

Kevin Warsh: An ode to independence

Speech by Mr Kevin Warsh, Member of the Board of Governors of the Federal Reserve System, at the Shadow Open Market Committee, New York, 26 March 2010.

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Thank you for welcoming me to a meeting of the Shadow Open Market Committee.¹

The overall profitability and balance sheet strength of large U.S. enterprises is impressive at this stage of recovery. Equity prices and credit terms in liquid markets corroborate these improved fundamentals. And for these firms, financial market conditions appear quite supportive of economic growth.

Still, significant economic challenges persist. While recent trends in personal consumption and business investment trends are positive, the underlying strength of the economy over the medium term is less clear. Unemployment remains high, and stubbornly so. Small and medium-sized enterprises, which have tended to lead recoveries, are still hesitant to expand – revenue growth is tepid, costs are uncertain, and credit conditions remain more difficult than for large firms.

Increases in government expenditures around the world – ostensibly instituted as a bulwark against further economic weakness – are raising fiscal deficits significantly. Unsustainable, projected fiscal debt loads – including large and growing implicit guarantees bestowed upon large financial firms by governments – are raising concerns in sovereign debt markets.

Taking account of the broad range of economic and financial conditions, there is no wonder that the electorate – in the United States and abroad – is unnerved. The uncomfortable juxtaposition of financial and economic realities has caused some fundamental precepts of the so-called Anglo-American economic model to be attacked.

Allow me to join your discussion on an increasingly questioned foundation of our economic system, the independent status of central banks.

Institutional credibility at stake

Monetary accommodation from the world's largest central banks remains extraordinary. Policy decisions made in response to the global financial crisis resulted in dramatic changes in the size and composition of central bank balance sheets. The Federal Reserve's balance sheet has nearly tripled, including about \$1.2 trillion of new mortgage-related securities, matched by a rise in excess reserve balances.

Yet, the Federal Reserve's most significant asset, like many other central banks, is not on its swollen balance sheet. Neither can it be found in the lengthy footnotes of its audited financial statements. Nor is it tucked away in the recesses of the Federal Reserve Act, like the long-dormant, now renowned, section 13(3).

The Fed's greatest asset is its institutional credibility. This institutional credibility is rooted in its inflation-fighting credibility, but it is broader still.² It is tied up in the full range of Fed

¹ The views expressed here are my own and not necessarily those of my colleagues on the Board of Governors or the Federal Open Market Committee. Nellie Liang and Dan Covitz of the Board's staff contributed to these remarks.

² In the economics literature, central bank credibility generally refers to its reputation for being more averse to inflation than the fiscal authority. The broad consensus is that credibility along this dimension allows better economic outcomes. Credibility anchors inflation expectations, which in turn allows the central bank to keep

actions and balance sheet commitments. This credibility is essential. It increases the heft of our communications. It gives weight to our economic assessments. It amplifies the effect of announced changes in the short-term policy rate on longer-term rates. It is, in some sense, the real money multiplier in the conduct of policy.

Given its immense value, we should not forget that the Federal Reserve's hard-earned credibility is no birthright. It is as much nurture as nature. It was earned by our predecessors in the conduct of their duties, making considered judgments consistent with the statutory mandate of price stability and maximum employment. Fortunately, for the asset to be burnished and bestowed upon the current crop of central bankers, it did not demand perfect clairvoyance or infallible judgments. But it did require fierce independence from the whims of Washington and the wants of Wall Street, and from a pernicious short-termism that can undermine the proper conduct of policy. This fierce independence is needed, perhaps now more than ever.

Central bank independence is precious. It can be taken for granted in benign times, but it is tested when times get tough. And we still have tough times ahead of us. My colleagues and I must demonstrate that Fed independence has not been relegated, and the Fed's long-term objectives not compromised. Ensuring Fed independence – as the cornerstone of institutional credibility – is our charge to keep. It is central to what the Federal Reserve represents, and to how policy is conducted.

The mantra of Fed independence is not some throw-away line that seeks to absolve the central bank of accountability. To the contrary, institutional credibility demands transparency so that the Fed's performance of its responsibilities can be judged on the merits.

But, the call for central bank independence can be misunderstood, its defense misconstrued, its threats dismissed, and the consequences of its breach underestimated. In the balance of my remarks, I will discuss these issues.

Central bank actions at the water's edge

The Congress is currently immersed in a significant policy debate on the role of the central bank, as part of legislation described by its authors as comprehensive, fundamental regulatory reform.³ And it is worth remembering that the Federal Reserve is the nation's third significant experiment with a central bank.⁴ As the Federal Reserve nears its centennial, the Fed's longevity should not allow our memories to fail us on its origin and the scope of its remit. Let me explain.

The grant of authority to the central bank is a considered judgment of the nation's elected representatives. Central bankers are entrusted with a revocable privilege. So, declarations of independence by Fed policymakers are heartening. But independence is ours to demonstrate, not principally to declare. And central bankers err if they presume that independence is some inalienable right, some entitlement.

A misconception on the nature of the central bank's authority gives succor to Fed critics. The Fed is not independent from government. It is independent within government. And elected representatives have every right to redraw the central bank's authority, even if a fuller reading of economic history considers it unwise.

actual inflation in check. See Ben S. Bernanke (2005), "What Have We Learned since October 1979?" Federal Reserve Bank of St. Louis, *Review*, vol. 87 (March–April), part 2, pp. 277–82.

³ See Kevin Warsh (2010), "Regulation and Its Discontents", speech delivered at the New York Association for Business Economics, New York, February 3.

⁴ The first Bank of the United States was founded in 1791, and its charter expired in 1811. The second Bank of the United States was founded in 1816 and lost its public charter in 1836.

The Federal Reserve's defenders also err if they seek to extend the Fed's vaunted independence to the full range of its activities. My reading has it that the Congress granted the Fed independence in the conduct of monetary policy. In my view, no particular deference is owed – no promise of non-intervention due – in the conduct of regulatory policy, consumer protection, or other responsibilities granted to the Federal Reserve. This sharp distinction should be sustained as the Congress considers revisions to the Federal Reserve's charter.

So, delineating that which constitutes the conduct of monetary policy – as distinct from these other activities – is critical. In normal times, there is less confusion. The Fed establishes short-term, risk-free interest rates across the economy. And it does its level best to signal the appropriate path of policy to ensure low and stable prices and maximum employment over the horizon. The Fed's lender of last resort authority manifests itself – usually only sparingly – in the operation of the discount window, lending against good collateral at a penalty rate.

In times of more significant economic and financial distress, the pace of monetary accommodation often increases. And when liquidity becomes scarce – as was the case during the Panic of 2008 – the Fed finds itself charged with more novel and significant challenges in providing liquidity to institutions and markets.⁵

History teaches us that fiscal and monetary policies tend to blur in these times of crisis. Capital and liquidity issues become difficult to disentangle at troubled institutions.⁶ Capital offsets losses. Liquidity bridges gaps in funding. And well-intentioned policymakers are compelled to make tough judgments amid significant time constraints. What constitutes an emergency liquidity provision backed by good collateral at a penalty price? And what is more aptly characterized as a fiscal provision to bolster capital?

The Federal Reserve must do its utmost to stay foursquare within its role as liquidity provider. The Fed's financial stability responsibilities, which may well be elevated in pending legislation, should not give license to central bankers to be emergency capital providers. Capital allocations should reside, if anywhere, with the fiscal authority and its fiscal agent, the Department of Treasury.

The Fed, as first-responder, must strongly resist the temptation to be the ultimate rescuer. No matter the congressional calendar or the pleadings of the elected, the Fed is not a repair shop for broken statutes or broken financial ecosystems.⁷ And it should not be an appeals court to those seeking relief from congressional appropriators or the fiscal agents at the Treasury. The Fed's credibility is severely undermined if it is perceived to wander from its mission into areas more appropriately handled by other parts of government.

The Panic of 2008 is now prologue. The Fed's actions going forward – especially when economic conditions still appear unsatisfactory – should go a long way to demonstrating its allegiance to mission. There will no doubt be added pressures for policy makers to aid and comfort the aggrieved. That help should be forthcoming does not address the question as to whether it is the institutional prerogative of the Fed to provide it. Even if the central bank *can* does not mean the central bank *should*.

⁵ Kevin Warsh (2009), "The Panic of 2008", speech delivered at the Council of Institutional Investors 2009 Spring Meeting, Washington, April 6.

⁶ The Fed's role as liquidity provider in the Term Asset-Backed Securities Loan Facility (TALF) exemplifies the challenge in drawing clear lines. The TALF made loans to investors for the purchase of highly rated assets. The assets, in turn, served as collateral for the loans. First losses were borne by the investors, as the loan was never for the full value of the assets. The Department of Treasury took the second-loss position behind investors, thereby acting as a fiscal agent providing credit and taking some risk. The Federal Reserve was in a third-loss position, and thus aimed to serve the role of liquidity provider.

⁷ Mortgage finance deserves careful review. Quasi-governmental entities, like Fannie Mae and Freddie Mac, are increasingly being deployed as fiscal agents. The Federal Reserve's actions should not slow the impetus to implement fundamental reform in housing finance.

Other threats to independence and credibility

There is no such thing as being a little bit independent or a little bit credible.

So, central bankers must be constantly vigilant, especially during times of fiscal expansion. Net global debt issuance in 2010 may be three to four times the average of the prior decade.⁸ Ratios of government debt to gross domestic product are growing rapidly among advanced economies. As I just discussed, the Fed should steer clear of fiscal policy. But, the threats to independence do not stop there. In this environment, let me briefly comment on two other pressure points. And note that not all of the threats to central bank independence come from outside the walls of the Federal Reserve. Some pressures, however well-intentioned, like in the clichéd scary movie, may come from inside the house.

First, governments may be tempted to influence the central bank to keep monetary policy looser longer to finance the debt and stimulate activity. In the more static short-run, the real burdens of nominal debt could be reduced by higher inflation. The consequences just over the horizon, however, would be most unwelcome. Higher expected inflation would lead to higher nominal interest rates, increasing the financing needs of the government yet further. Moreover, higher expected inflation could lead to more variable inflation outcomes and reduced living standards, especially for those least able to protect themselves from unexpected price movements.⁹

Central banks must take their own counsel when deciding upon the timing and force in removing monetary policy accommodation. I am confident that any attempt to influence inappropriately the conduct of Fed policy would yield a strong and forceful rebuke by Fed officials and market participants alike. The only popularity central bankers should seek, if at all, is in the history books.

The second threat, in this case to central bank credibility, may be better intentioned, but it is no less risky. Some suggest that central bankers themselves should choose to modify their definitions of price stability. If inflation persisted at higher levels during normal times, the theory goes, central bankers could cut rates more substantially in response to economic weakness. The theory, in my view, fails the real test of experience.

Central banks that desire just a little more inflation may well end up with a lot more. Some point to a strategy to accept a little more inflation for less unemployment as a primary basis for the great inflation of the 1970s in the United States.¹⁰ By definition, an increase in an implicit inflation target would lead to an upward shift in inflation expectations. And how would a central bank make credible its promise that such a shift would be only a one-time event?

We do not understand sufficiently the determinants of inflation expectations to be confident that a regime change can be controlled. Central banks, here and abroad, have worked for decades to get inflation down to levels consistent with price stability. We should not risk these hard-won gains. In changing the goal posts at this time of consequence, substantial harm would be done to a central bank's institutional credibility, and perhaps lead to an unmooring of inflation expectations. Such damage could lead investors to seek alternative currencies, with prices of commodities and other hard assets likely to increase.

⁸ See, for example, International Monetary Fund, *World Economic Outlook*.

⁹ See Thomas J. Sargent and Neil Wallace (1981), "Some Unpleasant Monetarist Arithmetic", Federal Reserve Bank of Minneapolis. *Quarterly Review*, vol. 5 (Fall), pp. 1–17.

¹⁰ See, for example, Robert J. Samuelson (2008), *The Great Inflation and Its Aftermath: The Past and Future of American Affluence* (New York: Random House).

Conclusion

Independence in the conduct of monetary policy is at the core of advanced modern economies. And it can be too easily forgotten by those who have only known its benefits. If the Federal Reserve lost its independence, its hard-earned credibility would quickly dissipate. The costs to the economy would be incalculable: Higher inflation, lower standards of living, and a currency that risks losing its reserve status.

Now more than ever, market participants are watching the relationship between central banks and their governments. They are keenly gauging whether changes in conditions, policies, or practices pierce the veil of central bank independence. Central bankers the world over must demonstrate that we are worthy of this moment, and will be steadfast protectors of our institutions' credibility. That means respecting our important but circumscribed role in the conduct of policy, and performing our mission with competence and consistency.