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# Cleveland Fed Conversations on Central Banking: The Case for Central Bank Independence

**Welcome:** **Damjan Pfajfar**, Vice President, Center for Inflation Research, Federal Reserve Bank of Cleveland

**Remarks:** **Beth M. Hammack**, President and Chief Executive Officer, Federal Reserve Bank of Cleveland

**Moderator:** **Edward Nelson**, Senior Advisor, Monetary Affairs, Board of Governors of the Federal Reserve System

## Panelists:

**Athanasios Orphanides**, Professor of the Practice, Global Economics and Management, Massachusetts Institute of Technology, Sloan School of Management

**Michael D. Bordo**, Board of Governors Professor of Economics, Distinguished Professor Emeritus, Director, Center for Monetary and Financial History, Rutgers University, New Brunswick

**Ricardo Reis**, A.W. Phillips Professor of Economics, London School of Economics

## **Damjan Pfajfar:**

Welcome everyone to the Cleveland Fed Conversations on Central Banking series. I'm Damjan Pfajfar with the Cleveland Fed Center for Inflation Research. Thank you all for joining us today. Before we start, these conversations are being recorded, and the recording should be up on the center's website shortly after the event. Disclaimer: The views expressed during this program are those of the panelists and not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System. We'll now turn to Beth Hammack, the president and CEO of the Cleveland Fed to provide introductory remarks.

## **Beth Hammack:**

Great, thank you so much, Damjan, and thanks everyone for joining us today. It's my pleasure to kick off today's conversation on central banking on central bank independence. Conversations on Central Banking is a semi-annual series of events that focuses on topics such as central bank communications, alternative measures of inflation and other monetary policy related topics.

It's organized by our Center for Inflation Research, which helps policymakers, researchers, and the public better understand inflation. I encourage you to check out some of the useful resources we provide on our website, [clevelandfed.org](http://clevelandfed.org). Today's topic, the importance of central bank independence, is particularly timely. Both during my

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career and financial markets and now as a policymaker, I've always believed that an independent and accountable Federal Reserve is essential for policymaking. Monetary policy independence is important in achieving our dual mandate goals of maximum employment and price stability. It allows FOMC members to make decisions based on incoming data and the evolving outlook, including our understanding of how businesses and communities are experiencing the economy.

A wealth of academic literature underscores the importance of central bank independence to low and stable inflation. This is because reducing inflation often entails tough trade-offs of short-term economic weakness in exchange for a future with lower inflation and stronger growth.

As policymakers, we try to balance our dual mandate goals of price stability and maximum employment so that the American public can benefit from a strong and resilient economy. Our decentralized structure with a seven-member board in Washington DC and 12 independent regional Reserve Banks further supports this policy independence.

Each of the 19 FOMC participants brings their unique vantage point, background, and regional perspective to ensure we make decisions in the best interests of the American people. But the Federal Reserve must be accountable as well as independent. That is why the chair testifies in front of Congress and we ensure there is transparency around our decision making.

We release minutes from our meetings with a three-week lag to highlight the discussion, and we release full transcripts of our meetings with a five-year lag. If you can't sleep at night, I encourage you to pick up a transcript and imagine you had a front row seat around the FOMC table.

Today we're going to hear the insights of three scholars who have a deep knowledge of the literature on this issue and how it translates to the practice of monetary policy.

Thank you very much for joining us on this important topic today. And I'll now hand it over to Ed Nelson, who's moderating the conversation.

**Edward Nelson:**

Thank you so much, Beth, for those remarks and I'm very thankful myself to the Center for Inflation Research and the Federal Reserve Bank of Cleveland for organizing this event.

And I'm delighted to be here to moderate today's conversation on central bank independence. This is not only a major part of US monetary policy arrangements. It's also a vibrant and long-standing area of economic research. In this connection, we'll be hearing from a panel today on central bank independence, a panel of three leading researchers in the area of monetary analysis.

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Now let me briefly introduce the panelists before you hear from each of them.

Professor Michael Bordo is a Distinguished Professor of Economics, Emeritus at Rutgers University and is a distinguished visiting fellow at the Hoover Institution at Stanford University.

Professor Athanasios Orphanides is a Professor of the Practice of Global Economics and Management at the MIT Sloan School of Management.

Professor Ricardo Reis is the A.W. Phillips Professor of Economics at the London School of Economics.

We'll kick off the panel discussion now with introductory remarks by each panelist starting with Mike, Professor Bordo.

**Mike Bordo:**

Okay. Thank you. I'm going to talk about the role of the Federal Reserve, Regional Federal Reserve Banks in FOMC policymaking.

So this is based on research I've done with, ongoing research with Ned Prescott, who is a researcher here at the Cleveland Fed.

So the Federal Reserve System is a unique institutional arrangement among the community of central banks. It was established in 1913 as a federation of regional banks of issue, coordinated by a board in Washington DC. It was designed to overcome the problems of financial instability and inefficient payments. That was the case throughout the 19th century under the national banking system and before that the free banking system.

It's evolved. I'm not going to go through the history of it. It has evolved through a process of trial and error, into the modern system created by the Federal Reserve Act of 1935, which consolidated power in the board of governors in Washington DC and the FOMC in which only four of the non-New York Feds vote on rate decisions.

Until the 1950s, the regional feds had a minimal role in fed policymaking, but since then they have developed into a crucial part of the policymaking process. And so what we do in our book is, we analyze how the regional Feds, since the 1960s, have contributed pathbreaking ideas into the Federal Reserve's system policy process.

And the Reserve Banks serve as a portal whereby important and controversial ideas were transmitted from academia to the policy process. And a sea change came in the 1960s

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and in the '50s, in fact, when Chairman McChesney Martin really changed the role of the regional feds.

Before the 1951 accord, the non-New York Feds really just focused on overseeing technical operations and ironing out regional banking problems. And they had small research departments and they really didn't do very serious economic analysis. So what Martin's reforms did was allow the Reserve Bank presidents and staff to regularly attend FOMC meetings and become part of the policy process.

That led to a demand for monetary policy ideas from the non-New York Reserve Banks. And gradually the Reserve Bank's research departments built ties with academics and expanded their expertise and scope. And then the Reserve Bank presidents effectively used the new ideas developed by the staff to influence system policy at FOMC.

And the public semi-private corporate structure of the Federal Reserve System facilitated the production and sharing of new ideas, which reflects the Reserve Bank's independence or limited independence from the board in Washington. So that's a story.

Now I don't have a lot of time, but I want to tell you about some of the history that we've been working on. So we're going to talk about mainly two very important advances in knowledge that came from the Reserve Banks to the board. The first is the role of St. Louis Fed in introducing monetarism to the Fed.

And so in the '60s, the Federal Reserve Bank of St. Louis became the center of monetarism in the Federal Reserve System. And initially the St. Louis Fed criticized the Martin and later Burns chair's reliance on money market conditions, free reserves as key indicators of the economy. Then when Keynesian ideas took over, they criticized them.

And what they did was they measured and advocated the role of monetary aggregates as policy indicators and tools in a lot of statistical and research publications that St. Louis put out. And their ideas did influence the Board of Governors staff. And during the Great Inflation, the St. Louis was a key part of the campaign by leading monetarists Friedman, Melzer and Bruner for the Fed to adopt monetary aggregate targeting. And that's what did happen coming through the Congress. And also, it had an influence on Chairman Paul Volcker's famous disinflationary shock in 1979.

The second case study that we focus on is Minneapolis and rational expectations. So in the late '60s, the Minneapolis Fed's research department teamed up with the pioneers of the new field of rational expectations, Lucas, Sargent, Prescott, and Wallace. And the research department became oriented toward long-term research.

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And the joint academic Fed team produced major breakthroughs in the role of expectations, credibility and time inconsistency in the policy process. And that research revolutionized macroeconomic research, both in academia and at the Fed.

And in the 1980s, '90s and early 2000s, a number of the Reserve Bank presidents, which were identified in the work I've done with Klodiana Istrefi of the ECB, we identified these people as anti-inflation hawks. They really did help change the discourse at FOMC towards the Minnesota paradigm of a strategy of low and credible inflation.

Also, a number of FOMC presidents in this period began using the language of rules based on the time consistency literature developed at the Minneapolis Fed.

And again, this comes from research I've done with Istrefi and Humberto Martinez. So these ideas contribute importantly to developing the policy strategy of low and credible inflation and inflation targeting in the Volcker, Greenspan and Bernanke era.

We are working also, we haven't finished yet, but we are looking at the role of Richmond Fed and policy transparency at the turn of the century, research on banking in the '50s and '60s at Boston and Chicago, focusing on market structure.

We're working on research on banking instability in the '70s, '80s and '90s at Minneapolis, Chicago and others. And we're looking at payments. So these are what we're doing. I've already told you what we did.

So the bottom line is, the Reserve Banks became important innovators in producing and disseminating knowledge on fed policy. The Fed's decentralized structure and semi-private corporate governance of the Reserve Banks helped make this possible because it allowed for internal differences of opinion to be made public.

It allowed new ideas to take hold and this is in contrast with other unified central banks, which have followed a more monolithic top-down approach, making it harder for new ideas to be adopted. So the Fed's experience makes a strong case.

The Fed's experience with the regional banks makes a strong case to preserve the independence of the knowledge process of these regional banks. That has been a key contributor to creating sound Fed system policymaking.

The regional feds should be insulated from both outside political pressure and undue dominance by the Federal Reserve Board in Washington. Thank you.

**Edward Nelson:**

Thank you very much, Mike. Next, Professor Orphanides.

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**Athanasios Orphanides:**

Thank you, Ed. It's a great opportunity to participate in this panel. Now, our topic is the Case for Central Bank Independence, but I would like to place this in the broader context of institutions and governance in our society.

Ideally, we want to have institutions that promote the common good, facilitate growth and prosperity for all over time. And we want to do this in the context of our democracy to ensure that public policy decisions reflect the preference of society over time.

The challenge is that politics can sometimes distort decisions, necessary but unpopular decisions can get postponed. Things that we wish were taken care of don't get done because they might compromise short-term electoral considerations.

And this is why it is desirable to delegate some decisions to independent institutions protected from shortsighted political influence. This is where central bank independence comes in.

The foundation for prosperity in our economy is monetary stability. An environment of high and volatile inflation harms stability, even when this means taking decisions that may be unpopular in the short run or perhaps harm some special interest in the electoral considerations of some politicians.

We need an independent institution to make sure that decisions will be the best for society over the long run.

Of course, independence must come with accountability and proper representation. And this is where the design of the central bank becomes so important. In the United States, the significance of setting up a well-functioning central bank was recognized early on, but the First Bank of the United States and the Second Bank of the United States did not fare well. Neither institution survived the nasty politics prevailing in the 18th and 19th century.

Their failure was indeed quite important for shaping the Federal Reserve System when it was founded in 1913 and what we have today.

The founders of the Federal Reserve System designed a far more resilient institution. And I think it's important for us to recognize some of the crucial aspects of that resilience. A critical aspect has been the decentralized structure of the system.

Avoiding the concentration of power, they wouldn't say that a century ago, but today we would say it's "inside the beltway." We do not want all power in this country to be inside the beltway. The 12 Federal Reserve districts geographically not aligned with border states. The partnerships of public and private representation in the governance all

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contribute to ensuring that local communities around the country can be represented strengthening the democratic legitimacy of the institution.

Now, the Fed is not a perfect institution. No human institution is. But its institutional structure, the culture, compare well to peer central banks and clearly it has become a successful central bank, whereas the first and second attempt at a central bank in this country had failed.

Now the Fed's ability to ensure monetary stability successfully is complicated by a number of factors. One challenge that I want to bring some attention to is the proper interpretation of the mandate. Starting with the Employment Act of 1946, the lofty goal of maximum employment has been one of the multiple objectives the Fed is asked to deliver on top of delivering price stability. And this is difficult. Indeed, throughout its history from 1913 on, the Fed has operated with a mandate that has never really strictly recognized price stability as the primary goal of monetary policy. And from time to time, this has led to problems.

Indeed, in my reading of the Fed's history, the Fed's success in maintaining price stability and fostering the good economic performance associated with it over time has depended on how it interpreted its mandate and implemented its policy strategy. In the 1970s and also in the recent past, the Fed has interpreted its mandate in an overambitious fashion, placing undue emphasis on the elusive goal of maximum employment, inevitably compromising price stability over time.

I want to simply end by noting, the Fed can interpret its mandate better, but in order to do this, it has to be protected from politics. Business and households only recognize the cost of losing price stability after the damage is done. This is why it's so important for the regional representation we have in the system, the presidents of the Federal Reserve Banks who are closer to the businesses and households in our country to make the case and defend the foundations that we need for the Fed to be taking better decisions more consistently in the future. I will just stop here. Thank you.

**Edward Nelson:**

Thank you very much, Athanasios. Next, we'll hear from Professor Ricardo Reis.

**Ricardo Reis:**

Thank you very much. The case for central bank independence, as is a topic of this panel, is one that both in theory and empirically, both in the US and in countries all over the world, both in academic debates as well as in practice, is really very strongly established. And it relies, if you want, on five pillars, five observations, five conjoining factors. The first, at the central bank, being ultimately the only supplier of money in the sense of, if you want to transact in dollars, your transaction one way or another in our digital economy is going to have to be settled at the central bank in the accounts that banks have at the central

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bank. It means that because the central bank is the one that controls money, either its quantity or its price, it has the ideal instrument with which one can affect any outcomes of what gets determined in dollars and namely inflation.

Second, that we can give it, this institution that can be made independent in using what really is its tool, its natural tool. It can be given a natural target in the sense of an inflation target that it wishes to achieve in the long run. As well as potential trade-offs along the way of achieving that long run between inflation and maximum or stable employment or stability of real outcomes. There is a clear target. It is inflation. There is a clear instrument. That instrument relies on the central bank, that target can be given to the central bank.

Third. From pursuing that target, there is a clear benefit to all. We all benefit from price stability. We all unambiguously benefit from it, not just in the long run, but also in the short run insofar as the trade-offs between price stability and some slight temporary deviation from it, may aid in outcomes, especially when it comes to employment.

Fourth, transparency. By having a regional structure like Professor Bordo noted, the central bank naturally in discussions of monetary policy can put out different points of view.

And unlike in many other discussions of economic policy, that discussion can be conducted in a frank and open way, and in a way that increases the legitimacy of the institution, but especially that leads to better outcomes. Four, there is less of having to convince others to go along and more of figuring out how to pursue this instrument to achieve its tool.

And fifth, in terms of accountability. Ultimately the Federal Reserve answers to the US voter. The Federal Reserve can set its monetary policy, its instrument in pursuit of its target to achieve the benefits that are in a transparent discussion in a way that relies and focuses on the US alone, counting on then floating exchange rates, the fact that the dollar will then appreciate, depreciate relative to other currencies, as a way to, if you want, affect other countries or insulate from those effects, and then leave to other central banks the job of dealing with their own problems.

So across these five pillars, the case for its central bank independence is very, very strong when it comes to inflation and the choosing of monetary tools.

However, I would note in this intervention that the case for independence in financial stability – which is one that is often associated with the central bank but not always, and certainly one that was not all that discussed when independence was given to central banks at different stages, it was for the monetary goal, not the finance stability one – is one that's less well established.

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First of all, when it comes to the instrument, the central bank, yes, it can regulate banks. By the way, it can regulate them in so far as banks create their own private money that coexisted is very useful, but there are many other institutions in the United States that regulate banks more having to do with risk taking, protecting consumers and others. There's nothing natural about the central bank in that sense that makes it want to be the prime or single or independent regulator.

What does give it a special power is the ability to create money very quickly through lender of last resort in terms of coming to aid of certain banks, but in that you suffer the problem of always having to trade off the extent to which you are indeed providing temporary liquidity to some without really undermining the market forces that mean that insolvent, bad institutions should go broke.

When you look at the goal as well, much less clear that independence should be there. The goal of financial stability ultimately you would say is to prevent crashes and no one would disagree with that, but crashes happen way too infrequently for that to be a goal that could be transparently communicated in an accountable way.

More often, unfortunately, it is the nature of financial sectors that government debt is an important part of it. And as a result, financial stability can veer much too quickly into supporting governments in financing themselves at steady prices, which, while sometimes a meritable goal, especially in situations of war, often leads to more problems in terms of fiscal profligacy among others.

Third, benefits. The benefits of strict financial stability may benefit some people, but many are hurt when a regulator is far too conservative and stops any attempt at risk taking or even a providing of insurance in a society.

Transparency, regulation is not only opaque on account of the instruments and the technicality often being a little harder, but especially it must often be opaque by design. For if a regulator says that a bank is in a lot of trouble, it will trigger the bank run that creates the bank in trouble. And so transparency cannot by a nature of regulation, financial stability be pursued.

And finally, accountability becomes also harder for in a global financial system like the one we have now, it is simply impossible for the central bank to ignore that US banks are connected to global financial markets.

That European, African, Asian, and other banks operate in US markets and therefore the central bank ends up having to have a series of tools that are designed to different parts of the financial market, but in which necessarily it will have strong impacts on other countries. And it will be affected by the citizens of other countries in ways that are ultimately the purview of foreign policy. So combined across all the five, the case for

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independence of financial stability is weaker. The fact that we have tied the two, and I don't think by design, I don't think that was the case when independence was given to the Fed and others, is much less clear. And I worry that by confounding the two, we can hurt the case for independence in monetary policy, which is, I repeat, very, very strong.

**Edward Nelson:**

Thank you very much, Ricardo. I thought we'd next move to an opportunity for each speaker to comment on issues raised that they didn't themselves cover in their opening remarks that the other speakers have raised. So maybe we'll start with you, Mike, if there's any follow-up remarks you'd like to make.

**Mike Bordo:**

Okay. First of all, I agree with what both of you said. On the financial stability issue, if you look at the history of central banks that I've looked at, in fact, the main *raison d'etre*, one of them, the second *raison d'etre*, is the lender of last resort. So the Bank of England was established to help the government finance its wars, but also it evolved as a lender of last resort.

And so that opens the question of, how do you do this if you don't know what the people you're lending to is? So this has always been a problem. Goodhart has really laid this down very clearly. So what you need to do is you need to have very tight rules on this and that's what Bagehot's rule was all about. Okay. And the trouble is, of course, and there's a gigantic literature, is for many, many reasons, central banks don't often follow Bagehot's rule and central banks have moved beyond what's very simple, which is you provide liquidity to banks that are illiquid but solvent and that's it. That was Bagehot, very simple. Okay. There are a lot of corollaries to that. And of course there were issues of what does it mean to be insolvent, illiquid? How do you know? Okay, and this was called the Bagehot problem. So Ricardo's on a very major point.

And of course, by the 21st century, things have moved so far away from Bagehot's rule that you get to this question where, wait a minute, this is really a problem. It's really a problem because if the central bank is doing what they do, which is bailing out entities like SVB, which in a sense were not properly supervised, that affects their credibility for what they do, their main goal today, which is the stability of the value of the money.

So it's a huge problem, but it seems to me that that problem can be corrected by moving back to much simpler mandates and simpler rules. So that's the issue that I kind of agree with him. There are other issues, international, the role of the Fed as providing liquidity to the rest of the world through its swap lines and crises. This is a very important role for the Fed. Ricardo's an expert on this, and I think it's something that is a very hot topic today.

Because the question is, who do you provide the swaps to? And of course what happened was that the swaps were originally designed during the Bretton Woods system to deal with

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the counterparts in Europe who were pretty well trusted, and they would pay back the dollars that were lent for francs and there was very little chance of something going wrong.

So then it was expanded to other countries and then that's where the problem comes in. Will they pay you back? And now the problem is, do we only lend to countries that we like? That is a very serious problem because now you politicize something, which is technically a brilliant idea, and you get to the same problem that Ricardo's raised about lender of last resort.

So I think I won't say anything much further, but so it is a problem in defining the mandate, and the mandate should be very, very, very narrow. I mean, for me, it would be going back to just price stability and lender of last resort, and everything else not. But let's stop there.

**Edward Nelson:**

Thanks, Mike. Athanasios? Any comments on what you've heard so far?

**Athanasios Orphanides:**

Thanks, Ed. So I have to start by saying that I broadly agree with interventions of Mike in regard, but I'm going to pick some points following up on what Mike just said.

The last one, as I get it, I'm going to start with how Mike ended, is to ensure what is the priority. Independence is most important for the central bank to deliver price stability. And this is the one thing we should be highlighting. Ricardo talked about it in the context of the inflation target, which is how this thing is defined, inflation targeting central banks. Price stability is the concept that we want to defend above all.

But as I pointed out before, in our societies, there are good reasons we want to have institutions that have operational independence in many other areas as well.

So financial supervision is one of those areas. Ideally, we also want to protect the financial sector and financial supervision from capture, from the industry, from short-term political considerations. And something that becomes critical, reading between the lines of what Mike mentioned, in crisis management. How do you allocate the losses? Whom do you favor and whom you do not favor?

These things are inevitably more political in nature. So indeed, if we put everything together and we try to protect the independence of the central bank in the same way in all of them, we may end up compromising the crucial element of independence of price stability. So we can look at this as a hierarchy and think about it as, price stability, we need to ensure most independence, with regional representation, with staggered terms.

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I think the way the Federal Reserve System is set up with the FOMC is quite, quite helpful in this regard. If only we had the terms of both governors respected, actually have people set 14-year terms, which doesn't happen that often. At least it happens quite a bit with the long terms of the presidents of the Reserve Banks. It's very good.

And then we want to have a slightly lower level of operational independence regarding crisis management where there are fiscal implications, but we want to set this up so that the public understands who is responsible for decisions.

So if the central bank is asked to bail out an institution, this should not be the decision of the central bank. This should be coming from the government and then government, the fiscal authority needs to take responsibility for this. Now sometimes the fiscal authority does not want to have that responsibility. It wants to push the responsibility to the central bank because it's politically expedient. And we need to be careful with the design of the system in this regard.

Again, bottom line, highlighting the insignificance of the independence, but recognizing that there is no ideal way we can protect independence in the same degree for all of the other functions of the central bank is expected to deliver on, besides price stability.

**Ricardo Reis:**

Three points I'd like to make if I can, Ed.

So the first one, and that was partly highlighted by Athanasios in response to what Mike said. To say that, there's a difference between saying the Fed should do some financial regulation as it is tied to lender of last resort and I would never disagree with that and I think that's absolutely correct, from saying that function should have the same standard of independence as the price stability one. It is perfectly feasible, conceivable, arguable that, while the premise here of price stability, as Athanasios very completely put it, requires, demands, especially independence.

But the lender of last resort role, perhaps for instance, using with rules could be completely non-independent and be done in consortium with the Treasury or someone else in some arguments. And so my point was really that the case for independence of pursuit of price stability and monetary policy is clear.

The case for independence in the use of lender of last resort and the financial risk that comes with it, I think has to be argued somewhat differently. And it may well coincide with it. I'm really not trying to rule it out, but my focus is really on independence.

A second point, I wanted to explain to the audience what these swap lines are, because I worry that they may get lost. And Mike really put it well, but I think I need to expand a little to help our audience. So he said, "Well, swap lines are like the lender of last resort." And

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he was absolutely right, but I'd like to expand on it. Swap lines are exactly lender of last resort. What is the swap line for the people in the audience? The reason why we have, or the main reason why we have a lender of last resort is say, well, a bank in the US invests in a lot of things, gives mortgages, buys some assets and others.

It gets its money from the deposits that people have. What that means is that it's very exposed that if people all of a sudden, all in a panic withdraw their deposits, that bank is going to have to foreclose your mortgage. They have to go to knock on your door tomorrow and say, "Give me your house now because my depositors took away the money," as well as all other kinds of investments. As well as mass sell all of the securities, government bonds it has, which will trigger a price spiral, while the price goes down and then other banks have to sell, and we may end up with a crash.

And so we have this brilliant solution, which is, if in the short run the central bank can replace the depositors for a few days until the panic goes, we can stop this fire sale, the spiral, this crash, this calling up on valuable projects that are done. What are then the swap lines?

The swap lines is that nowadays what you have is many foreign banks who, to the great benefit of the United States, are lending to mortgages in the United States, are investing in US securities, are putting a lot of money in the country.

Partly why? Because the United States runs a very large chronic deficit and has done so for many decades. Which nothing means that the foreigners are giving us all of these goods in excess of the ones we send to them and in exchange, they're investing in us. They're lending to us. Us in this case being Americans.

Now in that scenario, what we have is that because those foreign banks who are investing so massive in the US often also have the equivalent depositors, when they can panic and withdraw their dollars, and therefore you would have all these foreign banks from all over the world who suddenly would be causing a US crash, a US financial markets crash by panic selling a lot of assets, by calling on mortgages, on investments or corporations and saying, "I need my money back."

And so the swap lines are nothing but a way to lend to those foreign banks. But now how are you going to lend to those foreign banks? You don't know them and this comes exactly, Mike's very insightful point, but I think I need to expand it a little. Well, you can only lend to the people you know and the Fed is not going to lend to some bank in Taiwan it's never heard of. So instead it says, "I'm going to trust my friends at the Central Bank of Taiwan or France or someone else and say, 'You figure out who's the right person to lend and what conditions, and I will very short term swap,'" meaning lend you all the dollars you need to do that, "But then it's all your risk if you lend to the wrong guy, if you don't get paid, then

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it's really your problem.” So let me use the expertise of the foreign central bank, even though we, the Fed, are the one who supplies dollars.

But hopefully that was helpful for people to understand why the swap line comes up, why they are ultimately a big benefit to the American public and American economy that they exist, but also because you need to count on this foreigner to do some of the work for you, why they create some of the issues of foreign policy and others that might create it.

Third and finally, if I'm not expanding my time Ed, because you did ask me to comment on others. Let me disagree a little bit, only slightly with Athanasios. So not so much disagree but add another dimension. He really emphasized the risks of political capture, the importance of expertise in being themselves, a case for independence. And certainly I would agree with that. But as he well said, at the end, there are some instances in our society that are political in nature in the sense, and I mean here politically in the highest, noblest sense of the term, that involve assigning winners and losers.

And of course the most clear case of this is the courts. And the courts are going to have to do that assignment. We don't want to have puppet courts dictated by a dictator, but at the same time, the way we have independence of the courts is, I think, quite different from the independence of a central bank. And why? Because in the case of the courts, and going back to my exposition, the instrument is often very varied. It involves many different types of panels they can give you. The target is fairness and justice and we certainly have spent centuries discussing what that is. The benefits, again, are much more some people win, some people lose when they go to court. The transparency of court rulings have their norms that we have followed over time, but the accountability of judges is, again, one that is very different across jurisdictions.

So while I think there is a case for independence of monetary policy in the pursuit of price stability, the one that I laid out, I think it is not the same as the one that Athanasios has laid out. And the one that Athanasios laid out is a complement to it, but I think people may disagree on whether that one is that important because after all, an independent bureaucrat, technocrat that does not rely on the mood of politicians is also one that gets captured by elites and bad ideas, and note how the Federal Reserve System in its wisdom and its founders try to prevent that by having indeed a Federal Reserve System with many different institutions to allow for some political, in the grand sense of the word, of several Reserve Bank presidents bringing their views and bringing their opinions into the table so that we wouldn't fall to that technocratic trap.

**Edward Nelson:**

Thank you, Ricardo. I've noticed that there've been several questions from other participants in this conversation. We very much appreciate those. I'll try to get to at least one of them, which is, I'll rephrase it more about in terms of a comparison. Is there a feature of US central bank independence that you think other countries that have

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independent central banks could benefit from incorporating in their own framework, starting with Mike?

**Mike Bordo:**

Well, I mean, the whole point of my research with Ned is that having a regional Fed system is very different from a monolithic central bank like the Bank of England, which I know it's better than it was a long time ago when Ed was there. But the Bank of England, Bank of Canada, all these banks, information is within the bank.

It's hard to come up with new ideas because there's already in a sense a culture within the bank and the governor is in charge, and the power goes from the staff to the governor. And you can often make mistakes because there are different ideas that are being developed outside by academics and others, which you don't take on because you want to protect your own decisions. So what the Federal Reserve System does is allow these ideas to come in from outside. And in a sense, what our research showed was that it really did work. Okay.

Now what we're worried about is that in a sense, information is a lot easier to obtain than back then. And so you don't necessarily need the information coming from the Reserve Bank. It can come in from all directions. So that's one thing that's changed, but you really need the Reserve Banks to be independent in terms of the people that they have in their research departments, allowing them to do their research, et cetera.

And not having the research departments in a sense being dictated to by the board in Washington. And this is an issue that's always come up. The worst case was in the '70s, Ed knows this about Burns, and he had his finger on everything. And there were people that would write research papers on something he didn't like and he would fire them. So we don't want that. But it seems like, that this is one of the good things about the Fed that I would like to emphasize.

**Edward Nelson:**

Thank you, Mike. Athanasios?

**Athanasios Orphanides:**

Thanks, Ed. So I'm going to also comment on the decentralized nature of the system as something that some other central banks actually have learned from it.

If you look at the design of the European system of central banks, it actually lifted some of the aspects from the design of the Federal Reserve System, and I would say, improved on it. Because the issue relates to what we know about decision making that is best done by committees, not by one individual. This is why we want to avoid the concentration of power inside the beltway where you may have a committee that's really governed by one individual. We don't want to do that. We want to have members of a committee with

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different views to bring them diversity of views, diversity in terms of monetary policy, thinking about the world, assessment of risks that they see in their communities, thinking differently. And this is what we want to protect, wanting to protect that independence of thought.

Now to do that, there are some elements that I think the design of the Federal Reserve System was meant to do well, but in practice they may not be working very well. And we see that they may come under some legal challenges at the moment.

So consider, for example, the role of the appointment process in the committees. In the European Central Bank, if you look at the equivalent of the Board of Governors would be the executive board of the ECB. Executive board members at the ECB serve eight years non-renewable terms and they are incredibly, incredibly difficult for any politician to get rid of. And we may not like that. Any politician might want to install their own people, but we actually do want to protect the independence of the policymakers there. So eight staggered, non-renewable.

Now ideally, this is something we would have wanted to have at the board, but we don't because governors leave too early in their 14-year term. The average tenure of governors is way too short at the Federal Reserve Board, with the exception of the chair, I should say. And the other element is that the possibility of having a term renewed once a governor starts an incomplete 14-year term means that you do have the potential influence of the renomination process getting in.

Another aspect regards the appointment process for the chair and vice chairs of the Federal Reserve. In addition to 14-year appointments, they have four-year appointments that are way too short. Four year and potentially renewable is not the best way to actually preserve independence. And this is really not in line with the vision of the founders of the Federal Reserve System to ensure we have an appointment process that would have staggered long-terms, diversity of views in the committee.

So there are some things that other central banks have already picked up on, but there are some things that unfortunately I see in our country, the system right now is not working quite as robustly as was envisioned originally.

**Edward Nelson:**

We're almost out of time. Thank you, Athanasios, but I'll give you the last word to Ricardo.

**Ricardo Reis:**

So just very briefly, I will say the strength of the staff at the board, since we've all talked too much about the regional banks, especially because that's a very hard one to copy for others. And why is that so important? Because as much as one wants to bring diversity of views, as Athanasios spoke eloquently about the appointment process, it is important

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that the views that are brought in are not seen as political partisan views that make decisions to obey whomever appoint them or not, but rather are disciplined by good arguments, good models, and what is, let's say, defensible by economics and other arguments.

The board has been extremely fortunate that for decades has built a staff and a procedure of, people don't know, but there's these books that have colors that the board staff is very proud of and that generate a depth of analysis. That means that when it comes to discussions with the FOMC and the others, discussions cannot stray too much from what is defensible by the staff in terms of being of sound judgment and well-informed.

And I think that provides a great discipline that most of the central banks in the world have great difficulty with. They have the same appointment, but then people come in and take partisan views. The Fed has a staff that provides analysis that anchors the discussions around what should be the priorities.

**Edward Nelson:**

Thank you very much, Ricardo. And, I certainly think my colleagues will be very pleased to hear. What you've just said, and I'm very pleased to have hosted this conversation on behalf of the Federal Reserve Bank of Cleveland and thank you very much everybody for joining this conversation. We look forward to the next Conversation on Central Banking. Thank you.