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THE FEDERAL RESERVE: A STUDY IN SOFT CONSTRAINTS

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I
INTRODUCTION

In response to the greatest financial crisis since the Great Depression, the Federal Reserve (the Fed) took a number of unprecedented steps to try to minimize the adverse economic consequences that would follow. From providing liquidity injections to save companies like Bear Stearns and American International Group (AIG) to committing to a prolonged period of exceptionally low interest rates and buying massive quantities of longer-term securities to further reduce borrowing costs, the Fed's response to the 2007 through 2009 financial crisis (the Crisis) has been creative and aggressive. These actions demonstrated that the Fed is uniquely powerful among federal agencies, and its authority is even greater than most had previously appreciated.[1] They also made clear that the Fed's actions can have significant distributional consequences, in addition to affecting the health of the overall economy.[2] These developments have led many to suggest that the Fed should be far more accountable, or less powerful, than it currently is.[3]

Attacks on the Fed's power are not new. Vesting so much power in the

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1. ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 348 (2013) (noting that "even Barney Frank, as smart and knowledgeable a member of Congress as there was, expressed surprise to learn that the Fed has an essentially unlimited pocketbook"); Nicholas Lemann, *The Hand on the Lever: How Janet Yellen is redefining the Federal Reserve*, THE NEW YORKER, July 21, 2014, *available at* http://www.newyorker.com/magazine/2014/07/21/the-hand-on-the-lever ("There is an old saw that the Chair of the Fed is the second most powerful person in government. In the aftermath of the financial crisis, that may actually be an understatement.").

2. *See infra* Part II.C.

3. *E.g.*, Memorandum from the Fin. Services Comm. Majority Staff to the Members of the Comm. on Fin. Services 3–5 (Sept. 6, 2013) (http://financialservices.house.gov/uploadedfiles/091113_mpt_memo.pdf); RON PAUL, END THE FED 141–48 (2009); John H. Cochrane, *The Danger of an All-Powerful Federal Reserve*, WALL ST. J., Aug. 7, 2013, at A15; *see also* Michael D. Bordo, *Could the United States have had a better central bank? An historical counterfactual speculation* 34 J. MACROECONOMICS 597 (2012); George Selgin, William D. Lastrapes & Lawrence H. White, *Has the Fed Been a Failure?* 34. J. MACROECONOMICS 569 (2012).

hands of an unelected few inevitably raises questions about legitimacy, for which there are no easy answers. Using traditional mechanisms to make the Fed more politically accountable could substantially impede the Fed's capacity to achieve the aims assigned to it.[4] Yet, as reflected in the demise of the First and Second Banks of the United States, ignoring these concerns can prove even more detrimental. In the United States, the outer limits of independence are delineated by the Constitution,[5] but important questions regarding legitimacy and accountability arise far shy of the Constitution's outer bounds. Many of these issues are not specific to the Fed, and there is a robust body of literature examining these dynamics.[6] Nonetheless, this article suggests that many of the forces that influence the degree of independence that the Fed enjoys in practice are largely overlooked in much of this literature.

Those overlooked forces are "soft constraints," a range of forces that are not legally binding and that can even be a little fuzzy in application, but that nonetheless impose meaningful limits on how the Fed exercises its seemingly vast authority.[7] This article illustrates the power of soft constraints by examining the role that two particular soft constraints—principled norms and the Fed Chair's concern with her reputation—have played in shaping Fed action over the last hundred years.

Principled norms are guidelines regarding how the Fed ought to act in a given set of circumstances. They are "principled" not because they are necessarily right or righteous, but because they derive their normative weight from a widespread perception that the quality of the Fed's decisionmaking will be enhanced if it adheres to the guidelines embodied in the principled norm. To illustrate their operation and explore their limits, this article examines three principled norms: (1) the real bills doctrine, which played a critical role shaping Fed policy from its 1913 founding through 1935; (2) the Taylor Rule, a formula proposed by Stanford economist John Taylor for setting interest rates in a way that balances the Fed's dual aims of promoting full employment and maintaining stable prices; and (3) Bagehot's dictum, a set of guidelines proposed by Walter Bagehot in the nineteenth century regarding how a lender

4. *See infra* Part II.A.

5. *See, e..g.*, Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477, 496–97 (2010).

6. *E.g.*, Rachel Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 42–64 (2010); Lawrence Lessig & Cass Sunstein, *The President and the Administration*, 94 COLUM. L. REV. 1, 93–94 (1994); Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 612–15, 631 (2010); Lisa Schultz Bressman, *Beyond Accountability: Arbitrariness and Legitimacy in the Administrative State*, 78 N.Y.U. L. REV. 461, 492, 499–500 (2003) [hereinafter Bressman, *Beyond Accountability*]; Adrian Vermeule, *Conventions of Agency Independence*, 113 COLUM. L. REV. 1163, 1168–81 (2013).

7. These characteristics distinguish the types of constraints here at issue from the more law-like conventions that Adrian Vermeule suggests also merit further attention and from many of the informal mechanisms of Fed independence identified by Peter Conti-Brown, although there is meaningful overlap. Vermeule, *supra* note 6, at 1165; Peter Conti-Brown, *The Structure of Federal Reserve Independence* 42 (Stanford Univ. Rock Ctr. for Corporate Governance, Working Paper Series No. 139, 2013). For further discussion, see *infra* Part I.A.

of last resort should respond to liquidity shortages.

The second soft constraint this paper considers is the reputation of the Chair of the Federal Reserve (the Fed Chair). The Fed Chair often serves a lengthy term, exercises significant control over Fed activity while in office, and is a focal point, both during and after her tenure, for analyses of the Fed's actions during her reign.[8] These dynamics both shape the incentives facing a Fed Chair, as the effects of the Fed's actions directly impact her reputation and enable her to influence Fed action in light of her reputational concerns.

These are not the only soft constraints that influence the Fed's policymaking, but they are two of the most important. Two additional benefits of focusing on these particular constraints are that they operate in quite distinct ways, and thus reflect the range of soft constraints that can affect agency action, and they illustrate how soft constraints can interact with one another. For example, when the Fed pursues a course of action that is contrary to a principled norm, it invites scrutiny. Such actions thus tend to have a greater effect on the reputation of a Fed Chair than policies that adhere to an established norm. This can provide an added incentive to comply with principled norms, but it can also provide a mechanism for incenting a Fed Chair to deviate from an established norm when changed circumstances or new information suggest that adherence would have undesirable consequences.

By demonstrating the capacity of soft constraints to shape Fed action, improve transparency, and facilitate oversight and discussion, this article suggests that the Fed is far less unbridled than many of its critics contend. This by no means resolves the pressing concerns about whether the Fed is sufficiently accountable in light of the massive power that it wields, but it does highlight the importance of developing a descriptively accurate account of the problem before seeking to solve it, and it contributes to the project of building such an account.

This article also contributes to the literature on agency accountability and independence. In recent years, a growing number of administrative law scholars have suggested that agency independence is best understood as a point along a continuum rather than as a dichotomous term of art. Nonetheless, these scholars have tended to focus on formal constraints on an agency's autonomy in determining where along this spectrum a particular agency lies. This article demonstrates the importance of adding soft constraints to the range of factors relevant to this determination. It shows that soft constraints can enhance legitimacy by improving the quality of decisions an agency makes and by reducing the likelihood of arbitrary action. The analysis further suggests that, in settings where formal constraints may undermine the ability of an agency to achieve its statutorily mandated aims, soft constraints may play a critical role in promoting accountability without excessively hindering efficacy.

This article proceeds in two parts. The first part examines how principled

8. *See infra* Part I.B.

norms and the reputation of the Fed Chair constrain Fed activity. In addition to demonstrating the power of principled norms, each example also sheds light on the processes through which principled norms gain and lose influence, and some collateral consequences of their power. The second part addresses some implications of this analysis. It suggests that soft constraints may enhance the Fed's legitimacy and merit a place in discussions of agency independence more generally. It further argues that soft constraints may be particularly important in the context of the Fed and in other environments where short-term political accountability may undermine the agency's capacity to achieve socially valuable aims.

II
SOFT CONSTRAINTS

There are a wide range of soft constraints that shape Fed action. For example, the efficacy of Fed policymaking depends in significant part on its credibility. One of the "tools" that the Fed has employed to promote investment in the period following the Crisis has been a commitment to maintain low interest rates.[9] Because the Fed has no legally enforceable obligation to act in accordance with its previous statements, it is the Fed's reputation for doing so that enables its statements (and not just its actions) to affect market activity. The Fed is aware of this and the importance of its credibility, and it acts accordingly. Similarly, the Fed's policymaking is often shaped and constrained by international obligations, including rules promulgated by international organizations and the need to work with foreign central banks in order to achieve certain policy objectives. This part thus seeks to illustrate, rather than exhaust, the soft constraints on the Fed's activities. It focuses on just two—albeit two of the more important—constraints, and it also shows how they interact with one another, at times functioning as complements and at other times pulling in different directions.

A. Principled Norms

Norms denote a range of social conventions that shape behavior. Many norms are straightforward in application, even if sensitive to context. In Japan, individuals remove their shoes upon entering a home; in Spain, they keep them on. Location determines the appropriate course of action.[10] The same can be true for norms regarding the operation of federal agencies. For example,

9. Frederic S. Mishkin, *Monetary Policy Strategy: Lessons from the Crisis* 25 (Nat. Bureau of Econ. Research, Working Paper No. 16755, 2011) [hereinafter Mishkin, *Lessons from the Crisis*], *available at* http://www.imf.org/external/np/seminars/eng/2011/res2/pdf/fm.pdf; *see also* Frederic S. Mishkin & Michael Woodford, *In Defense of the Fed's New Interest-Rate Policy*, WALL ST. J., Jan. 6, 2013, at A13 (stating that the Fed's policy to keep rates low, based on clarified unemployment and short-term inflation thresholds, is a way that the Fed "can loosen current financial conditions").

10. For further information about how norms operate and the interactions between norms and law, see ERIC POSNER, LAW AND SOCIAL NORMS 145 (2000); Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 958–61 (1995).

Adrian Vermeule has noted that there is no statute preventing the President from firing the Fed Chair, yet there is a clearly established norm that effectively denies the President such authority.[11] This is but one of a number of norms that rise to the level of "conventions," in Vermeule's parlance, which constitute the "operating rules of independence in the administrative state."[12] Similarly, Peter Conti-Brown has identified a range of "environmental mechanisms," including conventions and institutional practices that undergird the Fed's independence.[13]

The norms at issue here tend to be fuzzier than the forces examined by these and other scholars in a number of ways. They are defined, first and foremost, by what they are not—binding legal rules that dictate how the Fed must act or cannot act.[14] Nonetheless, they are guidelines to which the Fed frequently adheres and they typically display a number of common characteristics. First, although many principled norms aspire to operate in a rule-like fashion, they often fail in this regard. As a result, how the type of norms at issue here applies to a particular set of circumstances is often not self-evident, at least to a lay observer. Second, although deviation may lead to retribution or reputational damage, the degree of force backing the norm tends to be relatively soft, making it costly, but not unfathomable, for an agency to act contrary to the norm.[15]

A distinct issue is that Fed action may conform to a principled norm either because of its status as a norm or because it embodies a principle that Fed officials believe to be correct. There is no way for outside observers to distinguish, and the examples below suggest both forces often operate simultaneously to increase the likelihood of compliance. In light of the imperfect overlap with existing notions, this article uses the term "principled norms" for the types of constraints here at issue. The remainder of this part examines the operation of three principled norms—the real bills doctrine, the Taylor Rule, and Bagehot's dictum—to demonstrate the influence of principled norms on Fed policymaking, as well as the processes through which principled norms gain and lose force. The descriptions of each of these norms, and the roles that they play, are somewhat stylized to focus the analysis.

11. Vermeule, *supra* note 6, at 1166.

12. *Id.* at 1167.

13. Conti-Brown, *supra* note 7, at 3.

14. By drawing attention to the power of principled norms to meaningfully constrain Fed activity, despite operating through mechanisms that allow some flexibility when the situation warrants, this article suggests that there may be a viable middle ground in the long-simmering debate on whether the Fed should be forced to adhere to rules or whether it should exercise discretion in its policymaking. *See, e.g.*, Benjamin M. Friedman, *Rules Versus Discretion at the Federal Reserve System: On to the Second Century*, 24 J. MACROECONOMICS 608 (2012); John B. Taylor, *Discretion Versus Policy Rules in Practice*, 39 CARNEGIE-ROCHESTER CONF. ON PUB. POL'Y 195, 202 (1993) [hereinafter Taylor, *Discretion Versus Policy Rules*].

15. For similar reasons, this article does not refer to the referenced constraints as "rules," though at least one has been given that label by economists. *See infra* Part I.A.2.

1. Real Bills Doctrine

The real bills doctrine informed the Fed's policymaking from its founding through the Great Depression, though its roots go back much further.[16] The core idea is that a central bank should lend only against short-term commercial bills of trade. Proponents believed that if a central bank provides credit only when secured with collateral used for commercial purposes, the central bank would support only real economic activity, not speculation.[17] More importantly, it would thus encourage banks to do the same.[18] An additional benefit is that any assets the Fed accepted as collateral would be self-liquidating, ensuring that the effects of the Fed's actions would automatically dissipate in time.[19] This led to the belief that, so long as the Fed adhered to the doctrine, it need not otherwise worry about monetary supply.[20] Another factor operating in favor of the real bills doctrine was the belief that adherence to it would constrain the Fed's exercise of its authority, a matter of great concern to Congress when it approved the formation of the Fed.[21] It was reflected accordingly, albeit in a way that allowed flexibility, in the original Federal Reserve Act of 1913.[22]

The importance of the real bills doctrine and its role in shaping the degree of discretion Congress vested in the Fed is reflected in the debate over a 1926 proposal to amend the Federal Reserve Act to impose more formal constraints on the Fed's authority. The proposed bill would have formally authorized the Fed to engage in open market operations, an activity only indirectly contemplated by the Federal Reserve Act, but the primary aim of the bill was to constrain Fed discretion by making price stability the Fed's sole objective.[23]

Three figures—two Mr. Strongs and a Mr. Miller—represented the three

16. *See* Thomas M. Humphrey, *The Real Bills Doctrine*, 68 ECON. REV. 3, 3–4, 6–8 (1982), *available at* http://www.richmondfed.org/publications/research/economic_review/1982/pdf/er680501.pdf.

17. Charles W. Calomiris, *Volatile Times and Persistent Conceptual Errors: U.S. Monetary Policy 1914–1951* 11 (Am. Enter. Inst., Working Paper No. 26097, 2010), *available at* http://www.aei.org/files/2010/11/22/CalomirisMonetaryPolicyNovember2010.pdf.

18. *Id.*

19. *Id.* at 12.

20. *Id.*

21. *See* 1 ALLAN H. MELTZER, HISTORY OF THE FEDERAL RESERVE 22 (2003) [hereinafter Meltzer, Volume 1] (identifying the real bills doctrine as one of three core principles "accepted as basic at the start of the Federal Reserve System"); *id.* at 70 (noting that "[a]uthority to discount real bills was seen by many at the time as the main improvement of the new legislation," that is, the version that was the basis for the Federal Reserve Act that was eventually adopted); Perry Mehrling, *Economists and the Fed: Beginnings*, 16 J. ECON. PERSP. 207, 209 (2002) (stating that a reason for the passage of the Federal Reserve Act "was the rhetorical success of the 'real bills doctrine'").

22. The original Federal Reserve Act provided the Fed and member banks significant discretion, including the power to set the discount rate, while providing that such "rates . . . shall be fixed with a view of accommodating commerce and business." Federal Reserve Act of 1913, Pub. L. No. 63-43, § 14, 38 Stat. 251,264 (1913); *see also* Meltzer, Volume 1, *supra* note 21, at 729 (noting that "[t]he original Federal Reserve Act wrote the real bills doctrine into law").

23. Robert L. Hetzel, *The Rules Versus Discretion Debate Over Monetary Policy in the 1920s,* 71 ECON. REV. 3, 3 (1985), *available at* http://www.richmondfed.org/publications/research/economic_review/1985/pdf/er710601.pdf (noting that B. Strong "dominated monetary policy in the 1920s through the force of his personality").

positions relevant to the analysis here. The first Strong was Kansas Representative James Strong who introduced the bill. The second was Benjamin Strong, then-Chair of the New York Fed and widely regarded as one of the most influential figures in the early Fed.[24] The final figure, Adolph Miller, was a member of the Washington, D.C.–based Federal Reserve Board, which at that time enjoyed significantly less power than it does today. Benjamin Strong and Miller both opposed the bill, but for very different reasons.

Miller and other members of the Federal Reserve Board believed that the Strong bill relied upon fundamentally incorrect assumptions about the authority of the Fed to use open market operations and their capacity to affect price levels. Motivated by a version of the real bills doctrine, Miller believed that the discount rate (the rate the Fed charges when it loans money to a bank through its discount window) should be the primary tool used by the Fed, and that it should be set with regard to the degree of banks' speculative activity.[25] This camp further believed that the Fed's discretion was already significantly constrained by virtue of the real bills doctrine and indirect reference to it in the original Federal Reserve Act.[26]

Benjamin Strong, by contrast, believed that the real bills doctrine was fundamentally flawed. He recognized that credit, once obtained, could be used by a bank to fund loans or engage in whatever other activity it expected to yield the highest return irrespective of the type of collateral used to secure the credit.[27] As a result, the real bills doctrine would not effectively prevent banks from engaging in speculation. Strong had also come to appreciate that open market operations, in which the Fed bought and sold securities, thereby affecting the amount of high-powered money in the financial system, could be an important tool for the Fed to utilize in its operations.[28] He opposed the Strong bill because of its mandate regarding price stability. Specifically, Strong was concerned about the imprecise nature of the Fed's control over prices, the risk that the Fed might be pressured to use its control over prices to serve aims other than price stability, and that the constraint may prevent the Fed from pursuing other legitimate aims.[29]

The bill did not pass, but Congressman Strong's rationale for proposing the bill illustrates that concerns about Fed accountability are not new.[30] Similarly,

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24. *Id.*

25. *Id.*at 3–4, 9–11; *id.* at 9 ("The characteristic of the good functioning of the credit system is to be found in the promptness and in the degree with which the flow of credit adapts itself to the orderly flow of goods in industry and trade.") (quoting 10 FED. RESERVE BD. ANN. REP. 34-S (1924)); *see also* Meltzer, Volume 1, *supra* note 21, at 53 (noting that the Federal Reserve Board was dominated throughout the 1920s and early 1930s by advocates of the real bills doctrine).

26. *Id.* at 12–13 (quoting in part *Stabilization: Hearing Before the H. Comm. on Banking and Currency*, 70th Cong. 252 (1928) (statement of Adolph Miller, Member, Fed. Reserve Bd.)).

27. *Id.* at 3–5.

28. *Id.*

29. *Id.*; *see also* Meltzer, Volume 1, *supra* note 21, at 273.

30. Hetzel, *supra* note 23, at 13 (quoting *Stabilization, Part 1: Hearing Before the H. Comm. on Banking and Currency*, 69th Cong. 569 (1926) (statement of Rep. James G. Strong)).

the different rationales for opposing the bill reflect both the challenges that arise when one tries to constrain the Fed's authority through traditional mechanisms and the possibility that the Fed's authority is more constrained than it seems. It was precisely because the Federal Reserve Act inadvertently provided the Fed with a powerful tool—the ability to engage in open market operations—that Benjamin Strong could take actions generally viewed as having very positive effects. Put differently, flexibility in the Act enabled Strong to respond when faced with changed circumstances and new insights about the power of open market operations to impact economic activity.[31] Yet, in the view of Miller and others at the Federal Reserve Board, their authority was already quite constrained even if the statutory scheme had significant wiggle room in it. They viewed themselves as bound to act in accord with the real bills doctrine, despite flexibility in the statutory scheme, and they understood it to be more constraining than the proposed bill. Moreover, although there was some variation, most of the actions taken by the Board and the regional reserve banks during this time adhered to the real bills doctrine.[32]

Unfortunately, this story does not have a happy ending. Although the real bills doctrine appears to have been effective in constraining how the Fed used its authority, the country likely would have been better served had it been less effective in this regard. Many economists today view adherence to the real bills doctrine as a significant factor contributing to the Fed's failure to respond more aggressively and effectively to mitigate the Great Depression.[33] There is ongoing controversy regarding the magnitude of the role it played, and whether Benjamin Strong would have pursued a different course had he not passed away in 1928.[34] Regardless of what alternative scenarios may have looked like, the evidence suggests that the real bills doctrine played a meaningful role in constraining how the Fed understood and used its discretion, illustrating the power of principled norms to shape Fed action.

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31. Despite his stated position and the position taken by many academics that, had Strong survived, the course of the Depression may have looked very different, other studies suggest that Strong's policies actually tended to conform to the real bills doctrine. Calomiris, *supra* note 17, at 13–14 and sources cited therein.

32. *Id.* and sources cited therein; *cf.* John. H. Wood, Monetary policy and the Great Depression (Working Paper, 2008) *available at* http://users.wfu.edu/jw/ (reviewing the studies and other literature suggesting that the real bills doctrine played a significant role shaping the Fed's actions during this period and the arguments and evidence to the contrary).

33. Calomiris, *supra* note 18, at 14; William Troost & Gary Richardson, *Monetary Intervention Mitigated Banking Panics During the Great Depression: Quasi-Experimental Evidence from a Federal Reserve District Border, 1929–1933*, 117 J. POL. ECON. 1031, 1040–68 (2009); Ben S. Bernanke, Chairman of the Fed. Reserve Sys., Speech at "The First 100 Years of the Federal Reserve: The Policy Record, Lessons Learned, and Prospects for the Future," conference sponsored by the National Bureau of Economic Research (July 10, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm (recognizing that the magnitude of the role played by various factors remains contested, but identifying the real bills doctrine as among those forces that likely contributed to the Fed's failure during this period).

34. *See, e.g.,* Calomiris, *supra* note 18, at 13 (suggesting that Strong's policies actually tended to conform to the real bills doctrine); Wood, *supra* note 32 (describing the debate about the role the real bills doctrine played).

The debate over the Strong bill also illustrates a second function of principled norms—that they can serve as reference points that facilitate oversight and debate. This is one way that principled norms may complement, and thereby enhance the efficacy of, traditional tools used to hold agencies accountable.

In addition to illustrating the power of principled norms and the costs that arise when an erroneous principled norm becomes influential, the evolving influence of the real bills doctrine illustrates the processes through which such norms can be displaced, and how these norms can influence learning. Even at the founding of the Fed, the real bills doctrine had powerful critics, so the presence of critical voices, even influential and informed ones, does not seem to suffice.[35] The influence of Benjamin Strong cuts in multiple directions. On one hand, it suggests that when an influential policymaker holds beliefs contrary to a principled norm, that policymaker can use his position to promote action in accordance with his distinctive beliefs, perhaps facilitating a weakening of the guideline as a principled norm. On the other hand, it is possible that members of the Board, threatened by Strong's influence, became even greater advocates of the real bills doctrine in order to legitimize their position and protect their power. Members of Congress and other critics of a particular Fed policy may similarly invoke principled norms to enhance or detract from the legitimacy of policies or individuals supporting them (for reasons quite apart from the merits), complicating the process through which principled norms take hold and erroneous norms are discredited.

A related challenge is the impact of principled norms on learning. As reflected in the debate over the Strong bill, many of the Fed officials who were making decisions consistent with the real bills doctrine were doing so, at least in part, because they believed it embodied the best policy for the Fed to follow. This belief not only prevented the Fed from acting more aggressively to prevent the depths of the Great Depression; it also inhibited the capacity of many Fed officials to appreciate even after the fact that there was more that they could have done.[36] In part because of this, it took decades for academics and policymakers to appreciate many of the core lessons that the Depression held for central bank policymaking. This suggests another effect of having a principled norm that has achieved widespread acceptance—it can retard learning and prevent experimentation, leading experts to fine-tune an established norm when it would be more productive to question its fundamental accuracy.[37] If policymakers and others come to appreciate the capacity of

35. Meltzer, Volume 1, *supra* note 21, at 53, 64.

36. *See id.* at 411 (noting "that most of the governors accepted the real bills doctrine" and "Federal Reserve officials were not alone in their acceptance"); *id.* at 729 (noting that, in addition to members of the Federal Reserve, "[e]conomists, bankers, congressional leaders, and many others accepted the theory and believed the Federal Reserve was right to follow it"); Calomiris, *supra* note 18, at 18 (discussing the Fed's slow learning process as contributing to conceptual errors in policymaking).

37. Ricardo J. Caballero, *Macroeconomics After the Crisis: Time to Deal with the Pretense-of-Knowledge Syndrome*, 24 J. ECON. PERSP. 85, 85 (2010).

principled norms to shape Fed action, it may be worthwhile to investigate whether it is possible to improve the processes through which such norms rise and fall. For purposes of this article, the analysis here suffices to establish the relevant point: Adherence to a principled norm, the real bills doctrine, meaningfully shaped Fed action before and during the Great Depression. Its influence was incomplete—Strong arguably disregarded it and there were no formal mechanisms through which he could be called to task for doing so—but it was powerful nonetheless.

2. The Taylor Rule

The Taylor Rule provides a formula for setting the federal funds rate (the fed funds rate)—the target rate for overnight, interbank loans—by reference to "the deviation of inflation from its desired level or target (the inflation gap) and the deviation of output from its natural rate level (the output gap)."[38] As a result, it provides a guide for how the Fed should set the fed funds rate to balance its dual aims of maintaining stable prices and promoting full employment. First articulated by Stanford economist John Taylor in 1993, the equation was designed, as the name suggests, to be a rule and thus straightforward in its application.[39]

In proposing the Rule, Taylor demonstrated that the fed funds rate that the rule called for mapped relatively cleanly onto the Fed's then-recent monetary policies.[40] In this sense, it may be viewed as having largely descriptive origins.[41] Subsequent studies revealed that during the 1960s and 1970s, central banks often failed to adhere to the Taylor Rule, and this likely contributed to the rise in inflation that followed.[42] In contrast to the real bills doctrine, many of the studies invoking the Taylor Rule examine Fed policy in periods prior to its introduction. Because these analyses tended to suggest that the Fed acted in conformity with the Rule during periods subsequently viewed as successful and that deviation often preceded adverse macroeconomic outcomes, the Rule came to have normative weight.[43] That the Taylor Rule appeared to be

38. Mishkin, *Lessons from the Crisis*, *supra* note 9, at 7; *see also* Taylor, *Discretion Versus Policy Rules, supra* note 14, at 199–202.

39. *See* Taylor, *Discretion Versus Policy Rules, supra* note 14.

40. *Id.* at 204, Fig. 1.

41. John Judd & Glenn D. Rudebusch, FRBSF Econ. Letter No. 1998-38: Describing Fed Behavior (Dec. 25, 1998), http://www.frbsf.org/economic-research/publications/economic-letter/1998/december/describing-fed-behavior/. In Taylor's assessment, Greenspan kept rates too low for too long from 2003 through 2005. John B. Taylor, Keynote Address at the Financial Markets Conference "Maintaining Financial Stability: Holding a Tiger by the Tail": Simple Rules for Financial Stability 7 (April 9, 2013), *available at* http://www.frbatlanta.org/documents/news/conferences/13fmc_taylor_pres.pdf.

42. Richard Clarida et al., *Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory* 151 (Nat'l Bureau of Econ. Research, Working Paper No. 6442, 1998), *available at* http://www.nber.org/papers/w6442.pdf?new_window=1 (examining the Fed's monetary policy during the 1960s through the 1970s by reference to the Taylor Rule).

43. *E.g.*, *What is Taylor's Rule?*, FED. RESERVE BANK OF S.F. (Mar. 1998), http://www.frbsf.org/education/publications/doctor-econ/1998/march/taylor-rule-monetary-policy (noting that "many

straightforward and was proposed at a period when central banks were seeking to enhance the public's perception of their legitimacy, a goal furthered by rule-like principled norms, may further help to explain its quick rise to prominence as a principled norm.[44]

Consistent with Taylor's aspirations, the Rule has come to shape policy in addition to informing debates about the same. As explained by George Kahn: "The Taylor Rule has revolutionized the way many policymakers at central banks think about monetary policy."[45] Examining "[s]peeches by policymakers and transcripts and minutes of policy meetings," Kahn's analysis suggests that "the Taylor rule became integrated into policy discussions and, in some cases, the policy framework itself."[46] To be sure, the Rule has never been formally adopted as a policy to which the Fed must adhere, and the Fed has often set the fed funds rate at levels that deviate from that which the rule would prescribe.[47] Nonetheless, both proponents and opponents of the Fed's policies often frame their positions by reference to the Taylor Rule, reflecting its influence.[48] Moreover, members of the Federal Open Market Committee (FOMC) know that the Taylor Rule will be among the tools used to assess the legitimacy and correctness of their actions. This gives them a reason to adhere to it apart from its merits. Although it is impossible to determine the degree to which a person's statements about the reasons for his actions accurately reflect his underlying rationale, the frequency with which the Rule is invoked by Fed policymakers and other commentators suggests it has come to play a meaningful role shaping the Fed's interest-rate policies.[49]

Like the real bills doctrine, it also appears that the Taylor Rule serves a second function of complementing traditional tools of accountability. One challenge impeding public discourse about monetary policy is that the fed funds rate, standing alone, provides limited insight into whether the rate is accommodative or restrictive, and the likely effects of setting the rate at a particular level.[50] This is one of many reasons that experts have long dominated debates about monetary policy. By contrast, whether a rate is above or below

economists inside and outside of the Fed [have cited the close correlation between the Fed funds rate the Taylor Rule would prescribe and the actual Fed funds rate under Greenspan as] a reason that inflation has remained under control and that the economy has been relatively stable in the US over the past ten years"); Mishkin, *Lessons from the Crisis*, *supra* note 9, at 3 (identifying the Taylor Principle as one of the core "elements of what has been dubbed the new neoclassical synthesis[, which] were agreed to by almost all academic economists and central bankers" prior to the Crisis).

44. George A. Kahn, *The Taylor Rule and the Practice of Central Banking*, *in* THE TAYLOR RULE AND THE TRANSFORMATION OF MONETARY POLICY 63, 68–70 (Evan F. Koenig et. al., eds., 2012).

45. *Id.* at 63.

46. *Id.* at 65.

47. *E.g.,* Kahn, *supra* note 44, at 84.

48. *See, e.g.*, *id.*; Clarida et al., *supra* note 42, at 5, 13; Judd & Rudebusch, *supra* note 41.

49. *See, e.g.*, *id.* at 73 (noting that "it is clear from the transcripts that the Taylor rule became a key input into the FOMC's policy process").

50. Another factor inhibiting an effective response to the Depression was the Fed's own tendency to focus on nominal, rather than effective, interest rates. Calomiris, *supra* note 18, at 14.

that which the Taylor Rule dictates under the circumstances provides meaningful information in this regard.[51] The Taylor Rule thus facilitates oversight and informed discussion, important prerequisites for effective accountability.[52]

The analysis thus far suffices to establish the two points critical to the argument here: the Taylor Rule appears to shape Fed action and to facilitate informed discussions about the same. Yet, to better understand the value of principled norms and limitations on them, two final points merit mention. First, the Rule is not quite as rule-like as the name suggests. Taylor clearly intended the Rule to function as a rule that could be cleanly applied to any situation. Much of the article proposing the Rule focused not on the Rule itself, but on the value of having clean rules for monetary policy.[53] As Taylor explained, he and other economists believed that having a central bank follow such rules was better than giving policymakers complete discretion for a number of reasons, including the time-inconsistency problem and the expectation that rules would increase credibility and, along with it, efficacy.[54] In his view, any policy rule should evolve over time, should be among the factors that the FOMC (the committee that determines the fed funds rate) routinely consults in making decisions though not dictating a particular outcome, and should be adhered to for a sufficiently long period of time to facilitate learning and to meaningfully restrain discretion, but need not persist indefinitely.[55] Taylor thus assumed that principled norms could and should meaningfully shape Fed action, and he provided helpful guidelines with regard to their operation.[56]

Yet the Taylor Rule itself has not provided as clean of a guideline as Taylor had hoped. For example, Taylor and others have used the Taylor Rule to suggest that the Fed's policies were overly accommodative in the years prior to

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51. For example, a number of analyses suggest that the Fed, the central banks of most industrialized nations, and the central banks of many emerging economies had interest-rate policies that were consistently more accommodative than the Taylor Rule would dictate since 2003. Boris Hofmann & Bilyana Bogdanova, *Taylor Rules and Monetary Policy: A Global "Great Deviation"?*, 2012 BIS Q. REV. 37, 41 Graph 1.

52. *See, e.g.*, Janet L. Yellen, Vice Chair, Bd. of Governors of the Fed. Reserve Sys., Speech at the Haas School of Business, University of California, Berkeley: Revolution and Evolution in Central Bank Communications, *available at* http://www.federalreserve.gov/newsevents/speech/yellen20121113a.htm and accompanying slideshow (using a modified Taylor Rule as primary reference point in explaining the FOMC's approach to setting the fed funds rate).

53. *See* Taylor, *Discretion Versus Policy Rules*, *supra* note 14.

54. *Id.* at 196.

55. *Id.* at 203–10.

56. Taylor's analysis of the importance and drawbacks of policy rules, and the appropriate contours of such rules, has been nearly as influential as the specific rule that he proposed, and has facilitated the development of other principled norms for guiding monetary policy over the last two decades. *See, e.g.*, Donald L. Kohn, Former Vice-Chairman of the Bd. of Governors of the Fed. Reserve Sys., Remarks at the Conference on John Taylor's Contributions to Monetary Theory and Policy: John Taylor Rules (Oct. 12, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/kohn20071012a.htm (describing the benefits and drawbacks of such rules and Taylor's role in promoting their development).

the Crisis and thus were a significant factor contributing to the Crisis.[57] Reflecting his awareness of the importance of the Taylor Rule, Chairman Bernanke has sought to rebut these claims.[58] Rather than arguing against the value of the Rule, however, he has formulated his rebuttal in a way that reaffirms its importance. More specifically, he has highlighted that the rate the Taylor Rule dictates depends on the inputs one uses and that jiggering one assumption underlying the traditional formulation in a seemingly justifiable way produces a modified version of the Taylor Rule that tracks rather closely the Fed's policies during the relevant period.[59]

The capacity of the Taylor Rule to be modified in this way may help to support its utility and resilience, allowing it to evolve to accommodate learning and changed circumstances; however, this flexibility also alters its role in constraining policy action and shaping debate about the same. As the room for disagreement increases, the capacity of the Taylor Rule to constrain action and identify deviations declines.[60] Relatedly, the debate becomes more specialized, as participants must now be sufficiently informed to evaluate claims about the inputs and assumptions used before they can assess the significance of an action that appears to deviate from the Rule. This raises the possibility that principled norms may be making the Fed more accountable to experts than the public generally.

Also noteworthy is how the rise of the Taylor Rule impacted the reputation and influence of John Taylor. As noted, Taylor has been a critic of the Fed's recent policies and has advocated for the adoption of more-clear standards for monetary policy.[61] Taylor has also been able to reach public audiences through, for example, opinion pieces in major publications on topics outside the scope of the Taylor Rule.[62] Although he is not alone among academics in this regard, the influence of the Taylor Rule likely enhances his relative stature from the

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57. Hofmann & Bogdanova, *supra* note 51, at 37 and sources cited therein. *See also* John B. Taylor, *Housing and Monetary Policy* 2–3 (Nat'l Bureau of Econ. Research, Working Paper No. 13682, 2007), *available at* http://www.nber.org/papers/w13682.pdf?new_window=1.

58. Jon Hilsenrath, *Bernanke, Taylor Rules and the Fed Funds Rate*, WALL ST. J. ECON. BLOG (Jan. 11, 2010, 9:04 AM), http://blogs.wsj.com/economics/2010/01/11/bernanke-taylor-rules-and-the-fed-funds-rate/.

59. Ben S. Bernanke, Chairman of the Fed. Reserve Sys., Speech at the Annual Meeting of the American Economic Association: Monetary Policy and the Housing Bubble (Jan. 3, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm; *see also, e.g.*, Alan S. Blinder, *An Unnecessary Fix for the Fed*, WALL ST. J., Jul. 18, 2014, at A11 (noting that "hundreds of 'Taylor rules' have been considered over the years").

60. See *infra* Part I.A.C. for a further discussion of the tensions that arise from the flexibility inherent in a principled norm.

61. John B. Taylor, Keynote Address at the Financial Markets Conference, *supra* note 41, at 8 (calling for "[a] return to a conventional rules-based monetary policy as we had in the 1980s, the 1990s, and until recently").

62. *E.g.*, John B. Taylor, *The Economic Hokum of 'Secular Stagnation,'* WALL ST. J., Jan. 2, 2014, at A17; John B. Taylor, *The Weak Recovery Explains Rising Inequality, Not Vice Versa*, WALL ST. J., Sept. 10, 2013, at A17; John B. Taylor, *How the Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19.

perspective of the informed public, increasing his influence and opportunities to be heard.[63] This is relevant to the analysis here in two ways. First, it highlights a potentially significant reward for economists and others to formulate influential principled norms, facilitating their creation. Second, it may further enhance oversight and discourse by providing a platform for an outside expert to be heard.[64]

3. Bagehot's Dictum

The final principled norm this paper examines is a series of admonitions by Walter Bagehot, editor of *The Economist* during the late nineteenth century, regarding the role that a central bank should play during a systemic liquidity shortage. Walter Bagehot was not a trained economist, but rather a journalist and essayist who wrote about government, economics, literature, and other topics.[65] In *Lombard Street*, published in 1873, he analyzed the Bank of England's response to a recent financial crisis and provided his view of the appropriate role that a lender of last resort should play in responding to such a crisis.[66] Among other admonitions, he claimed that when significant liquidity shortfalls plague the market, a central bank should step in and provide liquidity by lending freely against any collateral that had been considered good collateral prior to the crisis.[67] At the same time, to discourage excessive reliance on the lender of last resort, he argued that the rate of interest charged on such loans should be a penalty rate (that is, a rate well above that being charged just prior to the crisis)[68] and the lender of last resort should lend only to those with adequate collateral.[69] These maxims have come to be known, collectively, as

63. Perhaps the strongest evidence of his perceived influence is the way other public commentators have used him as a target. New York Times columnist and esteemed economist Paul Krugman, for example, recently published a short piece almost exclusively about two seemingly inconsistent positions by Taylor—both having little to do with the Taylor Rule—reflecting Krugman's perception of his influence or the capacity of Taylor's name to attract readers. Paul Krugman, *Taylor's Rule on Fiscal Policy*, THE CONSCIENCE OF A LIBERAL (June 16, 2013, 8:13 AM), http://krugman.blogs.nytimes.com/2013/06/16/taylors-rule-on-fiscal-policy/.

64. *Cf.* Dahlia Lithwick, *The Souter Factor*, SLATE (Aug. 3, 2005, 5:27 PM), http://www.slate.com/articles/news_and_politics/jurisprudence/2005/08/the_souter_factor.html (defining "Greenhouse Effect" as "a phenomenon popularized by D.C. Appeals Court Judge Laurence Silberman referring to federal judges whose rulings are guided solely by their need for adulation from legal reporters such as Linda Greenhouse of the *New York Times*").

65. *Walter Bagehot*, ENCYCLOPEDIA BRITTANICA ONLINE ACAD. EDITION, http://www.britannica.com/EBchecked/topic/48750/Walter-Bagehot (last visited Apr. 3, 2015).

66. Today, Fed officials tend to view the monetary policy and lender of last resort activity as fundamentally distinct. Mark A. Carlson & David C. Wheelock, *The Lender of Last Resort: Lessons from the Fed's First 100 Years* 2 (Fed. Reserve Bank of St. Louis, Working Paper No. 2012-056B, 2012), *available at* http://research.stlouisfed.org/wp/2012/2012-056.pdf. This was not the case in Bagehot's time, and, examined in context, his dictum also has monetary policy implications. Given that his dictum clearly addresses the role of a lender of last resort and others have viewed his dictum solely as relevant to such activity, this article does not explore this issue. *See infra* note 79 and accompanying text.

67. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 56 (1873).

68. *Id.* at 57.

69. This requirement has been interpreted by some to mean that central banks should lend only to

Bagehot's dictum.

During the recent Crisis, Bagehot's name and this simplified version of his dictum were invoked with great frequency by members of the Fed and outside commentators. For example, in a series of four speeches Chairman Ben Bernanke delivered to explain the Crisis and the Fed's response to it, Bernanke repeatedly invoked the principled norms set forth in Bagehot's dictum to explain what central banks should do during a financial crisis and what the Fed actually did.[70] Other Fed officials and the heads of foreign central banks similarly employed Bagehot's dictum as the reference point for explaining the legitimacy of their actions.[71] Just as significantly, Bagehot's dictum was regularly invoked in debates about the Fed's Crisis-era policies. For example, during the 2009 Jackson Hole Economic Policy Symposium, an annual meeting attended by Fed officials, officials from other central banks, and other esteemed experts, Bagehot's name was invoked forty-eight times.[72] These indicia suggest that Bagehot's dictum functioned as a principled norm during the Crisis: it appears to have both influenced Fed policies and served as a reference point shaping discussions about the same.

In addition to illustrating these two functions of principled norms, the influence of Bagehot's dictum also sheds additional light on the processes through which such norms gain influence and the role that regulators themselves can play in that process. Based upon the frequency with which Bagehot's dictum has been invoked in recent years, one might think that it had been influential in shaping Fed policy throughout its history. A brief look at that history suggests otherwise. For example, while some senior Fed officials referenced Bagehot's work during the period leading into the Great Depression, "they did not follow his advice."[73] Moreover, even following the Great Depression, the policy that the Fed adopted to govern its lender of last resort activity directly contravened Bagehot's admonition.[74] It was not until

solvent institutions. *E.g.*, Brian F. Madigan, Dir. Div. of Monetary Affairs, Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium: Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis (Aug. 21, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm.

70. BEN S. BERNANKE, THE FEDERAL RESERVE AND THE FINANCIAL CRISIS: LECTURES BY BEN S. BERNANKE 7 (2013) (providing transcripts of the four lectures Bernanke presented at George Washington University on the role of the Federal Reserve in the economy).

71. *See, e.g.*, NEIL IRWIN, THE ALCHEMISTS: THREE CENTRAL BANKERS AND A WORLD ON FIRE 10 (2013) [hereinafter IRWIN, THE ALCHEMISTS] (noting that Trichet (the head of the European Central Bank), Bernanke, and King (the head of the U.K.'s central bank) "often invoked Bagehot's words as a model for their own crisis response almost 150 years" after he wrote); Brian F. Madigan, *supra* note 69.

72. IRWIN, THE ALCHEMISTS, *supra* note 71, at 28.

73. Meltzer, Volume 1, *supra* note 21, at 729.

74. Rather than employing a penalty rate, the Fed set the discount rate below prevailing market rates. And, rather than lending freely to anyone with good collateral, the Fed lent only to banks, requiring the banks to demonstrate that they could not meet their funding needs in the market before becoming eligible to borrow. Olivier Armantier et al., *Stigma in Financial Markets: Evidence from Liquidity Auctions and Discount Window Borrowing During the Crisis* 6 (Fed. Reserve Bank of N.Y., Staff Report No. 483, 2011), *available at* http://www.newyorkfed.org/research/staff_reports/sr483.pdf.

2003 that the Fed modified its policies to better align with the dictum, but even the revised policies deviated in some significant ways.[75] To be sure, Bagehot's dictum has played a continuing role in academic discussions about why we have a lender of last resort and the role such an institution should play.[76] It was thus well positioned to be among the principled norms that influenced policymaking during the Crisis. Nonetheless, given the policy history, its influence could not have been assumed. Examining why Bagehot's dictum was so influential in recent years thus sheds light on how an idea rises to the level of functioning as a principled norm.

A number of possible explanations for the influence of Bagehot's dictum during the Crisis fail to hold up under scrutiny. Its influence, for example, cannot be attributed to the similarity between the situation that the Fed faced during the Crisis and that which motivated Bagehot's writing. Financial markets have evolved dramatically since Bagehot's time, and a range of financial and regulatory innovations arguably weaken the need for a central bank today to function in the manner Bagehot envisioned.[77] Moreover, there has been a significant amount of learning about the effects of different central bank policies in the nearly century and a half since Bagehot authored his treatise. As Allan Meltzer explains, "neither Bagehot nor those who followed his lead attempted to combine the theory of central banking or monetary policy with what is now called macroeconomic theory."[78] These topics have been the subject of significant, and often quite rigorous, academic analysis in the intervening period, and those analyses have had the benefit of numerous additional data points (in the form of additional financial crises across a wide variety of settings) to assess the efficacy of different policy responses.[79] Additionally, in contrast to the time when Bagehot was writing, discounting is not the primary tool through which the Fed (or any central bank) influences monetary supply, further attenuating Bagehot's dictum and the challenges facing the Fed during

75. *Id.* (imposing a penalty rate but continuing to limit the collateral it would accept and restricting access to banks).

76. *E.g.*, Carlson & Wheelock, *supra* note 66, at 36 (all using Bagehot's dictum as reference point of a sort); Marvin Goodfriend & Robert G. King, *Financial Deregulation, Monetary Policy, and Central Banking (excerpts)*, *in* FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT 145 (Charles Goodhard & Gerhard Illing, eds., 2002); Charles Goodhard & Gerhard Illing, *Introduction*, *in* FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT 1 (Charles Goodhard & Gerhard Illing, eds., 2002); Fred Hirsch, *The Bagehot Problem*, *in* FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT 187 (Charles Goodhard & Gerhard Illing, eds., 2002).

77. *E.g.*, Gara Afonso et al., *Stressed, Not Frozen: The Federal Funds Market in the Financial Crisis*, 66 J. FIN. 1109, 1113 (2011); Xavier Freixas et al., *Lender of Last Resort: A Review of the Literature*, 7 FIN. STABILITY REV. 151, 153 (1999); Kathryn Judge, *Thirteen Months: The Role of a Modern Lender of Last Resort* (2014) (unpublished manuscript) (on file with author).

78. Meltzer, Volume 1*, supra* note 21, at 20.

79. *See* Xavier Freixas et al., *Lender of Last Resort: What Have We Learned Since Bagehot?*, 18 FIN. STABILITY REV. 63, 64–70 (2000) (noting several studies and empirical analysis conducted on previous banking crises and bank runs to address cases of emergency lending by central banks to illiquid but solvent institutions).

the Crisis.[80]

The question of why Bagehot's dictum was invoked with such frequency by the Fed, other central banks, and commentators assessing the appropriateness of the Fed's actions thus remains. Even though his dictum may have had some persistent influence since it was first espoused, it was only during the Crisis that its influence and pervasiveness seem to have risen to the level of a principled norm. One possibility is that the very uniqueness of the actions being taken invited scrutiny. Aware that it was doing something unusual, but wanting support for its actions and seeking to deflect attention away from the unprecedented nature of the actions it was taking, Fed officials may have looked for a norm that had sufficiently deep roots to give an impression of legitimacy yet was sufficiently flexible to be relevant. Bagehot's dictum satisfies both requirements. Commentators on the Fed similarly were grappling for reference points as they attempted to analyze the legitimacy and appropriateness of the Fed's actions. Invoking Bagehot's dictum thus gave their work an air of legitimacy, thereby allowing them to say something more authoritative than "It looks like a good move to me," or "Seems a little troubling, but in light of the unprecedented nature of all that is happening, it's hard to know why."

In other words, the Fed, other central banks, academics, and other commentators shared a common interest in establishing the legitimacy of their respective work. Invoking Bagehot's dictum served this end for each group, albeit in slightly different ways. And the more frequently it was invoked, the greater legitimacy it came to possess, and the greater legitimacy its use could confer. Hence, there may have been a self-perpetuating cycle through which the status of the dictum evolved to become the primary reference point against which lender-of-last-resort activity was assessed.

Other considerations support the notion that the frequency with which Bagehot was invoked reflects an effort to establish legitimacy and not just earnest accounting of the sources of wisdom shaping the Fed's policymaking. It is notable, for example, that Bagehot's dictum provides cover for one of the most controversial aspects of the Fed's actions during the Crisis—its extensive lending to nonbank institutions—and was invoked by Fed policymakers to justify these actions.[81] At the same time, other aspects of the Fed's actions did not neatly conform to his dictum, as one would expect if it were functioning primarily as a guide.[82] The point here is not to assess whether the Fed's actions

80. *See* Meltzer, Volume 1, *supra* note 21, at 740–42 (describing the relative decline of rediscounting and the correspondent rise of open market operations).

81. *E.g.*, Brian Madigan, *supra* note 69 (claiming that the "recent financial crisis provides considerable evidence in support of what Bagehot knew more than 135 years ago . . . . To cushion the adverse effects of a financial panic on economic activity, a central bank must be ready to lend freely, potentially to a broad range of counterparties").

82. *Id.* (suggesting that "Bagehot's precepts need to be interpreted and applied in light of practical considerations, . . . that application is not necessarily straightforward," and explaining why it justifies the Fed's failure to adhere fully to other elements of the dictum).

conformed to Bagehot's dictum or whether they were justified as a matter of policy, but to highlight that the facts do not support the notion that the Fed was merely following a clear and long-established principle.

This examination of Bagehot's dictum and its role as a principled norm during the Crisis has important implications for its utility as a means of enhancing accountability. The frequency with which Bagehot was invoked seems likely to be, at least in part, a byproduct of a desire among those invoking his dictum to establish the legitimacy of their claims or actions, and Fed officials appear to have been among those invoking it for this purpose. This may well have shaped subsequent Fed action—as the more frequently the dictum was invoked, the more normative weight it came to carry—but it does suggest that Fed officials may have been using the dictum to deflect scrutiny, an aim not entirely consistent with promoting political accountability.[83]

Additionally, the dictum's ongoing influence and the way it has been interpreted to fit various contexts reaffirm a challenge noted in connection with the Taylor Rule. Given the dynamism of financial markets and ongoing learning, the most resilient principled norms are likely to be those that are sufficiently flexible that they can be translated to accommodate changed circumstances and new insights.[84] Yet, the process of translating a principled norm in light of such developments may compromise its capacity to constrain action. Excessive wiggle room may gut a principled norm of any force or meaning. And, even if the wiggle room is constrained by the need to justify the modifications, that process is likely to require expertise, thereby making Fed policymakers more accountable to experts without necessarily making them equally accountable to the public or elected representatives.[85]

B. Reputation

The second soft constraint this article examines is the reputation of the Fed Chair. Reputational considerations have been invoked in a wide variety of

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83. *See* Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2002–03 (2014) (suggesting that a compilation of speeches published by Ben Bernanke about the Crisis in which Bernanke regularly invokes Bagehot to explain the Fed's lender-of-last-resort activities mounts a "defense of the Fed . . . based on showing that the Fed was technocratically masterful," but challenging whether the Bernanke succeeds in that regard, highlighting accountability and transparency deficiencies inherent in the Fed's approach to its lender-of-last-resort activities and noting that "Bernanke seems oblivious to these shortcomings").

84. For a thoughtful analysis of some advantages of principled norms that do not act as "ironclad rules," see Ben S. Bernanke & Frederic S. Mishkin, *Inflation Targeting: A New Framework for Monetary Policy?* 9–15 (Nat'l Bureau of Econ. Research, Working Paper No. 5893, 1997) (discussing the importance of this distinction in the context of inflation targeting).

85. The related questions of the optimal amount of flexibility and the mechanisms through which a principle is enforced are important and challenging issues and may favor having principled norms enforced through informal rather than formal mechanisms even when the latter may seem viable. *See, e.g.*, Blinder, *supra* note 59, at A11. For a thoughtful discussion of these challenges through the lens of assessing how best to implement cost-benefit analyses of financial regulation, *see* John C. Coates, IV, *Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management*, 78 LAW & CONTEMP. PROBS., no. 3, 2015 at 1.

contexts, including discussions of agency structure to shed light on incentives and actions.[86] Reputational constraints also operate at numerous levels, and an individual working for the Fed may have numerous and conflicting reputational agendas. As a member of the Fed, she may seek to ensure that the Fed has a "good" reputation and may also seek to promote the Fed's reputation for specific characteristics, like credibility. She may also have individual aims, like cultivating a reputation that will enhance her capacity to obtain a high-paying job if and when she leaves the Fed.[87]

These various reputational forces may have correspondingly mixed effects on the nature and quality of Fed actions. All of these forces are soft constraints and therefore merit consideration in any comprehensive examination of the Fed and its accountability. This article nonetheless focuses exclusively on the Fed Chair and her individual incentives. It does so in part to make its analysis tractable, but also because the Fed Chair appears to exercise significant influence over Fed action, suggesting that her incentives will play a significant role in shaping Fed action.[88]

Fourteen men and one woman have chaired the Fed since it was founded in 1914. In the decades since the Depression, the majority of Chairs have served for relatively long terms.[89] Through a number of mechanisms, the Chair is often

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86. *See* Jacob E. Gersen, *Designing Agencies*, *in* RESEARCH HANDBOOK ON PUBLIC CHOICE AND PUBLIC LAW 333, 334 (Daniel A. Farber et. al., eds., 2010) [hereinafter Gersen, *Designing Agencies*] (referring to William Niskanen's 1971 study, which found that bureaucrats maximize "some mix of salary, perks, reputation, power, and flexibility," and stating that James Q. Wilson echoed this sentiment in 1989); Bressman & Thompson, *supra* note 6, at 635 (noting that the public's evaluation of the health of the economy can translate into reputational or approval ratings for the Fed and the President).

87. *Cf.* Steven L. Schwarcz, *Intrinsic Imbalance: The Impact of Income Disparity on Financial Regulation*, 78 LAW & CONTEMP. PROBS., no. 3, 2015 at 102–07.

88. *E.g.*, Conti-Brown, *supra* note 7, at 42 (stating that there is an "equation of the Chair[man of the Board] with the Fed" which has led some to conclude that the "'Fed's history . . . is largely the product of the leadership of its Chairman,'" and providing a variety of forms of evidence to support the conjecture) (quoting DONALD KETTL, LEADERSHIP AT THE FED xi (1988)); IRWIN, THE ALCHEMISTS, *supra* note 71, at 266 (noting that "even though the Fed chairman has only one vote out of twelve, his true power goes far beyond that" as "[h]e sets the agenda and frames the options on the table" allowing him to "guide[] the discussion toward directions he believes useful and away from those he disfavors"). Another advantage of focusing on the Chair is that doing so is consistent with a recent trend in the literature on reputation—focusing on the individual, rather than the entity for which he works, as the appropriate level for analyzing how reputational concerns shape action. JONATHAN MACEY, THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET 1–2 (2013); Alan D. Morrison & William J. Wilhelm, Jr., *Trust, Reputation and Law: The Evolution of Commitment in Investment Banking* 28–31 (Feb. 2013) (unpublished draft), *available at* http://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/Morrison,%20A%20-%20Spring%20%202013%20BS.pdf. *See also* Jon Hilsenrath & Kristina Peterson, *Federal Reserve 'Doves' Beat 'Hawks' in Economic Prognosticating: Slow Growth, Low Inflation Give Yellen, Dudley Upper Hand on Forecasts*, WALL ST. J., July 29, 2013, at A1 (empirically assessing the accuracy of statements by individual Fed officials regarding their expectations for future economic activity to assess their relative performance).

89. *Membership of the Board of Governors of the Federal Reserve System, 1914–Present*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/aboutthefed/bios/board/boardmembership.htm (last visited Apr. 1, 2015) (providing the following tenures for Fed Chairs since

held accountable and has her reputation shaped by the effects of the Fed's actions during his tenure. For example, at least twice a year, in connection with statutorily mandated written reports to Congress on "the conduct of monetary policy and economic developments and prospects for the future," the Fed Chair testifies before Congress.[90] The Fed Chair is often also called to testify on other actions of the Fed, particularly when it takes actions that are unprecedented or otherwise unusual.[91] There are also numerous academic articles assessing the efficacy of Fed policies under particular Fed Chairs,[92] as well as academic and popular press books highlighting the influence of particular Fed Chairs.[93] Most recently, the significant influence of Ben Bernanke on the Fed's action during and since the Crisis has been widely touted by the press in addition to being a common theme in many books about the Crisis.[94]

The evolving reputations of two previous Fed Chairs—Paul Volcker, who chaired the Fed from 1979 until 1987, and his successor Alan Greenspan, who served until Bernanke was appointed in early 2006—illustrate how these assessments are formulated and revised over time. When Volcker took the reins in 1979, the economy was suffering from a period of stagflation—high interest rates and inflation, low economic growth, and relatively high unemployment.[95] Under Volcker, the Fed responded by dramatically increasing the fed funds rate, which had the foreseeable effect of driving up interest rates and increasing unemployment.[96] Unsurprisingly, the immediate public response was powerful

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1934: Marriner Eccles, 1934–1948; Thomas B. McCabe, 1948–1951; William McChesney Martin Jr., 1951–1970; Arthur Burns, 1970–1978; William Miller, 1978–1979; Paul Volcker, 1979–1987; Alan Greenspan, 1987–2006; Ben Bernanke, 2006–2014; Janet Yellen, 2014–present).

90. 12 U.S.C. § 225b (2010). For further information, *see* Monetary Policy Report, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/mpr_default.htm (last visited Apr. 1, 2015).

91. *E.g.*, Ben S. Bernanke, Chairman, Fed. Reserve Sys., Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate: Developments in the financial markets (Apr. 3, 2008), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20080403a.htm; Alan Greenspan, Chairman, Fed. Reserve Sys., Testimony Before the Committee on Banking and Financial Services, U.S. House of Representatives: Private-sector refinancing of the large hedge fund, Long-Term Capital Management (Oct. 1, 1998), *available at* http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm.

92. *E.g.*, Henry W. Chappell Jr., Rob Roy McGregor & Todd Vermilyea, *Majority Rule, Consensus Building, and the Power of the Chairman: Arthur Burns and the FOMC*, 36 J. MONEY, CREDIT & BANKING 407 (2004); David R. Hakes, *The Objectives and Priorities of Monetary Policy under Different Federal Reserve Chairmen*, 22 J. MONEY, CREDIT & BANKING 327 (1990); Peter G. Vanderhart, *The Federal Reserve's Reaction Function under Greenspan: An Ordinal Probit Analysis*, 22 J. MACROECONOMICS 631 (2000).

93. *E.g.*, LIAQUAT AHAMED, LORDS OF FINANCE: THE BANKERS WHO BROKE THE WORLD (2009); IRWIN, THE ALCHEMISTS, *supra* note 71; DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC (2010).

94. *Id. See also* Christopher Matthews, *3 Ways Ben Bernanke Revolutionized the Fed*, TIME MAG. (Nov. 20, 2013), http://business.time.com/2013/11/20/3-ways-ben-bernanke-revolutionized-the-fed/; Victor Li, *The Right Man at the Right Time*, U.S. NEWS (Aug. 19, 2013), http://www.usnews.com/opinion/articles/2013/08/19/federal-reserve-chairman-ben-bernankes-legacy-right-man-right-time.

95. IRWIN, THE ALCHEMISTS, *supra* note 71, at 67.

96. *Id.* at 70.

and negative.[97] Nonetheless, the policies achieved their intended aim of reining in inflation and ultimately restoring a healthy economy.[98] As a result, with the benefit of hindsight, few characterized his tenure in anything less than glowing terms.[99] His reputation and influence have grown accordingly.

Greenspan, by contrast, was revered during his tenure, as the economy generally thrived and financial crises were averted even in the wake of events that may have precipitated them.[100] Since the Crisis, however, his reputation has suffered a significant hit.[101] The Fed's low-interest-rate policies during the early to mid-2000s have been cited as a key factor contributing to the housing bubble that followed, and Greenspan's faith in market forces to produce socially desirable outcomes, a faith reflected in a range of policies that the Fed both adopted and failed to adopt during his reign, is now viewed by many as fundamentally flawed.[102]

As these contrasting accounts reflect, the monetary and other policies implemented by the Fed often have very different short-term and long-term consequences. This is a primary factor complicating the use of more-traditional mechanisms of promoting accountability.[103] It also complicates the operation of reputational constraints. To the extent a Chair chooses to prioritize his short-term reputation or influence, he may seek to further policies that are contrary to the public's long-term welfare. Yet Fed Chairs are quite aware of the differences between the short- and long-term effects of the policies that the Fed promulgates, and they are aware that their legacy depends on the long-term effects of their actions. To the extent a Chair opts to prioritize his legacy, reputation maps well onto the primary rationale for central bank independence and may serve as an effective tool for promoting the adoption of policies that yield long-term, socially desirable outcomes.

This does not mean that reputational constraints alone are a panacea. As reflected in the criticisms of some of the Fed's policies under Greenspan, the Fed clearly has adopted policies that are now viewed as having been contrary to the public interest.[104] This could indicate that Greenspan prioritized the short-

97. *Id.* (noting that during the early part of his tenure, Volcker's policies made him "one of the most unpopular people in the country").

98. *Id.* at 71.

99. Martin Hutchinson, *To Treat the Fed as Volcker Did*, N.Y. TIMES, Nov. 5, 2008, at B2 (describing the "1979–87 chairmanship of Paul Volcker" as one of the Fed's "few moments of glory," as a result of the Fed successfully "bringing inflation under control, providing a sound store of value for the United States economy").

100. *E.g.*, IRWIN, THE ALCHEMISTS, *supra* note 71, at 54–55 (describing 2005 Jackson Hole conference celebrating Greenspan's tenure and the adulation lathered upon him).

101. Kara Scannel & Sudeep Reddy, *Greenspan Admits Errors to Hostile House Panel*, WALL ST. J., Oct. 24, 2008, http://online.wsj.com/news/articles/SB122476545437862295 (noting harsh congressional questioning of Grenspan's actions during the crisis); *25 People to Blame for the Crisis*, TIME MAG. (Feb. 11, 2009), http://content.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877331,00.html.

102. POSNER, *supra* note 10, at 255–57.

103. *See infra* Part II.C.

104. *See, e.g.*, Scannel & Reddy, *supra* note 102 (identifying keeping the short term interest rate at

term, but it may also reflect that he was mistaken about the effects those policies would have. Reputational concerns cannot eliminate mistakes. Another challenge is that a Chair's reputation is usually the product of numerous different actions. If a Fed Chair makes a bad policy decision with respect to one issue, but the effects of that decision are dwarfed by other actions that have the desired effect, that error is unlikely to be penalized through reputational checks. As a result, reputation is likely to be less effective than principled norms at shaping behavior at a granular level.

Yet reputational constraints also have some distinct benefits. The types of actions that may affect a Fed Chair's reputation are as diverse as the types of policies that the Fed can lawfully pursue. This enables reputational constraints to be dynamic, responsive, and forward-looking, attributes that few other constraints can replicate. Principled norms, for example, tend to arise over time and require inputs and learning. Thus, a novel situation will often lack an applicable principled norm or the guidance such a norm provides may be wrong when applied under the circumstances.[105] By contrast, reputation is always present as a constraint. No matter how unprecedented a challenge, a Chair's reputation will depend on whether she responds to it in a way that produces the desired outcome. If anything, the more unusual the circumstance, the more powerful the feedback loop between the Fed's actions and the Chair's long-term reputation.

In part because of these considerations, reputation may serve as a complement to principled norms. When a Fed Chair adheres to an existing norm, the probability of criticism, at least in the short run, is reduced substantially. The principled norm, rather than the Chair, receives the bulk of the credit or blame for the success of the policy pursued. By contrast, the more willing a Fed Chair is to deviate from an established norm, the more the policy pursued will be attributable to her. In the short term, deviation invites scrutiny. In the long run, the success of such policies can be the cornerstone of a Fed Chair's reputation. For example, in their critique of the Fed's overly rigid adherence to the real bills doctrine, Milton Friedman and Anna Schwartz suggest that Benjamin Strong demonstrated a willingness to deviate from the doctrine when circumstances warranted and, had Strong lived, the Fed may have more successfully combatted the greatest depths of the Depression.[106] While others have questioned Friedman and Schwartz's analysis, it remains influential and illustrates the ways that reputational concerns may facilitate deviation from a principled norm.

1% to spur home buying, employing a "hands-off regulatory philosophy," and advocating the use of risky and unregulated credit default swaps as crucial policy mistakes of the Fed under Greenspan's tenure).

105. *See supra* Part I.A.3.

106. Other academics have subsequently claimed that Strong's supposed deviations were actually consistent with the real bills doctrine. Calomiris, *supra* note 17, at 13 (arguing that Strong's "supposed exceptions to real bills targeting . . . were not really exceptions, since [they] occurred at times of high borrowed reserves").

The analysis here suggests that reputational concerns may promote or inhibit a Chair's tendency to adhere to a principled norm. A Chair whose primary aim is to minimize short-term scrutiny will tend to comply. Similarly, when a Chair is conservative in the sense of preferring to avoid lionization or demonization, reputational concerns will tend to increase the probability that the Chair will use her influence in support of policies that conform to principled norms then in effect. By contrast, a Fed Chair who is concerned primarily with her long-term reputation is incented to deviate when she believes a principled norm is wrong or not applicable.

Another important relationship between these two soft constraints is that each relies upon outsiders—popular commentators, academics, Congress, and others—in order to be effective. With respect to principled norms, outsiders play two critical roles—first in the development and evolution of the norm, and second in assessing whether the Fed's actions comply with the norm.[107] Similarly, part of the reason that Fed Chairs have reason to worry about their reputation is that the success of monetary and other policies promulgated under their oversight are subject to scrutiny by academics and others for years to come.

Collectively, this analysis suggests that reputation may help to address concerns about the Fed's legitimacy through multiple mechanisms. The two overarching dynamics of note are the capacity of reputation to serve as a partial substitute for accountability and its capacity to complement more traditional mechanisms for promoting accountability. It functions as a partial substitute by increasing the probability that it will act in ways that further the public interest and correspondingly reducing the probability of arbitrary or self-serving action. It serves as a complement because one of the best ways for a Fed chair to ensure that her actions have the desired effect on her reputation is to explain what she is doing and why she is doing it.[108] This can improve transparency and facilitate oversight. Ultimately, the power of reputation to address concerns about the Fed and accountability are likely to depend in part on the reasons we care about accountability in the first place.

III

ACCOUNTABILITY

Having established that the identified soft constraints play a role shaping Fed action, the question becomes: so what? For some, the answer may be the same as the question: so what? Even if one accepts the preceding analysis, the constraints that it reveals are not only informal but also imperfect. Although probabilistically meaningful, none of the identified constraints ensures that the Fed will act a certain way in a given set of circumstances. For similar reasons, even those who recognize that soft constraints matter may disagree about why.

107. *See supra* Part II.A.2–3.

108. *See infra* note 119 and accompanying text.

These challenges are not unique to this article. As Jerry Mashaw explained, accountability often serves as "a placeholder for multiple contemporary anxieties."[109] Greater accountability to one constituency can promote or impede accountability to others, and the rationales for accountability can vary dramatically, as can the ends it is meant to achieve.[110] Similar tensions surround the notion of independence.

These challenges are not intractable. Mashaw, for example, has identified six related inquiries that allow for a more nuanced analysis of the question of accountability and has proposed a partial taxonomy of independence that builds upon these inquiries.[111] Others have used definitions, sometimes implicit, to structure the inquiry.[112] Rather than trying to reconcile disparate conversations about accountability, this part considers three ways that soft constraints contribute to these overlapping debates. It considers, in turn: the capacity of soft constraints to mitigate concerns about the Fed's legitimacy; the value of adding soft constraints to the range of factors that academics consider when placing an agency along an independence spectrum; and the particular importance of soft constraints in settings where more binding constraints are excessively costly to employ. Although soft constraints alone are far from a solution to the revived concerns about the Fed's independence and authority, the analysis here provides a necessary prerequisite to that discussion, enabling all participants to better understand the nature of the accountability challenge as it actually exists.

A. Legitimacy

Accountability at times serves as a means, rather than as an end, with the desired end being to promote good performance. One rationale for making boards of directors primarily accountable to shareholders, for example, is that,

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109. Jerry L. Mashaw, *Accountability and Institutional Design: Some Thoughts on the Grammar of Governance*, *in* PUBLIC ACCOUNTABILITY: DESIGNS, DILEMMAS AND EXPERIENCES 115, 115 (Michael Dowdle ed., 2006); *see also* Adrian Vermeule, *The Administrative State: Law, Democracy, and Knowledge* (Harvard Public Law, Working Paper No. 13-28, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract+id=2329818, at 11 (describing the "growing body of work that complicates 'accountability'" and its connection to democratic values and identifying as the "critical problem . . . that measures that aim to enhance good accountability may also enhance bad accountability").

110. An important issue this article does not address is the mechanisms, both formal and informal, through which the Fed is held to account by member banks and how those dynamics affect its legitimacy and actions.

111. Mashaw, *supra* note 109, at 118.

112. *See, e.g.*, Bressman, *Beyond Accountability*, *supra* note 6, at 462–64 (noting that, in an attempt to "reconcile the administrative state with a constitutional structure that reserves important policy decisions for elected officials rather than appointed bureaucrats," the country has become fixated on political accountability, which is seen as a proxy for agency legitimacy); Conti-Brown, *supra* note 7 (establishing the Fed's independence by showing its limited accountability to a range of possible constituencies, implicitly assuming that independence means freedom from accountability to any identifiable group); Edward Rubin, *The Myth of Accountability and the Anti-Administrative Impulse*, 103 MICH. L. REV. 2073 (2005) (defining key uses of the term "accountability" in contemporary scholarship).

as residual claimants, they should incent the board to maximize firm value.[113] Similarly, many of the calls for the Fed to be more accountable are animated by concerns that the Fed may use its discretion in troubling ways.[114] In this view, greater accountability serves as a means of reducing the risk that Fed policymakers will use their discretion in arbitrary or self-serving ways. Relatedly, much of the debate about the Fed arises from questions of its legitimacy, and accountability is not the sole metric determining legitimacy. Lisa Bressman, for example, has argued that agency legitimacy depends not only on political accountability but also on "the avoidance of arbitrary agency decision-making."[115] In so doing, she not only suggests flaws with models that place excessive weight on presidential control over agency action, but she also highlights that it may be appropriate to focus more directly on whether a structure promotes good governance.[116]

Using Bressman's definition of arbitrary as "administrative decision-making [that] is not rational, predictable, or fair"[117] suggests that each of the soft constraints identified here, and other soft constraints, will tend to reduce arbitrariness. By making it more likely that the Fed will act in accordance with a principle that has been vetted by leading experts in the field and promoting action that serves the long-term interests of the economy, the identified soft constraints incent Fed officials to act in particular and generally beneficial ways. In this sense, soft constraints may function as partial substitutes for accountability, an alternative mechanism for helping to achieve the desired aim of promoting action in the public interest. This may be particularly valuable in

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113. *See* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 404 (2001) (noting shareholders are residual claimants in a public firm and that contemporary corporate perspectives believe directors should be accountable to shareholders for the purpose of maximizing share value); Mashaw, *supra* note 109, at 89 (stating that if the concern is that corporations are "fleecing their shareholders," the solution is to make them more accountable).

114. *E.g.*, PAUL, *supra* note 3, at 4; Cochrane, *supra* note 3 (calling for an end to "the system of Fed domination"); John B. Taylor, *The Dangers of an Interventionist Fed*, WALL ST. J., Mar. 29, 2012, at A19, *available at* http://online.wsj.com/news/articles/SB10001424052702303816504577307403971824094 (arguing that the Fed's discretion is now virtually unlimited and that it should move "move to a less interventionist and more rules-based policy of the kind that has worked in the past").

115. Bressman, *Beyond Accountability*, *supra* note 6, at 464. In subsequent work with Robert Thompson, Bressman has further explained how certain features of agencies focused on financial regulation, including the Fed, may help to address concerns about agency legitimacy and can contribute to the debate about independence. This article complements that work, largely by focusing on different mechanisms that shape agency action. The analysis here regarding reputation loosely overlaps with Bressman and Thompson's claim that accountability may be less important in certain domains, including the promotion of financial stability, because the interests of President and agency are well aligned. Bressman & Thompson, *supra* note 6, at 635. The analysis here differs, however, in that reputation is recognized to vary by time period. To the extent that regulations may have short-term costs but long-term benefits, a characteristic that will often apply to regulations promoting financial stability in addition to matters of monetary policy, reputational concerns may cause the Fed to act in ways that are actually contrary to the interests of the current President (a fact Bressman and Thompson also acknowledge but do not fully reconcile). *Id.* at 635–36.

116. Bressman, *Beyond Accountability*, *supra* note 6, at 493–503.

117. *Id.* at 495.

the context of the Fed, as at least some commentators have suggested that the interests of the President and financial regulators are particularly well aligned.[118]

Soft constraints are not a legitimacy panacea, even if one focuses solely on this narrow rationale. As reflected in the adverse effects of the Fed's adherence to the real bills doctrine, soft constraints do not always improve the quality of the policies that the Fed pursues. Additionally, as reflected in the ways that soft constraints can compete with one another, when viewed collectively, they will not always render Fed action more predictable. Nonetheless, such situations seem likely to be the exception rather than the rule. Principled norms may at times be erroneous, but the iterative processes through which they are established and discredited, and the myriad voices, including academics, regulators, and other policymakers, engaged in those processes, suggest that they should often embody current best principles. Similarly, although the actions that promote a good reputation in the short run may at times run counter to those that promote a long-term glow, concern with reputation will tend to promote normatively desirable action. Soft constraints may also reduce the likelihood of arbitrary action by increasing the probability that Fed actions that fail to prioritize the aims mandated by Congress will be identified, and perhaps punished, accordingly. Soft constraints thus seem to play a meaningful, even if inherently incomplete, role in helping to establish the Fed's legitimacy.

B. Accountability and Independence

A second implication of the analysis here is that soft constraints should likely be among the factors considered in assessing an agency's independence. Traditionally, whether an agency was "independent" was assumed to be a binary determination that rested on whether the President had statutory authority to remove the head of the agency without cause.[119] Yet numerous scholars have highlighted ways that this approach is descriptively inaccurate and incomplete, if the aim is to have the label correlate to the amount of independence an agency actually enjoys in its operations.[120] In addition to looking beyond removal, scholars have also expanded the analysis to consider Congress, as well as the President and the judiciary, when assessing an agency's independence.[121]

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118. Bressman & Thompson, *supra* note 6, at 603, 635.

119. *See* Barkow, *supra* note 6, at 16–17; Kirti Datla & Richard L. Revesz, *Deconstructing Independent Agencies (and Executive Agencies)*, 98 CORNELL L. REV. 769, 776–77 (2013); Vermeule, *supra* note 6, at 1168–70.

120. Barkow, *supra* note 6, at 17 ("Threats of removal are not the only way presidents control agency heads."); Aziz Z. Huq, *Removal as a Political Question*, 65 STAN. L. REV. 1, 39 (2013) ("As a method of exercising control over an agent, removal is simply not all it is cracked up to be."); Vermeule, *supra* note 6, at 1176–79. *See also* Matthew D. McCubbins, Roger B. Noll & Barry R. Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431, 435 (1989); Geoffrey P. Miller, *Independent Agencies*, 1986 SUP. CT. REV. 41, 51; Peter L. Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573, 583–87 (1984).

121. *E.g.*, Barkow, *supra* note 6, at 42–45, 55–56; McCubbins, Noll & Weingast, *supra* note 120, at

These moves have spurred some scholars to suggest that the independence inquiry should be revised. Rather than a dichotomy, these scholars suggest that independence should be viewed along a spectrum, with a range of factors. These analyses have also started to identify the factors, such as multimember leadership structure, partisan balance requirements, and litigation authority, which should be weighed in determining where along that spectrum a particular agency falls.[122] Notably, however, even these more expansive lists tend to focus on formal mechanisms through which members of the three constitutionally recognized branches of government can influence agency action. The analysis here suggests that if the aim is to develop a more accurate and complete picture of the range of factors that influence the amount of independence an agency actually enjoys, the inquiry should be expanded further to incorporate the ways that soft constraints affect an agency's operations.

As an initial matter, the factors suggesting that soft constraints may support legitimacy also suggest that soft constraints should be considered when assessing an agency's effective independence. Additionally, soft constraints may promote transparency, communication, and understanding. They can thereby increase the efficacy of traditional mechanisms for promoting accountability. For example, in order to cultivate a good reputation, or to try to mitigate a bad one, the chair of an agency must communicate. If her agency takes an action that is not popular, reputational concerns make it more likely that she will seek to explain, in a way that the public and elected officials can understand, why the agency took that action. Bernanke, for example, has expended significant efforts trying to explain the actions of the Fed under his watch, and he has done so even though he is not seeking reappointment and even though he often had no formal obligation to do so.[123] Similarly, principled norms can play a critical role in facilitating public disclosure of, and discussions about, particular agency actions.[124]

This does not mean soft constraints are an unmitigated good for those seeking to maximize political accountability. Principled norms may be used by an agency to deflect attention away from a controversial act and may shift the locus of discourse toward a small band of specialists, limiting engagement with the public and their elected officials. Similarly, if the Fed Chair is exceptionally popular, the President may feel constrained in his capacity to exercise freely his power of appointment when the Chair is up for reappointment.[125] Such

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435; Strauss, *supra* note 120, at 583.

122. *See* Bressman & Thompson, *supra* note 6, at 623; Datla & Revesz, *supra* note 119, at 774; *see also* Barkow, *supra* note 6, at 17 (considering, more broadly, factors that can help to "insulat[e] [an agency] from interest groups and partisan pressure").

123. Ben S. Bernanke, Chairman, Fed. Reserve, Address at the Annual Meeting of the American Economic Association: The Federal Reserve: Looking Back, Looking Forward (Jan. 3, 2014), *available at* http://federalreserve.gov/newsevents/speech/bernanke20140103a.htm.

124. *See supra* Part II.B.

125. If one considers political accountability as a means to public accountability rather than an end in itself, such a shift may be quite welcome. *See generally* Vermeule, *supra* note 109 (discussing the limitations of using a principal–agent framework to assess agency accountability)

situations are likely to be the exception rather than the norm, however, and at least some of these examples may not be all that troubling.

A distinct challenge is that the focus here is on the Fed, and one cannot assume that what is true for the Fed applies equally with respect to other agencies. The Fed is more powerful and more independent than any other federal regulator;[126] its chairmen serve for exceptionally long tenures and other members of the Fed's Board of Governors have exceptionally long appointments.[127] Moreover, it has a unique structure as a result of the important (albeit waning) influence of the regional reserve banks in policymaking and implementation,[128] and there is a robust body of empirical literature supporting making central banks independent of elected officials.[129]

The difference between the Fed and other federal agencies along these and other dimensions is often one of degree rather than kind, but the former can sufficiently shape an agency to morph into the latter. As a result, both the types of soft constraints that affect an agency's actions and their relative importance may be quite different when the analysis shifts to other agencies. Nonetheless, the analysis here suggests that soft constraints can meaningfully impact how an agency exercises its discretion and can facilitate other modes of accountability. As a result, so long as independence is viewed as a point along a spectrum, with its location determined by a range of considerations, soft constraints should be among the factors considered in making that determination.[130]

C. Context Matters

Soft constraints, by their nature, tend to be weaker than formal constraints on an agency's authority.[131] They may alter Fed action in a way that is probabilistically meaningful, but they cannot ensure that the Fed will respond in a predetermined way to any particular set of circumstances, and there is limited recourse should the Fed's response deviate from the course that a particular soft constraint would seem to require. Yet, it does not follow from this that soft constraints are necessarily inferior as tools for promoting accountability.

Soft constraints could be part of an optimal regime for agency accountability in a range of circumstances. Whenever the costs associated with using a soft constraint are less than the costs of using a formal constraint for achieving the same aim, one might consider the soft constraint to be a superior means for achieving the desired aim. Similarly, there may be a range of behaviors that

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126. Conti-Brown, *supra* note 7, at i.

127. *Id.* at 27.

128. *Id.* at 36.

129. Datla & Revesz, *supra* note 119, at 825 (analyzing several factors as "indicia of independence" of an agency's independence and ranking the Fed in the group with the second highest number of indicia).

130. *Id.* at 824.

131. Given the Fed's creativity in how it interpreted its formal authority during the Crisis and the capacity of soft constraints to at times be quite powerful, formal constraints cannot be assumed to always be more binding than their soft counterparts discussed here.

cannot easily be furthered using formal restraints on an agency's authority, but that may be effectively (even if imperfectly) furthered through an appropriate soft constraint. Of particular importance, however, is the role of soft constraints in settings where accountability is important but formal mechanisms for promoting it are problematic. Put differently, the more costly it is to use formal constraints to make an agency politically accountable, the greater the relative benefits soft constraints may confer. The Fed illustrates this dynamic and the exceptional importance of soft constraints in such settings.

One justification for the existence of independent agencies in general is that direct accountability to elected officials can impede regulators' capacities to achieve certain policy aims.[132] This commonly arises when the policies required to achieve a socially desirable long-term outcome entail significant (or particularly salient or unpopular) short-term costs. This tension is vividly present in the realm of monetary policy and is a core justification for central bank independence. As Ben Bernanke has explained, "monetary policy works with lags that can be substantial," so it is best administered by a body who can take a long-term perspective, and "political interference in monetary policy can generate undesirable boom–bust cycles."[133] Insulation from political branches enables central banks to more credibly commit to maintaining a low rate of inflation, and the market's beliefs regarding such commitments can be self-fulfilling. There are also longstanding concerns about giving political actors the power to create money.[134] Because formal mechanisms for enhancing political accountability, by their nature, are intended to confer some degree of control and increase responsiveness, using such tools to reduce the Fed's independence with respect to monetary policy could have significant and deleterious effects on its performance.

A range of other considerations provide further support for the notion that making the Fed more formally accountable to elected officials may not be in the best interests of the public. For example, there are concerns that elected officials would encourage the Fed to abuse its role as lender of last resort by pressuring the Fed to support particular firms or industries to serve political

132. *E.g.*, Bressman & Thompson, *supra* note 6, at 613–14.

133. Ben S. Bernanke, Chairman, Fed. Reserve Sys., Speech at the Institute for Monetary and Economic Studies International Conference: Central Bank Independence, Transparency, and Accountability (May 26, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20100525a.htm; *see also* Geoffrey P. Miller & Rosa Lastra, *Central Bank Independence in Ordinary and Extraordinary Times*, in CENTRAL BANK INDEPENDENCE: THE ECONOMIC FOUNDATIONS, THE CONSTITUTIONAL IMPLICATIONS, AND DEMOCRATIC ACCOUNTABILITY 31 (Jan Kleiniman, ed., 2000); Alberto Alesina & Lawrence Summers, *Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence*, 25 J. MONEY, CREDIT & BANKING 151 (1993), http://www.econ.ucdenver.edu/smith/econ4110/Alesina%20Summers%20-%20Central%20Bank%20Independence%20and%20Macro%20Performance.pdf; Frederic S. Mishkin, *Central Banking After the Crisis*, 16 ANN. CONF. OF THE CENT. BANK OF CHILE, Nov. 2012, at 44.

134. *E.g.*, Allan H. Meltzer, Testimony before the House Financial Services Committee: Reforming the Federal Reserve for the 21st Century (Sept. 11, 2013), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba19-wstate-ameltzer-20130911.pdf.

aims.[135] There are also new reasons to expect that short-term accountability may inhibit the Fed's ability to promote financial stability.[136] And the incredible dynamism of the financial markets is yet another factor favoring granting the Fed relatively broad authority and the discretion that comes with it. Although giving agencies such discretion shifts the locus of decisionmaking from Congress to the agency, in light of the constantly evolving nature of the financial markets, a broad grant of authority may be necessary to ensure that the Fed has the tools it needs to respond effectively in the face of a crisis.[137]

While these considerations help to explain the Fed's broad authority and extreme independence, they do not undermine the importance of ensuring that an agency as powerful as the Fed is politically accountable. This is particularly true in light of recent events, which clearly illustrate that the Fed's actions can have significant ramifications beyond affecting the health of the overall economy.[138] For example, the Fed's actions to stabilize the financial system, even if undertaken to promote the overall size of the pie, can also have significant distributional consequences. Providing liquidity support to a financial institution to prevent the negative externalities that would result from its failure inevitably confers benefits on employees, creditors, and other stakeholders in a manner that is disproportionate to the social benefits that result. Similarly, quantitative easing and other unconventional monetary policies may help promote the health of the economy, but they too inevitably benefit some segments of the population, like homeowners and other borrowers, more than others. These are just a few examples of the difficult trade-offs inevitably at stake when the Fed acts. By making such trade-offs salient, and by perhaps forcing the Fed to take more actions that disproportionately affect identifiable segments of the population, the Crisis appropriately renewed longstanding debates about the legitimacy of the Fed.

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135. *See* Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, 74 FED. RES. BANK OF ST. LOUIS REV. 58, 66 (1992).

136. Andrew G. Haldane, Exec. Dir. of Fin. Stability of the Bank of Eng., Speech at the Centre for Research on Socio-Cultural Change Annual Conference: Why Institutions Matter (More than Ever) 9 (Sept. 4, 2013), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech676.pdf (arguing that "in light of informational and other dynamics, the case for placing financial stability policy in the hands of [a policymaker somewhat shielded from electoral accountability] is at least as strong, and arguably stronger, than for monetary policy").

137. *Cf.* Gersen, *Designing Agencies*, *supra* note 86, at 339 (explaining that one way that Congress can control agency action is through very detailed grants of authority); McCubbins, Noll & Weingast, *supra* note 120, at 440 (same).

138. *E.g.*, Meltzer, Testimony before the House Financial Services Committee, *supra* note 134, at 3. ("The current Federal Reserve has engaged in such non-monetary functions as fiscal policy, debt management, and credit allocation."); Lemann, *supra* note 1. Lemann notes that,

> Since the financial crisis, … people working [at the Fed]… have driven down the value of the dollar, infuriating exporting nations such as Brazil and India[,]… have kept interest rates low enough to give enormous advantages to debtors, from homeowners to hedge-fund managers and private-equity barons, at the expense of people who depend on the interest from their life savings[,]… have conferred significant government subsidies on the biggest banks[, and]… are helping to push stock prices higher.

Id.

Ultimately, there is no solution to these fundamental tensions, and soft constraints certainly do not eliminate them. Nonetheless, soft constraints may have a particularly important role to play in helping to mitigate these tensions given the drawbacks of using more traditional tools to limit the Fed's authority and independence. Put differently, the relative fuzziness of soft constraints may at times be a virtue, enabling them to facilitate oversight, informed discourse, and good action while still providing the Fed the independence and discretion it needs to make credible commitments and to respond to unforeseen developments.

More generally, the "soft" nature of soft constraints may make them particularly useful in settings where the costs of using formal constraints to increase political accountability are simply too great to justify their use. The ability to "translate" the dictates of a principled norm in light of new circumstances, for example, may impede judicial review and make it less effective at promoting predictability, but it simultaneously may enable the constraint to remain binding even when the Fed is facing challenges for which there is no clear precedent. Given the iterative process through which the Fed's authority and independence have grown and evolved over time, it is also quite possible that the Fed would not be as independent and powerful as it is today if it were not subject to powerful soft constraints on how it uses its authority.

IV

CONCLUSION

Ultimately, tensions are inevitable when policymaking authority is delegated to an agency run by unelected officials, and the tensions surrounding the Fed are particularly great. On the one hand, there is increasing concern about the degree of independence that the Fed enjoys, and recent events attest to the legitimacy of those concerns. On the other hand, theory and empirical literature suggest that the efficacy of monetary policy improves when administered by a body that is independent from political branches, and the Fed, as it currently exists, remains powerful and very independent. The analysis here suggests that soft constraints on the Fed's authority may provide a palliative, reducing the magnitude of the tension even if not resolving it completely. It further suggests that soft constraints may be an important additional set of factors that should be considered in assessing the effective independence of any agency. Although different in kind from more commonly recognized tools for enhancing legitimacy, and inherently weaker in some regards, soft constraints have the capacity to meaningfully constrain agency action and to facilitate oversight and discourse. Operating independently and in conjunction with formal tools, the analysis here suggests soft constraints sufficiently impact agency action to merit more consideration than they have received thus far.

The analysis here also holds a second lesson for those concerned about the Fed's legitimacy: the importance of continuing to invest in the creation and

enforcement of soft constraints. The quality and efficacy of soft constraints depends on the effort that academics, the financial press, policymakers, and others expend in the processes through which soft constraints are formed and enforced. Reputation will only serve as a useful tool for promoting good behavior to the extent that the actions of a Fed Chair meaningfully (and correctly) inform his subsequent reputation. This requires analysis, and that analysis must be regularly revisited and disseminated.

Similarly, principled norms can constrain only to the extent that there is an established principled norm governing how the Fed ought to act in a given situation, a condition not satisfied for many actions that the Fed took during the Crisis.[139] Even then, the value of principled norms depends on their correctness, giving rise to the need to regularly reassess such norms in light of new information. Thus, while soft constraints have and will continue to play an important role enhancing Fed accountability, just how effective they are will depend in part on the efforts invested to ensure they remain robust.

139. For example, the Fed entered into a number of reciprocal currency arrangements with foreign central banks pursuant to that appear to have been quite helpful in practice and exposed the Fed to minimal credit risk, yet there is no principled norm about when and with whom the Fed should enter into such relationships. Colleen Baker, *The Federal Reserve's Use of International Swap Lines*, 55 ARIZ. L. REV. 603, 619–21 (2013); Michael J. Fleming & Nicholas J. Klagge, *The Federal Reserve's Foreign Exchange Swap Lines*, 16 FED. RES. BANK OF NY CURRENT ISSUES IN ECON. AND FIN., April 2010, Issue No. 4. Similarly, in previous work, I have suggested that Bagehot's dictum, although helpful, is too vague on its own to serve as the sole principled norm guiding the Fed's lender-of-last-resort activities. Kathryn Judge, *Three Discount Windows*, 99 CORNELL L. REV. 795, 802–05 (2014).