The Case for a Limited Central Bank

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In his book, *The Alchemists*, Neil Irwin (2013) follows the history of the recent financial crisis of 2007, examining the difficult decisions made and the bold actions carried out by three central bankers: Ben Bernanke of the Federal Reserve, Mervyn King of the Bank of England, and Jean-Claude Trichet of the European Central Bank (ECB). Irwin not only justifies the unconventional methods such as quantitative easing, that was used by these three men, but applauds them, for “peace and prosperity… require people like Bernanke, King, and Trichet to safeguard them, often by doing things that are widely unpopular” (p.388). He accepts the expanding role of the central banks as a necessary measure given the changing times. He believes “central banks [should not] let precedent or politics stop them from doing what they need to do to keep their economies healthy” at all costs even, if it means bailing out investment banks, telling Parliament how to manage its books, and propping up financially troubled economies (p.390). Irwin believes we shouldn’t expect perfection, but rather progress, and trust intelligent men to handle economic crises and manage the economies in ways that they best see fit because they are so “technically complex that we can’t put them to a vote” (p.390). So, even though we still have high unemployment and slow economic growth, the three central bank chairmen did perform “alchemy” because they managed to prevent a global economic meltdown. However, Irwin’s justification for the changing role of central banking is a cursory one that prioritizes a short-term perspective over a long-term one. The recent unconventional changes to central banking should be considered temporal at best. In the future, central banking should turn away from recently increased coordination between monetary and fiscal policies, and instead, return to its smaller role before the crisis as the regulator of the monetary policy and inflation rate. This is because continuing patterns of central banking undermines its independence, which is required to carry out its duty effectively, and deters future growth by amassing colossal debts.

The history teaches us that the significance of the central bank’s independence cannot be understated: its independence is crucial in order to effectively control inflation and have a healthy economy. In the United States, it took two failed central banks, repeated financial crises, and finally the Panic of 1907 to have the Federal Reserve that Americans have today (Bruner & Carr, 2007). As a government agency, the goal of a central bank is to serve the society and its people the best it can. Traditionally, this meant expanding the monetary supply to meet increased demand. However, as Reis (2013) points out, the mandate for most central banks is unclear because there is a wide range of differing opinions when it comes to deciding what the best practices are (p.2). Nonetheless, there is a consensus that the primary goal of central banks should be to target a particular rate of inflation through monetary policy (Kahn, 2009, p.35). Despite varying opinions on what the optimal inflation rate is, study on the subject has shown that low inflation is crucial to long-term price stability, which is necessary to spur investment and economic growth (Reis, 2013, p.5). However, the Federal Reserve under Bernanke has added to its traditional focus on maintaining a low inflation a focus on the employment rate as well. Bernanke said, “The stagnation of the labor market in particular is a grave concern not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years” (Irwin, 2013, p.384). This is a deliberate shift because there is often an observed trade-off between inflation and unemployment as shown by the Phillips Curve. Therefore, any decrease in unemployment today may be matched by increase in inflation in the future, slowing down economic growth. Greater independence may allow a central bank to keep its inflation rate low, and thus, keep

the price level stable. Independence from the central government also frees central banks from short-term political constraints, allowing them to have a broader perspective (Meltzer, 2012, p.255).

It is necessary to make sure that the central bank is unaffected by changing political situations in order to establish its credibility and maintain its power to oversee the long-term economic well-being of the country. Because of its incredible power to create money out of thin air, this power has been abused numerous times, despite the painful lessons of previous attempts. Even as recently as 2008, the Zimbabwean government decided to print money maniacally, hiking its inflation rate to a staggering 6.5×10^{108} percent, devastating its economy, and making its currency practically worthless. Because of the short-term nature of political positions, when a party that is currently in power faces an upcoming election and has the power to print money, it tends to overspend to increase its appeal to voters. The incumbent party compensates for the overspending by overprinting money, leading to slow economic growth in the future or hyperinflation. In all cases, the result is drastically negative economic performance due to politicians caring only for re-election and disregarding long-term consequences of their actions (Blinder, 2012, p.485). To prevent such abuses, it is necessary to subject central banks to mechanisms that limit such great power because the negative long-term economic consequences of dramatically increasing the money supply have been documented very well (Lacker, 2012, p.249).

There is a strong causal correspondence between the rate of growth in the money supply and the subsequent change in the growth of nominal income (Borbo & Rockoff, 2013, p.3). “In the short-run changes in money would produce changes in real output; in the long run changes in money would be fully reflected in changes in the price level. In modern terms, monetary changes would temporarily impact real output reflecting nominal rigidities but ultimately the growth of real output is independent of monetary forces and monetary neutrality would prevail.” (p.3). Essentially, the only thing that the quantitative easing, as implemented by the U.S. Federal Reserve and other central banks, guaranteed us in the long-run is colossal debt. Although central banks have not increased their respective money supplies to the extent that Zimbabwe has, they have increased it by an extraordinary amount, and it is crucial to recognize the fact that we are setting the stage for an even bigger economic financial disaster in the coming years.

The amount of debt amassed by central banks in response to the 2007 financial crisis is astonishing. Even more astonishing are the ways they decided to respond to the crisis. The Federal Reserve oversaw the buyout of Bear Stearns by JPMorgan Chase and bailed out several private investment banks at the cost of billions of taxpayers’ money (Irwin, 2013, p.134). The ECB violated its long-held principle by printing money to fund financially-crippled governments and buy their bonds, some of which were considered junk (p.231). The Bank of England agreed to spend £50 billion on buying bonds and its chairman, King, urged the Parliament to accept immediate fiscal austerity, which it eventually did (p.241, p.244). Such measures were unprecedented. In *The Alchemists*, Irwin details the extreme pressure and time limit under which these three central men, especially Bernanke, had to make decisions. Even though we can sympathize and say that their actions were permissible given the situation, we have to establish that such measures cannot be repeated and cannot guide the future of central banking. For one thing, Ben Bernanke did overreact to the financial crisis and

overstepped his authority. He overreacted because he believed that the Great Depression was a result of financial institutions being allowed to fail, which brought the entire U.S. economy down with them (Irwin, 2013, p.133). However, Bernanke and his counterparts made the mistake of focusing too much on the Great Depression, and not enough on other crises, such as the Great Inflation of 1970s, which was caused by the Federal Reserve frantically printing money.

Jeffrey Lacker (2012) argues that the extraordinary actions taken by central banks in response to the recent financial crisis are problematic because they are engaging in credit allocation by expanding their set of private assets (p.248). For example, the Federal Reserve provided direct assistance to “dysfunctional segments of the credit markets” by giving loans to financial institutions, and purchasing troublesome mortgage-backed securities and debt issued by Fannie Mae and Freddie Mac (p.248). The problem with credit allocation is that it “can redirect resources from taxpayers to financial market investors and, over time, can expand moral hazard and distort the allocation of capital,” increasing inequality in the long-run and encouraging more risk-taking behavior in the future (p.248, p.250). This is because the Federal Reserve and other central banks which engage in credit allocation choose which firms get access to loans and which do not. Lacker also argues that the firms they choose to give loans to are unsovereign, and under natural circumstances would have failed or been denied access to credit, but unnatural intervention by central banks is propping them up. Such interventions set the precedent that central banks will help firms who are too big to fail. This “guarantee” encourages firms to take on more risks in the future, which in turn increases the likelihood of future financial crises (p.251).

Coibion et. al (2012) also found in their research that nonconventional methods used by central banks to conduct their monetary policy affect both income and consumption inequality. They affect income because of heterogeneity across households—due to differing primary sources of income. For the majority of households, their primary income is labor earnings, but there are also households which rely more heavily on business and financial income (p.2-3). Therefore, “if expansionary monetary policy shocks raise profits more than wages, then those with claims to ownership of firms will tend to benefit disproportionately” (p.2). Also, because people who have claims to ownership of firms are usually wealthier, such a shock would further increase inequality. In addition, if the money supply increases, agents who trade more frequently in financial markets would benefit more from the shift in money supply than less active agents. This leads to increased inequality because wealthy people trade more frequently in financial markets. Lastly, the drastic expansion of monetary supply by central banks in the recent years will result in higher inflation in the future. Inflation harms low-income households the most because low-income households hold most of their wealth in currency compared to high-income households (p.2).

In light of such evidence, it is difficult to deny that the recent inflationary actions of central banks will not have serious consequences in the future. Advocates of increased cooperation between monetary and fiscal policies, and an expansive role of central banks, like Irwin, argue that the extraordinary measures taken by central banks were necessary to avoid a global financial meltdown (Lacker, 2012, p.248). However, there is always a danger of engaging in counterfactuals. Though we cannot predict any conclusive statements about the effects of such measures on the broader economy and in the future yet, we can say with certainty that

the staggering amount of debt that we have incurred will slow down economic growth in the future. (Fawley & Neely, 2013, p.81). We have also observed that the current patterns, if continued, will negatively affect income and inequality. Irwin concludes his book by saying that the successors of Ben Bernanke, Mervyn King, and Jean-Claude Trichet will learn from their failures (Irwin, 2013, p.390). However, we cannot wait that long—current central bankers need to learn that returning to their pre-financial crisis role, when central banks were more independent, engaged in little to zero coordination between monetary and fiscal policies, and conducted monetary policy through conventional methods as necessary. As King said, "Printing money is not… simply manna from heaven" (p.388). We will pay the price for it eventually.

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