Defending Central Bank Independence

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Gracias por darme la oportunidad de hablar ante ustedes. Para mi estar aquí es como regresar a casa. Yo crecí en la Ciudad de México y, aunque les pueda resultar difícil de creer por lo rudimentario de mi español, cursé la primaria aquí, estudiando inglés como segunda lengua. Tengo un profundo afecto por México y todo lo mexicano. De hecho, debo decir que aprendí acerca del Cura Hidalgo y Benito Juárez antes de conocer a George Washington o Abraham Lincoln. También conocí las culturas maya, tolteca, y azteca antes de estudiar la historia antigua de los griegos y romanos en las escuelas estadounidenses. Guardo con mucho afecto estos recuerdos de mi niñez y llevo a México prendado en mi corazón. Es para mi un gran honor hablar en este importante recinto, ante esta audiencia de las mentes jóvenes mas brillantes de este gran país.

Esta tarde voy a hablar acerca de lo importante que es tener un banco central independiente. Trataré de hacerles ver que un banco central independiente es un elemento lógico y fundamental de una economía en buen estado; protege a un gobierno democrático de sus propios demonios. Creo firmemente que uno de los más grandes logros del México reciente ha sido la adopción de la enmienda constitucional de 1994 que otorga verdadera independencia al Banco de México. Afirmo además, que el liderazgo del Gobernador Ortiz ha sido insuperable…bueno, estoy obligado a decirlo porque él me va a invitar a cenar al rato y quiero estar seguro de que nos la vamos a pasar bien.

Al final de esta presentación hablaré de asuntos recientes tales como la última reunión del Comité Federal de Mercado Abierto (FOMC, por sus siglas en inglés). Eso me servirá para ilustrar, en tiempo real, los retos y desafíos a los que se tienen que enfrentar los bancos centrales en cuestión de la política monetaria, especialmente en tiempos de coyuntura económica como los que estamos viviendo.

Esta tarde, como siempre, hablo desde mi propia perspectiva, como presidente de uno de los doce bancos regionales de la Reserva Federal, como una sola voz de entre las 17 que actualmente participan en las deliberaciones del Comité de Mercado Abierto. No hablo a nombre de ningún otro oficial de la Reserva Federal, ni a nombre del comité.

Entiendo que todos ustedes hablan inglés, por lo tanto voy a dejar de torturarlos con mi español, y continuar en inglés. Al final, tendremos una sesión de preguntas y respuestas que podremos llevar a cabo en cualquiera de los dos idiomas, o incluso en la lengua de mi amada Texas: Spanglish.

Let me start with a refresher course on economics, so that we are all on the same page.

The price of a good or service is determined by supply and demand. Too much demand relative to supply leads to an increase in the relative price of that good or service. Too little leads to a price decrease. Money and credit are the means by which aggregate demand is managed in the economy. The central banker’s task is to provide the monetary and credit conditions that achieve the ideal balance between accommodating economic expansion and engendering inflation or deflation.

The ultimate task assigned to central banks is to maximize the welfare of the people by providing the monetary conditions for sustainable, noninflationary economic growth. In the long run, growth cannot be sustained if markets are undermined by inflation or deflation. The idea that stable prices go hand in hand with achieving sustainable economic growth has led more and more central banks around the world to adopt price stability as their exclusive mandate. Mexico took that view one step further by explicitly writing price stability into the constitutional amendment that granted Banco de México its independence.

I submit that the likelihood of achieving sustainable economic growth and keeping inflation at bay is best enhanced by having central banks that operate with independence from government meddling.

Economic theory generally embraces the idea that a nation's money supply ought not be directly controlled by its government because such an arrangement would create a perverse incentive structure that would lead to economic disaster. Printing money, or debasing the currency, to pay off government debt is an old concept, noticed by the ancient Greeks and famously practiced by the Romans. In 1824, David Ricardo warned that a government entrusted with the power to issue money would most certainly abuse it.[1] Like all good economists, Ricardo knew the destructive dynamic of printing excess money: The result is inflation, the cruelest form of taxation—especially for the poor and for savers—and the greatest obstacle for entrepreneurs and financiers seeking to invest and grow their businesses.

We have some glaring examples today of the destruction that can be wrought by governments with direct control over monetary policy. Zimbabwe is the most egregious. A year ago, after having let monetary printing presses run wild to cover up problems created by misgovernment, President Mugabe famously declared inflation illegal, promising to arrest and punish anyone who raised prices or wages. Of course, that didn't work. Just last week it was announced that Zimbabwe's inflation reached 26,470 percent in November. The economy of Zimbabwe has been destroyed and its people cast further into poverty as their savings disappear.

There are some instructive examples of poor monetary governance in our own hemisphere. In the interest of time, I'll point to just one case: Venezuela.

One would think that Venezuela would be enjoying the prosperity that comes from oil priced above $80 a barrel. But Venezuela's government has taken effective control of the central bank and printed trillions of bolivars to finance ambitious social programs. The result has been an official inflation rate of 22.7 percent. However, the official figure includes a broad basket of items for which the government has declared price controls, so it is more likely that the real purchasing power of the bolivar is being cut in half or more each year. The Venezuelan consumer has been decimated.

To counter the inflation the government itself has created, Venezuela recently introduced a new currency, the "bolivar fuerte," which is basically the old bolivar with three zeros trimmed off.

[1] Ricardo, David, 1824. *Plan for the Establishment of a National Bank*, Murray, London.

Some of your economics professors are old enough to remember when Mexico trimmed zeros off the peso during a time of high inflation. I am sure they will agree that getting rid of all those zeros made it easier to do everyday transactions, but the idea that inflation can be brought under control simply by dividing all prices and the currency by 1,000 is like believing you can keep a room's temperature constant by dividing the thermometer marker by two every time the heat index doubles. Marketing gimmicks with new paper money do not lower the heat of inflation; they do not make prices stable. The problem is a lack of economic discipline and bad government policies that have undermined sustainable economic growth and destroyed Venezuela's prosperity.

I think you get the picture. Why do we have independent central banks? To provide a barrier between government and the money supply. Why is this necessary? Because doing the right thing for the long-term interests of the people can be very hard to do. Monetary policymakers often have to make decisions that can cause economic pain for real people in the short term, or decide not to do things that could help people out of an immediate bad situation, in order to preserve the welfare of the people over the long run.

The incentives given to elected officials, even in the most praiseworthy democracies, increase the likelihood of harnessing monetary policy to their political needs. A congressman or a senator or a president who has all the best intentions and works earnestly for long-term prosperity is still subject to reelection and would quickly find himself voted out of a job if he tried to implement some of the stern policies that an independent central banker is often required to carry through.

It is always easier, for example, to float a weakening economy by loosening the moorings of monetary policy rather than cutting taxes or increasing spending. It is easier to allow inflation to finance ambitious social programs or bail out a government from the burden of debt. Forgive me for invoking Greek mythology and the work of Homer, but governments often fall victim to the Siren call of monetary accommodation. But with an independent central bank, a government, like Odysseus, can tie itself to the mast and commit to the best policy course for the long haul. Aware of the perilous fate that awaits those who succumb to the Sirens, a wise government can direct its central bankers to stuff beeswax in their ears and ignore the seductive calls of powerful interests that demand accommodation to satisfy immediate political needs. Undistracted by political motivation, the central bank can focus exclusively on piloting economic policy on a consistent course toward sustainable, noninflationary growth.

An independent central bank thus occupies a unique place in the pantheon of government institutions. Properly designed, it will pursue a deliberate and steady course, untainted by the passion of the moment and immune to political exigency and influence. Governments bestow independence upon their central banks once they realize that the best approach to monetary policymaking is a clearly defined mandate for price stability and noninflationary economic growth, applied consistently from administration to administration, year to year, decade to decade, generation to generation.

To understand the rewards that come from having an independent central bank able to block out the Siren calls and focus on price stability, the world need only look here to Mexico. Mexico can boast today of an inflation rate that by some measures is even lower than that of the U.S. Mexico has managed two presidential transitions without a peso crisis. Mexican financial markets now have the credibility to issue debt in pesos up to 30 years at less than 8 percent, whereas only a decade ago the longest maturity horizon for Mexican government debt was one year at over 20 percent. The yield curve for Mexico has been extended, and Mexican businesses and consumers can now borrow in pesos longer term, enabling the development of crucial infrastructure, such as housing stock. Foreigners can now invest in Mexico without fear of significant peso devaluations.

This is not the Mexico I grew up in. Today, the Mexican people have greater wherewithal to realize their dreams. Mexican leaders have earned some impressive bragging rights: Two weeks ago in Davos, as the various leaders assembled there were bemoaning the financial crisis presently afflicting global credit markets, Governor Ortiz, looking back to the Tequila Crisis and other episodes, exclaimed that "this time, it wasn't us."

Mexico would not be in this proud position today had your government not amended the constitution in 1994 to create a fully independent central bank with price stability as its main goal. Banco de México has become a no-nonsense practitioner of inflation targeting, rightfully earning the respect of the international investment and monetary policy communities. And here comes the flattering part that I hope will earn me a nice dinner with Governor Ortiz: It is widely accepted in central banking circles that under his direction, Banco de México has become one of the most highly regarded central banks in the world.

It requires more than just a law bestowing independence upon a central bank for the bank to actually be independent. It also requires that it be independent in practice. By definition, for a central bank to be independent, it must possess the ability to define its policy objectives without political pressure and it must be free to use its policy instruments without constraints. This is easier said than done.

We know from our own experience at the Federal Reserve that in times of duress, Congress or the executive branch can interfere with the workings of a central bank with disastrous consequences. In the 1960s, a populist congressman from East Texas named Wright Patman, who was chairman of the House Banking Committee, launched a comprehensive review of the Federal Reserve System that exacted an enormous strain on the System's staff and resources. Congressman Patman was convinced that, contrary to David Ricardo, "money need[ed] to be back in politics where it was in the 19th century."[2] He wanted to legislate away the Fed's independence and turn it into an arm of the executive branch. Patman's investigation had reached a point where the 12 Federal Reserve regional banks and the Washington-based Board of Governors could no longer focus on economic analysis or other functions. Complying with Patman's congressional subpoenas was keeping the Fed from doing its job.

At the same time, President Lyndon Johnson was escalating the U.S. military presence in Vietnam and spending a pretty penny to do so; federal defense expenditures rose to over 10 percent of GDP, more than double the burden of U.S. military spending today. Johnson needed to finance that spending and felt that the Federal Reserve could provide funds cheaply by keeping interest rates low. The Federal Reserve had a real dilemma. It could cut a deal with President Johnson, who, as the most powerful Texan, could call Patman off, but at the price of

[2] Lyndon Baines Johnson Presidential Library. William McChesney Martin Collection. Box 163; Folder: "Martin Addresses (5) April 1962 to July 1964."

surrendering Fed policy independence to Johnson's desires; or it could continue to endure the Patman investigation and risk the Fed's charter and long-run institutional independence.

I should note that whether the then-chairman of the Fed, a very talented and honorable man named William McChesney Martin, and Johnson made a deal is a matter of speculation. Such an agreement would not have been documented if it did exist. What is known is that Chairman Martin met with Johnson at the White House in May 1964, and soon thereafter the Patman hearings unceremoniously ended without any legislation amending the Federal Reserve's standing. The Fed held interest rates mostly unchanged over the next 19 months—until December 1965—despite mounting inflation fueled by government spending.

U.S. government budget deficits continued to grow, reaching their highest relative levels on record in the 1970s. Sadly, the Fed monetized these deficits for several years during the 1960s under Martin's chairmanship and in the 1970s under his successors, Chairmen Arthur Burns and William Miller. By 1979, inflation had jumped to 14 percent and the prime rate reached 20 percent.

The Federal Reserve managed to regain control of the economy and its own independence under the firm leadership of Paul Volcker. But the cure for high inflation was a dose of harsh medicine. A severe recession ensued, followed by years of high unemployment and high interest rates. Monetary decisions made for short-term political gain exacted a heavy toll on the American people.

The Siren call for monetary accommodation to address political ends is universal and can seduce any leader. Whether you live in Zimbabwe, Venezuela, Mexico, the United States or anywhere else, maintaining true central bank independence is required for achieving long-term economic prosperity. The Federal Reserve and Banco de México can best preserve our charters and the sacred trust of the people by doing what we have been assigned to do: remain focused on making monetary policy that achieves long-term sustainable noninflationary growth. The future prosperity of our two countries depends upon it.

Which brings us to the present situation.

Under Chairmen Alan Greenspan and Ben Bernanke, the Federal Reserve has been left alone to conduct monetary policy. We are a truly independent central bank. Policy is set by the Federal Open Market Committee. The 17 current participants in the FOMC deliberations consist of five governors, including the chairman, who are appointed by the president of the United States and confirmed by the Senate, and 12 presidents of the Fed's regional Banks, each of whom serves at the pleasure of his or her Bank's board of directors. All 17 participate in honest and vigorous discussion of the economy and each offers his or her individual policy prescription at FOMC meetings convened and presided over by the chairman. At the end of these meetings, the chairman calls for a vote. All the governors vote every year and five of the presidents vote under a rotation system so that different presidents vote year by year. This year, I have the privilege of being one of the five voting presidents.

At the last meeting of the FOMC, I voted against lowering the federal funds rate—the target rate we set for banks to loan overnight money to each other—from 3.5 percent to 3 percent. The minutes of that meeting will be released on Feb. 20, 2008. It would be inappropriate for me to discuss the deliberations; however, I can give you a perspective.

I spoke earlier of William McChesney Martin. He famously said that the job of a good central banker is to take away the punchbowl just as the party gets going. For the past few years, we have had a raucous party of economic growth fueled by an intoxicating brew of credit market practices that financed a housing boom of historic, and late in the cycle, hysteric, proportions. With the benefit of perfect hindsight, some have argued that the Fed failed to take away the punchbowl as the subprime party spun out of control, leaving rates too low for too long and not using our regulatory powers to restrain excessive complacency in the pricing and monitoring of risk. But that is beside the point.

Now we are faced with the consequences of a process that lawyers would call the "discovery phase": As big banks and other financial agents confess their acts of fiduciary omission and excesses of commission, credit markets have effectively de-leveraged important segments of the economy, slowing growth suddenly and precipitously. Instead of taking the punchbowl away, the Federal Reserve is now faced with the task of replenishing the punch.

Yet at the same time, we are faced with the unprecedented consequence of demand-pull inflationary forces fueled by the voracious consumption of oil, wheat, corn, iron ore, steel and copper, and all other kinds of commodities and inputs, including labor, among the 3 billion new participants in the global economy. When it comes to these precious inputs, we have no control over the surging demand from China, India, Brazil, the countries of the former Soviet Union and other new growth centers, but we know that it is putting upward pressure on prices in our economy. Economists note that the "income elasticity of demand" for food is higher in China and other emerging economies than in the United States. Many of these countries' income elasticity of demand for oil and certain other vital commodities is greater than 1, meaning that their demand for these items will increase faster than their income. Even if growth slows somewhat in some of these important emerging economies—the World Bank, for example, projects China's growth will be 9.6 percent in 2008, down from 11 percent last year—demand for inputs relative to the world's ability to supply them will likely continue to exert upward pressure on key commodity prices.

We also know that the inflationary expectations of consumers and business leaders are impacted by what they pay for gasoline at the pump and food at the grocery store.

Monetary policy acts with a lag. I liken it to a good single malt whiskey or perhaps truly great tequila: It takes time before you feel its full effect. The Fed has to be very careful now to add just the right amount of stimulus to the punchbowl without mixing in the potential to juice up inflation once the effect of the new punch kicks in.

We have been hard at work trying to find the right mixture. Before the meeting last week, we had reduced the fed funds rate by 175 basis points in 18 weeks—cuts that I supported even though I did not have a formal vote. During that time, we also initiated a new system for term money that has auctioned $100 billion at rates below the official discount rate.

My dissenting vote last week was simply a difference of opinion about how far and how fast we might re-spike the monetary punchbowl. Given that I had yet to see a mitigation in inflation and inflationary expectations from their current high levels, and that I believed the steps we had already taken would be helpful in mitigating the downside risk to growth once they took full effect, I simply did not feel it was the proper time to support additional monetary accommodation.

I respect the majority view of the committee. I sleep well at night knowing that the collective wisdom of the group is guided by one common goal: the continued prosperity of the American people.

Bueno amigos míos, así es la vida de los que hacemos la política monetaria. Gracias por darme la oportunidad de platicar con ustedes. Ha sido un gran placer. Espero que ahora que conocen más acerca de lo importante que es tener un banco central independiente, puedan salir de aquí orgullosos del papel que juega el Banco de México en el desarrollo económico de este gran país. Por mi parte, después de contestar a sus preguntas, voy a taparme los oídos con cera, amarrarme al mástil, y esperar que el distinguido Gobernador Ortiz me ofrece unos tragos del “ponche”. Una vez más, gracias por su atención.