PERSPECTIVES ON MONETARY POLICY INDEPENDENCE

A Federal Reserve that is insulated from short-term political pressures but accountable to public concerns is more likely to pursue policies that align with its congressional mandate to promote stable prices, full employment, and moderate long-term interest rates.

KEY POINTS

- A central bank with independence in the conduct of monetary policy can more credibly commit to promoting price stability and maximum employment in the long run.

- Elected officials face political incentives to favor accommodative monetary policies that promote short-run gains in output and employment and reduce the real value of government debt. But these policies pose long-run inflationary risks.

- The Fed solidified its monetary policy independence in the late 1970s and early 1980s by committing to monetary tightening to reduce high and persistent inflation, despite the widespread unpopularity of such actions at the time.

- Recent actions by the Fed have blurred the line between monetary policy and credit policy, putting the Fed’s monetary policy independence at risk. To preserve its monetary policy independence, the Fed should be cautious about taking actions that allocate credit to specific firms or markets.

- The Federal Reserve System is decentralized by design but accountable to Congress. This mix of independence and accountability has been beneficial to both the public and the economy.

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DISCUSSION

The Federal Reserve has a number of responsibilities, but its most visible role is the formulation of monetary policy. While the Federal Reserve’s Board of Governors is appointed by the president and approved by the Senate, and the chairman of the Board reports to Congress biannually, the Fed conducts monetary policy without further legislative or executive branch involvement. A consensus has evolved among economists that a Fed with independence in the conduct of monetary decisions is more likely to pursue policies that align with its congressional mandate, last revised in 1977, to promote the goals of moderate long-term interest rates, maximum employment, and stable prices (See Board of Governors, Current FAQs).

Elected governments in a democratic society potentially face incentives to pursue accommodative monetary policies that promote output and employment for political gain in the short run, even when those policies would eventually lead to inflation. Central banks that are independent in the conduct of monetary policy can better maintain credibility for consistently pursuing price-level stability than those that do not enjoy independence. The case for central bank independence is necessarily limited in other non-monetary policy operations, however, as a central bank serves a public purpose and must be accountable to the government.
Economic Arguments for Monetary Policy Independence

The arguments in favor of monetary policy independence derive from a central bank’s monopoly over money creation. This monopoly carries with it certain powers that elected governments may be tempted to misuse for short-term benefits at the cost of rising inflation over time. Resisting such temptations requires a degree of commitment on the part of the central bank, and without independence, that commitment might be difficult to maintain.

Two broad incentives might lead a government-controlled central bank to abuse its money-creation powers. First, money creation that leads to unexpected inflation reduces the real value of nominal liabilities, such as interest-bearing debt. In turn, this relieves the government of the need to increase taxes or reduce spending to balance its budget. Second, a surprise monetary expansion can increase output and employment in the short run, permitting governments to engineer expansions in an effort to increase their popularity.

The temptation for governments to use money creation to inflate away the real value of nominal liabilities has been studied by Columbia University economist Guillermo Calvo (Calvo 1978) and University of Chicago economists Robert Lucas and Nancy Stokey (Lucas and Stokey 1983), among others. For instance, take a case of extreme lack of policy commitment in which decisions are made with no regard for past promises. If there is nominal debt outstanding, then ignoring the costs of inflation, the government might choose to produce a monetary expansion large enough to eliminate or greatly reduce the real debt. Over time, though, the public would come to expect such behavior and this would result in ever-higher inflation and nominal interest rates.

This vicious cycle can be forestalled through a commitment to future low-inflation policies. A central bank with independence in the conduct of monetary policy can provide such commitment because the formation of monetary policy occurs outside the day-to-day demands of government finance and the sphere of political influence.

University of California, Santa Barbara economist Finn Kydland and Arizona State University economist Edward C. Prescott (Kydland and Prescott 1977), as well as Harvard University economist Robert Barro and Clemson University economist David Gordon (Barro and Gordon 1983), have studied the interaction between lack of policy commitment and inflation. In their analyses, monetary policy can affect the real economy only through expansions that come as a surprise to the public. These expansions are tempting to pursue if there are inefficiencies in the economy that make real activity undesirably low. For example, labor or product markets may not be perfectly competitive, and some wages and prices may be inflexible.

If monetary policy is controlled by a government that cannot commit to its future policy behavior, then such surprise expansions would result in a high inflation rate but no benefit in terms of real activity — over time the public would no longer be surprised by the monetary expansions. But if monetary policy is conducted under commitment, the economy can benefit from lower inflation with the same level of real activity (for example, see Wolman 2001). Insulating monetary policy decisions from short-term political pressures can facilitate such commitment.

Evolution of Monetary Policy Independence

From the passage of the Federal Reserve Act of 1913 until 1935, the Federal Reserve Board of Governors was relatively closely tied to the federal government. The Board was composed of five members appointed to staggered 10-year terms by the president and two ex-officio members, the secretary of the Treasury and comptroller of the currency. The Fed was subordinate to the U.S. Treasury’s priorities. For example, it was called upon to help fund World War I by lending money to banks to buy Liberty bonds.

But in the wake of the stock market crash and the Great Depression, Congress passed the Banking Act of 1935, which made the Board the center of power in the Federal Reserve System. Its seven governors, plus five of the 12 Reserve Bank presidents serving on a rotating basis, became the Federal Open Market Committee (FOMC) and gained the authority to buy and sell U.S. government securities on the open market. The Act also gave the Board the power to set minimum legal reserve requirements, within a certain range, for member commercial banks and to fix the discount rate that the Reserve Banks charged member banks for loans. In addition, the Act removed the secretary of the Treasury and his deputy, the comptroller of the currency, from the Board of Governors.
Challenges to the Fed’s ability to independently set monetary policy arose during World War II when the Fed committed to a low-interest rate peg on government bonds at the Treasury’s request in 1942. This allowed the federal government to finance the war with cheaper debt. But support of government debt required the Fed to relinquish control of its portfolio size and the money supply. After the war, the conflict escalated between the Fed and the Treasury over which agency should control monetary policy.

The dispute came to a head when the Treasury directed the central bank to maintain the interest rate peg after the Korean War started in 1950. President Truman wanted to protect the value of war bonds, while the Fed wanted to contain inflationary pressures caused, in part, by the war. Many members of the FOMC understood that the low peg on interest rates would produce excessive monetary expansion and inflation. These events led to the Treasury-Federal Reserve Accord of 1951. Details from the era provide insight into the Fed’s effort to resist inflationary pressures by raising short-term interest rates while the Treasury wanted lower interest rates, a recurring tension in later decades (Hetzel and Leach 2001).

The Accord eliminated the Fed’s obligation to monetize the Treasury’s debt at a fixed rate, allowing the Fed to conduct monetary policy by varying the size of its balance sheet. This is a cornerstone of the Fed’s independent monetary policy.

A significant test of the Fed’s ability to maintain independence occurred in the late 1970s and 1980s, when Federal Reserve Chairman Paul Volcker took widely unpopular measures to reduce monetary accommodation that had led to high and persistent inflation. These measures contributed, in part, to the significant recession of 1981–82, but they brought about lower rates of inflation and, not long after, the economy experienced a sustained period of growth.

The Fed’s actions during this period helped to solidify its independence and its credibility to pursue price stability.

The Fed’s monetary policy independence also can be threatened when the line between monetary policy and credit policy becomes blurred. The latter—which includes liquidity assistance to institutions, sterilized foreign exchange operations, and transfers of Federal Reserve assets to the Treasury for the purpose of deficit reduction—changes the asset composition of a central bank’s balance sheet and holds the stock of monetary liabilities fixed (Goodfriend 2001). The Fed has been called upon to provide liquidity to specific firms or sectors several times in its history. During the Great Depression, the Fed was given the authority to make loans directly to businesses (Sablik 2013). Part of that authority was repealed in 1958, but the Fed faced renewed pressure from Congress in the 1960s to extend credit to specific sectors of the economy. In 1966, the Federal Reserve Act was modified to allow the Fed to purchase agency debt to support the housing market, and Congress exerted strong pressure on the Fed to exercise that power (Haltom and Sharp 2014).

The Fed used this authority again in 2008 to conduct “quantitative easing,” a policy of expanding its balance sheet through the purchase of agency debt in order to stimulate the economy.

Credit policy is a form of fiscal policy and has distributional or public finance consequences that can put monetary policy independence at risk (Goodfriend 2012, Lacker 2011). Moreover, the ability to conduct credit policy is inessential to the Fed’s core monetary policy mission and can potentially contribute to financial instability (Haltom and Lacker 2014). To preserve its monetary policy independence, and thus protect its ability to maintain price stability, Richmond Fed economists have advocated that the Fed limit its purchases to Treasury debt. This would leave fiscal decisions to Congress, which is subject to public review and the checks and balances of the political system (Broaddus and Goodfriend 2001). Richmond Fed President Jeffrey Lacker cited these arguments in his dissents against the Fed’s agency debt holdings and swap agreements to support foreign currency lending during and after the 2007–09 recession (Lacker 2011, Lacker 2012a, Lacker 2012b, Lacker 2012c, Lacker 2014, Lacker and Weinberg 2014).

Additionally, the extension of credit to specific firms under lending facilities operated by both the Fed and the Treasury during the financial crisis blurred the distinction between the responsibilities of those two institutions. Those measures arguably have bolstered the case for a formal “credit accord” that would spell out which actions should be undertaken by the Fed and which should be performed by the Treasury (Lacker 2009).

Another source of concern is the United States’ current fiscal situation. Although investors remain willing
to lend to the United States at very low rates, that might change if investors fear that the United States will not be able to generate sufficient surpluses in the future to cover interest payments on the outstanding debt. If that were to occur, it could prompt a fiscal crisis that would overwhelm the central bank’s commitment to keep inflation low and stable (Haltom and Weinberg 2012).

Monetary policy independence also may be jeopardized by lawmakers’ temptation to draw funds from the Fed to plug particular fiscal holes. For example, a five-year transportation bill signed into law in late 2015 raised those concerns because some of its funding came from the Fed’s capital surplus account and from a reduction in dividend payments to member banks (Fessenden 2015). Such actions may have consequences for the Fed’s relationship with banks and for Fed governance that adversely affect monetary policy independence (Lacker 2015).

**The Central Bank’s Structure and Public Accountability**

The Federal Reserve System is decentralized by design. It combines the benefits of its 12 regional Reserve Banks with a government agency, the seven-member Board of Governors in Washington, D.C. The independent Reserve Banks serve as conduits, providing economic data from regions across the country and research from a variety of analytical perspectives. The Reserve Banks also collect timely grassroots information from personal contacts that describe local economic conditions. This information is critical to the formation of monetary policy, especially in times of financial stress.

The Reserve Banks are governed by nine-member boards that represent the public; they come from communities, businesses, and shareholder banks located in each bank’s district. This structure helps support monetary policy independence by providing a diversity of voices within the System (Lacker 2016).

As noted, however, the Fed’s independence is limited to the conduct of monetary policy. In addition to its regular reports to Congress, the Fed’s non-monetary policy operations are audited by the Government Accountability Office and a public accounting firm. The Dodd-Frank Act also established several reviews of the Fed’s lending programs — including an audit of lending during the financial crisis — and required the Fed to disclose the amounts, terms, and conditions of its emergency and discount window lending and open market transactions. The Act also specified that Reserve Bank directors representing the banking industry not participate in the hiring of Reserve Bank presidents. The Act maintained the exclusion from GAO audit of monetary policy deliberations, decisions, and actions — the aspects of monetary policy implementation on which the chairman of the Board of Governors reports directly to Congress.

The governance of the Federal Reserve has changed significantly over its 100-year history. The Fed’s conduct of monetary policy is now largely independent of political forces that otherwise might lead to less desirable policy actions and outcomes. However, several important checks and balances ensure that the Fed does not become insulated from public concerns. On balance, this system of governance, one of independence but also accountability, has been beneficial to the public and the American economy.

**REFERENCES**

**Richmond Fed References**


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Other References


Research Publications

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