

Chapter 15 – Central Bank Independence and the Financial Crisis

In the financial crisis of 2007-09, the Federal Reserve and the Treasury cooperated in an unusually close fashion. At times, the Fed appeared to act as if it were an agent of the Treasury – “the Government’s bank” described in Chapter 15 – assigned to restore financial stability.¹

In supporting the Treasury, did the Federal Reserve sacrifice its monetary policy independence and its objective of low, stable inflation? The crisis has led to unusual uncertainty about the economic and inflation outlook in coming years. However, the return to high and sustained inflation that some observers fear is far from inevitable.

To be sure, many Fed actions in the crisis were radical and unprecedented. Utilizing its emergency powers for the first time since the Great Depression, the Fed lent directly to nonbank intermediaries (including Bear Stearns and AIG) and purchased commercial paper from nonfinancial firms that had lost market funding. To counter the liquidity crisis following Lehman’s failure, the Fed allowed its balance sheet to more than double in the space of two months. To lower long-term borrowing costs, it acquired several hundred billion dollars of mortgage debt and U.S. Treasuries. And, of course, the Fed cut its policy rate close to zero for the first time.

Do these actions mean that the Fed is no longer independent of U.S. government policy wishes? Not really. In a financial crisis, the policy goals of financial stability, stable growth, and stable prices often are mutually consistent.

Three reasons make clear why efforts to counter a financial crisis may also promote macroeconomic stability. First, modern economies cannot operate without a functioning financial system, so a minimal level of financial stability is a prerequisite for economic stability. Second, financial crises often trigger deep cyclical recessions. They also can slow the sustainable growth rate over a long period.

Finally, when inflation is already low, a deep recession can lead to *deflation* – a persistent and potentially unstable decline of the price level. Two of the largest financial disruptions of the 20th century – the Great Depression of the 1930s and the Japan’s post-bubble stagnation in the 1990s – led to and were aggravated by deflations. Deflation can trigger a vicious cycle of financial stress and economic

¹ For example, in arranging the emergency acquisition of Bear Stearns in March 2008, the New York Federal Reserve Bank (NYFRB) had to accept on short notice collateral with highly uncertain market value. This action put U.S. taxpayers at risk of loss in a way that – in ordinary circumstances – only Treasury would. The Treasury Secretary endorsed the action in a letter on March 17, 2008, that protected the NYFRB (see <http://finance.senate.gov/press/Bpress/2008press/prb040108a.pdf>). One year later, Treasury added that it would “seek to remove” these risky assets from the Fed’s balance sheet or “to liquidate” them. In effect, the Fed had acted in a temporary, emergency capacity as “the Government’s bank” to address a systemic crisis until the Treasury gained the flexibility to respond.

decline. For example, falling prices make it more difficult to repay debts, spurring defaults and diminishing confidence and risk-taking. Unlike inflation, deflation also adds to information problems in intermediation by depressing net worth (see Chapter 11 Applying the Concept: Deflation, Net Worth and Information Costs).

Consequently, in a financial crisis, an independent central bank typically will try to promote economic expansion. It also may cooperate with fiscal authorities to promote financial stability and counter the risk of deflation.

Of course, an independent central bank must be prepared to reverse course when necessary to keep inflation low. For example, in Chapter 17 we will learn that a central bank balance sheet that *stays* bloated over the long term *eventually* leads to inflation. The authorities need the proper tools to reverse their emergency actions when the time is right (see the Chapter 18 module: Paying Interest on Reserves).

Yet, if policymakers do reverse course in a timely fashion, their actions to counter a crisis need not lead to inflation (see the Chapter 18 module: Unconventional Policy 4 – Exit Strategies). The difficulty is judging when and how to reverse course. Given the frailties of the U.S. financial system, and the uncertainties about the economy and the impact of the Fed's balance sheet expansion, the chances of a policy misjudgment seem unusually high. Waiting too long or reversing policy too cautiously will lead to inflation. Acting too early can dampen or undermine economic recovery. In 1936, the Fed acted far too early, prolonging the Great Depression. The Bank of Japan made similar, if less egregious, errors during Japan's stagnation.

Against this background, you might wonder – as some critics do – if the Fed's radical crisis interventions have diminished its independence and the credibility of its commitment to price stability. Despite all the heightened uncertainties about the economic and policy outlook, both professional forecasters and the Treasury market seem confident that the U.S. monetary authorities will succeed at keeping inflation low over the long term. On average, both surveys and bond prices remain consistent with average inflation of about 2% over the next decade, not very different from pre-crisis expectations. On this evidence, market economists and bondholders view Fed independence and the credibility of U.S. monetary policy as largely intact.