

FEDERAL RESERVE

The Road to Independence

The Federal Reserve was created by Congress, but must retain autonomy from the political branches to effectively execute monetary policy

BY ERIC NIELSEN

Since this nation's founding, central bank independence (CBI) has been a contentious and often-misunderstood issue. Our government and national character were formed in reaction to monarchy and centralized power, yet from the First and Second Banks of the United States to the current Federal Reserve System, central banks have played key economic and political roles at various points in history.

These banks have been attacked for being both too powerful and independent of the political structure, as well as for being too partisan in setting economic policy. Only through extensive trial-and-error experimentation, as well as significant economic scholarship, has the proper role of a

central bank within a constitutional framework become understood and widely accepted.

Economists, policymakers, and journalists frequently make reference to "central bank independence," but what is meant by this term? There is no consensus as to what the definition of CBI ought to be (see sidebar), yet broadly speaking, independence is the ability of the bank to formulate and carry out monetary policy as best it can without political intervention. Independence is a complex blend of the bank's enumerated powers, its structure, and its leadership, as well as many other factors.

Central bank independence is important because it allows the government to commit credibly to a program of low inflation. On their own, governments have a strong inflationary bias; they often will try to boost output and employment in the short run for political gain, even though eventually such policies lead to inflation, not sustained growth.

Inflation can also act as a source of revenue for governments, further tempting them. Even if a government promises not to inflate, the public may remain skeptical, producing high inflationary expectations. By delegating responsibility for money creation to a central bank, the legislature can remove the temptation to abuse its power and pursue bad monetary policy for short-run gain. (It is important to note that this temptation to



Former Federal Reserve Chairman Paul Volcker talks with Sen. Paul Sarbanes of Maryland prior to a 1979 Senate hearing on monetary policy. The Federal Reserve is formally independent of the executive and legislative branches, but the President appoints the Fed's chairman, who must report regularly to Congress.

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inflate is particularly acute in a system of fiat money. When a nation's currency is backed by a commodity, such as gold, the ability of the government to inflate at will is limited. Of course, such commodity-backed systems have their downsides as well.)

The Federal Reserve System clearly demonstrates this delegation of monetary authority by a legislature to a central bank. The Fed is ultimately a child of Congress, to which the chairman must report regularly, but it is free to pursue monetary policy as it sees fit. As economist Allan Meltzer of Carnegie Mellon University puts it, "The Fed is independent *within* government, not independent *from* government."

Modern ideas about the importance of central bank independence in maintaining good monetary policy took a long time to develop, with many missteps along the way. After two initial experiments in central banking, the United States went almost 80 years with no central bank. These early banks failed due to fears that they were too powerful, too corrupt, and too free from government oversight.

During the Revolutionary War, the fledgling U.S. government had difficulty financing wartime expenditures and resorted to excessive printing of continental dollars. (This is how the phrase "not worth a continental" originated.) This prompted the founding of the First Bank of the United States (FBUS) in 1791, a private bank with some special privileges to finance government debt. Though the FBUS worked reasonably well, its charter was not renewed in 1811 largely due to the belief that such an institution did not have an explicit constitutional mandate and fears that it wielded too much financial power.

After the United States once again experienced credit problems during the War of 1812, the Second Bank of the United States (SBUS) was chartered in 1816. The SBUS was not conceived as a central bank in the modern sense, though it soon evolved to fill that role during the 20 years of its initial charter. It was fairly successful

in its attempts to regulate and stabilize the nascent U.S. banking industry.

When the time came, however, for the bank to be rechartered, President Andrew Jackson and Nicholas Biddle, head of the SBUS, argued fiercely about the Bank's place in U.S. governance. Jackson complained that the bank was run for the private interests of its shareholders and was not provided for by the Constitution. Biddle countered by arguing that a central bank was effective and justified, and should be separated in powers from the government, which might abuse its role in the financial system. Ultimately, Biddle lost the fight, and with it the Bank. The United States had no central banking authority until the Federal Reserve System was founded in 1913.

The Birth of the Modern Fed

The story of the modern Fed really begins in 1934, in the midst of the Great Depression. After its apparent failure to avert the economic disaster of the 1930s, the Fed subordinated its policy role to the U.S. Treasury. Once World War II broke out, the Fed further sacrificed independence, propping up government debt by holding interest rates constant. This policy was both inflationary and limiting since it prevented the Fed from taking other monetary actions. After the war was over, the Treasury as well as President Truman wanted the Fed to continue supporting their fiscal policies, but there were critics within the Fed of continuing this arrangement, and eventually the conflict escalated into open argument as each side publicly contradicted the other about the direction of U.S. monetary policy.

The dispute was finally resolved by the signing of the Treasury-Federal Reserve Accord of 1951. In the Accord, both parties agreed that the Fed should be the sole conductor of monetary policy. The disengagement of monetary from fiscal policy in effect allowed the Fed to gain back the independence it had lost during the war.

In the period immediately following the Accord, the modern character and role of the Fed were formed under the

chairmanship of William McChesney Martin. According to Robert Hetzel, a senior economist at the Federal Reserve Bank of Richmond, "What happened after the Accord was that Martin gave effective substance to the federal character of the Reserve System by bringing in regional bank presidents as key members of the FOMC. So while there was no change in the law concerning Fed independence, there was an institutional change." Furthermore, the Accord saw the Fed commit to "lean against the wind" — that is, to adopt monetary policy with the intention of smoothing out business cycle fluctuations.

Since 1951, the results of Fed policy have been highly variable. During the 1950s and early '60s, inflation was low and steady. But in the late 1960s and much of the '70s, the United States suffered from high and variable inflation along with high rates of unemployment. Fortunately, since the early 1980s, inflation has been generally quite low, and it seems that price stability finally has been achieved. Some economists have suggested that at least some of this variation in performance should be attributed to occasional partisan political intervention by the Fed.

Others argue that the Fed simply did not have sufficient economic understanding during these bad spells to formulate effective policy. For instance, under the chairmanship of Arthur Burns (1970-1978), the Federal Reserve often pursued unwise monetary policies. Persistently high inflation coupled with economic stagnation, derogatorily dubbed "stagflation," characterized Burns' tenure.

Economists like Richard Timberlake of the University of Georgia think that Burns' Fed was clearly politically active. Timberlake argues that by keeping monetary policy loose throughout 1971, despite rising inflation, Burns boosted President Nixon's chances at re-election in 1972 by artificially stimulating the economy. "He [Burns] made the Fed, at least as far as he had control of it, an aide of the Nixon Administration," Timberlake says. He further cites Burns' unortho-

dox and ineffective use of wage-price controls in an effort to curb inflation.

Other economists such as Hetzel counter that, though misguided, Burns' policies were failures of economic understanding and leadership, not of political independence. He argues that most of Burns' policy blunders were foreseeable results of his previously stated economic beliefs — which, in large measure, were representative of the economics community generally during this period. As Marvin Goodfriend, an economist and

senior vice president at the Richmond Fed, points out, "The central bank cannot be expected to do better than the economists."

In addition to hewing to questionable economic theories, Burns also changed his outlook and explanations frequently. This had the unintended policy effect of making it more difficult for businesses to understand and predict which policies the Fed was likely to pursue. This combination of loose policy, high inflationary expectations, and dimin-

ished Fed credibility set the stage for stagflation.

The quality of Fed monetary policy has improved markedly over the last two decades under the leadership of Paul Volcker and Alan Greenspan. For instance, during the presidential election in 1980, Volcker drastically tightened monetary policy. This put an end to inflation, although it caused a short but severe recession. Such actions seem to indicate that the Fed is more able, or at least more willing, to follow good policy regardless of political repercussions.

Measuring Independence

The chief problem facing economists seeking to understand the effect of central bank independence (CBI) on economic performance is the difficulty in ranking and comparing CBI across countries. Unlike many economic variables, independence is not simply a number, but instead a loosely defined concept dependent upon the specific institutional, legal, and cultural framework within which a particular central bank operates. No two countries, or their central banks, are alike. Essentially, researchers must find a way to compare apples to oranges.

Economists generally break independence down into two subcategories, political and economic, which they can then examine separately or in combination. Political independence is the degree to which a central bank is insulated from short-term political censure. Infrequent appointments of bank directors, legally mandated independence, and other institutional arrangements are taken to correspond with high political independence.

Compared to other countries' central banks, the Fed has a good deal of political independence. It can conduct policy that is contrary to the wishes of Congress (at least until Congress decides to change the law governing the Fed). Additionally, the chairman of the Fed serves a 14-year term, thus isolating him somewhat from political threats to his job. At the same time, informal bonds between members of the Fed and elected officials may jeopardize independence at times. For instance, some have argued that former Fed Chairman Arthur Burns' friendship with President Nixon may have informally

decreased the Fed's independence from the executive branch.

Economic independence is the central bank's ability to effectively enact any monetary policy it may decide is best. The Fed now has economic independence since it has direct control over the implements of monetary policy, but did not through part of its history.

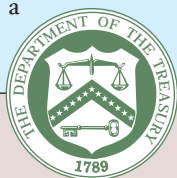
Until the Treasury-Fed Accord of 1951, the Fed was required to support the nation's fiscal policy, which removed a huge array of options from its policy palette.

Attempts to rigorously analyze CBI are complicated further by cultural factors extending beyond mere institutional and legal arrangements. For instance, a country with a long tradition of deference to authority may have a less independent central bank in practice, regardless of how independent it looks on paper. Determining the cultural attitudes toward central banking within a given country requires intimate knowledge of its history and national identity.

Studies showing a correspondence between CBI and low inflation, then, need to be taken with a grain of salt. The indices used are generally quite crude. The most popular consist of a simple 1 to 4 ranking, and may be subject to researcher bias. Encouragingly, though, researchers have found similar results using a wide

array of ranking schema, indicating that though the specifics may be difficult to measure, there is a real underlying relationship between CBI and some aspects of economic performance.

—Eric Nielsen



The Treasury-Federal Reserve Accord

The Treasury and the Federal Reserve System have reached full accord with respect to policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

What the Data Say

A great deal of theoretical and empirical investigation tentatively indicates that some form of CBI does indeed have beneficial long-run effects. For instance, economist Alberto Alesina of Harvard University has used various methods to quantify independence and has found that, across a wide sample of countries, greater CBI tends to correspond to lower and less variable inflation. At the same time, research also indicates that CBI has little effect on other important economic variables such as GDP growth.

Like all research, these results come with major caveats. As discussed in the sidebar, it is very hard to come up with a ranking of independence across countries. Though the correlation between high CBI and low inflation holds for a wide array of independence indices, the strength of the results does change.

Although economists and policy-makers have made great strides in understanding the economic importance of CBI, there is still much work to be done. There are now major proposals being discussed to further institutionalize the Fed's independence and help protect it from potential crises.

The most prominent suggestion advocated by many monetary economists is that the Fed adopt an explicit inflation target as its primary operational goal. Under an inflation target, the Fed would simply pursue whatever monetary policies were necessary to maintain inflation at the desired level.

Over the last 20 years, the Fed has focused most of its energies on maintaining low inflation, yet there is nothing in the mandate of the Fed requiring that it make inflation its main priority. As Goodfriend puts it, "You want an inflation target to guard against the bad old days of high inflation. Independence becomes moot if the Fed follows an inflation target because it will be held accountable to something. Holding inflation constant would completely determine Fed policy — there would be no degrees of freedom to do anything else."

In addition to a publicly stated inflation target against which actual Fed performance could be compared, the Fed

might also want to make its operating procedures more transparent. "The issue for the Fed is that it is not enough that we have oversight hearings in Congress. We also have a responsibility to conduct monetary policy in a way that allows easy monitoring by the public," says Hetzel. "It is incumbent upon us to make policy in a way that is in the spirit of a constitutional democracy."

An explicit inflation target mandate for the Fed would also help it surmount another potentially difficult issue: that of succession and leadership. Many economists now see the leadership of the chairman as vital to Fed success. "A lot of the credibility of the Federal Reserve System rests in the person of the Federal Reserve Chairman *because* we don't have any institutional requirements to target low and stable inflation," Hetzel says. "There is no obvious answer to how well we would work under a poor leader." As a result, some fear that when Greenspan retires, a lot of the faith in the effectiveness of the Federal Reserve System will retire with him.

Marvin Goodfriend and Robert Hetzel are not especially concerned, though. Goodfriend stresses that, over the last 20 years, a consensus has emerged within the economics community that the Fed should primarily strive to maintain low inflation. Such agreement effectively limits the opportunities for politicians to push for deviations from best practice behavior. "Intellectuals matter, when they are united," Goodfriend says.

New Pressures to Inflate?

Questions about the Fed's independence and ability to stave off political pressure may become particularly pressing in the near future. Laurence Kotlikoff of Boston University and Scott Burns of the *Dallas Morning News* argue in their new book, *The Coming Generational Storm*, that in the next 30 years, the Social Security and Medicare systems will come under tremendous pressure as the baby boom generation reaches retirement age. These programs' liabilities are close to 12 times the current national debt, Kotlikoff and Burns estimate.

Without a large increase in the size or productivity of the American work

force, the government will have difficulty financing these expensive programs through the conventional means of taxation and borrowing. Kotlikoff and Timberlake fear that the Fed will be put under tremendous pressure by the political branches to use inflation to pay down this debt.

Another potential source for political pressure on the Fed comes from hard-to-predict geopolitical events such as terrorism. Several studies have shown that terrorism imposes enormous costs on the U.S. economy. In the wake of 9/11, the Fed drastically loosened monetary policy to help the economy rebound. That action has seemed to work, but a particularly severe attack in the future may prompt politicians to pressure the Fed into unsound monetary practices.

Such potential pressures on good monetary policy give the issue of central bank independence new relevance. The economic performance of the coming decades could hinge in part on how well the Fed can insulate itself from political machinations in the face of extreme circumstances. **RF**

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