Who's the Boss?

How Congress holds monetary policymakers accountable

BY RENEE HALTOM AND JESSIE ROMERO

In 1956, Federal Reserve Chairman William McChesney Martin Jr. stood before the Senate Committee on Banking and Currency to have his reappointment to the Board of Governors confirmed. Sen. Paul Douglas, D-Ill., went to great lengths to remind Martin who was in charge: "Mr. Martin, I have had typed out this little sentence which is a quotation from you: 'The Federal Reserve Board is an agency of the Congress,'" he said. "I will furnish you with Scotch tape and ask you to place it on your mirror where you can see it as you shave each morning." In 2013, Chairman Ben Bernanke was asked if he had any advice for incoming chair Janet Yellen. "The first thing to agree to," he replied, "is that Congress is our boss."

In fact, though, Congress does not dictate or audit monetary policy decisions. Instead, lawmakers establish general goals for monetary policy and evaluate its effectiveness over time — a structure designed by Congress itself to keep monetary policy free of political pressure.

In recent years, the Fed has come under intense scrutiny as a result of its unconventional policy responses to the financial crisis of 2007-2008 and the ensuing recession. While many observers credit the Fed with protecting the U.S. economy from an even worse outcome, others believe the central bank has displayed a troubling lack of transparency and accountability. These critics have proposed a number of reforms to increase congressional oversight of the Fed. But how does Congress currently hold the Fed accountable? And what is the right balance between monetary policy independence and accountability? As with so many relationships, the answer is: It's complicated.

A Balancing Act

Both research and history have shown that when monetary policy is divorced from politics — and thus, for instance, from the pressure that might be exerted by politicians hoping to stimulate the economy before an election — monetary policymakers have more credibility in maintaining low and stable inflation and are better able to focus on that long-term goal. At the same time, monetary policy decisions have far-reaching consequences; thus, the public reasonably expects the Fed to be accountable to elected officials.

Policymakers have attempted to resolve the tension between independence and oversight by giving the Fed independence in the use of its policy instruments — that is, allowing the Fed to set interest rates or apply other monetary policy tools without congressional input or approval — while allowing Congress to determine monetary policy objectives and review the Fed's performance over time. In economics parlance, the Fed has "instrument independence" but not "goal independence."

This does not mean that the Fed has always acted independently; the Fed's relationship with the legislative and executive branches has evolved over the past century. But especially since the early 1950s, the Fed has increasingly asserted its independence from Congress and the president. At the same time, in more recent decades, the Fed has made a number of changes to be more transparent. Some of those changes have been dictated by law, such as requiring the Fed's monetary policymaking body, the Federal Open Market Committee (FOMC), to report to Congress twice per year; others have been initiated by the Fed itself, such as issuing a detailed statement after each FOMC meeting and holding press conferences four times per year.

What's the right amount of independence? That's a question economists are still trying to answer. Although the consensus is that independence is beneficial, researchers have not yet pinned down precisely which aspects of independent governance structures — other than the absence of overt, frequent demands from elected leaders — contribute to better policy outcomes. In addition, macroeconomic outcomes depend on many factors: It's difficult for researchers to disentangle whether those outcomes result from different economic circumstances, policy strategies, mandates, or political environments. That makes it hard to say whether or not the current amount of congressional oversight is effective, not to mention if a change in oversight would be more effective.

The Big Club Behind the Door

Congress has both implicit and explicit tools for ensuring the Fed is meeting the goals lawmakers have established. For example, the Senate has the ability to approve — or delay approving — presidential nominations of many of the Fed's leaders, including the Fed chairman and the governors who compose the majority of the FOMC. Especially when there is a strong partisan divide, senators have been able to signal their dissatisfaction with monetary policy by delaying the approval of Fed leaders. In 1996, for example, Sen. Tom Harkin, D-Iowa, held up Alan Greenspan's confirmation for a second term as chairman for months to protest what he and some other Democrats viewed as Greenspan's focus on inflation at the expense of economic growth.

Congressional hearings are another form of oversight. The Federal Reserve Reform Act of 1977 required the Board of Governors — in practice, the chairman — to appear before Congress twice per year. (Fed governors and regional Bank presidents also testify before congressional committees occasionally, on an array of topics.) The nature of those hearings has changed over time. In the late 1970s, when both inflation and unemployment were high, committee members were relatively quick to challenge rhetorically the Fed's independence and decisionmaking, according to research by Cheryl Schonhardt-Bailey of the London School of Economics and Political Science and Andrew Bailey of the Bank of England. But during the period known as the Great Moderation, from the mid-1980s to the mid-2000s, committee members increasingly used the hearings to talk about topics other than the Fed, such as the United States' international competitiveness, education policy, and the activities of Fannie Mae and Freddie Mac — perhaps to use the Fed chairman as expert support for their positions in other policy debates.

The ultimate source of Congress' authority is its ability to amend the Federal Reserve Act, the law governing the Fed. Lawmakers have amended the Act many times over the past century, including some major changes to the conduct of monetary policy. (See box.) In addition, lawmakers can try to steer the central bank via proposed legislation (even if members know it won't pass), public statements, and even implicit threats.

These measures add up to what Stanford University political scientist Barry Weingast has dubbed "the big club behind the door," meaning that the threat of punishment — whether directly via amendments to the Act or through more indirect means — should, in theory, push the Fed to understand and comply with congressional wishes. In this view, the absence of visible struggle suggests congressional dominance rather than congressional impotence. This view also suggests that overt efforts to reform the Fed aren't actually about trying to improve the Fed's performance, since the Fed already has plenty of incentive to keep Congress happy. So what are reform attempts actually about?

Assigning Responsibility

Economists and others traditionally have been concerned that members of Congress might favor accommodative monetary policy to boost employment and output in the short run — but according to one theory, individual lawmakers might not have much incentive to try to influence the Fed. In the seminal 1974 book *Congress: The Electoral Connection*, political scientist David Mayhew of Yale University modeled politicians as "single-minded seekers of reelection," meaning they are motivated to pursue activities for which they can take credit in the eyes of voters. But because Fed policies affect many regions and many aspects of the economy, no single legislator can credibly claim to have directly influenced them. So self-interested lawmakers actually should not have much interest in monetary policy.

Alternatively, the same electoral incentives could spur politicians to use the central bank as a scapegoat if the economy turns sour or if interest rates get uncomfortably high — whether or not those outcomes are actually the result of monetary policy missteps.

Milestones in Monetary Policy Governance

- **The Banking Act of 1935** created the modern Federal Open Market Committee, a body of board members and a rotating subset of Reserve Bank presidents. The Act effectively removed monetary policy as the exclusive purview of Reserve Bank presidents and centralized it in the FOMC.
- **The Treasury-Fed Accord of 1951** allowed the Fed to pursue independent monetary policy, ending a period of low interest rates at the Treasury's behest to ease war financing.
- **The Federal Reserve Reform Act of 1977** established the Fed's dual monetary policy mandate and required the Board of Governors to testify before Congress twice per year. **The Humphrey-Hawkins Act of 1978** required the Board also to submit written reports.
- **The Dodd-Frank Act of 2010** significantly expanded the Fed's supervisory powers over financial institutions while limiting the Fed's emergency lending authority. The Act also directed the Government Accountability Office to audit the Fed's governance structure and its lending programs during the financial crisis and required the Fed to disclose the details of discount window loans.

In recent work, Sarah Binder of George Washington University and the Brookings Institution and Mark Spindel of Potomac River Capital examined congressional scrutiny of the Fed by measuring the number of bills introduced to the House and Senate between 1947 and 2014. They found that lawmakers did appear to be motivated by economic conditions: The number of bills introduced spiked with the onset of recessions. Consistent with Schonhardt-Bailey and Bailey's results, Congress was notably quiet with respect to the Fed during the Great Moderation. (Binder and Spindel's research will be published in their forthcoming book, *Monetary Politics: Congress and the Federal Reserve, 1913-2016*.)

Binder and Spindel also found differences between the two political parties. Democrats were more likely to introduce legislation when unemployment spiked, although this subsided somewhat after employment was officially added to the Fed's mandate in 1977. Republicans showed little interest in the Fed until the "stagflation" of the 1970s, perhaps reflecting their greater concern with inflation, which had been relatively low and stable since the end of World War II.

Some periods spur both parties to action. During the recession induced by the Fed under Chairman Paul Volcker in the early 1980s to bring inflation down from the double-digit levels it had reached, Democrats introduced bills increasing the number of presidential appointees on the board, which would have weakened the influence of Reserve Bank presidents and of the chairman. Republicans pushed for monetary policy audits and for synchronizing the chairman's terms with presidential administrations, "likely a GOP rebuke," Binder and Spindel have written, "to the independent-minded Volcker," whose recession probably contributed to Republican losses in the House of Representatives in the 1982 midterm elections.

Under Pressure

Does the Fed respond to political scrutiny? The evidence is mixed. Between 1973 and 2008, Binder and Spindel found little evidence that the Fed attempted to appease Congress by lowering interest rates when legislative activity targeting the Fed increased. But other research suggests the Fed has factored political threats into its policymaking.

While economists generally believe that a mistaken understanding of the forces driving inflation, and of the relationship between inflation and employment, was at the heart of the Great Inflation and the stagflation of the 1970s, political pressure also may have played a part. In a 2016 article in the *Journal of Money, Credit and Banking*, Gregory Hess of Wabash College and Cameron Shelton of Claremont McKenna College concluded that during the 1970s, the Fed lowered the federal funds rate more than warranted by economic conditions in response to bills that threatened the Fed's power.

Research by Charles Weise of Gettysburg College also finds evidence of political motivations. In a 2012 *American Economic Journal: Macroeconomics* article, Weise reviewed FOMC meeting transcripts from 1969-1982 for statements referencing the political implications of monetary policy. He concluded that monetary policy was about 25 basis points lower than it would have been, given economic variables, during periods when the chairman expressed feeling pressure for loose policy and 25 basis points higher when there was pressure for tight policy. Even Volcker — arguably the most famous inflation hawk of all time — urged the committee when he was its vice chairman to back away from policy that would be appropriate "if we were living really in an apolitical climate."

Sometimes, Weise notes, political pressure might actually motivate the Fed not to comply with Congress' wishes. By 1982, Congress and the president were pushing for easier monetary policy. But some FOMC members believed a change in policy would be "politically suspect" and damage the Fed's credibility. (Later that summer, inflation began to ease off and the Fed finally lowered the target for the federal funds rate.)

Congress also has pressured the Fed to use monetary policy tools for nonmonetary purposes. "What would Congress have to do to indicate that it wishes the Board to change its policy and give greater support to the housing market?" asked Sen. William Proxmire, D-Wis., in a 1968 hearing. Proxmire went on to imply that Congress would change the law if it had to. In that case, the Fed complied voluntarily by purchasing debt issued by federal housing agencies rather than risking new legislation that could have permanent effects.

The Fed also was very cognizant of Congress as it moved toward adopting an explicit inflation target, as Binder and Spindel document. Bernanke wanted the Board to announce a target when he first joined the Board in 2002, but other FOMC members were concerned that Congress might perceive the Fed as straying from its dual mandate. In 2009, Bernanke received explicit advice from Rep. Barney Frank, D-Mass., that such a move in the middle of the Great Recession would seem politically tone deaf. In the end, the 2 percent target wasn't adopted until 2012, when employment had somewhat recovered.

Gathering Steam

Binder describes the relationship between Congress and the Fed as interdependent. "Congress doesn't want to be responsible for monetary policy," she says. "It needs someone to blame when things go wrong. But the Fed's independence is contingent on keeping Congress on its side."

That's been a difficult task in recent years, with both political parties expressing dissatisfaction with various aspects of the Fed's response to the financial crisis and Great Recession. Reform proposals have been wide-ranging, including subjecting monetary policy to government audits; requiring the FOMC to follow a monetary policy rule; restricting the Fed's emergency lending powers; and changing the appointment process for Reserve Bank presidents. Some also have proposed going back to the drawing board altogether and appointing a longer-term commission to study monetary policy reforms.

Some of these proposals have garnered bipartisan support, potentially increasing the likelihood of legislative action. In both 2012 and 2014, more than 300 House members from both sides of the aisle voted in favor of "audit the Fed" legislation that would enable the Government Accountability Office to audit the Fed's monetary policy decisions. The bills didn't make it out of the House, and a stand-alone vote in the Senate in January 2016 failed to reach cloture, but the fact that the issue came to a vote nearly 40 years after Congress explicitly prohibited such audits sent a clear signal that such scrutiny was back on the table.

To be sure, there is still room for the Fed to continue to increase its transparency and accountability. But given the uncertainty surrounding the appropriate balance between independence and accountability, it's not clear that more direct oversight would necessarily improve the Fed's performance. And there might be other costs. "As Congress gets more willing to attack the Fed, does that put the Fed in a weaker position to protect itself from congressional incursions that may have policy implications?" Binder asks. "If we think there's economic value to the Fed's reputation and credibility, then these attacks on the Fed do have consequences." **EF**

Readings

Binder, Sarah, and Mark Spindel. *Monetary Politics: Congress and the Federal Reserve, 1913-2016*. Manuscript, September 2016.

Meyer, Laurence H. "The Politics of Monetary Policy: Balancing Independence and Accountability." Remarks at the University of Wisconsin, LaCrosse, Wis., Oct. 24, 2000.

Schonhardt-Bailey, Cheryl. *Deliberating American Monetary Policy: A Textual Analysis*. Cambridge, Mass.: MIT Press, 2013.

Weise, Charles L. "Political Pressures on Monetary Policy During the U.S. Great Inflation." *American Economic Journal: Macroeconomics*, April 2012, vol. 4, no. 2, pp. 33-64.