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Federal Reserve Independence

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What does "independent" mean when the Federal Reserve is called an independent agency? The question is not one that the Federal Reserve or others try to answer, so we must look at what it does to supplement its few efforts to define independence.

The answer is mixed. Any agency that can quadruple the size of its balance sheet without oversight over four or five years, as the Fed has just done, has considerable freedom or independence. Yet, many of the increased services, more than 40 percent, went to finance the outsized budget deficits during the period. Independent central banks do not finance budget deficits.

In fact, the original Federal Reserve Act in 1913, did not permit any Federal Reserve support of the Treasury. For the founders, an independent central bank followed a gold standard rule and also a rule that prohibited financing the Treasury and the budget. Those two rules supported an independent Federal Reserve during the 1920s. After surrendering independence to finance World War I and accepting control by the Treasury and administration in the early postwar, the Federal Reserve restored its independence by restoring the gold exchange standard. That standard was a weaker type of gold standard that became an operating rule. The Fed worked to expand the gold exchange standard internationally. The U.S. did not leave the standard until 1934, but it did not monetize gold inflows in 1930-32, a mistake but made independently.

The prohibition against financing the Treasury did not last long. By 1923, the Reserve Banks, subject to Board approval, bought and sold Treasury issues to change bank reserves.

Once open market operations became the principal means of implementing monetary policy, the Federal Reserve could buy new Treasury issues, not directly from Treasury, but in the market.

Legally the Federal Reserve remained an independent agency. Once the two rules were no longer binding, independence lost much of its meaning. As Milton Friedman claimed (Friedman, 1959), and Thomas Cargill recently documented (Cargill, 2014), it is a rule that restricts Federal Reserve actions. And it is the decision to follow a rule that maintains central bank independence.

In the 1930s, once the two original rules no longer affected Federal Reserve decisions, the Treasury demanded monetary actions. Secretary Morgenthau wanted low interest rates to finance budget deficits. He threatened to use the profit from revaluing the gold stock to purchase debt, if the Federal Reserve allowed interest rates to rise. Legal independence gave no protection.[1]

As is well-known, the Federal Reserve agreed to hold interest rates fixed to finance World War II debt. The Federal Reserve sacrificed its independence. The Korean War is the only war in which the federal government ran a budget surplus in the war years 1951-52.

The Federal Reserve used concern about Korean wartime inflation to end its policy of pegging rates inherited from World War II. From the end of the war in 1945 to March 1951, the prevailing Federal Reserve position was that it could not regain independence because it lacked political strength. The Federal Reserve acted only after several U.S. senators led by Senator Paul Douglas insisted on an end to the wartime pegging policy. The Fed's independence remained restricted by its agreement to maintain an "even keel" when the Treasury issued debt, so independence of Treasury was not complete. Even keel required the Federal Reserve to support Treasury issues by purchasing treasuries if a treasury issue was mispriced. The Fed continued even keel interventions until the 1970s when the Treasury finally decided to auction its bonds and notes.

A much greater restriction on independence after 1951 was Chairman Martin's definition of independence, borrowed from an earlier statement by Alan Sproul of the New York bank. This is the only explicit definition offered by officials. Martin said that the Fed was independent within the government, not independent of the government.

[1] More detail on this period and other examples of lack of independence that I cite, and some that I don't cite, come from my Federal Reserve history.

Martin explained the distinction on several occasions. Independence within government turned out to have little true independence. Martin explained that if Congress passes and the president signs a budget that requires substantial deficit finance, the Federal Reserve has the obligation to help finance the budget. A consequence of this policy was that inflation remained lower than the 1.4 percent average of consumer price inflation in the 1950s, when President Eisenhower maintained small deficits or surpluses except in the recession year, 1958. In the years of President Johnson's larger Federal budget deficits, 1965-69, the average inflation (CPI) rate rose to 3.5 percent and was rising at a 5.5 percent rate when Martin retired.

Arthur Burns replaced Martin. Burns was a frequent visitor at the White House and considered himself a friend and confident of President Nixon. During his term as chairman, cpi inflation averaged 6.6 percent and reached as high as 11 percent in 1974. Burns was present with administration officials when President Nixon adopted price and wage controls in 1971. As part of the controls program, Burns chaired the Committee on Interest and Dividends. He cannot be regarded as independent during President Nixon's terms.

The Carter administration did not reappoint Burns to a third four year term as chairman because he did not share information with them. This was a more independent Burns. His replacement was a businessman who had worked in the Carter presidential campaign and served on a regional Federal Reserve Bank board. The choice shows no evidence of a desire for an independent monetary policy.

When President Carter moved William Miller to Treasury Secretary, he appointed Paul Volcker as Federal Reserve chairman. Volcker was a relatively independent chairman committed to a policy of reducing inflation. President Carter shared his aim. He did not share Volcker's belief that the Federal Reserve had to reduce money growth to lower inflation. President Carter under pressure from Congressional members of his own party, chose to have the Federal Reserve impose credit controls. Volcker participated in the administration discussions and agreed to implement the control program. This is a breach in his independence.

The Federal Reserve credit control program was rather benign. The public's reaction much less so. A widespread surge of popular support for lower inflation brought a large decline in spending and quarterly GNP. Although use of credit cards was not restricted, thousands mailed their credit cards to the White House and the Fed.

The response to credit controls was so strong that the open market committee shifted to expansive policy in the summer of 1980. Credit controls ended.

In the fall of 1980, the Federal Reserve raised interest rates and renewed anti-inflation policy. President Carter accepted the Fed's actions. He declined to act despite the urgings of his advisers who warned that high unemployment and high interest rates would hurt his campaign for re-election. Volcker was not pressed to lower interest rates.

Ronald Reagan won the 1980 election. His campaign promised to reduce inflation. Despite urgings from the so-called supply-side economists at the Treasury, President Reagan did not pressure the Federal Reserve. The president accepted the highest unemployment rate of the postwar years, 10.8 percent, and with it the loss of many Republican seats in the fall 1982 election.

Volcker called himself a "practical monetarist." He explained repeatedly what I call the anti-Phillips curve foundation of his strategy. He often told Congress and the public that the way to reduce the unemployment rate was to lower expected inflation. Despite long term interest rates of 5 to 7 percent, the economy recovered strongly in 1983 and 1984. Inflation remained low most years after 1984.

Alan Greenspan replaced Volcker in 1986. Greenspan further lowered the inflation rate. He was also a relatively independent chairman who resisted open criticism from the administration of his anti-inflation policy during the 1992 election year.

Greenspan made a radical departure from the discretionary policy followed by many of his predecessors. From 1986 to about 2002, he let the Fed more or less follow a Taylor rule. This produced a long period of growth, short and mild recessions, accompanied by low inflation. After the fact, the period was called "the great moderation" because of the combination of relatively stable growth, low inflation, and short, mild recessions.

By following a rule, the Greenspan Fed produced the longest period of stable growth and low inflation in Federal Reserve history. Greenspan was able to maintain Federal Reserve independence because his policy maintained popular support. Following a rule sustained independence.

There are many explanations of the so-called great moderation. I believe the main reason is reliance on the Taylor rule to guide policy. Following that rule induces policymakers to avoid responding to noisy monthly and quarterly data. By following a Phillips Curve, FOMC actions increase variability. The Fed responds to the unemployment rate and ignores inflation until inflation rises. Then it ignores unemployment until unemployment rises. By approximately following a Taylor rule, the Federal Reserve responded to both unemployment and inflation. That gave more of a medium-term focus to their actions and avoided shifting from one goal in the dual mandate to the other.

Unfortunately, the Greenspan Federal Reserve reverted to earlier procedures after 2003. And when Ben Bernanke became chairman in 2006, the Fed restored its policy of responding to noisy, frequently revised monthly reports on unemployment.

The Bernanke Fed made the mistake of bailing out a failed Bear-Stearns early in 2008. This contributed to the belief that the Fed would support failing financial firms. By encouraging this belief and doing little to force banks to strengthen their balance sheets and increase equity reserves, the Fed encouraged the financial system to be unprepared for the crisis that followed failure of Lehman Brothers in October 2008. Bankers interpreted Federal Reserve policy statements as an indication that it would bail out large banks. Lehman's failure came when the financial system was undercapitalized. Fear of additional failures—widespread collapse of the payments system—was met by massive Federal Reserve action including a bailout of a major insurance company.

The Treasury and the Federal Reserve worked together to restore confidence and solvency. There was no thought of independence. In a major crisis independence vanishes. This was true of the Bank of England under the traditional gold standard, and it remains true.

Preventing systemic collapse avoided the mistakes of 1929-32. Although some at the Fed claimed to follow Bagehot's (1873) rule, that is only partly true. The Fed lent freely to all legitimate borrowers, but it did not charge a penalty rate to limit lending to those at risk. Most importantly, in its 100 year history it never announced a rule for the lender of last resort. Bagehot understood that announcing the crisis rule encouraged banks to hold short-term paper eligible for discount.[2]

Following its successful policy of preventing financial collapse, the Federal Reserve pursued the most expansive policy in its history. Idle excess reserves of banks rose from less

[2] Bagehot criticized the Bank of England for not publicly announcing its lender-of-last-resort policy. In its entire history, the Federal Reserve has never announced a crisis policy. By announcing its policy, the Federal Reserve would encourage some banks to act prudently. For more detail on Federal Reserve lender-of-last-resort policy see Goodfriend (2012, 2013) where he relates the Federal Reserve failure to the incentives induced by its governance structure. See also Bordo (2014) at this conference.

than $800 billion to more than $2.5 trillion. Currently, on its projected path, idle reserves will reach $3 trillion in 2014.

This policy finances massive government budget deficits at very low interest rates. This is the very opposite of what an independent central bank does. I do not know of any example, anywhere, in which base money creation to finance large budget deficits avoided higher inflation. The Federal Reserve has not revealed a credible policy that will prevent future inflation.

Market participants credit the Federal Reserve with ability to prevent inflation. That seems to neglect much previous history. Perhaps market expectations are encouraged by the low inflation to date. That ignores the possible tsunami of idle reserves that spill over the domestic and international economy.

What We Should Learn

In its first 100 years, the cpi inflation rate rose from 1 percent in 1914 to 18 percent during World War I, then fell to -10.5 percent in 1926. Under the gold exchange rule from 1923 to 1929 inflation remained relatively low and stable, never exceeding 2.3 percent in 1925.

During the 1930s, inflation fell to -9.9 percent in 1932 and rose to 3.6 percent during the inflation scare of the mid-1930s. Price and wage controls held down reported inflation rates during World War II. Nevertheless, cpi inflation reached 10.9 percent in 1942 and 14.1 percent in 1947 after the Congress removed controls.

By the late 1960s and the 1970s, inflation rose as the Federal Reserve helped to finance federal budget deficits. That ended with the Volcker disinflation and the Greenspan policy.

Table 1 shows a rough measure of recent Federal Reserve independence, the portion of a relatively large budget deficit financed by issuing base money. This measure is not useful for periods like the 1950s, when the budget deficit was small in most years and budget surpluses were frequent.

The chart shows the large difference between the Volcker years and the Bernanke years. President Obama’s deficits increased massively, and the Federal Reserve financed a much larger share. The inflation consequences are currently postponed because banks hold most of the reserves idle. Independent central banks behave like the Volcker Fed, not like the Bernanke Fed.

Table 1

Base Money Finance of Budget Deficits

Period	**Cumulative**	**Cumulative**	**Percentage**
	Change in Base	**Deficit**	**Col. 2/Col. 3%**
	Billions	**Billions**	
(1)	**(2)**	**(3)**	**(4)**
Volcker			
1979/8 – 1987/8	$115.3	-$1251.2	9.2
Greenspan			
1987/8 – 2006/1	589.4	-2795.2	21.1
Bernanke			
2006/2-2013/2	2901.1	-6685.9	43.4

The Bernanke Federal Reserve never claimed to hold interest rates low to help the Treasury and it did not repeat Chairman Martin's definition of independence. It defended its policy as an effort to lower the unemployment rate. With trillions of idle reserves on bank balance sheets and additional trillions of money and short-term securities on corporate balance sheets, it did not explain what it thought additional reserves could achieve that could not be achieved by the banks and corporations. This seems an elementary error, but an error nonetheless. I believe it is a political decision made by a politicized and therefore non-independent Federal Reserve.

A main lesson of this trip through history is that following a rule or quasi rule in 1923-28 and 1986-2002 produced two of the best periods in Federal Reserve history. The lesson I draw, as Friedman (1959) taught us, following a rule contributes to independence by producing better outcomes, but claiming independence does not.

No rule will work perfectly in all circumstances. The classical gold standard rule required suspensions during crises. Following a Taylor rule produced better than average results. Congress, under Article I, Section 8 of the Constitution, should require the Federal Reserve to follow a specific Taylor rule with opportunity to deviate based on an announced objective.

The Federal Reserve is an agent of Congress. Congress holds a hearing twice a year to fulfill its oversight requirement. Federal Reserve chairmen are able to avoid serious oversight because they are able to talk around their mistakes. A rule would increase control by Congressional oversight committees.

A Taylor rule can improve monetary policy and economic performance. It achieves greater policy independence also. It should be supplemented by a pre-announced rule for its service as lender of last resort.

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