Hutchins Center
on Fiscal & Monetary Policy
at BROOKINGS

Federal Reserve Independence in the Aftermath of the Financial Crisis

SHOULD WE BE WORRIED?

BROOKINGS

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Notes

The following is adapted from a talk given on a panel of the National Association for Business Economics at the American Economic Association Annual Meeting on January 4, 2013. David Wessel made substantial contributions to the expansion of the original talk.

We are going through an extraordinary period in business cycles and central banking. The too-calm, too-confident veneer of the Great Moderation was shattered by the worst financial crisis in eighty years. The Federal Reserve—indeed central banks all over the industrial world—took extraordinary actions to make sure the crisis was not followed by an economic result like that of the 1930s, and they continue to pursue policies that not so long ago would have been considered unthinkable.

Naturally, understandably, and appropriately, these circumstances have increased the scrutiny of central banks and raised questions about the goals, governance, and accountability of these institutions. The issue before us is whether we should worry that this scrutiny will result in an erosion of their independence from the elected government. We should be concerned about the potential for reduced independence: evidence over time and across countries indicates that less independence is correlated with higher inflation.[1] To foreshadow my answer: the actions that the Federal Reserve and other central banks took should not and need not lead to a loss of monetary policy independence, but we need to be vigilant. The risks and threats to independence have increased.

The wisdom of a high degree of independence for central banks in the conduct of monetary policy is well established. Goals for policy are and should be set in the democratic process by elected representatives. The Federal Reserve Act, as amended in 1977, charges the Federal Reserve with pursuing "maximum employment, stable prices and moderate long-term interest rates."[2] The primary objective of the European Central Bank, by treaty, is "to maintain price stability."[3]

Independence is critical in the setting of the instruments—interest rates and the like—to achieve these goals. Central banks should be held ultimately accountable for outcomes, and not for the techniques they used to get to those outcomes. Instrument independence is necessary to overcome the short-term perspective of politicians, who tend to be more interested in boosting economic growth before the next election and less focused on the longer-term inflationary consequences of such actions. This view is widely shared around the globe as evidenced by the lengthening lists of central banks that are, in this sense, independent of the elected government.

The issue before us is whether we should worry that this scrutiny will result in an erosion of central banks' independence from the elected government.

Of course, instrument settings are subject to public discussion and legislative hearings. That is key to holding the independent central bank accountable. The Federal Reserve or any other independent central bank needs to explain how its actions are related to the achievement of its objectives. And those discussions and hearings will involve political pressures—alternative views about interest rates or the size and composition of the central bank's balance sheet. An independent central bank—one that has been insulated from these pressures—doesn't need to follow the politicians' instructions. It should resist where those desires are inconsistent with its own views of how to achieve the objectives.

The legislative framework for monetary policy can be changed, of course, and it can be changed in ways that impinge on a central bank's instrument independence and thus its ability to achieve its mandate. Proposals to alter the Federal Reserve's mandate or its governance surface regularly in Congress, though few have garnered substantial support and none has actually been passed since the late 1970s. But the crisis and the actions the Federal Reserve felt compelled to take during the crisis weakened public support for the institution and its independence, and led to some unusually stiff attacks from prominent politicians.

[1] See speech by Ben Bernanke (http://www.federalreserve.gov/newsevents/speech/bernanke20100525a.htm) and the references in that speech.

[2] For a brief history of the Federal Reserve's mandate, see Aaron Steelman, "The Federal Reserve's 'Dual Mandate': The Evolution of an Idea," Federal Reserve Bank of Richmond, December 2011 (http://www.richmondfed.org/publications/research/economic_brief/2011/pdf/eb_11-12.pdf).

[3] See Article 127, "Consolidated Version of the Treaty on the Functioning of the European Union" (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:326:0047:0200:EN:PDF).

To reprise briefly, during the crisis the Federal Reserve expanded access to the discount window for banks and opened credit facilities to nonbanks for the first time since the 1930s. It helped stabilize or facilitate the takeover of systemically important institutions at risk of failure that would have further disrupted the financial system. The Federal Reserve aggressively reduced short-term rates to zero and then, to spur growth, worked to reduce intermediate- and long-term rates even further by greatly expanding its balance sheet with purchases of long-term securities and by issuing guidance about the future path of short-term rates. It addressed perceived clogs in the transmission of monetary policy by intervening directly in the government-guaranteed mortgage market—taking a hand in credit allocation where markets were not functioning well. Other central banks in industrial countries that have been hit by crisis in recent years have taken comparable, unconventional steps to stabilize markets and encourage growth. We are in uncharted territory in our understanding of both economic developments and the policy response.

The old simple notion was that the Federal Reserve did monetary policy (essentially moving short-term interest rates up or down by announcing its target for these rates and intervening modestly in government securities markets to validate that target, and by serving as a very temporary—usually overnight—source of liquidity to depository institutions), and Congress and the president did fiscal policy (taxes, spending, and pretty much anything that put taxpayers' money at risk). A number of the actions the Federal Reserve took during and after the crisis straddled the line between fiscal and monetary policies. They involved taking some limited fiscal risk onto the central bank's balance sheet, and they entailed close cooperation between the monetary and fiscal authorities. This was particularly true in the depths of the crisis: when loans were made against collateral of unquestioned quality in normal markets but whose current market value was under pressure from panics, fire sales, and liquidity premiums; when, in an attempt to restart markets and calm fears, the Federal Reserve covered the tail risk of some types of assets—losses that might occur after the private sector (and sometimes the Treasury's Troubled Asset Relief Program) had already absorbed losses; when in the absence of Federal Deposit Insurance Corporation (FDIC) authority to resolve systemically important institutions the Federal Reserve took the tail risk on special facilities to stabilize such institutions or facilitate their takeover by another private sector entity (in some cases behind the Treasury's Troubled Asset Relief Program and the FDIC). Just as the distinctions between liquidity and solvency problems become much less sharp in a crisis, so, too, do the distinctions between fiscal and monetary policies designed to limit the scope of the crisis.

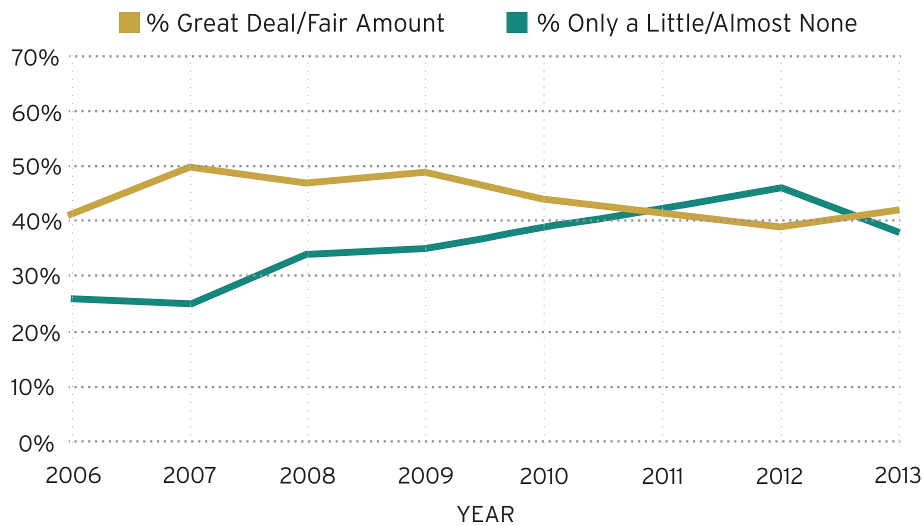
There is no doubt that the crisis elevated the public profile of the Federal Reserve.

The Federal Reserve did not expect to take losses on any of these facilities—and all those loans were indeed repaid without any losses to the Federal Reserve or the taxpayers. And the very act of making those loans helped to limit the extent and duration of the crisis—fulfilling one of the principal rationales for the founding of the Federal Reserve 100 years ago. But had the financial panics continued and deepened and many more borrowers failed, the taxpayer could have suffered losses.

There is no doubt that the crisis elevated the public profile of the Federal Reserve; the evidence of its authority—to make loans to nonbanks, to help rescue Bear Stearns and the American International Group (AIG), to backstop money market mutual funds, to buy hundreds of billions of dollars of mortgage-backed securities—startled many Americans, including members of Congress. To some, the Federal Reserve's actions challenged the essence of democracy: that the people's elected representatives levy taxes and spend the money. To some extent, this discomfort reflected Congress' inability (or unwillingness) to distinguish between lending and spending—the Federal Reserve had always had an unlimited ability to do the former, which for example it had exercised in size after 9/11. But the reach and extent of the lending was unprecedented, and it fostered a perception that Wall Street was being favored over Main Street. The Federal Reserve itself was uncomfortable with some of its operations, urging the Treasury to seek congressional funding for any rescues that might follow AIG, and urging Congress to give the FDIC resolution authority over systemically important financial institutions in Dodd-Frank.

Coupled with the Federal Reserve's failure to prevent the crisis, these actions greatly reduced public confidence in the institution. In 2007 a Gallup poll found that 50 percent of Americans expressed a great deal or fair amount of confidence that Mr. Bernanke would do or recommend the right thing for the economy and only 25 percent said they had only a little confidence or almost none. (The remaining 25 percent didn't have a view.) That confidence steadily eroded over the ensuing years. By 2012, 39 percent expressed a great deal or a fair amount of confidence in him and 46 percent said they had little or none. (Only 15 percent had no opinion.) The trend lines have turned more favorable lately: an April 2013 poll found 42 percent in the great deal/fair amount camp and 38 percent in the little/none camp (FIGURE 1).

FIGURE 1. **Confidence in Federal Reserve Board Chairman Ben Bernanke on the Economy (2006–2013)**



Source: "Americans Trust Obama Most on Economy," Gallup Politics, April 10, 2013 (http://www.gallup.com/poll/161723/americans-trust-obama-economy.aspx). See also "Gallup Poll Social Series: Economy and Personal Finance," Gallup News Service, April 4–7, 2013 (http://www.gallup.com/file/poll/161726/Who_You_Trust_%20the_Economy_130410.pdf).

Independence and Accountability

When discussing central bank independence and accountability, it's important to make a key distinction and to recall how we have arrived where we are.

The distinction concerns functions performed by the central bank. With regard to independence, our main focus has been on the setting of monetary policy, not regulatory policy. In this regard, the Federal Reserve has always lived with a bifurcated regime. The regulatory functions of the Federal Reserve have involved a very high degree of cooperation and coordination with other agencies. Major decisions are arrived at jointly by several agencies, and those decisions are subject to examination and oversight by the Government Accountability Office (GAO) of Congress.

The cooperative character of bank regulation is made necessary by the balkanized U.S. regulatory system, with many different agencies having a hand in regulation and supervision of the financial system. It also reflects the nature of the actions taken. Regulation is necessary to offset the moral hazard created by the safety net and to deal with externalities, but it involves elements of credit allocation, it constrains private decisions, and it affects the relative positions of individual firms. And it can have consequences for the public purse if regulation and supervision are not effective enough at constraining risk. Some degree of independence from political pressure is necessary in carrying out these tasks, but they may not lend themselves to the same arms-length relationship to elected representatives or other parts of the executive branch as does monetary policy.

The notion that different degrees of independence can apply to different categories of central bank decisions—more for monetary policy and less for regulation—makes some people uncomfortable. They express concern that the lesser autonomy of regulation can spill over to erode the arms-length relationship of the monetary policy decisions from political interference. But such differences have persisted for many decades in the United States, and practitioners see them as inevitable. As Stan Fischer has noted, "Some of my colleagues say, well, you can't be independent in one role and not in another. Well, I don't think any of them are married, if that's what they say. You can be. There are things you do (separately) and there are things you do together. I don't see why you can't be independent one way and not in the other."[4]

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The degree of monetary policy independence and associated accountability has changed considerably over the past several decades. In the 1960s, in the Kennedy and Johnson administrations, belief was widespread that explicitly coordinating the setting of monetary and fiscal policies would result in better overall outcomes for the economy, with emphasis on promoting growth and jobs. The resulting constraints on monetary policy now are seen as the first steps in what became in the "great inflation" of the 1970s. During the 1970s monetary policy became complicit in ever-rising inflation by holding back on decisive action as various administrations undertook incomes policies and jawboning of wages and prices to avoid the costs of the tough monetary policies that were needed and eventually implemented to reestablish price stability. By the end of the 1970s both experience and evolving theories of monetary policy effects and decision making pointed to a need for monetary policy to be implemented with considerable independence from these other types of policies if inflation were to be contained.

Congressional dissatisfaction with economic outcomes and the policies of the Federal Reserve resulted in legislative actions in 1977 and 1978 that established the "dual mandate" of the Federal Reserve for "stable prices" and "maximum employment," and also an accountability structure of regular reports and hearings on monetary policy—focused initially around the growth of monetary aggregates as the instruments or intermediate targets for achieving these long-term objectives. And those reports contained projections of policymakers of future output, inflation, and unemployment expected to be consistent with "appropriate monetary policy."

The sustainability of a high degree of independence for instrument settings in a democracy requires the independent authority to explain what it is doing and why. In that regard, although the congressional hearings have often been a disappointing forum for examining monetary policy choices, the Federal Reserve has taken the initiative over the years to become much more transparent about its thinking on monetary policy issues. In 1994 it began announcing and explaining its decisions on the day it made them, and those explanations have become much fuller over time. It sped up the production of the minutes of its meetings so the reasoning and discussion behind the decisions were available sooner. It lengthened the period of its projections. It initiated quarterly press conferences by the chair. And it spelled out its views of its responsibility for the two legs of its dual mandate and its strategy for achieving them.

To a large extent these steps were undertaken with a view to enhancing the effectiveness of policy by informing the expectations of financial market participants and the public making spending and saving plans. This is, of course, particularly important at a time when short-term interest rates are constrained by the zero lower bound and the Federal Reserve has been looking for alternative tools. To be sure, the messages have sometimes been misunderstood; both the

[4] Quoted in Pedro da Costa, "Central Bank Independence Is a Bit Like Marriage: Israel's Fisher," Reuters, April 18, 2013 (http://blogs.reuters.com/macroscope/2013/04/18/central-bank-independence-is-a-bit-like-marriage-israels-fischer/). See also David Wessel, "Are Central Banks Putting Their Independence at Risk?," *Wall Street Journal*, April 17, 2013 (http://blogs.wsj.com/economics/2013/04/17/are-central-banks-putting-their-independence-at-risk/).

Federal Reserve and those listening to it seem sometimes to lose sight of the inherent uncertainty around expectations for economic developments and appropriate policy responses, especially in circumstances like those prevailing in recent years, which have no real precedent in the economy, financial markets, and policy.

The additional information and transparency also play an important role in holding the central bank accountable and maintaining its instrument independence. As Chairman Ben Bernanke put it recently,

> One of my personal objectives since I became Chairman has been to increase the transparency of the Fed—to more clearly explain how our policies are intended to work and the thinking behind our decisions. As I already noted, improved communication can help our policies work better, whether through the disclosure of bank stress-test results or by helping the public and market participants better understand how monetary policy is likely to evolve. Ultimately, however, the most important reason for transparency and clear communication is to help ensure the accountability of our independent institution to the American people and their elected representatives. Clarity, transparency, and accountability help build public confidence in the Federal Reserve, which is essential if it is to be successful in fostering stability and prosperity.[5]

Threats to Independence

In considering whether Federal Reserve independence is likely to be threatened by the nature and aggressive character of its recent actions, it's important to keep in mind that there is no necessary connection between recent actions and future loss of independence. This is a decision for Congress to make, and it needs to understand the costs and benefits from any erosion of independence. Moreover, concern about a potential mistake by Congress in this regard is not a reason for the Federal Reserve to hold back on using the tools Congress has given it to accomplish the objectives Congress has set. The Federal Reserve needs to keep explaining why it considers its actions to have been consistent with furthering its objectives, and that any fiscal risk incurred or credit allocation affected by its actions has been necessary to achieve its legislated objectives and has been a temporary function of an extraordinary situation. We can see from what has occurred in Japan that perceptions of timidity and caution also have the potential to bring unusually intense political pressures to bear on a nominally independent central bank. The view that monetary policy needed to be much more aggressive and innovative was a central issue in the campaign of late 2012 in Japan, and the winning candidate appointed a new governor, whose policy innovations are characterized as one "arrow" in the government's overall economic strategy.

A number of risk factors suggest extra vigilance will be called for over the coming years to preserve the appropriate degree of Federal Reserve independence.

First, an era of polarization of political discourse has not proven conducive to a reasoned discussion of monetary policy and the pros and cons of independence. Exhibit 1 in this regard would be the debates in the Republican primaries with candidates competing as to how rapidly they would "fire" Ben Bernanke, with one characterizing a policy disagreement as "almost treasonous."[6] Also discouraging was the unprecedented letter from the four top Republican congressional leaders to the Federal Reserve in September 2011 trying to dictate an instrument setting—the management of its portfolio.[7] Although Ben Bernanke was, at least nominally, a Republican before coming to Washington, was appointed to the Federal Reserve Board by President George W. Bush, and served as the chair of Bush's Council of Economic Advisers, the antipathy to him and his actions has been markedly partisan. An April 2013 Gallup poll found 55 percent of self-identified Democrats but only 36 percent of Republicans express a great deal or a fair amount of confidence in Mr.

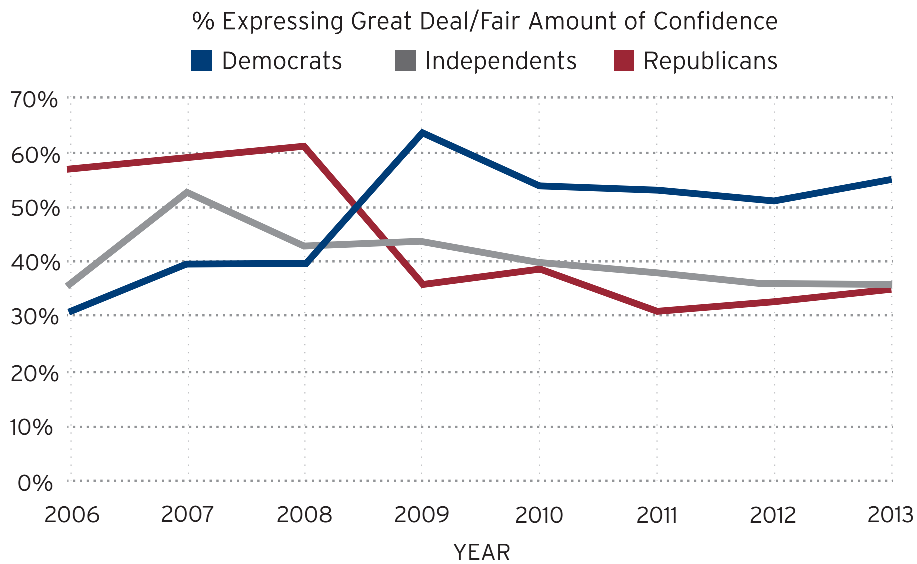
[5] Chairman Ben S. Bernanke, "At the Ceremony Commemorating the Centennial of the Federal Reserve Act," Board of Governors of the Federal Reserve System, December 16, 2013 (http://www.federalreserve.gov/newsevents/speech/bernanke20131216a.htm).

[6] Rick Perry, "Printing Money Is 'Almost Treasonous,'" video, August 15, 2011 (http://www.youtube.com/watch?v=goAj388gngI).

[7] "Full Text: Republicans' Letter to Bernanke Questioning More Fed Action," *Wall Street Journal*, September 20, 2011 (http://blogs.wsj.com/economics/2011/09/20/full-text-republicans-letter-to-bernanke-questioning-more-fed-action/).

Bernanke (see FIGURE 2).[8] Before the crisis, it was the other way around. The Senate vote on his confirmation for a second term as chair in 2010 was 70–30, with only five Republicans supporting him. Paul Volcker was confirmed 98–0 in 1979 and 84–16 in 1983. Alan Greenspan's confirmation votes were 91–2, unanimous, 91–7, 89–4, and a voice vote in which only one senator asked to be recorded as voting "no" (TABLE 1). As I'll underline in a second, we haven't yet heard from the forces that might eventually be aroused by exit from today's unconventional monetary policies and very low interest rates.

FIGURE 2. Confidence in Federal Reserve Board Chairman Ben Bernanke on the Economy (2006–2013): % Expressing Great Deal/Fair Amount by Party Affiliation



Source: "Americans Trust Obama Most on Economy," Gallup Politics, April 10, 2013 (http://www.gallup.com/poll/161723/americans-trust-obama-economy.aspx). See also "Gallup Poll Social Series: Economy and Personal Finance," Gallup News Service, April 4–7, 2013 (http://www.gallup.com/file/poll/161726/Who_You_Trust_%20the_Economy_130410.pdf).

TABLE 1. Confirmation Votes, Federal Reserve Chair

Nominee	Year	Votes
Paul Volcker	1979	98–0
Paul Volcker	1983	84–16
Alan Greenspan	1987	91–2
Alan Greenspan	1992	Uncontested (voice vote)
Alan Greenspan	1996	91–7
Alan Greenspan	2000	89–4
Alan Greenspan	2004	Uncontested (voice vote)
Ben Bernanke	2006	Uncontested (voice vote)
Ben Bernanke	2010	70–30
Janet Yellen	2014	56–26

Source: Gregory Giroux, "Bloomberg by the Numbers: 70," Bloomberg, December 20, 2013. Link: http://go.bloomberg.com/political-capital/2013-12-20/bloomberg-by-the-numbers-70-4/

[8] "Americans Trust Obama Most on Economy," Gallup Politics, April 10, 2013 (http://www.gallup.com/poll/161723/americans-trust-obama-economy.aspx).

Second, the Federal Reserve has had some powers trimmed in Dodd-Frank, suggesting that the erosion of trust and deference illustrated by the polls and confirmation votes can have implications for Federal Reserve authority. The restrictions apply to its authority to lend to nonbank institutions under 13-3 of the Federal Reserve Act, and include an obligation to get the approval of the secretary of the Treasury even for widely available facilities. In addition, against the recommendation of the Federal Reserve, the Congress mandated the publication of the names of all borrowers at the discount window—bank and nonbank—no later than two years after they borrow. So far, the instrument independence of the Federal Reserve in monetary policy per se has not been abridged in any way, but it may be that the Federal Reserve's views carry less weight than they did before the crisis.

Third, although in recent years the political blowback mainly has come from those who say they are worried about inflation, the major challenge to independence is likely to come from those concerned about unemployment as the Federal Reserve exits from unconventional policies. At some point the Federal Reserve will need to tighten policy to keep inflation from rising persistently above its 2 percent inflation target. It will need to raise rates and begin returning its portfolio toward its prior plain-vanilla size and composition. The decision to turn toward tightening is always difficult and subject to second-guessing in the political sphere. It will be even tougher after a long period of weak growth, unprecedented policy actions, and historically low mortgage and other interest rates.

It will be a complex exit involving many steps—with lots of opportunity for kibitzing and objecting over a long period. It will ultimately involve a sharp correction in long-term rates—an increase in term premiums as well as an upward adjustment in expected short-term rates. It will entail withdrawal of special support for the mortgage market. As long-term rates rise, the Federal Reserve will have mark-to-market losses on its balance sheet. These losses are not a threat to the Federal Reserve's ability to tighten nor do they have any economic significance, but losses could be used as a political weapon by those who seek to curtail the Federal Reserve's independence or limit its powers. A main tightening tool will be increases in the interest rate paid to banks on their deposits at the Federal Reserve, further damping Federal Reserve profits. This is a tool well known in other jurisdictions, but it is new for the United States. It could fuel accusations that the Federal Reserve is doing favors for the big banks. The size of the portfolio shouldn't impede the ability to tighten, given this new tool, but a huge volume of reserves could make control over the federal funds rate less precise than it has been in the past. Finally, in light of the apparent inability of Congress and the administration to deal with longer-term budget issues, the rise in rates could be occurring in context of a still-unsustainable path for budget and debt, and higher rates will underline that issue and make it worse. This will be another source of unhappiness in the political sphere.

The decision to turn toward tightening is always difficult and subject to second-guessing in the political sphere.

Fourth, the Federal Reserve, like many other central banks, has been given added responsibilities in regulation and supervision. These responsibilities include a key role in macroprudential regulation, with responsibility for protecting the overall stability of the financial system. Carrying out this regulation already involves a differential impact on some organizations—those identified as systemically important. It could also entail tightening up regulation when credit is growing too fast and financial imbalances are seen to be developing—another form of taking away the punch bowl as the party gets going—for example, through raising the countercyclical capital buffer under Basel III. This will not be popular with those drinking the punch. In the years leading up to the crisis we saw considerable political resistance to even mild forms of tighter supervisory policy, for example with respect to commercial real estate lending. The risk is that greater scrutiny and criticism of this aspect of Federal Reserve activity could spill over to monetary policy. It is important to retain the bifurcation—the differences in governance and accountability for regulation and monetary policy.

But macroprudential policy could also protect monetary policy independence and the flexibility to achieve its objectives. It reduces the need for the Federal Reserve to use monetary policy to deal with bubbles, imbalances, or a buildup of leverage. It now has another set of tools to apply to these. Monetary policy can be focused on price stability and maximum employment and more readily held accountable for those less diffuse goals than for "financial stability." More focused goals and accountability should support retaining monetary policy independence. In the United Kingdom, the Monetary Policy Committee (MPC) has put in place forward guidance on interest rates very similar to that in the United States. But it has accompanied this forward guidance with a "knock out" for the Financial Policy Committee (FPC)—the macroprudential authority. If the FPC sees a threat to financial stability from the low interest rates of the MPC, it can knock out the pledge of the MPC to maintain those very low rates until after unemployment reaches 7 percent, but only after the FPC has tried the other tools available to it to deal with the financial stability threat. Thus, each committee is held responsible for achieving its particular objectives, using as far as possible the instruments at its disposal.

The most immediate threat to appropriate independence now would seem to be the perennial proposal to allow the GAO to audit monetary policy, removing an exemption that has existed since the 1970s. The expanded GAO audit authority to review and critique monetary policy decisions would be another avenue to bring pressure on the setting of the Federal Reserve's monetary policy instruments. Of course, such pressure can and should be ignored when the Federal Reserve is convinced it is doing the right thing to accomplish its legislated objectives. But extending the GAO audit moves the needle, however slightly, in the wrong direction when it will be important to protect the Federal Reserve's instrument independence as it exits from unconventional monetary policies and ultra-low interest rates. It erodes the distinction between the governance of regulatory and monetary policy functions that seems so useful to make.

Preserving the Federal Reserve's monetary policy independence will be critical over the next few years. There's just too much history that shows that less independence leads to higher inflation over time.

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