature. Crisis response cannot be totally independent of political decision making. Central banks and governments have not entirely sorted out how to maintain the balance between political responsibility and independence for central banks with a broad mandate. CBI is a more nuanced and complex concept than it seemed 30 years ago as the role of central banks evolve.

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