Central banks and political economy
Financial Markets and Institutions

Jon Faust
Center for Financial Economics, Johns Hopkins U.
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- **'central bank' !?!**
  - Earliest English-language use (according to OED)

    To enjoy the full benefit of the banking system, you must combine with them [—the local banks—] a central bank...

    Hunt's Merchants' Mag., Apr. 1841, quoted in Oxford English Dictionary, 2016
  - Mysterious quote but holds one key: A banking system is deficient somehow unless there exists a central bank
- **What do central banks do?**
  - Central banks are government institutions with widely varying powers and responsibilities regarding government finances and the private financial sector.
- **Core central bank responsibilities:**
  - Act as lender of last resort to banks and/or the financial sector

    short version: lend to (what appear to be) solvent banks that are facing a liquidity crisis
  - Conduct monetary policy

    We'll cover thoroughly in next few lectures, but for now: manipulate various policy tools to affect how favorable financial conditions are for economic activity..
- **Non-core responsibilities:**
  - Bank supervision and regulation

    We've talked about this a good deal already

- Promoting/maintaining/safeguarding core elements of the payments system

  Check clearing, wiring of funds, etc.

- Foreign exchange market intervention

  Buying and or selling foreign currencies on behalf of the government (closely related to monetary policy)

- Be banker (or fiscal agent) to the governmet

  e.g., manage government payments and debt sales and servicing

- Issuing and maintaining the physical currency (notes and coins).

► **Core vs. non-core**

- The two core activities are essentially definitive of a central bank
- Just which of the non-core duties any given central bank has varies a good deal around the world.

► **Independence: an odd but essential feature**

► **Political economy and independence**

- Most major central banks are deemed to be 'independent'
- And it is a strongly held view of a wide range of experts that central banks should conduct monetary policy independently.
- Independence is generally not defined very precisely, but...
- Independence means that the conduct of monetary policy is insulated from direct influence by the rest of the government

  Insulate how? How insulated? We'll discuss the U.S. case...

- In the U.S., neither Congress nor the President can tell the Fed how to pursue its goals.
- This should disturb you.

  Monetary policy is one of the most powerful forces in the economy and it is run by a bunch of folks under no direct democratic control.

► **There is a profound tension between *accountability* to the governed and *independence* from government meddling**

► **On the accountability side**

- U.S. laws set the goals of monetary policy

(goals covered later)

- Fed Governors are nominated by the Pres. and confirmed by the Senate.
- Congress demands testimony, reports, audits, etc.

  ...that is, requires a thorough accounting of how tools of policy are being used to promote the legal mandate.

- But still, a select board of folks (the FOMC) make decisions that profoundly affected the entire world

▶ **Why independence?**

▶ **Possible answer**

- One reason for independence would be if monetary policy were deeply technical topic for which
  - Some select few experts understand it well, but most folks don't, and
  - Once we get the facts straight, the right decision is not very controversial

▶ **Example: Highway guard rail design**

- Society/government sets some broad parameters about how we trade off saftey versus cost
- Then we let 'experts' decide the most efficient way to employ guard rails in delivering safety.

  we turn implementation over to the experts—presumably traffic safety engineers.

- Of course, there may still be controversies here

  nothing is cut and dried

- But hopefully, I've picked an example where you can imagine that not too much is lost in turning it over to the experts.

▶ **Monetary policy is not like this**

- Monetary policy often require difficult value judgments
- Monetary policy is therefore deeply political—in the good sense of the word.
- Aftermath of the financial crisis made this very clear.

▶ **Low interest rates**

- Accept, for the moment at least, that very low interest rates stimulate the economy
- The low interest rate policy could could profoundly benefit lifetime income of young folks just joining the labor force

  There is evidence that your start in the job market may deeply affect whole lifetime trajectory.

- But very low interest rates can mean poverty for old folks living off interest income.
- Thus, to the complaining (hungry) Grandma, you say say, do you want your grandkids to get jobs?
- But she could reasonably answer yes or no

▶ **Why independence?**

- Central bank independence is the norm despite the fact that monetary policy decisions are inherently political.

▶ **The case for independence**

- The history of organized government (democratic and otherwise) is that governments 'abuse' monetary policy in times of great political stress.

  will clarify momentarily.

- But this is not quite enough to justify independence.

  If times of great stress are pretty rare, this problem might not have to drive the design of governance structures.

- Expectations matter for financial arrangements (including monetary policy)
- If folks know that when trouble arises, monetary policy will be abused, then they will hesitate to make long-term financial commitments

  e.g., buy corporate bonds, make long-term loans

- And we are once again driven back toward the neither a borrower nor a lender be world.

▶ **Example: U.S. just after the revolution.**

▶ **James Madison**

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  Democratic communities may be unsteady, and be led to action by the impulse of the moment. Like individuals, they may. . . may desire the counsels and checks of friends to guard them against the turbulency and weakness of unruly passions.

- –

  Real liberty is neither found in despotism or the extremes of democracy. . . Those who mean to form a solid republican government, ought to proceed to the confines of another government.. . . But if we incline too much to democracy, we shall soon shoot into a monarchy.

▶ **Madison cite**

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    cite: go

    http://avalon.law.yale.edu/18th%5Fcentury/yates.asp

- **Key tension: debtor vs. creditor**
  - The key tension at the founding of the nation and the Fed was between the rich and the poor

    Madison: [Checks and balances] ought to be so constituted as to protect the minority of the opulent against the majority.

  - In particular, the heavily-indebted majorities under the articles of confederation tended to vote themselves debt relief.
  - Chief Justice John Marshall (12 Wheat. 213, p.354) this 'threatened the existence of credit'
  - Recurring theme in this course: without proper institutions, economies tend toward 'neither a borrrower nor a lender be'
- **And remember:**
  - So long as debts are nominal, inflation is debt relief.
  - Thus, governments of all sorts for all of history have resorted to inflation in times of stress.
- **The debate over Fed governance**
  - Senator Aldrich:

    No government yet has been found strong enough to resist the urge for enlarged note issue in times of real or imagined stress. (in Kettl, 1986)

  - Paul Warburg, 1930

    A formula had to be found by which these two elements [pro-inflation and anti-inflation] would be called upon to balance one another.

- **The solution they chose**
  - Settled in the famous Glass-Steagall act (Banking act of 1935)
  - Monetary policy made by FOMC (federal open market committee)
  - FOMC includes 7 Governors of Federal Reserve System
    - Nominated by U.S. President, confirmed by Senate,
    - 14-year, overlapping terms

      Idea is that few would turn over in any given short period.

  - FOMC also includes 12 Presidents of the 12 Federal Reserve Banks

Chosen by the Boards of the banks in conjunction with the Federal Reserve Board according to complicated rules; gives banks and businesses a major role.

- **FOMC make-up and voting**
  - Overall 19 folks: $12 + 7$
  - Only 5 of the Presidents vote at any given time

    Vote rotates. (New York Fed president always votes.)
  - So 12 votes: 7 governors and 5 presidents.
- **On average**
  - On average, the designers figured that the governors would be softer on inflation (inflation doves)
  - And that the presidents would be inflation hawks
  - And this has been very consistently true and especially since the crisis.
- **What should we expect in tough times?**
  - Fed will be divided

    Presidents more hawkish on inflation
  - Fed will be highly unpopular (even if it is dutifully following its mandate)
  - Populist politicians will promoting popular control

    (Bernie Sanders is a prime example)
  - Now Trump seems to be taking up this populist line

    note: Trump tax plan is supposed to come out tomorrow.
  - Today, seems to be laying the groundwork to cut taxes even if there is no offsetting action to reduce the deficit.

    e.g., go

    https://www.wsj.com/articles/trump-wants-tax-plan-to-cut-corporate-rate-to-15-1493057898
  - And he recently flip-flopped on keeping Yellen

    Trump vigorously attacked low interest policies during the election, now says he likes low interest rate policies.
- **But it looks different when you are in charge**
  - Douglas Rediker in the Hill

> Even a monetary policy neophyte like our president is quickly becoming aware that any conservative alternative to Yellen will likely promote a less cautious, steeper and more rapid hawkish monetary policy agenda that could endanger his economic growth story go
>
> http://thehill.com/blogs/pundits-blog/economy-budget/329082-unsurprisingly-trump-has-done-180-on-fed-chair-yellen

- **Fed independence**
  - For the last several years, the Congress has kept two governor seats empty, and Gov. Tarullo just resigned
  - This gives Trump 3 governors to appoint
  - If he replaces Yellen early next year, that makes 4
- **Worried?**
  - The designers of the Fed were trying to avoid letting a President quickly have this large an effect on Fed governance.

    In general, this is probably a bad thing
  - But it remains true that we have the Presidents of the reserve banks who are not politically appointed.
  - And in practice, Trump is pulled in two directions

    classic conservative (inflation hawk) and populist (inflation dove)
  - Net will probably be fine, so long as he chooses competant people
- **Bottom line on independence in general**
  - Populists like to stimulate the economy
  - And don't mind the inflationary consequences.
  - And that's why we have an 'independent' central bank.