



## Challenges to the Federal Reserve's Independence

*Adam S. Posen assesses the record of the Fed before and during the recent crisis and discusses the role of its independence and openness as the United States embarks on an "exit strategy."*

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. It's a pleasure to have Adam Posen, Deputy Director of the institute, to talk today about an urgent issue of the future of the independence of the Federal Reserve Board and the US Monetary System. Thanks for joining us, Adam.

Adam S. Posen: Glad to talk about this, Steve.

Steve Weisman: Adam, you're about to step down as Deputy Director to serve as, I think, external member of the Monetary Policy Committee of the Bank of England. So, congratulations to you, and feel free to make some comparisons on central bank independence or to speculate, if you like.

Ben Bernanke, the chairman of the Fed has been giving a lot of speeches lately to defend himself and the actions of the Fed over the last year, year and a half. Does this enhance the chances of the Fed maintaining its independence or does it jeopardize them, in your view?

Adam S. Posen: In my view, it enhances, Steve, and I think, except obviously for some specific questions from congressional committees, it's been as much about explaining what the Fed is doing as defending what the Fed is doing. I had the opportunity to write with Chairman Bernanke and some other economists 10 to 12 years ago, a book on central banking, and one of the things that Ben, now Chairman Bernanke, felt very viscerally and we all felt very viscerally was that transparency was good, that part of being accountable to a democratic society is the central bank has to be out there, central bank has to commit to what it's trying to do, has to explain what it's trying to do, has to give clear answers. And while I certainly don't think all the policies pursued by the Fed in recent years was necessarily the right thing, I think the approach of trying to communicate and trying to be upfront, trying to communicate more directly with the public, all of which is commendable.

One more thing, and when you spoke about comparisons with the Bank of England, one of the reasons why I'm very excited to have the opportunity to join the Bank of England in this regard is that it has what we wrote about 12 years ago, and still what most of us think of as the state of the art in central bank transparency. They have a monthly meeting. They release minutes very shortly after the meeting. Individual

members are accountable for their individual votes and their individual opinions. The governor gives a press conference after every monthly meeting, and he's actually very good at it, but he's committed to do that and take lots of questions. It's, you know, not a huge difference from the Fed, but it is, I think, a lot of ways better, and it makes more regular the idea of this kind of explanation and access, and I think if the Fed will move in that direction, what Chairman Bernanke is doing now wouldn't seem like a shocking defensive measure. It would be seen, as it should be, part of the natural way of doing things.

Steve Weisman: Has the Fed been forced to become more open because of the crisis?

Adam S. Posen: I think the Fed had been on an opening trajectory for the last 15 years. I mean, Alan Blinder and others in the '90s when they were on the Federal Reserve Board and then Bernanke when he was simply a governor, were all pushing in that direction. But clearly, as Spiderman said, "With great power comes with great responsibility." They've got a whole bunch of new things they're doing, at least temporarily. Understandably congressional scrutiny is much higher. Understandably, press attention is much higher, to wit, this interview we're having on the exciting topic of central bank independence. So, it's both. I mean, I don't think anything they're doing now, including the town hall meeting Chairman Bernanke had or his *60 Minutes* interview, which frankly I thought was excellent, is contrary to where the Fed was going anyway, but clearly the need was more pressing. The bureaucratic inertia was overcome under the crisis.

Steve Weisman: Looking down the road, Adam, as the Fed confronts, sooner or later, the issue that you and others have called the exit strategy, which in the case of the Fed would mean restoring its balance sheet and also, of course, possibly raising interest rates and curbing the growth of money supply. All of those are related, do you see any cause for concern about the Fed's independence, and of course related to that is the question of, it's very sensitive, of Chairman Bernanke's possible reappointment. But let's talk first just about it institutionally.

Adam S. Posen: Yeah. I think the institutional question is more important and frankly, it's the only one I really feel comfortable talking about.

Steve Weisman: Of course, yeah.

Adam S. Posen: But it's interesting to go back to the history of the Fed. The Fed basically screwed up badly in the '30s, in the early '30s. They tightened monetary policy too soon. They weren't responsive enough to the banking crisis. This is the well-established history and this is stuff Milton Friedman and Anna Schwartz wrote about. The modern version of this was written by Barry Eichengreen and by Chairman Bernanke.

Steve Weisman: Yes, and of course, famously, Chairman Bernanke, at a birthday party for Milton Friedman, said something like, "I apologize. The Fed screwed up."

Adam S. Posen: Yeah, basically. And Anna Schwartz—who's still with us, thank God, would show up at academic meetings and say, "Don't do it again." And there's—I don't know if it's a bestseller—but there's a very good popular book out now called "The Lords of Finance," which is about how the Fed and some other, the Bank of England and the Bank of France, at that time really messed things up. So, there is an issue, but in the context of independence, what happened was the Fed lost a lot of independence from the late '30s into the early '50s because it screwed up. Not because of what it was doing in principle, not because there was this huge populist wave. It was because people felt they had blown it. And so there's a lot of talk now about "Oh, does the Fed have too much power?" or "Are they too intrusive?" That's not really the issue. If people felt that the Fed had done a good job, people wouldn't be talking about that. The reason there's so much pressure on the Fed right now is because frankly, they did screw up. They did mess up the regulatory role, which they were, and supervisory of banks for all they have.

Steve Weisman: You're now talking about the period of the years leading up to the current crisis, right?

Adam S. Posen: Yeah. I'm talking about the mid-90s or even the early '90s up through, say, 2008.

Steve Weisman: And how did they screw up? Remind us.

Adam S. Posen: Well, in my opinion, and I think a number of people agree and this will come out to be the right answer. They willfully neglected a bunch of things they could have done to rein in the banking system, to rein in the so-called shadow banking system, to protect consumers and mortgage markets and other banking markets, to constrain the hidden derivatives markets. All of which I think was a genuine mistake, as I've said in other contexts, because they believed in this ideology of laissez-faire and also frankly, they were kind of hoping that they wouldn't have to do all this regulatory stuff, which is why it's so ironic that now suddenly, they're out there testifying, "Oh! We want to keep all these at the Fed," which is, you know, whatever the right analogy is, it's just a little odd since a few years ago, they were very happy to ignore these things and hope that they would be taken away.

Steve Weisman: You subscribe to the view though that they screwed up in the, or let's use a more polite term, that they messed up in the regulatory area, but do you agree that they also kept interest rates too low for too long and failed by doing so to prick the asset bubble that was especially grievous in the last few years in the housing market?

Adam S. Posen: No. I definitely view their failings as being on the regulatory supervisory side. This was a popular point of view some years ago, and it has now become a very small minority view. I look forward to remaining in this point of view when the evidence brings us all back around to this point of view.

In a nutshell, there are two pieces to the argument. First is if the Fed was too easy

for too long, the amount they were too easy was probably somewhere between 25 and 50 basis points, and I'd say half a percent on interest rates for about six months. And you know, anybody who thinks that you're ever calibrating monetary policy so precisely and the effects are so exact, that that kind of error, if it was an error, made this enormous bubble, is just absurd. And even those who sanctimoniously say, "Oh, I would've popped the bubble. Oh, I would've lent against the wind," none of them were talking about, you know, putting up interest rates to 200 basis points, two full percentage points for a year or something, which is the only level that would have changed things.

Steve Weisman: That could've worked.

Adam S. Posen: That maybe could've worked or at least would have represented beyond the bounds of minor tweaking. So, I think the argument about the Fed causing or not pricking the bubble is pretty much irrelevant.

But the other point is, looking across the research I've done here at the institute, looking across countries and time, and I think we've spoken about this before, there's very little evidence that central banks can prick bubbles using interest rates. So there's a lot of talk about the Japanese bubble, but starting in '89 and into the early '90s, the Japanese central bank tried to prick the bubble. They raised interest rates; it didn't work. They had to resort to regulatory means, limiting leverage and putting up capital requirements for banks essentially, and restricting certain kinds of borrowing. That was what pricked the bubble.

The one example people used to cite was the Reserve Bank of Australia. The Australian central bank had successfully pricked a property bubble around Melbourne. That was very hot in early 2000s, but then you know, a year and a half later, *The Economist* and the IMF were both pointing out towards the huge overheated real estate market again in Melbourne. So, the record rather than the fantasy that you can pop bubbles with interest rates, is just not very good.

Again, I'm not saying the Fed shouldn't be responsible for looking at bubbles, Steve. I mean, I think I was wrong and a number of people were wrong and Fed Vice Chairman Donald Kohn has actually been pretty open about this recently too, saying you know, we said we couldn't tell when there was a bubble and we shouldn't guess. Well, in reality, we probably should've guessed. We make guesses about other things. But that doesn't mean that you use interest rates to prick it. What it means is frankly, you should be using regulatory means.

Steve Weisman: Okay. Now, looking forward, let's say next year, after the issue of whether or not Ben Bernanke will continue to lead the Fed has been settled, presumably, what is the danger that you see of political pressure affecting the Fed in terms of what it is going to have to do on this exit strategy problem?

Adam S. Posen: You're absolutely right to bring us back there, Steve. I got off on that historical question a bit.

Steve Weisman: No, I'm glad you did. The history is important.

Adam S. Posen: But you're right that that's the bottom line going forward, and I think there's a simple answer and then a harder answer.

The simple answer is if you define the exit strategy very narrowly, which is the central bank has printed a lot of money, or probably they prefer to say injected a lot of liquidity into the economy and kept interest rates low and will they, if the economy recovers, be able to reverse that. And the simple answer, which is what Chairman Bernanke said in testimony, I think, last week, which I happen to agree with, is technically, it's not that hard.

I mean, this isn't like we print the money and suddenly, it's out of our hands and automatically it leads to inflation. It depends on context. If you print money when the ship's going down, it doesn't suddenly right the ship. If it did, we would be out of the mess by now. But anyway, so it's not that technically hard to turn on the dime. If the Fed decides to put up interest rates, they can put up interest rates. They can stop buying T-bills. So, in that narrow technical sense, I know there are worries, oh, they've done all this; we're precommitted, they can't stop inflation. They're wrong. The broader sense, and this is the issue which I'm hoping to continue researching, if I will be continuing the researching in the coming year while at the Bank of England and working for PIIIE, is the exit strategy in the broader terms, which is not just the when do you tighten monetary policy, but when do you tighten the fiscal measures that are going forward. How do you extract the government guarantees from the banking system? How do you do this in a world where different countries may be trying to do this at different paces, which has big effects on capital flows and exchange rates? This is a much more complicated question.

There's no easy answer. You can, not easily but probably make a case of you know, ideally, how are you going to do this? The ideal thing is you fix the banking system first, then withdraw the public guarantees. Then, you start constraining your fiscal policy and you move monetary policy last.

But even that's not for sure, and then there's a sequencing question of if you're doing that and something goes wrong like the banking system isn't really fixed or suddenly you've got healthcare and the fiscal situation gets much worse, can the central bank wait to raise rates or does that let things get out of hand? And that starts being much more complicated.

Steve Weisman: And I don't see personally much prospect for fiscal tightening anytime soon, do you?

Adam S. Posen: It's a real question right now. I've said in various contexts that until this year, I've been doing this now close to twenty years, you know, and there are serious people like P. Peterson, the bestselling author for whom this institute is named, who care very deeply about the budget deficits and who thinks that that's a major issue. And until this year, I didn't disagree with him in principle, but I wasn't sure that it was a pressing major issue.

This year turned the corner for me because we did commit to doing this huge deficit spending in 2009-2010, probably a little less in 2011. I think that was the right thing to do under the circumstances, but that means we are tacking on to our national debt a good 25 to 30 percent of GDP in a very short amount of time.

And you can do this only once every couple of generations. You know, we did it for World War II, and then we paid it off. We're doing it now, and we better hope we don't need to do it again for another 20 to 30 years. So, that already would be a pretty grim fiscal situation.

To the credit of the Obama Administration and the Congress, almost all, not all, but almost all that they did on the stimulus stuff was cyclically driven or was temporary. It wasn't new entitlements. So you could imagine, all right, it comes down starting in 2011 and if we're really good boys and girls and don't need to go into the emergency fund again for another 10 years, we'll be all right.

Then, we get healthcare. And as everybody watching the press knows, there is a real question—how are you going to pay for it? You know, we all believe there are plenty of efficiencies that can be gained there, but it's not clear that any of the plans underway right now will deliver them in a short time. I think the CBO, the Congressional Budget Office Director Doug Elmendorf has done a huge service to the country being very brave and very forthright in talking about the issues and when stuff is not being paid for.

Steve Weisman: Talk about independence, that's a good example of it.

Adam S. Posen: Absolutely. I mean, he and his staff, the CBO, really deserve credit because they've just stood up to everybody and said, "These are the numbers as we crunched them. This is how we crunched them. And this is the reality." And they've been, you're absolutely right, it's great independence and they've done it very well.

But the point for our listeners in terms of the economic outcome besides the heroism of an economist is that we don't know really how much healthcare is going to cost. I am in favor of expanding healthcare to the 30 to 40 million people who don't have it in this country in terms of insurance, but I'm also in favor of paying for it, and that means you have to raise taxes somewhere or that means you have to radically change the healthcare payment system, probably both.

And right now, none of the programs being proposed really do that. So, as opposed to the stimulus package which is a one-shot thing, very big, can't repeat it, but can rebuild; healthcare potentially as something that could go on forever. It's a new entitlement and could just keep growing.

Steve Weisman: It's interesting. We started out by talking about Fed independence, but we're concluding by your pointing out that the Fed and the political leadership are going to have to cooperate in the next phase of this crisis or downturn.

Adam S. Posen: Well, I would I bring that back I wouldn't be so shocked by that. I'm not saying you are, but you know, sometimes people are saying, "Oh my God! It's a compromise if they cooperate." And I would suggest there are two things that I've researched for a long time that say that's exactly how you want things to work. The first is cooperation should never be stymied by just the desire to appear uncooperative. In other words, you know, you can show your independence by doing the right thing, and if the right thing happens to be agree with by the elected officials, well, that's a good thing.

This was part of the problem with the Bank of Japan and the elected officials in Japan in the late '90s was the Bank of Japan insisted that they had to stick with tight policies, in fact, some destructive policies because if they didn't, it would look like they were compromising independence. And in an Institute book I edited, a number of us including me, including now Chairman Bernanke wrote, you know, "For God's sake! You're not going to destroy your independence by doing the right thing. You may lose it by doing the wrong thing." Like the historical example I did with the Fed in the '30s.

But the second point, and this goes back to the stuff I wrote in my dissertation, which was a long time ago now, is that you only maintain independence when you're able to convince the populace and the political class in the country that your institution is doing the job well and there's reason to have it, that you have some political coalition behind you.

You can have all the legal barriers you want and all the stories, but in the end, if Congress decides that the Fed needs to be brought to heel, it can bring Fed to heel. And if on the other hand, they feel the Fed is doing a good job and serves a useful role, and the Fed is persuasive in getting out there and convincing people of that, then the Fed will be left well, not entirely, but mostly.

And so ultimately, it is politics. There is no simple institutional fix for politics, as I put it in the first article I ever published. You have to build a constituency. And right now, the way you would build the best constituency is by some cooperation between the fiscal authority and the monetary authority in the US and elsewhere, coming up with credible plans that the fiscal policy will be restrained in the future, and that then makes it more credible for the central bank to sort of hold their fire on

interest rates. And the messy part is going to be if we get into sort of a deterrence or competitive game where a central bank, I'm not saying the Fed or the Bank of England, where any central bank facing fiscal authority feels, "Geez! They are not being responsible, so we have to take action." That's what we saw with Volker and Reagan in the early '80s.

Steve Weisman: Exactly.

Adam S. Posen: And that was a bad outcome. Not that Paul Volker didn't do the right thing. He's a hero. He did do the right thing. But compare that to Rubinomics of the early '90s where essentially, you know, everybody says there was no explicit deal, I'm willing to believe that, but essentially—

Steve Weisman: But it was implicit, wasn't it?

Adam S. Posen: It was implicit. I mean, essentially, the early Clinton Administration delivered a credible commitment on fiscal policy, and as a result, the Fed was able to credibly hold off on some interest rate rises.

Steve Weisman: Well, Adam, as you head off to London, good luck to you and make sure that on your return trips, we review the bidding on all of this. It's going to be unwinding for many months and years to come.

Adam S. Posen: Yeah, it's going to be a fun thing, I guess, to try to help. Thanks again, Steve.

Steve Weisman: Thanks.