THE INDEPENDENCE OF THE FED:
“IN THE FED WE TRUST” OR ARE WE JUST “FED UP”?

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ABSTRACT

“The Federal Reserve System virtually controls the nation’s monetary system, yet it is accountable to no one. It has its own budget, it is subject to no audit, and no Congressional Committee knows of, or can truly supervise, its operations.”¹ Murray Newton Rothbard (1926-1995), a professor of economics at the University of Nevada, Las Vegas, and former vice president for academic affairs of the Ludwig von Mises Institute, provided this statement about the independence of the Federal Reserve System, which has institutional autonomy in establishing long-term monetary policy. Those who support this independence say that it is essential for proactive and responsible fiscal procedures. Critics, however, contest that this institutional independence is not consistent with democratic accountability. To test the theories, this thesis will assess the autonomy of the Federal Reserve System, focusing on its latent impact on the economic crisis. It will detail the three structural features that give the Fed independence in its conduct of monetary policy: the appointment procedure for Governors, the appointment procedure for Reserve Bank Presidents, and funding.

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Thank you…to my Cherubs Anaya and Airis…Airis and Anaya. Now both of your names appear 1st (what you do for one you do for the other… right? ♥)

    When people zig, continue to zag
    When they say no, hear YES after dag
    When you think there’s something you cannot do
    It’s not the Wiz or the shoes; the power’s from God & within you
    There’s no such thing as Santa or Superman
    So exceed what we do, read, invest and save all you can
    Use cash before credit sparingly
    Say no one on earth gets paid before me!
    You’re not too young to learn about the Fed
    The librarian was wrong so get that out of your head!

An extra special thank you also goes out to: my Heavenly Father, the Angels that protect me and those I love, my beautiful mother Marilyn for her endless love and support, my father Daniel (Lamont) who not only inspires me with his words but who inspired the words of this thesis by giving me this topic on the Fed, my brothers who really didn’t do anything but that I love nonetheless because they’re the best big brothers in the world…Mont and Leon, my Grandmother Gertrude for always having my back, Duke Ellington School of the Arts (in loving memory of Mrs. Susan Avant and Ciro Fuentes), Regina Robinson for all of her help and encouragement, and finally to the steel that has sharpened my steel: Anne Ridder for her tireless assistance, Father Timothy Healy and Dr. Phyllis O’Callaghan for their establishment of the Ellington Scholarship, D’ana Downing for being one of the sharpest sisters I know, my favorite Professors…Buck, Linafelt, Yonkers, Dr. Walker, Dr. Hester, and my mentor and his wife:

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INTRODUCTION

Whether overt or veiled, it can be argued that everything is created for a purpose even if that purpose is not always disclosed or understood. The Federal Reserve System, informally referred to as the Fed, is no exception to the rule. It was created on December 23, 1913 with a purpose. Its very existence and original purpose was to handle and calm financial panics or economic crisis. In other words, the Fed’s purpose was to convey, on a national scale, the coherence of a safe, secure, and stable U.S. economic and financial structure. Although, in this regard, the Federal Reserve’s original purpose has been disclosed, the role of the Federal Reserve System has expanded over the years; therefore, its purpose might not be fully understood by the populace it serves.

Though many are familiar with the Federal Reserve System, some may be unable to fully answer questions such as: What is the Federal Reserve System? Who makes up the Federal Reserve System? What does it have to do with the economy? What is the extent of its power? What gives it the authority to bail out institutions? What are its responsibilities, objectives, and goals? Is it responsible for the economic health of this nation? Did it contribute to the financial crisis? Why is it structured the way it is? Who owns the Fed? Why does it exist? Finally, how do the actions and decisions of the Federal Reserve System affect our lives?

It is interesting that one piece of financial legislation so pertinent to all, the Federal Reserve Act, seems to lacks proper public awareness, and has left so many
unanswered questions. To many people, the inner workings of the Federal Reserve System and how the Federal Reserve affects the economy is a mystery. In *Secrets of the Temple: How the Federal Reserve Runs the Country*, Fed critic William Greider confirms, “The anti-Fed polemics liked to quote Henry Ford, Sr., on the mysteries of money and the Federal Reserve: It is well enough that the people of the nation do not understand our banking and monetary system for, if they did, I believe there would be a revolution before tomorrow morning.”¹ Greider continues to describe the public’s lack of monetary this way:

> The American public, not unlike its political leaders, depended on familiar clichés for its limited understanding of money. The Federal Reserve controls the money supply. The Fed sets interest rates. When the government spends too much money, the Fed turns on the printing press and then we have inflation. All these crude generalities were either mistaken or too simplistic to describe the reality, and unless one was willing to move beyond them, it was impossible to understand the awesome powers of the Federal Reserve or its frailties. The public’s confusion over money and its ignorance of money politics were heightened by the scientific pretensions of economics. Average citizens simply could not understand the language, and most economists made no effort to translate for them.²

Greider’s description is applicable today. Many have no idea that the Federal Reserve System might have caused or worsened the Great Depression, or the manner in which that accusation may have affected the decisions and actions of the current Federal Reserve Chairman Ben Benanke during the financial crisis of 2007-2008. While it is

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² Ibid.
widely acknowledged that the Fed’s policies, actions, and decisions are not the only factors that play a role in the high prices of food, oil, and other goods, the Fed does play a role.

Many have no idea that when they hear reporters discuss unemployment on the news that it somehow correlates with one of the Federal Reserve’s goals of maximum employment. Some may not recognize that when they go to the grocery store and pick up a box of cereal that has become smaller, a pack of turkey bacon with less meat than the week before, or drive away from a fuel pump with less gas for the same amount of money, that they have been affected by the Fed’s policies. These people may not realize that the dollar bills they use not only have the Federal Reserve’s name on it, but also have a symbol representing one of twelve Reserve’s Banks. Even when they write a check from their bank to a company which uses another bank, they may be unaware that the transfer is carried out by the Fed. Or, if they opt to get a loan from a bank, they might not realize how that is ultimately tied into the actions of the Federal Reserve System.

The Federal Reserve is a powerful institution. It is the central bank of the United States. The Fed’s decisions, actions, inactions, and independence affect the lives of people in the United States and even abroad. For that reason, the Federal Reserve System was created to be part of the government but separate from it, too. Its monetary decisions, at best, are said to be long term, free from popular whims or political and social pressures of the moment that could later lead to inflation. With a
system of checks and balances mirrored after the system established by the Founding Fathers, the Federal Reserve System has an independence structure, members who serve long term appointments. It strives to focus on long term monetary policy goals, and tries to be independent and flexible enough to act quickly in times of crisis, while being accountable to the government and the people.

For these reasons and others, the Federal Reserve System and all that it encompasses, must be presented in a manner in which its purpose, decisions, and policies are clearly understood. With particular focus on the Fed’s autonomy, this thesis will analyze independence, political influence, and power as it relates to the Federal Reserve System.
PART I

INDEPENDENCE
CHAPTER I
OXYMORON (ALTOGETHER SEPARATE)

With all due respect, this chapter is entitled “Oxymoron” because the Federal Reserve is set up to be independent, classifies itself as a part of the government, and yet is separate from government. In the book *Alan Greenspan: The Oracle Behind the Curtain*, E. Ray Canterbery puts it differently. Canterbery says, “The Fed is both a part of government and apart from government. It is that great oxymoron, a ‘quasi-public’ institution or in politically-correct free market nomenclature, ‘quasi-private.’” Alan Greenspan who generally has had his way with the economy, has not seriously considered it either – rather, to him, the Fed is simply quasi.”¹ Canterbery deduces, “It is quasi-`private`, not quasi-public.”² Is it more accurate to describe the Federal Reserve System as independent within the government? Is it true that the Federal Reserve is no more Federal than Federal Express? Or, does its structure reveal that it is both a part of government and apart from government? Is it a part of the government at all?

In the view of Former Federal Reserve governor Lawrence H. Meyer, the Federal Reserve, is *part* of government and is not independent *from* government. At the University of Wisconsin on October 24, 2000, Meyer says in a speech, “Independence does not mean literally independence from government, because

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² Ibid., 43.
central banks here and abroad are almost always part of government. The relationship of central banks to the rest of government is, in practice, therefore much more complex than the term ‘independence’ might suggest.”\(^3\) A former member of the Fed’s Board of Governors, Robert P. Bremner, explains how former Federal Reserve Chairman William McChesney Jr. realigns the Fed’s relationship with other parts of government and redefines the position of the Fed’s independence:

Bill Martin realigned the Fed’s relationship with other parts of the U.S. government by establishing a delicate balance between cooperation and independence. He believed that the Fed was most effective when it was working with the administration, and he sought opportunities to coordinate monetary and fiscal policies. He fashioned the Fed-Treasury Accord as a ‘partnership of equals’ between the two agencies and brought this vision to reality. While Martin emphasized corporation, he and Allan Sproul redefined the position of the Fed as independent within the government, not independent of the government.\(^4\)

In reference to the position, Professor Allan H. Meltzer says, “Often System officials speak about independence within the government; a convenient phrase that recognizes that independence is not absolute but leaves open where the limits of government authority lie.”\(^5\) Yet, the assertion is that the Fed is relatively independent of government in order to accomplish its goals without political pressures.


The Federal Reserve has a unique structure: it is private, public, and operates within government. The Federal Reserve Board describes its configuration this way, “The Federal Reserve System is not ‘owned’ by anyone and is not a private, profit-making institution. Instead, it is an independent entity within the government, having both public purposes and private aspects.”6 The Federal Reserve System is an independent entity within the government with public and private aspects. In the Federal Reserve System Purposes & Functions publication, the Federal Reserve Board argues that it is more accurate to describe the Federal Reserve System as independent within the government. The Board insists, “The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government; therefore, the description of the System as ‘independent within the government’ is more accurate.”7

Since it is more accurate to describe the Federal Reserve System as an independent entity within the government, it may be more accurate to classify the Federal Reserve System as quasi-governmental. Quasi-governmental may be a more accurate description of the Fed since its structure reveals a combination of both governmental and private aspects. In reference to the Federal Reserve System’s


structure, the *Federal Reserve System Purposes & Functions* publication says, “Congress designed the structure of the Federal Reserve System to give it a broad perspective on the economy and on economic activity in all parts of the nation. It is a federal system, composed of a central, governmental agency - the Board of Governors - in Washington, D.C., and twelve regional Federal Reserve Banks.”

More specifically, the publication states, “The Board of Governors of the Federal Reserve System is a federal government agency.” Thus, the public or governmental sector of the Federal Reserve, the Board of Governors, governs monetary policy, supervises, regulates, oversees the operations of banks in the Federal Reserve System, and determines how to stabilize the economy.

In contrast, Federal Reserve banks are the private sector of the Federal Reserve System. In a response to a frequently asked question about ownership, the Fed confirms:

The twelve regional Federal Reserve Banks, which were established by Congress as the operating arms of the nation's central banking system, are organized much like private corporations - possibly leading to some confusion about ‘ownership.’ For example, the Reserve Bank issues shares of stock to member banks. However, owning Reserve Bank stock is quite different from owning stock in a private company. The Reserve Banks are not operated for profit, and ownership of a certain amount of stock is, by law, a condition of membership in the System. The stock may not be sold, traded, or pledged as security for a loan; dividends are, by law, 6 percent per year.

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9 Ibid., 4.

These twelve regional banks or Federal Reserve districts with twenty-five branches are located in “Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.”\textsuperscript{11} The \textit{Federal Reserve System Purposes & Functions} publication also notes, “As fiscal agents of the United States, the Reserve Banks function as the U.S. government’s bank and perform a variety of services for the Treasury, other government agencies, government-sponsored enterprises, and some international organizations.”\textsuperscript{12}

The Board of Governors is a government agency but the reserve banks have been held to be more private. In the case of \textit{John L. Lewis, Plaintiff/appellant, v. United States of America, Defendant/Appellee} – 680 F.2d 1239, according to the Circuit Judges, “On July 27, 1979, appellant John L. Lewis was injured by a vehicle owned and operated by the Los Angeles branch of the Federal Reserve Bank of San Francisco. Lewis brought this action in district court alleging jurisdiction under the Federal Tort Claims Act (the Act), 28 U.S.C. § 1346(b).”\textsuperscript{13} Although the case appears to be about a man’s attempt to sue the government for vehicular injuries, the outcome of the case answers whether Reserve banks are federal agencies.

\textsuperscript{11} Board of Governors, \textit{The Federal Reserve System}, 97.

\textsuperscript{12} Ibid.

\textsuperscript{13} United States v. Lewis, 680 F.2d 1239 (9\textsuperscript{th} Cir. 1982).
In Lewis’ case the Circuit Judges explain the Federal Tort Claims Act and how a Federal agency is defined:

Specifically, the Act creates liability for injuries ‘caused by the negligent or wrongful act or omission’ of an employee of any federal agency acting within the scope of his office or employment. 28 U.S.C. §§ 1346(b), 2671. ‘Federal agency’ is defined as: the executive departments, the military departments, independent establishments of the United States, and corporations acting primarily as instrumentalities of the United States, but does not include any contractors with the United States.\textsuperscript{14}

On appeal, the circuit judges agreed with the district judges’ decision and held that Reserve Banks are not Federal agencies. The circuit judges affirm, “The United States moved to dismiss for lack of subject matter jurisdiction. The district court dismissed, holding that the Federal Reserve Bank is not a federal agency within the meaning of the Act and that the court therefore lacked subject matter jurisdiction.”\textsuperscript{15} Lewis’ case clarifies, “Each Federal Reserve Bank is a separate corporation owned by commercial banks in its region.”\textsuperscript{16} Lewis’ case also points out, “The fact that the Federal Reserve Board regulates the Reserve Banks does not make them federal agencies under the Act.”\textsuperscript{17} In addition, the circuit judges examined the legislative history, namely the Federal Reserve Act, in order to determine whether Congress

\textsuperscript{14} Ibid.
\textsuperscript{15} Ibid.
\textsuperscript{16} Ibid.
\textsuperscript{17} Ibid.
intended to give the federal government direction over the operation of Reserve Banks:

It is evident from the legislative history of the Federal Reserve Act that Congress did not intend to give the federal government direction over the daily operation of the Reserve Banks: It is proposed that the Government shall retain sufficient power over the reserve banks to enable it to exercise a direct authority when necessary to do so, but that it shall in no way attempt to carry on through its own mechanism the routine operations and banking which require detailed knowledge of local and individual credit and which determine the funds of the community in any given instance. In other words, the reserve-bank plan retains to the Government power over the exercise of the broader banking functions, while it leaves to individuals and privately owned institutions the actual direction of routine.\(^{18}\)

The case added that these banks are neither “wholly owned” nor are they “mixed ownership” under government corporations.\(^{19}\) Perhaps that is why the judges never refer to the banks as Federal Reserve banks just as Reserve banks.

To distinguish the two sectors, it may be helpful to remember that the governmental sector of the Federal Reserve System, the Board of Governors, is appointed by officials of the government, namely the President after confirmation by the Senate. On the other hand, the private sector of the Federal Reserve System, Reserve Banks, consists of citizens from various backgrounds who worked in private industry. The *Fed Today* confirms, “Each regional Fed has a board of directors consisting of local citizens who represent the private sector. These directors come from all walks of life: bankers, business owners, educators, farmers, and other

\(^{18}\) Ibid.

\(^{19}\) Ibid.
professionals.”20 The Federal Reserve Board says that together, “The Board and the Reserve Banks share responsibility for supervising and regulating certain financial institutions and activities, for providing banking services to depository institutions and the federal government, and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system.”21

Together, seven Governors and five Federal Reserve Bank presidents also make up the Federal Open Market Committee (FOMC) which also consists of twelve members. The Federal Reserve Board confirms:

The FOMC is composed of the seven members of the Board of Governors and five of the twelve Reserve Bank presidents. The president of the Federal Reserve Bank of New York is a permanent member; the other presidents serve one-year terms on a rotating basis. All the presidents participate in FOMC discussions, contributing to the committee’s assessment of the economy and of policy options, but only the five presidents who are committee members vote on policy decisions. The FOMC, under law, determines its own internal organization and by tradition elects the Chairman of the Board of Governors as its chairman and the president of the Federal Reserve Bank of New York as its vice chairman. Formal meetings typically are held eight times each year in Washington, D.C. Telephone consultations and other meetings are held when needed.22

The FOMC determines how the Fed’s most important tool for economic stabilization, open market operations, will be executed.


22 Ibid., 11-12.
The final piece of this unique structure consists of member commercial banks. Member banks seem altogether with the Fed in the sense that, although the Fed says that it is owned by no one, David E. O’Connor and Christopher Faille have written, “At the local level are the thousands of ‘member banks’ in the Federal Reserve System. A unique feature of the Fed is that the ‘member banks’ own the Fed.”

Member banks are altogether and yet separate from the Fed in the sense that the member are chartered by the federal government and required by law to be members of the Federal Reserve System, while state-charted banks have the option to be members or not.

In addition, the Federal Reserve System Purposes & Functions publication reveals three types of commercial banks in the U.S. based on the governmental body that charters them and whether these commercial banks are members of the Federal Reserve System:

The nation’s commercial banks can be divided into three types according to which governmental body charters them and whether or not they are members of the Federal Reserve System. Those chartered by the federal government (through the Office of the Comptroller of the Currency in the Department of the Treasury) are national banks; by law, they are members of the Federal Reserve System. Banks chartered by the states are divided into those that are members of the Federal Reserve System (state member banks) and those that are not (state nonmember banks). State banks are not required to join the Federal Reserve System, but they may elect to become members if they meet the standards set by the Board of Governors.

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Simply put, in *Basic Economic Principles*, David E. O’Connor and Christopher Faille explain:

When a bank is ‘chartered’ by the federal government, this simply means that the bank applied to the federal government for permission to form and do business in the United States. State-chartered banks make similar applications to their own state governments. Virtually, all depository institutions – member banks and non-member institutions – are required to hold cash reveres with their district Fed bank and accept the supervision of Fed bank examiners. These cash reserves can be held at the district Fed bank itself, or in the faults of the commercial bank or other depository institution. Cash reserves create a large pool of money for Fed banks, which enables them to respond quickly to financial crisis in the banking system.²⁵

Thus, a bank chartered by the federal government has permission to do business in the United States while a bank chartered by state government has permission to do business in that particular state.

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CHAPTER II
FED INDEPENDENCE

The Federal Reserve is considered an independent central bank. But what makes the Federal Reserve independent within the federal government? The Federal Reserve Board gives one reason in, *The Federal Reserve System: Purposes & Functions* and gives two more reasons on its website. *The Federal Reserve System: Purposes & Functions* publication says, “The Federal Reserve System is considered to be an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive branch of government.”¹ Its website adds:

> It is considered an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive or legislative branch of government, it does not receive funding appropriated by Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms.²

Besides these three factors that make the Fed independent (in the Federal Reserve’s view), some might argue that a fourth one is the Federal Reserve Board’s response to the question, *Who Owns the Federal Reserve?* The Federal Reserve Board says, “The Federal Reserve System is not ‘owned’ by anyone and is not a private, profit-making institution.”³ Even so, others may argue that a Fed owned by no one in particular may be more easily influenced by others and relatively dependent.

³ Ibid.
In its *Frequently Asked Questions* section, the Federal Reserve Board asks, “Why did Congress want the Federal Reserve to be relatively independent?” “Relatively independent” could mean somewhat independent, fairly independent, or that the Federal Reserve is independent in comparison to another entity. The Fed’s meaning is, “The System is independent of other branches and agencies of government.” The Federal Reserve Board adds, “It is self-financed and therefore is not subject to the congressional budgetary process.” For that reason, some might argue that the Federal Reserve Board’s response makes it seem as if the Fed is only independent from other governmental branches and agencies who are not self-financed and therefore not subject to the congressional budget process. Federal Reserve Chairman Ben Bernanke referred to the Fed’s independence in a speech at the Institute for Monetary and Economic Studies International Conference in Japan:

But for a number of reasons, the nature and scope of the independence granted regulatory agencies is likely to be somewhat different than that afforded monetary policy. In the conduct of its regulatory and supervisory activities, the central bank should enjoy a degree of independence that is no greater and no less than that of other agencies engaged in the same activities; there should be no ‘spillover’ from monetary policy independence to independence in other spheres of activity. In practice, the Federal Reserve engages cooperatively with other agencies of the U.S. government on a wide range of financial and supervisory issues without compromising the independence of monetary policy.  

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4 Ibid.

5 Ibid.

6 Ibid.

Bernanke says that the independence granted to regulatory agencies is *likely* to be *somewhat* different than a monetary policy institution. Some might argue that Bernanke’s use of the words *likely* and *somewhat*, makes his statement appear equivocal.

So, what does independence as it relates to the Federal Reserve really mean? Does independence mean the central bank must have the freedom to act in a manner which may be in the best interest of the nation but detested politically? Does it mean that the Fed ought to be independent of political influence or control? Is the Fed truly independent? Is its independence absolute? Is it relatively independent? One answer can be found in Allan Meltzer’s *History of the Federal Reserve*. Professor Meltzer, an authority on the Fed admits, “The monetary and political authorities have not agreed on a definition of independence.”8 Another can be found in Chairman Bernanke’s speech at a National Press Club luncheon on February 3, 2011, Bernanke says, “Independence is the fundamental bedrock of central banking.”9 Bernanke made it clear that “all members, past and present, of the Federal Reserve Board agreed.”10 Bernanke also says, “Experience elsewhere demonstrates that a politically independent monetary policy leads to better economic outcomes.”11 While his comment coincides with Congress’

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10 Ibid.

11 Ibid.
intent to keep monetary policy free of politics. According to James Tobin, “It is not as if monetary policy is nonpolitical. Monetary policy is politics.”\textsuperscript{12} Perhaps that is why independence for the Fed is defined by some as meaning devoid of politics. For example, in a speech titled \textit{The Politics of Monetary Policy: Balancing Independence and Accountability}, Governor Lawrence H. Meyer says, “The dictionary defines independence as being free from the influence, guidance, or control of another or others. As applied to central banks, that translates into being free from the influence, guidance, or control of the rest of government, meaning both the executive and legislative branches in the United States.”\textsuperscript{13} Similarly, in \textit{Monetary Politics: the Federal Reserve and the Politics of Monetary Policy}, John T. Woolley provides two definitions related to the Fed’s independence:

\begin{quote}
In one sense, a government agency may be said to \textit{choose} a course of action independently if it does so without yielding to the pressures of others as to what that action should be. In another sense, a government agency may be said to be independent if its ability to achieve its objectives is not affected by the actions of others.\textsuperscript{14}
\end{quote}

Some might argue that the Fed is not independent if their independence is defined as free of the political influence of others.


Nevertheless, for purposes of this thesis, independence as it relates to the Fed is best defined as Alan Blinder and Stanley Fisher explain the term. First, Alan Blinder, a Princeton economist who was appointed as Vice Chairman of the Fed’s Board of Governors during the Clinton Administration in the mid-1990s, argues that the definition of central bank independence is two-fold. Blinder says, “To me, central bank independence means two things: first, that the central bank has freedom to decide how to pursue its goals and, second, that its decisions are very hard for any other branch of government to reverse.”\(^{15}\) Blinder also borrows the terminology of Stanley Fisher, former Deputy Managing Director of the International Monetary Fund, to further explain what makes the Fed independent:

If it is to be independent, the bank must have a great deal of discretion over how to use its instruments to pursue its legislated objectives. But it need not have the authority to set the goals itself and, indeed, I would argue that giving the bank such authority would be an inappropriately broad grant of power. The elected representatives of the people should make such decisions. The central bank should then serve the public will. In the terminology suggested by Fischer (1994), the bank should have *instrument* independence but not *goal* independence.\(^{16}\)

Secondly, in the ninth edition of his book, *The Economics of Money, Banking & Financial Markets*, Frederic Mishkin gives a few details about Stanley Fischer’s background and then expounds on the terminology coined by Fischer. With another two-fold definition Mishkin explains, “Stanley Fischer, who was a professor at MIT and is now governor of the Bank of Israel, has defined two different types of independence of


\(^{16}\) Ibid.
central banks: instrument independence, the ability of the central bank to set monetary policy instruments, and goal independence, the ability of the central banks to set the goals of monetary policy.”¹⁷ One of the Fed’s responsibilities is to stabilize the economy and instrument independence is vital for economic stability. While Mishkin argues that the Fed has instrument and goal independence, Meyer says that the majority of central banks do not have goal independence:

Most central banks have specific legislative mandates and therefore do not have goal independence. Thus the ‘independence’ of ‘independent’ central banks is instrument independence under which the central bank has authority to choose settings for its instruments in order to pursue the objectives mandated by the legislature, without seeking permission from, or being overturned by, either the executive or the legislature.¹⁸

Some argue that goal independence, in which the central bank has the ability or freedom to set and pursue its own monetary policy goals, is difficult to espouse in a democratic society. But how is central bank independence consistent with democratic theory?

Blinder argues that six factors help make central bank independence consistent with democratic theory. First, Blinder likens the Fed’s independence and monetary policy decisions to the “constitutional stage.”¹⁹ In other words, Blinder suggests that just as the founding fathers made a decision to make it extremely difficult to reverse certain Constitutional provisions of law (like the cap placed on the duration of Presidential


terms), monetary policy is very difficult for Congress or Legislators to overrule. Blinder says, “What made this decision ‘democratic’ is that elected members of Congress made it of their own free will.”

The second factor that helps make central bank independence consistent with democratic theory is, “The bank’s basic goals are chosen by elected politicians, not by unelected technocrats.” In Blinder’s view, to be independent and democratic, the Fed does not have to have the authority to set its goals but the Fed must have a great deal of discretion over how to pursue its objectives or goals as legislated by Congress. To illustrate, Blinder suggests that if citizens believe inflation is too high and that the Fed should be content with three percent inflation, citizens must remember that the problem is not with the Fed but with the law. Blinder argues that the problem is with the law because the Fed’s goals are established by Congress via the Federal Reserve Act and requires that the Fed stabilize prices not lower inflation.

The third factor that helps make central bank independence consistent with democratic theory is credibility of central bankers or the public’s right to demand their honesty. Blinder says, “The central bank owes this to the body politic in return for its broad grant of power. A central bank which dissembles or is imperiously silent is, in my

\[\text{20 Ibid., 67.}\]

\[\text{21 Ibid.}\]
view, behaving in a profoundly undemocratic manner. So are those who would cloak central bank actions in misleading rhetoric.”

Blinder says the fourth factor that helps make central bank independence consistent with democratic theory is the fact that central bank leaders are politically appointed. He gives a personal example:

When I went on the Federal Reserve Board in 1994, as a political appointee of President Clinton, I joined five other men and women who had been appointed by Presidents Reagan or Bush. None of us had ever been elected to anything; but Bill Clinton, George Bush, and Ronald Reagan had been. We obtained our political legitimacy from the men who appointed us; and they, in turn, got it the old-fashioned way: directly from the voters. That is as it should be. Central banks should not be self-perpetuating oligarchies.

While the argument is usually that appointments are a means for the President to influence the Federal Reserve, Blinder offers a unique perspective on Federal Reserve appointments with the voice of the people still heard indirectly through the elected President. In contrast, James Tobin, a Nobel laureate in economics says:

I don't think that there should be votes on the Federal Open Market Committee for people who are not appointed as public servants by the president and who are not subject to confirmation by the Senate. I think either the bank presidents should have no votes, or, to achieve voting status, they should be appointed and confirmed in the same manner as the governors….I just think it's contrary to democratic politics to have private citizens voting on the most important questions of macroeconomic policy.

In Blinder’s view, the fifth factor that helps make central bank independence consistent

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22 Ibid.

23 Ibid., 68.

with democratic theory, “Should be present but rarely used: Central bank decisions should be reversible by the political authorities, but only under extreme circumstances.”  

Meyers argues that this takes away from goal independence:

The legislation creating an ‘independent’ central bank--or in many cases revisions to such legislation - often entirely takes away goal independence by mandating objectives for monetary policy, but otherwise sets up a structure that confers and protects instrument independence. The most important requirement for instrument independence is that the central bank be the final authority on monetary policy. That is, monetary policy decisions should not be subject to veto by the executive or legislative branches of government. Instrument independence is further protected if other institutions of government are not represented on the monetary policy committee. A lesser protection would be to allow government representation but only in a nonvoting capacity.

Nevertheless, Blinder says, “Delegated authority should be retrievable.” Although it is difficult to do, “A Federal Reserve decision can in principle be overturned by an act of Congress. And Fed governors can be removed from office for cause.”

The sixth and final factor that helps make central bank independence consistent with democratic theory is the Fed’s “accountability and openness.” In Blinder’s view the Fed should be more accountable and open. He says, “Because monetary policy actions have profound effects on the lives of ordinary people, a central bank in a democracy owes these folks an explanation of what it is doing, why, and what it expects

25 Blinder, Central Banking in Theory and Practice, 68.


27 Blinder, Central Banking in Theory and Practice, 68.

28 Ibid.

29 Ibid.
Blinder says, “To me, public accountability is a moral corollary of central bank independence.”

Besides these six factors that help make central bank independence consistent with democratic theory, it is important to analyze how the institutional structure of the Federal Reserve System contributes to its independence. In the *Handbook of Monetary Policy*, Jack Rabin and Glenn L. Stevens argues, “Three structural features make the Fed independent: the appointment procedure for governors, the appointment procedure for Reserve Bank Presidents, and funding.” Put differently, the first two structural elements consists of appointment procedures for the Board of Governors as well as Reserve Bank Presidents and the last structural element consists of one of the most essential factors associated with independence, the source of funding or power of the purse.

The first structural element, the appointment procedure for the Board of Governors, contributes to the independence of the Fed by making terms on the Board of Governors fourteen years on a staggered basis. Due to this fact, Rabin and Stevens argues, “Independence derives from a couple of factors: first, the appointments are staggered to reduce the chance that a single U.S. President could ‘load’ the Board with appointees; second, their terms of office are 14 years – much longer than elected

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30 Ibid.
31 Ibid., 69.
officials’ terms.” While the President of the United States appoints the seven Governors on the Federal Reserve Board and the Senate confirms the appointees, the duration of the Governor’s terms is strategically designed to exceed Presidential terms of four or eight years. Meyer relates the overlaps in terms to instrument independence and says:

Instrument independence is further facilitated by long, overlapping terms for members of the monetary policy committee; by limited opportunities for reappointment; and by committee members not being subject to removal except for cause - where ‘cause’ refers to fraud or other personal misconduct but explicitly excludes differences in judgment about policy. An intangible contributor to independence, but arguably the most important, is the appointment of a capable, respected, politically astute, and ‘independent minded’ chairman.

In regards to the overlap in the terms of the Federal Reserve chairman and the President, Tobin argues that the terms of Fed chairmen should be better synchronized with Presidential terms:

I also think that the four-year term of the chairman of the Fed and the four-year term of the president should be better synchronized. I think the fact that it's not is completely accidental, it just got that way because of bad drafting of the law. Now, though, we have this anomaly that when a new chairman is appointed he's appointed for four years from that date. He's not appointed to fill out a term which has fixed dates of starting, as are the governors. Maybe six months after the president's term begins the chairman's term should begin, or maybe a year, but not three-and-a-half years the way it is now.34

33 Rabin and Stevens, Handbook of Monetary Policy, 308.

Some argue that the Fed’s appointment procedures not only promote independence but they also prevent hegemony which could result if a U.S. President was able to singlehandedly appoint each Governor on the Federal Reserve Board during their Presidential term.

The second structural element, the appointment procedure for Reserve Bank presidents, bypasses political involvement. Instead, Reserve Bank presidents are appointed to five year terms by the Reserve Bank’s Board of Directors. Rabin and Stevens argues, “This procedure adds to independence because the Directors of each Reserve Bank are not chosen by politicians but are selected to provide a cross-section of interests within the region, including those of depository institutions, nonfinancial business, labor, and the public.” However, the appointment procedure for Reserve Bank Presidents is subject to the final approval of the Federal Reserve’s Board of Governors. Thus, as Rabin and Stevens argues, independence as it relates to Bank Reserve presidents derives from the verity that the presidents of each Federal Reserve Bank are not selected by politicians. Kelly H. Chang, author of *Appointing Central Bankers: The Politics of Monetary Policy in the United States and the European Monetary Union*, shares the significance of appointments as they relate to the Fed’s independence, “Despite the Fed’s highly regarded independence, appointments remain an important avenue of political influence on monetary policy. In other words, independence does not imply total freedom from political authority. The Fed may have

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more autonomy compared to other American agencies, and the Fed is more autonomous compared to most central banks, but it hardly runs amok.”  

In reference to the third and final structural element, funding, Mishkin says, “Because the power to control the purse strings is usually synonymous with the power of overall control, this feature of the Federal Reserve System contributes to its independence more than any other factor.” This is the most essential contributor to the Federal Reserve System’s independence because the Fed controls its own purse strings. But does the Fed really control its own purse strings? Mishkin shows that while the Fed may control the purse strings, the purse still belongs to Congress who can do what it wants with the purse:

Yet the Federal Reserve is still subject to the influence of Congress because legislation that structures it is written by Congress and is subject to change at any time. When legislatures are upset with the Fed’s conduct of monetary policy, they frequently threaten to take control of the Fed’s finances and force it to submit a budget request like other governmental agencies. A recent example was the call by Senators Dorgan and Reid in 1996 for Congress to have budgetary authority over the nonmonetary activities of the Federal Reserve. This is a powerful club to wield, and it certainly has some effect on keeping the Fed from straying too far from congressional wishes.

In comparison to other governmental agencies whose purse strings are controlled by Congress, the Fed’s funding is independent of Congress and free of the appropriations process and the capricious ideas or whims of Congress. Mishkin argues, “Probably even


38 Ibid.
more important to its independence from whims of Congress is the Fed’s independence
and substantial source of revenue from its holdings of securities and, to a lesser extent,
from its loans to banks.” 39 Financially independent, the Fed is financially structured to
operate self sufficiently. Rabin and Stevens confirm the Fed’s financial structure when
they say, “The Fed is structured to be self-sufficient in the sense that it meets its
operating expenses primarily from the interest earnings on its portfolio of securities.
Therefore, it is independent of Congressional decisions about appropriations.” 40 Meyer
says, “An important protection of independence is achieved by freeing the central bank
from the appropriations process.” 41 Also, unlike other government agencies, the Fed is
also free of audits conducted by the General Accounting Office. As Mishkin confirms,
“Oh, the General Accounting Office, the auditing agency federal government, cannot
audit the monetary policy or foreign exchange market functions of the Federal
Reserve.” 42

Mishkin also says, “The strongest argument for an independent Federal Reserve
rests on the view that subjecting the Fed to more political pressures would impart an

39 Ibid., 330.

40 Rabin and Stevens, Handbook of Monetary Policy, 308.

41 Meyer, “The Politics of Monetary Policy,” The Federal Reserve Board,

inflationary bias to monetary policy. In his speech, while on the topic of the need for independence, Meyer argues:

Central bank independence is designed to insulate the central bank from the short-term and often myopic political pressures associated with the electoral cycle. Elected officials have incentives to deliver benefits before the next election even if the associated costs might make them undesirable from a longer-term perspective. This phenomenon has been called the political business cycle in which pre-election stimulus leads to higher inflation followed by monetary restraint after the election.

In other words, an independent Fed ought to have a tacit goal to insulate itself from political business cycles and short-run problems like expansionary monetary policy which will in turn afford the Fed the time to focus on the long-run objectives like the stabilization of prices.

In an article published in the *Economic Quarterly of the Federal Reserve Bank of Richmond*, Marvin Goodfriend, the senior vice president and director of research at the Federal Reserve Bank of Richmond argues:

The 1951 Accord established the principle that monetary policy should be used to stabilize the macroeconomy, regardless of the fiscal concerns of the Treasury. It restored the idea that a fully independent central bank contributes importantly to economic stability. Independence insulates the Fed from short-run inflationary pressures to stimulate employment and help finance the Treasury. It also frees the Fed from having to get Congressional or Treasury approval for its policy actions, enabling the Fed to react quickly to short-run macro-economic or liquidity shocks.

43 Ibid., 339.
Besides the benefits of stabilization and insulation from short-run pressures, Goodfriend proclaims, “The 1951 Accord between the Treasury and the Federal Reserve was one of the most dramatic events in U.S. financial history.” Goodfriend adds, “It reasserted the principle of Federal Reserve independence so that monetary policy might serve primarily as an instrument for macroeconomic stabilization.”

On the other hand, Mishkin says, “Another argument for Fed independence is that control of monetary policy is too important to leave to politicians…” For the case against Fed independence, Mishkin argues, “Proponents of a Fed under the control of the president or Congress argue that it is undemocratic to have monetary policy (which affects almost everyone in the economy) controlled by an elite group that is responsible to no one.” In reference to the Fed, Mishkin says, “Its independence may encourage it to pursue a course of narrow self-interest rather than the public interest.” Whether for or against the independence of the Federal Reserve, Mishkin argues, “There is yet no consensus on whether Federal Reserve independence is a good thing, although public support for independence of the central banks seems to have been growing in both the United States and abroad. As you might expect, people who like the Fed’s policies are

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46 Ibid.
47 Ibid.
49 Ibid., 340.
50 Ibid.
more likely to support its independence, while those who dislike its policies advocate a less independent Fed.”

51 Ibid.
PART II

POLITICAL INFLUENCE
CHAPTER III
CONGRESS, THE PRESIDENT, AND THE FED

Despite the Fed’s independence and the fact that the role of monetary policy is primarily conducted by the Federal Reserve Board of Governors (which includes the Fed’s chairman) and the Federal Open Market Committee (FOMC), other individuals, agencies, and groups influence monetary policy, though their power and influence are difficult to gauge.

One argument is that the chairman of the Federal Reserve conducts monetary policy. In the opinion of some, the chairman holds the most powerful position after the President of the United States. Some argue that the chairman of the Federal Reserve is just as powerful if not more powerful than the president because the chairman calls the monetary shots not only for the Fed but for the entire nation. While it is true that monetary policy is primarily conducted by the Federal Reserve Board of Governors and the Federal Open Market Committee (FOMC), it is the chairman who exercises power over both. In Mishkin’s view the following are respective roles of the chairman, the board, and the FOMC:

The Board of Governors is actively involved in decisions concerning the conduct of monetary policy. All seven governors are members of the FOMC and vote on the conduct of open market operations. Because there are only twelve voting members on this committee (seven governors and five presidents of the district banks), the Board has the majority of the votes. The Board also sets reserve requirements (within limits imposed by legislation) and effectively controls the discount rate by the ‘review and determination’ process, whereby it approves and disapproves the discount rate ‘established’ by the Federal Reserve banks. The chairman of the Board advises the president of the United States on economic policy, testifies in Congress, and speaks for the Federal Reserve
System in the media. The chairman and other governors may represent the United States in negotiations with foreign governments on economic matters. The Board has a staff of professional economists (larger than those of individual Federal Reserve banks), which provides economic analysis that the board uses in making its decisions.¹

However, Mishkin also makes it clear that it is indeed the chairman who runs “the show.”² For instance, it is the chairman who establishes the agenda for the other six members of the Board of Governors and for the Federal Open Market Committee. As the chairman sets the agenda for the meetings, it is reasonable to conclude that the Federal Reserve chairman exercises some influence or control over both groups. Mishkin says, “The chairman also exercises power by supervising the Board’s staff of professional economists and advisors.”³ But what Mishkin says next validates the argument that other groups influence monetary policy. Mishkin admits, “Because the staff gathers information for the Board and conducts analyses that the Board uses in its decisions, it has some influence over monetary policy.”⁴ As Mishkin notes, a chairman may call the shots but those decisions are made based on the expertise, research, and analysis of not only the chairman but of the board’s trusted staff of professional economists and advisors. Mishkin says, “The chairman also influences the Board

¹ Ibid., 326.
² Ibid., 330.
³ Ibid.
⁴ Ibid.
To illustrate this point Mishkin draws attention to the relationship between Fed chairmen and strong personalities. In Mishkin’s view and perhaps in the opinion of the public, “Chairmen of the Board of Governors (including Marriner S. Eccles, William McChesney Martin Jr., Arthur Burns, Paul A. Volcker, Alan Greenspan, and Ben Bernanke), have typically had strong personalities and have wielded great power.”

However, the current Federal Reserve Chairman Bernanke seems to disagree with the notion that the chairman runs the show. Bernanke made this point clear after he was sworn in as chairman on February 6, 2006. Bernanke says, with words directed towards President George W. Bush, that the Federal Reserve is far more than the work of one individual:

Mr. President, as you probably know, on September 11, 2001, and in the days that followed, Vice Chairman Roger W. Ferguson, Jr., who just swore me in, and many members of the Federal Reserve staff, here in New York, and around the country worked inexhaustibly to ensure the continued functioning and the recovery of the American financial system. The dedication and knowledge demonstrated that day by so many people exemplifies why the Federal Reserve, as an institution, is far more than a single individual.

In that same speech, Bernanke thanked President Bush for his presence and mentioned that he was the third President to visit the Federal Reserve building. Bernanke says,

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5 Ibid.

6 Ibid.

“Franklin Roosevelt dedicated this building in 1937, and President Ford was here in 1975.” In his speech Bernanke shared the remarks of President Roosevelt in 1937 at the dedication. While some might have expected a member of Congress or even the Federal Reserve chairman to describe the Fed’s purpose at that dedication, Bernanke disclosed that it was actually President Roosevelt who described the Fed’s purpose. Roosevelt says the Fed’s purpose was, “To gain for all of our people the greatest attainable measure of economic well-being, the largest degree of economic security and stability.” President Roosevelt’s words could have reflected an elitist, bureaucratic point of view, but his vision was clear that the Fed was created for all people.

Nevertheless, the number of Presidential visits to the Federal Reserve building should not be confused with the number of times the President and Federal Reserve chairman actually meet. In reference to the chairman, Mishkin says, “He is the spokesperson for the Fed and negotiates with Congress and the President of the United States.” While the focus for some might be on the power or influence of the chairman’s words as the spokesperson, the later portion of Mishkin’s statement is of particular interest. If the Federal Reserve chairman has full control and power and no political influence from the legislative and executive branch, then why does the

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8 Ibid.
9 Ibid.
chairman have to negotiate with Congress and the President of the United States? As the spokesperson for the Fed, the Chairman of the Federal Reserve meets with the President, members of the President’s Council of Economic Advisors, and the Secretary of the Treasury. The Encyclopedia of Public Administration and Public Policy by David Andrew Schultz confirms, “The board also meets frequently with members of the President’s Council of Economic Advisors and other key officials, and the chairman meets with the president and the secretary of the treasury.”

Schultz does not disclose how often the chairman meets with the president, but the Federal Reserve Board does. In its publication, The Federal Reserve System: Purposes and Functions, the Federal Reserve Board confirms, “The Board has regular contact with members of the President’s Council of Economic Advisers and other key economic officials. The Chairman also meets from time to time with the President of the United States and has regular meetings with the Secretary of the Treasury.” Whether these meetings are from time to time, quite frequent, or regularly it is difficult to imagine that they take place wholly devoid of political pressure or influence.

Although the Federal Reserve strives to promote the economic welfare of the nation and to remain independent from partisan politics, it is difficult to imagine a Federal Reserve Board headquartered in Washington, D.C. to be unaffected by partisan

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politics. Meltzer confirms the likelihood of political pressure from Congress and the president related to the close proximity of the Fed to policy makers:

One informal but powerful restriction on Federal Reserve independence is its presence in Washington, the political capital. Board members, especially the chairman, are conscious of political developments and pressure to accede them. Federal Reserve policy was an issue in the 1960 election and again in 1980. Arthur Burns as chairman was unusually partisan. He met with President Nixon regularly. Other chairmen and governors met at times with administration officials both at regular meetings and less formally. Pressure from Congress increased in the 2007-9 crisis.\(^\text{13}\)

Meltzer says that President Nixon met regularly with Federal Reserve chairman Burns. Some Federal Reserve chairmen may meet regularly instead of occasionally with the President. Moreover, Meltzer argues that the presence of the Fed in Washington, D.C. stirs up its own political pressures and places restrictions on the independence of the Federal Reserve System since the Board and chairman are conscious of the political developments around them and may feel pressure to acquiesce. Meltzer’s statement also indicates that both Congress and the President place political pressure on and attempt to influence the Fed.

In a democracy, policy is often influenced by political pressure from lobbyists of special interest groups. The politicians who create policy and have the power to amend policy must contend with political pressure. The difficulty is that the desires of special interest groups do not always reflect the best interests of the nation as a whole. Congressional hearings on monetary policy and the operations of the Fed are one form

of political pressure. Likewise, the board is frequently questioned by Congress about economic issues related to the economy and changes to monetary legislation. On behalf of the people or not, the briefs or reports from congressional hearings and meetings must have some affect or influence on monetary policy.

One argument is that since the Fed was created by Congress in 1913, Congress has the right to tell the Fed what it should and should not do. As the Fed’s creator, it seems reasonable that Congress might exercise some influence over the Fed and that the Fed would be responsible to Congress in some way. However, the Federal Reserve Act does not disclose clear guidelines of how the Fed ought to act. For that reason, the Fed has broad discretionary power over monetary policy. Alan Blinder’s two-fold definition of the Fed’s independence (mentioned from Chapter Two) is also relevant to this chapter. Blinder clarified his definition when he explains that although a central bank has considerable latitude to determine or to decide how to pursue its goals, this “…does not mean that the bank can select the goals by itself.”14 In a democratic political system, Blinder argues, “It seems entirely appropriate for the political authorities to set goals and then instruct the central bank to pursue them.”15 Blinder’s explanation seems to suggest that the Fed is not solely independent.

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15 Ibid.
Alan Blinder also described the “hallmark of independence” as “near irreversibility.”\textsuperscript{16} Blinder’s use of the word \textit{near} is of particular interest here because it suggests that it may in fact be possible for a branch of government to reverse the Fed’s decisions. Blinder later admitted, “The Fed’s independence – which derives from authority delegated by the Congress – makes it very difficult, but not quite impossible, for the elected officials to overrule a monetary policy decision.”\textsuperscript{17} He also says that the Fed’s independence meant that it would be “very hard for any other branch of government to reverse.”\textsuperscript{18} Blinder did not argue that it was impossible for any other branch of government to reverse.

Actually, the President and Supreme Court are unable to countermand the monetary policy decisions of the Federal Open Market Committee. The Federal Open Market Committee consists of seven members from the Board of Governors, the president of the Federal Reserve Bank of New York, and four of the eleven Reserve Bank presidents. These four serve for a term of one year on a rotating basis. Members of the Federal Open Market Committee (FOMC) hold eight meetings per year to review economic and financial conditions and to determine appropriate monetary policy for price stability and sustainable economic growth. Simply put, the Federal Open Market Committee controls the money supply and interest rates.

\textsuperscript{16} Ibid., 55.

\textsuperscript{17} Ibid.

\textsuperscript{18} Ibid., 54.
As Blinder put it, the Federal Open Market Committee’s decisions are “for all practical purposes, immune from reversal.”\(^\text{19}\) Blinder argues, “Without this immunity, the Fed would not really be independent, for its decisions would hold only so long as they did not displease someone more powerful.”\(^\text{20}\) While his argument that neither the President of the United States nor the United States Supreme Court are able to reverse the monetary policy decisions of the Federal Open Market Committee (FOMC) is defensible, Blinder’s argument is weakened by the fact that the President can attempt to sway the Fed’s decisions. Although convoluted, Congress can reverse the Federal Open Market Committee’s decisions via legislation signed by the President or by overriding a President’s veto. The Fed is independent of but accountable to Congress. Just as an act of Congress created the Federal Reserve System, an act of Congress could eradicate the Federal Reserve System. Meltzer points out the importance of Congress:

The Federal Reserve’s authority is delegated; the U.S. Constitution gives Congress the power over money. In 1913 Congress chose to appoint an agent to carry out these tasks. It granted independence, but it always retained the right to withdraw or restrict it. Members of the Board of Governors hesitate to act in ways that arouse public and congressional ire. This alone makes the Federal Reserve a political as well as an economic institution and weakens independence.\(^\text{21}\)

\(^{19}\) Ibid., 55.  
\(^{20}\) Ibid.  
At the same time, the Fed has both instrument and goal independence which should keep the Fed free of political pressures and influences. In addition, “The intent of Congress in shaping the Federal Reserve Act was to keep politics out of monetary policy.”

Martin Mayer says, “Despite its importance, historians have largely neglected the fight between the Fed and the White House that established the ground rules for central bank independence in 1951.” Meltzer explains the significance of that year:

The Federal Reserve Act gave the System independence that with few exceptions, as in wartime, administrations accepted until 1933. From 1933 to 1951, the Treasury Department dominated the Federal Reserve’s decisions, at first by direct pressure and in World War II and thereafter by agreement. Slowly after March 1951, the Federal Reserve regained some independence, but it remained responsible for assuring the success of Treasury debt sales. The System gained increased independence…and it retained its independence during the next quarter century.

Andrew F. Brimmer the author of “Remembering William McChesney Martin Jr.” published by *The Region* pinpoints Martin’s contributions to the 1951 Accord and the affects of the agreement:

Martin also fashioned other key features of the ‘Treasury-Federal Reserve Accord’ that was signed in May 1951. The Treasury agreed that the Federal Reserve would no longer be committed to supporting prices of U.S. government securities. This agreement restored harmony between the U.S.

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Treasury and the nation's central bank. It also led President Truman to appoint Martin as the new chairman of the Federal Reserve System.²⁵

Peter Hartcher asserts, “A president can and does, try to control a Fed chief. President Lyndon Johnson called William McChesney Martin to his ranch in Texas to try to bully him into reversing a decision to increase interest rates in December 1965.”²⁶ Johnson’s efforts were unsuccessful; Martin had the authority to compromise, but obdurately refused. In an the article “Remembering William McChesney Martin Jr.” published by The Region, Brimmer confirmed, “Throughout his 19-year tenure, he fought hard to defend the integrity of the System against encroachment from the White House.”²⁷ Brimmer provides two examples when Martin defended the Fed’s integrity: first in 1951 when President Truman tried to control monetary policy and again in 1968 when President-elect Richard Nixon sought to remove and replace William McChesney Martin as the Federal Reserve Chairman. Hartcher points out that Nixon believed the Fed had cost him the presidency in 1960 by maintaining a restrictive monetary policy. After becoming president in 1968, Nixon replaced Martin with Arthur Burns in 1970, and pressured him to have an expansive monetary policy for the


²⁶ Peter Hartcher, Bubble Man: Alan Greenspan & the Missing Seven Trillion Dollars (Melbourne: Black Inc., 2005), 86.

election in 1972. The article by Brimmer suggests, “[B]y deciding to serve out the balance of his Federal Reserve term, Martin prevented the System from being politicized by a president for whom that was a major goal.”

President George H. W. Bush also alleged that a Fed chairman cost him an election. Chairman Greenspan’s Fed had raised interest rates in order to contain inflation, and President Bush believed that the recession of 1990-1991, cost him a second term. Kelly Chang believes that a relationship exists between the economy and electoral success:

> It seems reasonable to assume politicians want their monetary policy preferences to be reflected in monetary policy. Monetary policy profoundly influences the economy, and the economy is often the key to electoral success. A strong empirical relationship exists between the economy’s performance and voting for the incumbent party (Kramer 1971; Stigler 1973; Tufte 1975; Fair 1978, 1980; Alesina and Rosenthal 1989, 1995; Erikson 1990; Alesina, Londregan and Rosenthal 1993). For example, Reagan took advantage of this relationship in 1980 with the campaign slogan, ‘Are you better off than you were four years ago?’

However, the relationships shared by chairmen and presidents were not always bad. President George W. Bush’s speech at the New York Economic Club seems to disclose a better political relationship between the president and the Fed chairman. President Bush says:

> In a free market, there’s going to be good times and bad times. And after fifty-two consecutive months of job growth, which is a record, our economy obviously is going through a tough time….But I want to remind you, this is not the first time since I’ve been the president that we have faced economic challenges. We inherited a recession. And then there was the attack of

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28 Ibid.

September the 11th, 2001, which many of you saw firsthand, and you know full well how that affected our economy.\textsuperscript{30}

President Bush continued on the economic challenges that the economy had faced due to natural disasters, corporate scandals, terrorists, and his decision to confront Afghanistan and Iraq. Yet despite these factors, the President asserts, “And the interesting thing, every time, this economy has bounced back better and stronger than before.”\textsuperscript{31} He praised the performance of Ben Bernanke under such tough circumstances and expressed his respect for the chairman. President George W. Bush told the crowd, in reference to Bernanke, “Since last year he has served as the Chairman of the Council of Economic Advisors at the White House.”\textsuperscript{32} If Bernanke was an advisor for the White House in 2005 and nominated by the President in 2006, it is highly likely that the President knew whether or not Bernanke shared his political views. He also praised the Fed for having cut interest rates several times. He added, “We also hold dear this notion of the Fed being independent from White House policy. They act independently from the politicians, and they should. It’s good for our country to have that kind of independence.”\textsuperscript{33} As the President praised the economic situation

\begin{thebibliography}{9}
\bibitem{DWS10} David Wessel, \textit{In the Fed We Trust: Ben Bernanke’s War on the Great Panic} (New York: Three Rivers Press, 2010), 163.
\bibitem{Ibid} Ibid., 164.
\bibitem{Wessel} Wessel, \textit{In the Fed We Trust}, 164.
\end{thebibliography}
and Bernanke, Wessel indicates, “As much as the President wanted to he was also
careful to genuflect at the altar of Fed independence.”

Furthermore, the Fed is independent from politicians like Congress and the
President from a budgetary perspective. Typically, Congress has the power of the purse
but the Fed is unique in the sense that it is financially independent and controls its own
purse strings. The Federal Reserve Board says, “It is self-financed and therefore is not
subject to the congressional budgetary process.” Primarily, the Fed’s income is from
interest earned on U.S. government securities or bonds acquired through open market
operations. The Federal Reserve Act of 1913 granted Reserve banks the right to sell
and purchase government securities. The Federal Reserve Board adds, “Other sources
of income are the interest on foreign currency investments held by the System; fees
received for services provided to depository institutions, such as check clearing, funds
transfers, and automated clearinghouse operations; and interest on loans to depository
institutions (the rate on which is the so-called discount rate).” The Fed loans money
and earns interest on the money it holds in reserve for banks but it does not pay
interest. After the Fed pays expenses, the Fed gives its surplus to the Treasury
Department.

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34 Ibid.

35 The Federal Reserve Board. “FAQs,”

36 Ibid.
Another argument for the Fed’s independence is that the Federal Reserve is not subject to budgetary cuts or other political consequences that could be threatened if the Fed’s objectives failed to mirror those of the other branches of government. The idea is that this will shield the Fed from the political pressures to yield or carry out the desires of the President and/or Congress. However, Meltzer argues to the contrary:

Informal restrictions on independence vary. Members of Congress and the administration urge the Federal Reserve to adopt policies that they favor. One example repeated in 1968, in 1982, in 1991, and at other times is pressure to reduce interest rates when Congress approves a tax increase. In 1968 and 1982 the Federal Reserve responded to this pressure. In 1991, following the Bush tax increase, the FOMC reduced rates to spur the economy.³⁷

Technically, legislation is the only means by which Congress or the President could change the board’s decisions. However, members of Congress and the administration still urge the Fed to adopt policies that they favor, as Meltzer suggests. Also, Congress may place pressure on the Fed to ease monetary policy or to cut interest rates after a tax increase has been approved.

Another argument is that the long terms for Federal Reserve Board members are designed to keep the Federal Reserve Board free of political pressures. Put differently, the fact that Federal Reserve Board members serve fourteen year appointments of non-renewable terms grants the Fed independence because presidents do not have the political power to reappoint and thereby influence monetary policy. But Chang recognizes a loophole in this argument and says, “Because politicians know

the appointment process and the Fed’s structure, they should be able to strategically appoint Fed members in order to obtain their preferred policy.”38 Chang describes the divergent powers of the Senate and the President:

The president moves first with his power of nomination and thinks about how to exploit that first-mover advantage, while the Senate tries to maximize its veto power over the president’s choice of nominee. Once they agree on a nominee, the president and senate face constraints on how far they can move Fed policy with a single appointment; the Fed’s multi-member decision-making structure forces the president and Senate to work around the existing Fed members.39

Simply put, the President selects the nominees but the Senate may opt to veto the nominee’s chosen by the President. But Chang also says, “The Senate does not actually have to exercise its veto power, and it rarely does; in the case of Fed appointments, the Senate has never rejected a nominee.”40 Another loophole in this argument is that sometimes Board members do not complete their entire terms. When this happens, the president is able to appoint more than one member during the presidential term. Mishkin believes that the president can influence the Federal Reserve through appointment power, Governors do not always complete their terms, and Mishkin explains why:

The president can also influence the Federal Reserve. Because congressional legislation can affect the Fed directly or affect its ability to conduct monetary policy, the president can be a powerful ally through his influence on Congress.

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38 Chang, Appointing Central Bankers, 4.
39 Ibid., 20.
40 Ibid., 7.
Second, although ostensibly a president might be able to appoint only one or two members to the Board of Governors during each presidential term, in actual practice the president appoints far more often. One reason is that most governors do not serve out a full fourteen year term. (Governors salaries are substantially below what they can earn in the private sector or even at universities, thus providing an incentive for them to return to academia or take private sector jobs before their term expires.\textsuperscript{41}

The President’s influence over the Fed and monetary policy is increased if the President is able to appoint multiple Governors who reflect his own sentiments. Besides the fact that a Governor on the Board may opt not to complete his or her term, every two years a fourteen year term expires. Therefore, the President may be able to appoint more than one member.

However, the President’s appointment power over the Federal Reserve Board of Governors is limited in the sense that the terms of the President and the chairman do not run concurrently. The staggered terms are intentionally designed to limit presidential influence. Since the President is unable to appoint the chairman at the onset of the presidential term, it means that the current President may have to work with the Federal Reserve Chairman appointed by the President of the former administration. The chairman of the Fed is supposed to serve a term of four years but the chairman’s term can be renewed, as Mishkin points out:

Alan Greenspan, for example, was appointed chairman in 1987 by President Ronald Regan and was reappointed to another term by a Republican president, George H. W. Bush, in 1992. When Bill Clinton, a Democrat, became president in 1993, Greenspan had several years left to his term. Clinton was put under tremendous pressure to reappoint Greenspan when his term expired and did so

\textsuperscript{41} Mishkin, \textit{The Economics of Money, Banking & Financial Markets}, 332.
in 1996 and again in 2000, even though Greenspan is a Republican. George W. Bush, a Republican, then reappointed Greenspan in 2004. Similarly, William McChesney Martin, Jr., the chairman from 1951 to 1970, was appointed by President Truman (Dem.) but was reappointed by Presidents Eisenhower (Rep.), Kennedy (Dem.), Johnson (Dem.), and Nixon (Rep.). Also, Paul Volker the chairman from 1979 to 1987, was appointed by President Carter (Dem.) but was reappointed by President Regan (Rep.).

The chairman’s term is different from the terms of the governors. The governors can serve a full nonrenewable fourteen year term while the chairman can serve a four year renewable term. A Federal Reserve Board publication states, “The terms for these positions are four years, but the Chairman and Vice Chairman may be reappointed for additional four-year terms, as long as their term as a Board member is active.” With regards to the governor’s term, Mishkin clarifies:

Although technically the governor’s term is nonrenewable, a governor can resign just before the term expires and then be reappointed by the president. This explains how one governor, William McChesney Martin, Jr., served for 28 years. Since Martin, the chairman from 1951 to 1970, retired from the board in 1970, the practice of allowing a governor to in effect serve a second full term has not been done and this is why Alan Greenspan had to retire from the Board after his fourteen-year term expired in 2006.

Since monetary policy profoundly impacts the economy, it is important to know who really conducts monetary policy. Although the short answer is the Federal Reserve, other individuals, agencies, and groups influence monetary policy as well. Congress the President, the Treasury Department and State Department all play a role.

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42 Ibid.


CHAPTER IV
ACCOUNTABILITY, TRANSPARENCY, AND OVERSIGHT

If the intent of Congress was to shape a non-partisan Federal Reserve System or to create a system independent from the other branches or agencies of government in order to keep monetary policy and the Federal Reserve System independent of politics, then why did Congress make the Fed relatively independent? The mere suggestion that the Fed is relatively independent makes it seem as if the Fed answers to or is accountable to someone. While some may agree that the popular axiom or catch phrase “independent of politics” has a rather nice ring, they may also question whether the Fed could ever consider itself truly independent of politics. They may reason that just as private industry organizations are accountable to stockholders and customers, the government is accountable to the nation or the public. In other words, the stance is that legislative representatives are elected to carry out the voice of the people. If legislative officials have passed the responsibility of monetary policy to the Federal Reserve, then some argue that the Federal Reserve is accountable to the people. Others argue that the Federal Reserve is accountable to no one, which means it lacks accountability. The Federal Reserve itself argues that it is accountable to someone. In the frequently asked question section of its website, the Federal Reserve Board asks, “Since the Federal
Reserve has considerable discretion in carrying out its responsibilities, to whom is it accountable?"¹

Some argue that the Fed is accountable to no one. For instance, in his book, The Case Against the Fed, Murray Newton Rothbard builds his case this way:

The Federal Reserve System is accountable to no one; it has no budget; it is subject to no audit; and no Congressional committee knows of, or can truly supervise, it operations. The Federal Reserve, virtually in total control of the nation’s vital monetary system, is accountable to nobody – and this strange situation, if acknowledged at all, is invariably trumpeted as a virtue.²

More than likely, it is argued as a virtuous thing in connection with its independence, to argue how it may be free of political influence in some respects, or to argue that the Fed may act or react without ratification from the branches of government. From a financial prospective, Rothbard argues that there is a lack of accountability and oversight in relation to the Fed’s budget and audits. It can also be argued that there is a distinct difference between being subject to an audit and actually being audited. Simply put, one might happen while the other will happen.

Like Rothbard, Former Federal Reserve Board Governor, Frederic S. Mishkin agrees that the Federal Reserve lacks accountability. In Mishkin’s view, “The current lack of accountability of the Federal Reserve has serious consequences: If the Fed performs badly, there is no provision for replacing members (as there is with

² Rothbard, The Case Against the Fed, 3.
politicians). In *The Federal Reserve System: Background, Analyses and Bibliography*, George Gray says:

No governor of the Federal Reserve ever has been removed from office for any reason. Some have, however, not been reappointed and, during Humphrey-Hawkins hearings, the Members of Congress have not been hesitant in voicing displeasure with the performance of the economy, especially during economic downswings and periods of inflation.

Mishkin, as well as those with a case against the Fed, argues that a lack of accountability of this sort has consequences. If the Fed performs poorly, the entire nation and economy as a whole must suffer the consequences of its monetary policy decisions and actions. *The Cato Handbook for Policymakers* focuses on one of the Fed’s goals, price stability, and examines how it relates to performance in addition to the accountability and transparency of the Fed:

For a law making price stability the sole aim of monetary policy to be effective, the Fed must be held accountable for failure to meet that target. Consequently, the law must clearly state the price-stability target while letting the Fed choose how best to achieve it. Transparency will make it easier for Congress and the public to monitor the Fed’s behavior and to effectively reward or penalize it.

Otherwise, how can it be determined whether or not the Fed has adequately met its target if the Fed’s behavior is not monitored? Likewise, what motivation would the Fed have to accomplish its goals if no consequences exist for insufficiencies?

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4 Ibid.

Yet, the Federal Reserve says the Federal Reserve System is accountable to the legislative branch that brought the central bank into existence:

The Federal Reserve’s ultimate accountability is to Congress, which at any time can amend the Federal Reserve Act. Legislation requires that the Fed report annually on its activities to the Speaker of the House Representatives, and twice annually on its plans for monetary policy to the banking committees of Congress. Fed officials also testify before Congress when requested.⁶

So, the Federal Reserve views itself as definitively accountable to Congress in the sense that the legislative body that brought the Fed into existence could change, amend, or even eradicate it at any given time. The Fed also mentions that it is required by law to report to the Speaker of the House on its activities once a year and to disclose its monetary policy plans to Congress twice a year. In The Federal Reserve System: Background, Analyses and Bibliography, George Gray reveals:

At these hearings, the Chairman of the Federal Reserve board presents a review of the current state of the economy and projections for the future course the economy is expected to take over the coming 18- and 24-months. Growth rate ranges for the monetary aggregates M2 and M3 and a Credit aggregate for the coming 12-months also are given. The report avoids any linkage of the growth rate ranges of the monetary and credit aggregates to the projected performance of the economy. This has prompted the Nobel Prize winning economist, James Tobin, to declare: ‘It is disingenuous for the FOMC [Federal Open Market Committee] to forecast or ‘project’ the economy, pretending that they have no control over it.’ When the economy behaves differently from these projections, little effort is exerted in the reports to explain why. When the effort is made, the explanation frequently attributes it to unexpected events. Federal Reserve policy is seldom, if ever, the culprit.⁷

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So, twice a year the Fed must report to Congress at Humphrey-Hawkins hearings. Mishkin confirms that Congress has passed legislation to make the Fed more accountable for its actions. For instance, “Under the Humphrey-Hawkins Act of 1978, the Federal Reserve is required to issue a *Monetary Policy Report to the Congress* semiannually with accompanying testimony by the chairman of the Board of Governors, to explain how the conduct of monetary policy is consistent with the objectives given by the Federal Reserve Act.”

But as Grey highlights and some may argue, while the Federal Reserve Board and the Federal Open Market Committee are unable to predict the future with great accuracy, the impact of their monetary policy actions and decisions may not make an impact on the economy until several months later.

Moreover, the Federal Reserve Board of Governors discloses that it adheres to being financially accountable. The Federal Reserve Board says, “To ensure financial accountability, the financial statements of the Federal Reserve Banks and the Board of Governors are audited annually by an independent outside auditor. In addition, the Government Accountability Office, as well as the Board's Office of Inspector General, can audit Federal Reserve activities.” For emphasis, the Federal Reserve Board, the Government Accountability Office, and the Board’s office of Inspector General *can*

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audit Federal Reserve activities. It does not say that they do audit the Fed’s activities. So, are the Federal Reserve System and Reserve Banks ever audited? If the Federal Reserve System and Reserve Banks are audited, it would provide another level of oversight that the Fed is subject to besides Congress.

This is a frequently asked question of the Federal Reserve System. The Federal Reserve Board answers the question this way:

Under the Federal Banking Agency Audit Act (enacted in 1978 as Public Law 95-320), which authorizes the Comptroller General of the United States to audit the Federal Reserve System, the Government Accountability Office (GAO) has conducted numerous reviews of Federal Reserve activities. In addition, the Board’s Office of Inspector General (OIG) audits and investigates Board programs and operations as well as those Board functions delegated to the Reserve Banks.\(^\text{10}\)

Although the Comptroller General of the Government Accountability Office is authorized to audit the Fed, the way the Federal Reserve Board responds to the question makes it seem as if the GAO may opt to audit the Federal Reserve or not. Notice that the Federal Reserve’s Board states that the Comptroller General of the Government Accountability Office is authorized to audit the Fed under the Federal Banking Agency Audit Act. It does not say that the Comptroller audits the Fed. Similarly, the Board of Governors states that the Government Accountability Office (GAO) has conducted numerous reviews of the Federal Reserve’s activities. It does not say that the Government Accountability Office (GAO) has conducted numerous audits of the Federal Reserve System. To the contrary, it might be argued that the words audit

\(^{10}\) Ibid.
and review could be used interchangeably. Although the Federal Reserve Board says, “The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review.”\textsuperscript{11} The Federal Reserve Board says audit and review not audit or review as if they are distinct. In addition, the Federal Reserve Board asserts that the Board’s Office of Inspector General (OIG) audits and investigates Board programs, operations, and functions. This reveals another level of oversight over the Federal Reserve System. But who audits the Federal Reserve System’s financial statement?

The Federal Reserve Board of Governors asserts that the financial statements of the Board of Governors along with the financial statements of Federal Reserve banks are audited by an outside auditor annually:

The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the OIG. The financial statements of the Reserve Banks are also audited annually by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board.\textsuperscript{12}

Usually, government agencies are not audited by an outside auditor; they are audited by the Government Accounting Office (GAO). In the \textit{Troubled Asset Relief Program: Status of Efforts to Address Transparency and Accountability Issues} Gene L. Dodaro

\textsuperscript{11} Ibid.

\textsuperscript{12} Ibid.
(the Acting Comptroller General of the United States) discloses:

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO’s commitment to good government is reflected in its core values of accountability, integrity, and reliability.\(^\text{13}\)

Since Congress created the Federal Reserve System, continues to carry out oversight over the Fed, and the Reserve System is labeled as Federal, there is an expectation that the Government Accountability Office would conduct audits of the Federal Reserve System on behalf of Congress. It may also be expected that Congress would want to ensure that its constitutional responsibility of monetary policy (though delegated to the Fed) was carried out by an auditor with a mission like the Government Accountability Office (GAO). It might also be expected that like the Government Accountability Office (GAO) the Federal Reserve System should also be committed to improve its performance, accountability, and transparency for the American people.

But how can the Federal Reserve Board and Reserve Banks be more transparent, if their audits have restrictions and are incomplete? For example, the United States Code 2006, Volume 7 Title 12, Banks and Banking, Sections 1751 to

End, states that most of what the Federal Reserve Board and Reserve Banks do is exempt from audit:

Audits of the Federal Reserve Board and Federal Reserve Banks may not include – (A) transactions for, or with, a foreign central bank, government of foreign country, or nonprivate international financing organization; (B) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, or open market operations; (C) transactions made under the direction of the Federal Open Market Committee; or (D) a part of a discussion or communication among or between members of the Board of Governors of the Federal Reserve System related to subparagraphs (A) through (C) of this paragraph.\(^{14}\)

The assumption for most might have been that audits conducted on the Fed (whether by an outside auditor or not), were at least comprehensive or all-inclusive. How could a financial audit that excludes discount windows, open market operations, and other transactions conducted by the Federal Open Market Committee attest to the accuracy, reliability, or the fairness of the Fed’s financial data? Does the Fed want to be transparent? What is transparency and how should the term be defined as it relates to monetary policy?

The Executive Summary of the Joint Economic Committee Study, written by Chief Macroeconomist Dr. Robert E. Keleher, identifies the distinct difference between transparency as most might understand the term and transparency as it relates to monetary policy.

The study defines transparency this way:

Dictionaries define ‘transparency’ as easily seen through or detected; obvious, candid or open, clear; free from guile. A transparent monetary policy is characterized by lack of secrecy, obfuscation, or ambiguity, and should be understandable to those outside the policy process including both ordinary citizens as well as legislators responsible for policy oversight.\textsuperscript{15}

At the Institute for Monetary and Economic Studies International Conference, Bernanke gives the Fed’s perspective of transparency as it relates to monetary policy:

Democratic principles demand that, as an agent of the government, a central bank must be accountable in the pursuit of its mandated goals, responsive to the public and its elected representatives, and transparent in its policies. Transparency regarding monetary policy in particular not only helps make central banks more accountable, it also increases the effectiveness of policy. Clarity about the aims of future policy and about how the central bank likely would react under various economic circumstances reduces uncertainty and-by helping households and firms anticipate central bank actions - amplifies the effect of monetary policy on longer-term interest rates. The greater clarity and reduced uncertainty, in turn, increase the ability of policymakers to influence economic growth and inflation.\textsuperscript{16}

Keleher argues that transparent monetary policy should not be secretive or obfuscatory. He also argues that transparent monetary policy must be understandable not only to the politicians responsible for oversight over monetary policy but to the ordinary citizens who are affected by monetary policy. How could monetary policy be transparent if it is unclear? Bernanke puts it another way, arguing that democratic principles demand that


the Fed be transparent in its policies and responsive to the public as well as elected officials. Overall, there appears to be a consensus that the people do not collectively understand or even know the inner workings of the Federal Reserve System. If the Fed possessed the type of transparent monetary policy Keleher describes, citizens and Fed critics may be less likely to perceive the Federal Reserve System as a secretive, deliberately obfuscatory, conspiracy. Keleher argues that more transparent monetary policy has six advantages:

More transparent monetary policy has a number of advantages. It can work to (1) clarify policy objectives, (2) improve the workings of financial markets, (3) enhance central bank credibility, (4) reduce the chances of monetary policies manipulation for political purposes, (5) foster better monetary policymaking, and (6) complement congressional monetary policy oversight responsibilities.\(^\text{17}\)

Benanke confirmed that transparency of monetary policy would make the Fed more accountable and would increase the Fed’s effectiveness. Yet, Keleher says, “The concept of transparency for monetary policy has multiple dimensions.”\(^\text{18}\) Monetary policy could be transparent politically, economically, procedurally, operationally, or the policies and goals of the Federal Reserve System could be more transparent. However, in Keleher’s view, “Monetary policy transparency involves a number of different dimensions including the clarification of policy goals and policy procedures


\(^{18}\) Ibid.
as well as the timeliness in reporting policy decisions.”\(^{19}\) Keleher says, “Establishing understandable monetary policy goals, informing the public about policy decisions in a timely fashion, and explaining how other variables are employed in the policy process have a number of advantages which work to improve monetary policy.”\(^{20}\) Keleher acknowledges that the Federal Reserve has come a long way from its initial more secretive approach to monetary policy. Chairman Bernanke says, “Over the years, the Federal Reserve - like many central banks around the world - has taken significant steps to improve its transparency and accountability.”\(^ {21}\) However, Keleher says, “Although the Federal Reserve has come a long way from its earlier, more secretive approach to policy, its journey toward openness is still incomplete.”\(^ {22}\)

For that reason, Keleher says, “The Federal Reserve could move toward a more transparent monetary policy by (1) adopting explicit inflation targets, (2) reporting more frequently to the Congress, (3) releasing information earlier, and (4) providing more information to the public.”\(^ {23}\) Of the four recommendations, Keleher asserts, “The most important step the Federal Reserve could take in moving to a more transparent

\(^{19}\) Ibid.

\(^{20}\) Ibid.


\(^{23}\) Ibid.
policy would be to explicitly adopt price stability as the primary goal of monetary policy.”

He says the best way to accomplish this is by adopting explicit inflation targets. In reference to the second recommendation, Bernanke argues that the Federal Reserve is transparent in the sense that “policymakers give frequent speeches and testimonies before the Congress on the economic situation and on the prospects for policy, and the Federal Reserve submits an extensive report to the Congress twice each year on the economy and monetary policy.”

Keleher states, “Reporting quarterly or every four months would be more appropriate.” In reference to the release of information earlier to the public, Bernanke says:

The FOMC, the Fed's monetary policymaking arm, releases a statement after each of its meetings that explains the Committee's policy decision and reports the vote on that decision. The FOMC also publishes the minutes of each meeting just three weeks after the meeting occurs and provides, with a lag, full meeting transcripts. In addition, the FOMC has begun providing the public a quarterly summary of Committee participants' forecasts of key economic variables and, more recently, their assessments of the longer-run values to which these variables would be expected to converge over time. The information released by the FOMC provides substantial grist for the activities of legions of ‘Fed watchers’ who analyze all aspects of monetary policy in great detail.

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24 Ibid.


Keleher argues that minutes, transcripts, and forecast of FOMC meetings should be released earlier. He says, “The Federal Reserve, for example, could make available to the public more internal research, forecasts, memos, and internal briefings that are currently restricted unnecessarily.”

Keleher acknowledges, “The argument has been that fuller disclosure would promote unnecessary volatility in financial markets, benefit certain speculators, and interfere with the execution of monetary policy.” However, in Keleher’s view, the Fed should provide or disseminate to the public more useful information, comprehensive explanations, and economic expectations relevant to the market and the economy.

On September 25, 2009, Scott G. Alvarez, General Counsel of the Board of Governors, spoke before the Committee on Financial Services of the House of Representatives about Federal Reserve transparency and the Federal Reserve Transparency Act of 2009. His testimony indicates the Fed’s views on accountability, transparency, and oversight:

The Federal Reserve is accountable to the Congress and the public. To inform the Congress and the American people about our actions and accommodate appropriate oversight of those actions, the Federal Reserve has further strengthened its ongoing commitment to transparency. We provide substantial information to the Congress and the public on the policies, actions, and operations of the Federal Reserve; routinely testify before this and other congressional oversight committees on all areas of our responsibilities; and publish the results of annual audits of the Federal Reserve's financial statements.

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29 Ibid.
by an independent accounting firm. Importantly, the Federal Reserve also is subject under current law to, and cooperates with, the Government Accountability Office (GAO) in its audits of nearly all of the functions and actions of the Federal Reserve.\textsuperscript{30}

In reference to accountability, Alvarez testified that the Federal Reserve is accountable to not only Congress but to the public. Alvarez affirms that the Federal Reserve has made an effort to inform Congress and the American people of Fed actions, policies, and operations. In reference to oversight, in \textit{A History of the Federal Reserve}, Allan H. Meltzer says:

> Institutions both shape the society of which they are part and adapt to the dominant views in that society. Although the Federal Reserve was independent of the day-to-day political process, the public, acting through its representatives, could insist on structural changes or, without formally changing structures, demand that the Federal Reserve undertake new responsibilities or give up old ones. No institution can be independent of this pressure for change.\textsuperscript{31}

Through its representative, the public has insisted that the Fed take on new responsibilities after the financial crisis. Alvarez emphasized the Fed’s adherence to routine and new responsibilities interconnected with oversight. For example, the Fed conducts routine testimony before Congressional oversight committees on \textit{all} areas of the Fed’s responsibility. Although, there were restrictions on what aspects of the Federal Reserve could be audited, now the Fed is subject under current law to cooperate with the GAO on more comprehensive audits.


\textsuperscript{31} Meltzer, \textit{A History of the Federal Reserve}, 4.
In reference to the requirement to publish the results of the Fed’s annual audits, under Section 1103 of the *Dodd-Frank Wall Street and Consumer Protection Act*, several amendments were made to the Federal Reserve Act in order to improve transparency, oversight, and public access to information. For instance, under this section of the Act, the Federal Reserve is required to even make changes on its website:

(c) PUBLIC ACCESS TO INFORMATION.—The Board shall place on its home Internet website, a link entitled ‘Audit’, which shall link to a webpage that shall serve as a repository of information made available to the public for a reasonable period of time, not less than 6 months following the date of release of the relevant information, including— (1) the reports prepared by the Comptroller General under section 714 of title 31, United States Code; (2) the annual financial statements prepared by an independent auditor for the Board in accordance with section 11B; (3) the reports to the Committee on Banking, Housing, and Urban Affairs of the Senate required under section 13(3) (relating to emergency lending authority); and (4) such other information as the Board reasonably believes is necessary or helpful to the public in understanding the accounting, financial reporting, and internal controls of the Board and the Federal reserve banks.\(^\text{32}\)

The Federal Reserve has adhered to the requirement and does have a link entitled Audit at the bottom of its website. As the Act requires, the Audit page sequentially includes reports prepared by the Comptroller General under section 714 of title 31, United States code; Annual Federal Reserve System financial statements and the independent auditor reports; reports to the Committee on Banking, Housing, and Urban Affairs of the Senate (relating to Emergency Lending Authority); and other

information the Fed believes is necessary to disclose to the public on liquidity, credit programs, and monetary policy tools used in response to the financial crisis.

In the Fed Chairman’s semiannual monetary policy report to Congress on March 1, 2011, Bernanke mentions the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010:

In recent years the Federal Reserve has...substantially increased the information it provides about its operations and its balance sheet. In particular, for some time the Federal Reserve has been voluntarily providing extensive financial and operational information regarding the special credit and liquidity facilities put in place during the financial crisis, including full descriptions of the terms and conditions of each facility; monthly reports on, among other things, the types of collateral posted and the mix of participants using each facility; weekly updates about borrowings and repayments at each facility; and many other details. Further, on December 1, as provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Federal Reserve Board posted on its public website the details of more than 21,000 individual credit and other transactions conducted to stabilize markets and support the economic recovery during the crisis.33

Bernanke states that the Federal Reserve voluntarily provides information at times. Although the Fed may appear to be, and in fact is, more accountable and transparent as a result of the disclosure of information, the Fed’s accountability and transparency is not always initiated autonomously by the Federal Reserve. Sometimes, the Fed’s accountability and transparency stems from the oversight of Congress and the President when regulatory reform legislation is passed by the House as well as the

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Senate and then signed into law by the President. The Federal Reserve Board divulges in the first sentence of the audit page, “The information below is provided as required by the Wall Street Reform and Consumer Protection Act. The page will be updated as reports and other information becomes available.”  

The Federal Reserve was required to have an audit tab inclusive of specific information on its website.

On June 9, 1994, at the Tercentenary Symposium of the Bank of England, Alan Greenspan, (then Chairman of the United States Federal Reserve Board) offered a unique perspective on the independence of the Fed in relation to accountability:

If we are going to have independent central banks, then implicit in that independence is accountability. You cannot in a democratic society have an institution which is either fully or partly disassociated from the electoral process and which has powers that central banks inherently have. So the question really amounts to how does one position the central bank with respect to the issue of disclosure and accountability - which are related questions. The position that we [the Federal Reserve] take is that the burden of proof is against the central bank; that is, we have to demonstrate that either delayed disclosure or non-disclosure is a policy which is required for us to implement our statutory goals. We have struggled with this, and have concluded that we should make available to the electorate what it is we think, why we are doing what we are doing and in a general way under what conditions we would behave differently.  

Bernanke echoes the words of Alan Greenspan in his semiannual monetary policy report to Congress On March 1, 2011. In his testimony, he confirms that the independence of the Federal Reserve correlates with the obligation to be accountable

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and transparent in a democratic society. He says, “The Congress and the public must have all the information needed to understand our decisions, to be assured of the integrity of our operations, and to be confident that our actions are consistent with the mandate given to us by the Congress.” In a democratic society, the Federal Reserve must be accountable, transparent, and subject to oversight.

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PART III

THE FED'S POWER
CHAPTER V

MONETARY POLICY

What is monetary policy? Former member of the Board of Governors of the Federal Reserve System, Frederick S. Mishkin captures the definition of monetary policy in a few words. In his view, monetary policy is “the management of money supply and interest rates.”¹ In contrast, the Federal Reserve Board’s definition of monetary policy does not include the words management, money supply, or interest rates. However, the Federal Reserve Board does provide details that expand on monetary policy, stating, “The term monetary policy refers to the actions undertaken by a central bank, such as the Federal Reserve, to influence the availability and cost of money and credit as a means of helping to promote economic goals.”² If references to the central bank and the Federal Reserve were omitted, the Federal Reserve’s Board’s definition of monetary policy would read, “The term monetary policy refers to the actions undertaken…to influence the availability and cost of money and credit as a means of helping to promote economic goals.”³ As argued, originally, this was the responsibility of Congress.

To illustrate, Article I, Section 8 of the United States Constitution granted Congress the enumerated power over money. The monetary power granted in this


³ Ibid.
clause permits Congress to coin, make, or issue money and to regulate the value of currency. But the final clause of Article I, Section 8, also authorizes Congress, “To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.” Therefore, under its right to enact a law “necessary and proper” to execute or carry out the power vested in them to create and regulate the value of money, Congress created the Federal Reserve System to regulate the nation’s money supply and monetary policy in 1913.

Specifically, Congress devolved the responsibility and power to regulate the nation’s monetary policy to the Board of Governors and the Federal Open Market Committee of the Federal Reserve. The Board of Governors of the Federal Reserve confirms, “Monetary policy is made by the Federal Open Market Committee (FOMC), which consists of the members of the Board of Governors of the Federal Reserve System and five Reserve Bank presidents.”

In other words, a total of twelve people (seven Governors and five district bank Presidents) are involved in the conduct of monetary policy decisions that affect the entire economy. But others are involved as well. Two other groups that play a role in the function of the Federal Reserve System are the “depository institutions, through which monetary policy operates, and advisory

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committees, which make recommendations to the Board of Governors and to the Reserve Banks regarding the System’s responsibilities.”

However, for the purpose of this thesis, the most appropriate definition of monetary policy is from the March 31, 2010 CRS Report for Congress entitled, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*. The report was prepared by the Congressional Research Service (CRS), a division of the Library of Congress, for Members and Committees of Congress. Since Congress delegated the responsibility of monetary policy to the Federal Reserve System, it seems reasonable to conclude that a Congressional Research Service would not be needed to explain what monetary policy means to Members and Committees of Congress. Nevertheless, the non-partisan research of the CRS explains, as Mishkin does, that monetary policy is related to money supply and adds:

The Fed defines monetary policy as the actions it undertakes to influence the availability and cost of money and credit to promote the goals mandated by Congress: a stable price level and maximum sustainable economic growth. Since the expectations of households as consumers and businesses as the purchasers of capital goods exert an important influence on the major portion of spending in the United States, and these expectations are influenced in important ways by the actions of the Fed, a broader definition of monetary policy would include the directives, policies, statements, forecasts of the economy, and other actions by the Fed, especially those made by or associated with the chairman of its Board of Governors, the nation’s central banker.

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The definition of the Congressional Research Service shows that the policies, directives, pronouncements, decisions, actions, and even forecasts of the Federal Reserve drive monetary policy, affect the economy, and influence the future. This definition suggests that the behaviors of those in control of monetary policy affect the economy. In fact, the economy affects monetary policy and monetary policy affects the economy. But, to avoid monetary policy that is based on reactions to fluctuations of the business cycle or the economy, United States monetary policy needs goals.

There are three main economic goals of monetary policy as prescribed in the 1977 amendment to Section 2a of the Federal Reserve Act which states, “The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” Mishkin notes these primary goals as well but inserts two additional goals or objectives. Mishkin argues, “While price stability is the primary goal of most central banks, five other goals are continually mentioned by central bank officials when they discuss the objectives of monetary policy: 1) high employment, 2) economic growth, 3) stability of financial markets, 4) interest-rate stability, and 5) stability in

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foreign exchange markets.”

The two additional objectives added by Mishkin, stability of financial markets and foreign exchange markets, provide evidence that the role of the Federal Reserve has not only evolved but has expanded.

Though the Federal Reserve’s role as it relates to monetary policy has expanded into numerous responsibilities, in its Frequently Asked Questions section, the Federal Reserve Board notes that its responsibilities generally fall into four main categories:

- conducting the nation’s monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices
- supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing certain financial services to the U.S. government, to the public, to financial institutions, and to foreign official institutions, including playing a major role in operating the nation’s payments systems

As mandated by Congress, the Fed must formulate monetary policy, ensure financial stability as a lender of last resort, supervise banks, and provide financial reserves or

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payment to the United States government and financial institutions (both domestic and foreign). In its conduct of monetary policy, the CRS Report for Congress says:

Traditionally, the Fed has had three means for achieving its goals: open market operations involving the purchase and sale of U.S. Treasury securities, the discount rate charged to banks who borrow from the Fed, and reserve requirements that governed the proportion of deposits that must be held either as vault cash or as a deposit at the Federal Reserve.\(^\text{10}\)

However, one argument is that multiple monetary objectives or goals instead of one single clear objective or goal produces uncertainty and conflict. For instance, the *Cato Handbook for Policymakers* argues that Section 2a of the Federal Reserve Act should be amended because it lacks a clear monetary rule to guide the monetary policies of the Fed. The view of William Poole, a former President of the Federal Reserve Bank of St. Louis is highlighted in the handbook, asserting that monetary policy is either unclear or misunderstood. Poole argues this point with the example that today’s markets do not evaluate or understand monetary policy but instead the markets often listen intensely to the words of Fed officials and respond negatively or positively thereafter. The *Cato Handbook for Policymakers* suggests that Congress can address this problem if it amends Section 2a of the Federal Reserve Act to make the primary objective or aim of monetary policy long-run price stability. As a proponent of long-

run price stability himself, Poole concurs:

The logic, and the evidence, both suggest that the appropriate goal for monetary policy should be price stability, that is, a long-run inflation rate of approximately zero….A central bank’s single most important job is preserving the value of the nation’s money. Monetary policy has succeeded if the public can reasonably trust that a dollar will buy tomorrow what it will buy today….I am confident that our economy’s long-run performance would be enhanced by a monetary policy that aims at, achieves, and maintains a zero rate of inflation.11

Both the Cato Handbook for Policymakers and Poole agree that instead of discretionary monetary authority, the Fed ought to be legally mandated to achieve the single objective or goal of long-run price stability in order to build public confidence and trust. The Fed itself acknowledged that this is a problem and that conflict exists among goals in the short run: “The challenge for policy makers is that tensions among the goals can arise in the short run and that information about the economy becomes available only with a lag and may be imperfect.”12 In other words, besides the fact that policy makers face uncertainty and cannot accurately predict the future, key information related to prices, production, and/or expenditures will often be delayed. This lag could cause monetary policy makers to make dire decisions based on information that is not based on real-time but delayed. Even so, to ease tensions among the goals, the Cato Handbook for Policymakers argues:

If the Fed were held accountable for achieving zero expected inflation, the inflation component of nominal interest rates would vanish and rates would fall

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to their ‘natural’ level. Increased certainty about the future value of the dollar would also have a beneficial effect on investment and would attract foreign capital, thus promoting output and employment. There would be no need to list, ‘maximum employment’ and ‘moderate long-term interest rates’ as separate goals of monetary policy.\(^{13}\)

The handbook also recommends that Congress make Section 2a of the Federal Reserve Act a clear-cut rule and the amend the clause to state: “The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates so as to maintain long-run price stability.”\(^{14}\) Although the amended version of Section 2a focuses on long-run objectives, the handbook seems to recognize the benefits of short-run objectives as well because it argues, “That amendment would not preclude the Fed from acting as a lender of last resort in a liquidity crisis, but it would require a reversion to noninflationary growth of money and credit—and thus ground the public’s expectations with regard to the future value of the dollar.”\(^{15}\)

Presently, there is a dual mandate in which the Federal Reserve is instructed by Congress to not only stabilize prices but to also promote maximum employment. The March 31, 2010 CRS report for Congress views the mandate as a further source of political independence:

As a practical matter, the Fed’s mandate can be seen as a further source of political independence by giving it broad policy discretion. The Federal

\(^{13}\) Cato Institute, *Cato Handbook for Policymakers*, 368.

\(^{14}\) Ibid.

\(^{15}\) Ibid.
Reserve Act of 1977 (P.L. 95-188, 91 Stat. 1387) charged the Fed with ‘the goals of maximum employment, stable prices, and moderate long-term interest rates.’ Note that the Fed controls none of these three indicators directly; it controls only overnight interest rates. Because it has only one instrument at its disposal and three goals, there will be times when the goals will be at odds with each other, and the Fed will have to choose to pursue one at the expense of the other two. Critics have argued that the ambiguity inherent in the current mandate makes for less than optimal transparency and accountability. It may also strengthen political independence if it allows the Fed to deflect congressional criticism by pointing, at any given time, to whatever goal justifies its current policy stance.\footnote{16 Labonte, "Monetary Policy and the Federal Reserve,” Congressional Research Service \url{http://www.fas.org/sgp/crs/misc/RL30354.pdf} \url{http://www.fas.org/sgp/crs/misc/RL30354.pdf} (accessed February 4, 2011).}

Thus, the Fed is independent in the sense that it has broad policy discretion. Besides discretion, Blinder adds interpretation to this argument when he says, “In each case, the goals of monetary policy are set forth in legislation but are sufficiently imprecise that they require considerable interpretation by the central bank.”\footnote{17 Blinder, Central Banking in Theory and Practice, 54.} In other words, Blinder suggests that an examination of the Federal Reserve reveals a considerable amount of \textit{de facto power} and independence. Both the Fed’s independence and \textit{de facto power} are increased when the Fed interprets its dual mandate, determines what goals ought to take precedence, and decides which tools will be used and when to accomplish its goals. Blinder touches on both the Fed’s independence and power as related to its legislative objectives and goals, he says:

\begin{quote}
If it is to be independent, the bank must have a great deal of discretion over how to use its instruments to pursue its legislated objectives. But it need not have the authority to set the goals itself and, indeed, I would argue that giving
the bank such authority would be an inappropriately broad grant of power. The elected representatives of the people should make such decisions. The central bank should then serve the public will. In the terminology suggested by Fischer (1994), the bank should have instrument independence but not goal independence.\textsuperscript{18}

In Blinder’s view, to grant the Fed, the most powerful financial institution in the World, the authority to set its goals itself would be not only inappropriate but a broad grant of power.

In an interview with \textit{The Region} in December 1996, economics Nobel Prize winner James Tobin was questioned about the Fed’s dual mandate. Tobin won the Nobel Prize “for his development of a model of the way in which monetary, financial, and real variables are jointly determined.”\textsuperscript{19} \textit{The Region} asked Tobin, “In an essay on monetary policy in Fortune’s \textit{Encyclopedia of Economics} you ask the question, ‘Should policymakers give priority to price stability or full employment?’ What is your response to that question?”\textsuperscript{20} Tobin’s stance was that the Fed ought to focus on both objectives and “take a pragmatic view at the combination of those goals.”\textsuperscript{21} In the interview, Tobin admitted that he had not been a routine fan of the Fed throughout his

\begin{itemize}
\item \textsuperscript{18} Ibid.
\item \textsuperscript{19} Federal Reserve Bank of Minneapolis, “Interview with James Tobin,” \textit{The Region}, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3649 (accessed February 3, 2011).
\item \textsuperscript{21} Ibid.
\end{itemize}
career. Yet, Tobin commended the job the Fed and its Chairmen Volker and Greenspan had done in the past related to their dual mandate:

I think they look at unemployment numbers as one guide to policy, and inflation numbers as another guide to policy. They don’t say, ‘We’re just going to look at one.’ Likewise they don’t make monetary policy in terms of some intermediate monetary aggregates: that was very popular in the ’70’s, until Paul Volcker abandoned the monetary aggregates in 1983. We have the best record since the 1980’s of any G-7 country in terms of macroeconomic policy, and I think that comes from not saying we are for price stability only; rather, it comes from saying we care about what happens to the real economy.

Like Tobin, the CRS Report for Congress looks at the same two goals, employment and inflation. The report shares the argument of those in favor of a dual mandate. The report also argues that some focus on employment is appropriate, given that monetary policy has powerful short-term effects on employment, and that too great a focus on inflation could lead to an overly volatile business cycle. Although opponents of a single mandate argue that there is no need to fix a system that is not broken, whether the Fed’s monetary policy objectives are singular or plural, what matters is that the Fed strikes the right balance among the goals in addition to what Tobin suggested, which was to care about what happens to the real economy as a whole.

Even if the focus is on the economy as a whole, monetary policy has limits. For instance, the Fed is unable to directly impact its goals. In other words, the Fed cannot directly impact factors like maximum employment or provide jobs to every unemployed citizen. The Fed must carry out its monetary policy goals indirectly. For example, the Fed influences monetary policies indirectly when it influences interest

\[22\] Ibid.
rates, foreign exchange rates, unemployment, and financial market prices. The Cato handbook for policymakers explains:

The Fed cannot permanently increase the rate of economic growth or permanently lower the rate of unemployment by increasing money growth, nor can it permanently lower real interest rates. But it can throw the economy off track by policy errors – that is, by creating either too much or too little money to maintain stable expectations about the long-run value of the currency. The most grievous error of discretionary monetary policy, as Milton Friedman and Anna Schwartz have shown in *A Monetary History of the United States*, was the Fed’s failure to prevent the money supply from shrinking by one-third between 1929 and 1933, which turned a sharp but otherwise ordinary recession into the Great Depression.\(^{23}\)

A historical analysis of the Fed’s interpretations, actions, and inactions relating to monetary policy reveals that these factors impact monetary forces of the United States economy. To illustrate, as mandated by Congress, the Fed must issue U.S. currency or put just enough money in circulation to promote its goal of maximum employment. However, if the Fed misfires and places too much into circulation, inflation will result. In this way, the Fed’s actions affect employment, economic growth, and the economy in general.

In addition, monetary actions, inactions, and forces influence the economy. To illustrate, Milton Friedman and Anna Schwartz’s classic book, *A Monetary History of the United States, 1867-1960*, argues that monetary forces caused the Great Depression and identifies four pivotal mistakes the Fed made related to monetary policy in the Great Depression era. The first monetary policy action pointed out by Friedman and

\(^{23}\) Cato Institute, *Cato Handbook for Policymakers*, 371.
Schwartz occurred from the spring of 1928 until the stock market crash in October of 1929. At that juncture, commodity prices had declined sharply with little suggestion of inflation but the Fed tightened monetary policy and raised interest rates. The reason the Fed raised interest rates was due to concerns on Wall Street. The Fed supported loans issued by banks for productive purposes, but tried to persuade or discourage speculative loans lent by banks to brokers and investors on Wall Street. The cause of the Fed’s concern was speculation that the money loaned by banks to brokers and investors was used to perpetuate volatility in the stock market. Since the Fed was unable to directly deter these practices, it decided to deter the behavior with higher interest rates. The Fed raised interest rates in August of 1929, and the stock market crashed in October. Friedman and Schwartz argue that monetary policy was too contractionary and turned a recession into a calamity. In other words, the Fed’s monetary policy was too tight. Christopher Faille and David E. O’Connor describe a tight monetary policy and also explain three ways the Fed can implement a tight monetary policy:

A tight money policy is designed to reduce the money supply and thereby decrease aggregate demand in the economy. A tight money policy is used to fight inflation, which often occurs during the expansionary phase of the business cycle when high demand for goods and services causes prices to rise. How can the Fed implement a tight monetary policy to reduce aggregate demand? First, the Fed increases the discount rate. This makes it more expensive for banks to borrow from the Fed. Banks, in turn, raise their own interest rates. This discourages borrowing by individuals and firms, and reduces aggregate demand… Next, the Fed sells government securities to investors. In effect, by selling Treasury bills, notes, or bonds, the government “soaks up” excess cash in the economy and reduces aggregate demand. The third, infrequently used monetary tool - the reserve requirement - could also be
increased to force banks to limit the amount of money they can loan to consumers or businesses.\textsuperscript{24}

Contractionary policy slows the economy while expansionary policy boosts the economy. The CRS report for Congress describes monetary policy as measured:

Because the Fed defines monetary policy as the actions it undertakes to influence the availability and cost of money and credit, this suggests two ways to measure the stance of monetary policy. One is to look at the cost of money and credit as measured by the rate of interest relative to inflation (or inflation projections), while the other is to look at the growth of money and credit itself. Thus, one can look at either interest rates or the growth in the supply of money and credit in coming to a conclusion about the current stance of monetary policy, that is, whether it is expansionary, contractionary, or neutral.

Although its monetary policy was too contractionary in 1929, the Fed succeeded in its efforts to discourage bank loans lent for speculative market booms. Nevertheless, there were consequences for the Fed’s monetary policy decisions, proving that the Fed’s monetary policy tools not only have the power to directly or indirectly impact specific targets but can affect the economy as a whole as well as stock prices.

In the view of Friedman and Schwartz, the second Fed monetary policy action transpired in the months of September and October of 1931. Similarly, the second policy action involved speculation. However, instead of a speculative attack on the stock market or Wall Street, the second policy action involved a speculative attack on the dollar. At that time, the majority of nations, including the United States, operated on the gold standard. The value of currency was based on ounces of gold, and central banks could tender gold for money at fixed rates of exchange. Eventually, speculative

\textsuperscript{24} Faille and O’Connor, Basic Economic Principles, 168.
attacks resulted from parity suspicions related to the devaluation or value of currency versus the fixed rate for gold. The first speculative attack on the dollar occurred after upheavals in Europe led to concerns about British investments. A prevalent loss of trust and confidence accompanied by heavy speculative attacks or demands for gold led to the collapse of the British pound and then the depletion of the Bank of England’s gold reserves. As a result, Great Brittan was forced to abandon the gold standard. Now, instead of the gold standard, market forces determined the value of the pound.

Shortly thereafter, in September and October of 1931, a similar speculative attack occurred on the United States dollar due to fears that it too would share a similar fate of devaluation, causing banks to fail. Consequently, foreign central banks and many foreign and domestic investors withdrew their funds and rushed to convert dollars to gold. Despite the fact that bank runs had caused thousands of banks to fail just a year before, the Fed did not respond to the quandaries of banks, even though required to do so. Instead, the Fed aggressively tackled the speculative attacks on the dollar. It raised interest rates sharply in an attempt to stabilize the dollar and to change the behavior of speculators. The Fed’s hope was that speculators would be attracted to a higher rate of return on their money and would to stop the liquidation of their funds or dollar assets. Although the Fed’s actions worked in the short term, the Fed had tightened monetary policy once again when the economy demanded an ease.

The third monetary policy action identified by Friedman and Schwartz transpired in 1932. By this time, the Depression had progressed and the Fed was under
pressure from Congress to ease its monetary policy. Faille and O’Connor explain easy monetary policy and how it is implemented:

An easy money policy is designed to increase the money supply in order to increase aggregate demand in the economy. An easy money policy is used to fight recessions by stimulating business activity – such as increased production, more jobs, more investment, and so on. The two monetary tools most commonly used to stimulate business activity are the discount rate and open market operations. To implement its easy money policy, the Fed lowers its discount rate. This encourages other banks to do the same and, thus, create additional borrowing and spending. Secondly, through its open market operations, the Fed buys back government securities to increase the flow of money back into the economy. In extreme situations, the third major monetary policy tool might be used - the reserve requirement. This tool is not used much because of the enormous disruption it causes within the banking system. In an extreme case, to support an easy money policy the Fed could lower the reserve requirement and, thus, increase the pool of funds that banks could loan to people.25

Although reluctant to adhere to Congress’ request, in April and June of 1932, the Fed conducted open-market operations to increase the money supply nationally. Kelly Chang explains how the Fed could have alleviated problems related to policy actions two and three:

Through monetary policy, a central bank could have alleviated problems caused by the sudden increased demand for currency by anticipating seasonal fluctuations in currency demand and increasing currency in the system through open market operations. By buying domestic assets, a central bank increases money supply because it buys those assets from banks and pays them with currency they create. By selling assets, a central bank decreases the money supply because it takes back some currency as payment for assets. Open market operations are also an alternative or complementary method of injecting liquidity into the banking system during panics.26

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25 Ibid., 167-168.

26 Chang, Appointing Central Bankers, 120.
However, the Fed’s monetary policy actions had nominal affects. Prices declined provisionally and the Fed’s policy actions led to lower interest rates. Besides that, there were disputes as to what ought to be done. Some policymakers felt that nothing more needed to be done. Others felt that the Fed’s monetary policy actions just deferred the inevitable. Then, in July of 1932, the Fed invoked its independence and reversed the policy actions pressured by Congress. As a result, the economy degenerated.

The final policy action identified by Friedman and Schwartz is actually a policy inaction. It is an inaction in the sense that the Fed had the power to ameliorate problems in the United States bank sector but did not. Banks failures as a whole could not be ignored because their failure precipitously impacted the money supply. For example, when depositors withdrew cash, either to convert into gold or to hoard underneath their mattresses, they took money out of circulation, prolonging the depression. Chang argues, “The Fed’s inaction eventually worsened the Depression; its refusal to inject additional liquidity into the financial system meant that banks could not deal with the increasing cash crunch caused by banks runs, which were in turn exacerbated by failing businesses.”27 In hindsight, the Fed had the power to offset bank panics and runs if it had placed more money into circulation. The Fed could have also acted as a lender of last resort and lent more money to banks in order to calm the fear that banks would be unable to liquidate funds. Chang notes the benefits of a lender of last resort within and after her definition of the term, “A lender of last resort

27 Ibid., 134.
provides banks the liquidity necessary to meet the demands of its customers in time of crisis. Even more important than providing the actual cash on hand, the mere existence of a lender of last resort provides general confidence in the banking system." General confidence in banks was an issue at the time because any money deposited into a bank was at risk for loss. While, the Fed was accused of inaction, the President and Congress did act to ameliorate problems. For example, the Federal Deposit Insurance Corporation (FDIC) was created by the Glass-Steagall Banking Reform Act to calm banks runs and raise depositor confidence in the banks. The Act insured the deposits of investors up to twenty-five hundred dollars and no longer allowed banks to recklessly invest the money of depositors in the stock market.

These four pivotal monetary policy actions were not examined to paint the Fed in a negative light. The intention was to examine monetary policy as it relates to the Fed’s impact on the economy. Overall, a historical analysis of the Fed’s monetary actions reveals that monetary policy that was too contractionary in the Great Depression era led to a decline in prices and output. An inadequate money supply leads to deflation which could lead to a recession or depression. Opponents of this historical analysis may argue that contractionary monetary policy and the decline in money supply was not enough to autonomously cause the catastrophic events that led to the Great Depression. They argue that other monetary and even some nonmonetary forces may have contributed to the crisis. The point is that monetary forces and monetary

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28 Ibid., 119.
policy contributed to the Great Depression whether it caused it or not. More importantly, this historical analysis has revealed that the Fed may give in to the pressure of Congress. In the same era, President Roosevelt brought a halt to the bank crisis when he declared a Bank Holiday. All bank transactions were suspended while Roosevelt presented Congress with the Emergency Banking Act. The Act authorized the President through the Treasury Department to revive solvent banks and demonstrates the President’s influence on the crisis:

One the Sunday evening before the banks reopened, Roosevelt addressed the nation through one of his signature ‘FIRESIDE CHATS.’ With honest words in soothing tones, the President assured sixty million radio listeners that the crisis was over and the nation's banks were secure. On the first day back in business, deposits exceeded withdrawals. By the beginning of April, Americans confidently returned a billion dollars to the banking system. The bank crisis was over. 29

Again, the question is who conducts monetary policy? Since the actions of central banks like the Federal Reserve impact financial markets, economic aggregates, the economy as a whole, credit, interest rates, money supply, and inflation, it is important to know who makes the decisions for the Fed and controls the Fed’s actions.

CHAPTER VI
IN TIMES OF CRISIS

In order to fully understand the Fed’s structure, it is imperative to analyze the period prior to the twentieth century. Our founding fathers disliked centralized power. This attitude led to the preservation of state’s rights, the Bill of Rights, and the establishment of a system of checks and balances that dispersed governing powers among three branches of government.

This same distrust of centralized power created the resistance against the establishment of central banks prior to 1913. As Mishkin says, “The open hostility of the American public to the existence of a central bank resulted in the demise of the first two experiments in central banking, whose function was to police the banking system: The First Bank of the United States was disbanded in 1811, and the national charter of the Second Bank of the United States expired in 1836 after its renewal was vetoed in 1832 by President Andrew Jackson.”¹ Mishkin points out that the demise of the Second Bank of the United States in 1836 created severe problems for American financial markets. This was mainly because there was no longer a lender or central bank to provide reserves to the banking system in order to avert bank panics. Consequently, beginning in the nineteenth century and through the early part of the twentieth century, a vicious cycle of bank panics continued along with widespread failures of banking systems every two decades or so until its culmination in 1907. In regards to the panic

of 1907, Mishkin notes, “The 1907 panic resulted in such widespread bank failures and such substantial losses to depositors that the public was finally convinced that a central bank was needed to prevent future panics.”² Yet Federalists, mainly Alexander Hamilton, had recognized the need for a greater banking system with centralized control back in the 1700’s.

Although the American public now recognized the need for a central bank in order to avert bank panics in the future, serious issues remained. For example, there was no diminution of fear of centralized power among the American public. There was the added distrust due to the vicious cycle of bank failures and substantial financial losses, but the American public had deeper fears as well. As Mishkin notes, “Fear was rampant that the moneyed interest on Wall Street (including the largest corporations and banks) would be able to manipulate such an institution to gain control over the economy and that the federal operation of the central bank might result in too much government intervention in the affairs of private banks.”³ Republicans desired a private central bank. Democrats wanted a government central bank. The fear of centralized power, public hostility, and disputes as to whether the central bank ought to be federal or private led to resistance towards the establishment of a single central bank but also to a compromise. The compromise was the unusual structure of the Fed.

² Ibid.
³ Ibid., 321.
Just as the founders of the U.S. Constitution designed an elaborate system of checks and balances to avert opposition, Mishkin points out, “In the great American tradition, Congress wrote an elaborate system of checks and balances into the Federal Reserve Act of 1913, which created the Federal Reserve System with its twelve regional Federal Reserve banks.”⁴ As a compromise, Congress created a quasi-private institution. Instead of a single central bank with too much power concentrated in Washington, D.C. or New York City, the founders of the Federal Reserve designed a decentralized banking system. This system consisted of not one central bank but twelve decentralized Federal Reserve banks spread throughout the United States. The Federal Reserve System was to be overseen by a Board of Directors (now a Board of Governors) from the private sector who not only embodied the views and concerns of the people from their regions but who would be in close proximity to and in close contact with the presidents of Federal Reserve Banks.

Although the Federal Reserve System was created to prevent financial crisis and to provide a safer banking system, the Fed failed to ward-off the worst economic crisis in United States history. Many economists agree that the Federal Reserve turned the recession of 1929 into the global economic catastrophe now known as the Great Depression. Mishkin confirms, “When the Federal Reserve System was created, its most important role was intended to be as the lender of last resort; to prevent bank failures from spinning out of control, it was to provide reserves to banks when no one

⁴ Ibid.
else would, thereby preventing bank and financial panics.”⁵ In order to prevent bank and financial panics, the Fed could opt to not only act as a lender of last resort for banks but it could also act as a lender of last resort for the financial systems en masse. For instance, as Mishkin illustrates, “The existence of the Fed’s discount window can help prevent and cope with financial panics that are triggered by bank failures, as was the case during the Black Monday stock market crash of 1987, the terrorist destruction of the World Trade Center in September 2001 and the subprime financial crisis.”⁶ Yet, partial blame for the Great Depression could be placed on the Fed because the Fed let the bank panics of 1930-1933 happen. Although expected to do so, the Federal Reserve did not act as a lender of last resort. At a time when the Fed wanted to, and probably should have used its primary tool, the change of the discount rate to temper the stock market boom of 1928 and 1929, the Fed wrestled with the idea of whether it should raise the discount rate. The Fed could have raised the discount rate to immediately channel reserves into banking systems in dire need cash. But ultimately Mishkin notes, “Finally, in August 1929 the Fed raised the discount rate, but by then it was too late; the speculative excesses of the market boom had already occurred, and the Fed’s actions merely hastened the stock market crash and pushed the economy into

⁵ Ibid., 384-385.
⁶ Ibid., 385.
recession.” The point here is that it was not enough for the Federal Reserve to react. It had to act at the right time.

Furthermore, while a change in the discount rate could have prevented massive bank failures, it would not have come without cost. If the Fed had raised the discount rate as it wanted to in order to temper the boom of 1928 and 1929, it would have rescued banks but would have simultaneously raised interest rates for individuals and businesses that may have actually needed credit. Yet, it is necessary to digress for a moment in order to make note of an important point. Mishkin shares, “When the Fed was created, changing the discount rate was the primary tool of monetary policy – the Fed had not yet discovered that open market operations were a more powerful tool for influencing the money supply, and the Federal Reserve Act made no provisions for changes in reserve requirements.” This new monetary policy was stumbled upon by accident but would prove to be invaluable in the future. Meanwhile, the Fed remained inactive from 1931 to 1932. As a result, thousands of banks spiraled out of control and failed, which triggered the worst economic crisis to date. Some seventeen years later, the Fed was unable to stop the spread of what Milton Friedman and Anna Schwartz referred to as a “contagion of fear.” They describe how fear spread among depositors who frantically withdrew their money from banks. Of all the sectors impacted by bank

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7 Ibid., 419.
8 Ibid., 418.
failures in the twenties, the agricultural sector experienced the heaviest hit. As a whole, Mishkin confirms, “During the Great Depression years 1930-1933, some 9,000 bank failures wiped out the savings of many depositors at commercial banks.”\textsuperscript{10} When the spate of bank panics ended in March of 1933, more than one-third of the commercial banks in the United States had failed. The fact that the Federal Reserve did nothing to avert the failure of thousands of banks, proved to be one of its most costly mistakes.

But why would the Federal Reserve let the Great Depression happen especially since its original purpose was to prevent economic crisis? Do the facts yet again point to fear? It is no secret that fear can immobilize and can lead to vacillation that could prove to be costly. It has been argued that the Great Depression may have been worsened by passiveness and inaction on the Fed’s behalf. Mishkin supports this saying, “The primary reason for the Fed’s inaction was that the Federal Reserve officials did not understand the negative impact that bank failures could have on the money supply and on economic activity.”\textsuperscript{11} From this, one learns that inaction could prove to be just as detrimental as action. On the other hand, it is extremely difficult to fathom why Federal Reserve officials did not understand the correlation between bank failures, money supply, and economic activity although bank failures had occurred prior to the Great Depression and was the reason for the Fed’s very existence. More viable arguments are made by Milton Friedman and Anna Schwartz who give several

\textsuperscript{10} Mishkin, \textit{The Economics of Money, Banking & Financial Markets}, 283.

\textsuperscript{11} Ibid., 321.
reasons for the Fed’s passivity around this time. First, they boldly declare that political infighting was one cause of the Fed’s passivity. Next, they blame some of the Fed’s failure to act on the fact that in the early phase of bank panics, bank failures “were concentrated among smaller banks, and since the most influential figures in the system were big-city bankers who deplored the existence of smaller banks, their disappearance may have been viewed with complacency.”

They also explain that Federal Reserve officials “tended to regard bank failures as regrettable consequences of bank management or bad banking practices, or as inevitable reactions to prior speculative excesses, or as a consequence but hardly a cause of financial and economic collapse in process.” Friedman and Schwartz raise a valid point here. Since nothing of its magnitude had occurred before the Great Depression, some of the hesitation on the Fed’s part could have been based on the fact that Federal Reserve officials were forced to carefully decipher whether it ought to act as a lender of last resort. The Fed would not want to act as a lender of last resort if they were faced with banks and financial institutions that had just been managed poorly. It seems as if the Federal Reserve officials were faced with what Mishkin referred to as, “a moral hazard problem.”

Shared by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), the ideal behind a moral hazard problem is that if the Federal Reserve always acts as a

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12 Ibid., 420.


lender of last resort, banks and other financial institutions might assume more risk and expect the Federal Reserve to make discount loans in order to bail them out of trouble and avert an imminent financial panic. Mishkin explains, “The moral hazard problem is most severe for large banks, which may believe that the Fed and the FDIC view them as ‘too big to fail’; that is, they will always receive Fed loans when they are in trouble because their failure would be likely to precipitate a bank panic.”

Those against the Fed’s independence argue that the Fed has not always used its freedom or power to perform successfully. As Mishkin notes, these critics argue, “The Fed failed miserably in its stated role as lender of last resort during the Great Depression, and its independence certainly didn’t prevent it from pursuing an overly expansionary monetary policy in the 1960’s and 1970’s that contributed to rapid inflation in this period.”

To epitomize the Fed’s power, David Wessel strongly argues, “Although neither legislation nor the gilt lettering that adorns the Fed’s building makes mention of the fact, Congress had created what would become a fourth branch of government, nearly equal in power in a crisis to the executive, legislative, and judicial branches.”

During the economic crisis of 2008, the Fed’s power emerged as nearly equal as the other branches of government when it became known to Congress and other

15 Ibid., 385-388.
16 Ibid., 340.
17 Wessel, In the Fed We Trust, 39.
Americans that the Fed could do more than raise or cut taxes. It became evident that
the Fed could, without prior approval from Congress or the President create billions of
dollars overnight. This also demonstrates another factor which makes the Fed
independent, financial independence.

Financial independence and the Fed’s role as a lender of last resort were of
particular importance at the onset of the financial crisis in the summer of 2007. More
specifically, in August of 2007, financial turmoil arose with the mortgage meltdown,
which consisted of subprime loans and toxic assets. Lender after lender failed. Banks
became concerned and uncertain about losses that might have to be absorbed on
mortgages and about the financial stability of borrowers. This moved banks towards
safer liquid assets, like Treasury bonds. As a result, banks became more cautious and
were hesitant to lend to businesses as well as households. The Congressional Research
Service (CRS) report for Congress confirms, “The ‘liquidity crunch’ was most extreme
for firms and securities with links to subprime mortgages, but it also spread rapidly
into seemingly unrelated areas.”18

The Fed’s response was immediate. On August 9, 2007, the Fed injected large
volumes of reserves into the banking system that exceeded its norm. From September
to December of 2007, Chairman Bernanke, who had been appointed only a year prior,
aggressively cut interest rates repeatedly to nearly zero and eventually to zero. Aside

Research Service (July 15, 2010), under “Introduction,”
from the interest rate cuts, with regard to Bernanke’s appointment, Paul Krugman, who had received a Nobel Prize in economics, says, “If you had to choose one individual to be in charge of the Fed during this crisis, that person would be Bernanke.”19 But the cuts were not enough and multiple institutions found themselves on the brink of failure. Some institutions actually failed. With interest rates cut as low as they could go, the Fed had no recourse but to increase its direct assistance to institutions in order to stimulate the economy.

First, the Federal Reserve made a controversial move and stepped in to stop the collapse of Bear Stearns in March of 2008. Controversy stemmed from the fact that Bear Sterns was not a depository institution and therefore not a member of the Federal Reserve banking system. But Krugman clarifies, “When Bear Stearns, another of the original five major investment banks, got in trouble in March 2008, the Fed and the Treasury moved in – not to rescue the firm, which disappeared, but to protect the firm’s “counterparties,” those whom it owed money or with whom it had made financial deals.”20 Right after the Fed stopped the collapse of Bear Stearns, mortgage giants Fannie Mae and Freddie Mac were seized by the Government. The mortgage giants had only a few bad loans on their books, but they were no longer able to provide stability and liquidity for the housing market because their capital base was too thin.


20 Ibid., 178.
Then, Merrill Lynch was sold in distress. Afterwards, one of the oldest corporations, Lehman Brothers (who some may have believed was too big to fail) went bankrupt. Although Lehman Brothers had been in business for more than a century, it was a very large company internationally, which meant the impact of its failure would be felt worldwide. The failure of Lehman Brothers triggered a global panic. The government provided no emergency assistance to Lehman Brothers, and the Federal Reserve did not step in to rescue Lehman Brothers as many had expected. The Treasury Department decided the impact of Lehman’s failure would be minimal and the Fed did not have the tools to rescue Lehman Brothers. The Fed tried unsuccessfully to find a buyer for Lehman, and it can only loan money against collateral. In reference to loans and collateral, the CRS report for Congress states:

> All loans are backed by collateral that reduces the risk of losses. Any losses borne by the Fed from its loans or asset purchases would reduce the income it remits to the Treasury, making the effect on the federal budget as if the loans were made directly by Treasury. It is highly unlikely that losses would exceed its other income and capital, and require revenues to be transferred to the Fed from the Treasury. To date, the Fed’s crisis activities have increased its net income.\(^{21}\)

In reference to the Fed’s net income, the *New York Times* was specific about the Fed’s profitability, stating:

> Felix Salmon notes that the Federal Reserve earned net income of $80.9 billion in 2010, with a return on assets of 3.3 percent, while its return on equity a jaw-dropping 143 percent: I think it’s fair to say that no bank in the history of the

world has ever had income of anywhere near $80 billion in one year: that’s
over $700 per U.S. household.22

On the other hand, if the Fed had issued loans that were not backed by collateral during
the financial crisis of 2008, it would have resulted in a net loss.

However, for the first time since the Great Depression era, the Fed made an
unprecedented move and loaned billions of dollars to a non-depository institution
directly. The company was American International Group (better known as AIG), a
global insurance giant that also backed risky mortgage investments. In contrast to
Lehman Brothers, AIG was granted a loan because it had collateral. AIG was rescued
by the Fed, not once, but four times. Mathew Perry confirms, “….AIG has been bailed
out four times so far by the government.”23 AIG unconscionably gambled outside the
scope of regulators. Yet, the Fed had no recourse but to continue to stabilize AIG and
other financial institutions even if it took more than one attempt. The Fed averted
bankruptcy for AIG because of the detrimental impact its failure would have created.
But the Fed also stipulated that AIG had to divest some of its subsidiaries and use the
proceeds to pay back the government. Nevertheless, the Fed’s actions as they relate to
AIG raised two policy issues as pointed out by the Congressional Research Service:

Two policy issues raised by the Fed’s actions are issues of systemic risk and
moral hazard. Moral hazard refers to the phenomenon where actors take on

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more risk because they are protected. The Fed’s involvement in stabilizing Bear Stearns, AIG, and Citigroup stemmed from the fear of systemic risk (that the financial system as a whole would cease to function) if they were allowed to fail. In other words, the firms were seen as ‘too big (or too interconnected) to fail.’ The Fed regulates member banks to mitigate the moral hazard that stems from access to government protections. Yet Bear Stearns and AIG were not under the Fed’s regulatory oversight because they were not member banks.  

In the case of AIG (the moral hazard), these two policy issues posed a problem for the Fed because, without intervention, the failure of AIG would have not only brought down the financial system but the entire United States economy. For that reason, when the financial crisis worsened and the economy was on the brink of a global financial meltdown in September of 2008, Fed Chairman Bernanke and former Treasury Secretary Hank Paulson urged a massive bailout of the banking system on Capitol Hill (due to fear of systemic risk). The very next month, just one week prior to the pinnacle of the crisis when the Dow fell to its lowest point in history in the second week of October, Congress passed legislation which gave Treasury the right to put capital into banks. The November 10, 2009 CRS report for Congress says: “On September, 19, 2008, Treasury and Federal Reserve officials with the bipartisan support of the congressional leadership announced a massive intervention in the financial markets, requesting authority to purchase up $700 billion in trouble assets over the next two years.”  

Ironically, October was the same month the stock market crashed in 1929 just

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25 Ibid.
before the Great Depression years. Nevertheless, without the power granted to Treasury by Congress and the power of the Fed to act immediately without prior approval from Congress or the President, the recession could have easily slipped into a Greater or second Great Depression. Thus, Bernanke invoked the Fed’s emergency authority of Section 13(3) of the Federal Reserve Act to pump more than a trillion dollars into the economy. The CRS report for Congress confirms, “On March 18, 2009, the Federal Reserve announced plans to purchase more than $1 trillion in assets, including $750 billion in mortgage back securities and $300 billion in long-term Treasury debt.”26 The CRS report also notes, “The statutory authority for most of the Fed’s recent actions is based on a clause in the Federal Reserve Act to be used in “unusual or exigent circumstances.”27 The Federal Reserve Act does not, however, provide direction as to its authority to assist institutions outside the banking system. For that reason, when the Fed opted to assist institutions outside of its realm, critics argued that the Fed favored certain sectors. The Fed’s aim was not to favor certain sectors but more importantly to increase credit flows and liquidity.

As if a lesson had been learned from the past, the Fed took unprecedented actions or steps in its conduct of monetary policy to ease the financial turmoil of the 2008 economic crisis. When the aggressive cuts in interest rates failed to be enough, the Fed expanded on its traditional tools to accomplish its goals. Put differently, when

26 Ibid.
27 Ibid.
the Fed’s open market operations had nominal effects, the Fed created new loan programs and resorted to direct lending. Over a dozen financial rescues were launched by the Fed, doubling its balance sheet. The July 15, 2010 CRS report for Congress tallied the amount of these programs to “$1.4 trillion at its peak in December 2008.”\(^{28}\)

In addition, the Fed used conventional/non-conventional actions, new policy tools, and facilities to extend or provide credit to institutions and markets. The Fed injected reserves through open market operations to banks, provided liquidity for banks to promote its economic goals, purchased mortgage-backed securities, and purchased agency and Treasury debts to get the economy back on track. Historically, the Fed used three sets of tools: 1) open market operations and interest rates, 2) quantitative easing, and 3) the discount window. However, in response to the financial crisis, the Fed used some new tools and facilities. For instance, the Fed eased the terms on money lent to depository institutions or banks, resorted to direct lending to banks and nonbank institutions, subsidized money market funds, mortgages, student loans, auto loans, and short term small business loans.

But what does any of this have to do with the independence of the Fed? Federal Reserve Vice Chairman Donald L. Kohn answers the question and whether the Fed had compromised its independence:

No. Central banks all over the world and the legislatures that created them have recognized that considerable independence from short-run political influences is essential for the conduct of monetary policy that promotes economic growth.

\(^{28}\) Ibid.
and price stability. To be sure, in the process of combating financial instability, we have needed to cooperate in unprecedented ways with the Treasury. Our actions with the Treasury to support individual systemically important institutions have sparked intense public and legislative interest. As Chairman Bernanke has indicated, the absence of a regime for resolving systemically important nonbank financial institutions has been a serious deficiency in the current crisis, one that the Congress needs to remedy.\textsuperscript{29}

Kohn’s response shows that the Vice Chairman recognizes the need for the Fed to be considerably independent from short-run political influences so as to not get diverted from its dual mandate from Congress. Whether it was intentional or not, Kohn also pointed out that the Fed has limits. The Fed did not and could not directly prevent negative equity (where mortgages were more than a home’s value), foreclosures, and job losses. The Fed was also limited in its ability to assists nonbank financial institutions, which Bernanke suggests needs a regime for resolution by Congress. But should the Fed be expected to bail out nonbank financial institutions like AIG because they are too big to fail and decide to take risk that could have a detrimental impact on the economy as a whole? Kohn says the Fed’s actions in conjunction with the Treasury to support systemically important institutions sparked intense interest from the public and legislators:

> It is natural and appropriate for our unusual actions in combating financial instability and recession to come under intense scrutiny. However, increased attention to, and occasional criticism of, our activities should not lead to a fundamental change in our place within our democracy. And I believe it will not; the essential role for an independent monetary policy authority pursuing

economic growth and price stability remains widely appreciated and the Federal Reserve has played that role well over the years. The recent joint statement of the Treasury and the Federal Reserve included an agreement to pursue further tools to control our balance sheet, indicating the Administration's recognition of the importance of our ability to independently pursue our macroeconomic objectives.30

The Fed’s unusual actions may have sparked intense interest and scrutiny. For instance, the Fed intervened and opened foreign currency swaps with the European Central bank in the European debt crisis, which included the central banks of Canada, England, Switzerland, and Japan. The New York Times also reports, “An equivalent program was announced in April 2009 to give the Fed the ability to provide liquidity to American institutions in foreign currencies, but the Fed did not end up having to use the program.”31 Again, if the Fed’s unusual actions sparked intense interest and scrutiny, the Fed’s inaction would have sparked more than just interest and scrutiny. The Fed eased the financial conditions of the financial crisis during 2008 and independently accomplished its objectives with new measures. But at who’s expense? The CRS report for Congress highlights another issue related to the recent economic crisis and the Fed’s independence:

Some policymakers have questioned whether an institution largely independent from the elected branches of government should be able to (indirectly) place significant taxpayer funds at risk by providing the financial sector with hundreds of billions of dollars of assistance through use of its emergency

30 Ibid.

powers. This raises the policy issue of how to balance the needs for congressional transparency and oversight against the economic benefits of Fed independence.\textsuperscript{32}

The Fed did what was necessary to stabilize financial conditions related to the financial market and then shifted its attention to the housing market in order to counter the effects of falling housing prices on the economy. The CRS Report for Congress confirms that the Fed’s response was consistent with its original purpose and attests to the Fed’s independence as it relates to the financial crisis of 2008:

One of the original purposes of the Federal Reserve Act, enacted in 1913, was to prevent the recurrence of financial panics. To that end, the Fed has been given broad authority over monetary policy and the payments system, including the issuance of Federal Reserve notes as the national currency. Because this authority is delegated from Congress, the Fed’s actions are subject to congressional oversight. Although the Fed has broad authority to independently execute monetary policy on a day-to-day basis, questions have arisen as to whether the unusual events of recent months raise fundamental issues about the Fed’s proper role, and what role Congress should play in assessing those issues.\textsuperscript{33}

Although critics may have disagreed with some of the Fed’s actions, they must agree that the outcome would have been far worse if the Fed failed to act. It was as if the Fed had learned from its inaction in the Great Depression era. The Fed sprung into action. Krugman argues, “The Fed is set up to do two main things: manage interest rates and, when necessary, provide cash to banks.”\textsuperscript{34} An analysis of the Fed’s response to the


\textsuperscript{33} Ibid.

\textsuperscript{34} Krugman, The Return of Depression Economics and the Crisis of 2008, 173.
current economic crisis reveals that the Fed did many things. The Fed acted as a lender of last resort, supplied liquidity, sharply lowered interest rates, stabilized money market accounts, purchased mortgage-backed securities, Treasury bonds, and improved credit market conditions - things it failed to do enough of in the Great Depression era. Bear Sterns, AIG, and Citigroup all received emergency assistance from the Fed. The Fed’s independence allows it to freely interpret the actions necessary to accomplish its goals. Besides that, Chairman Bernanke kept his word to Milton Friedman. At Milton Friedman’s ninetieth birthday party, Bernanke ended his speech with a promise to Friedman and Schwartz. In reference to the Great Depression, Bernanke says, “You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again.”

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CONCLUSION

At the onset of this thesis, some readers may have perceived independence in a different light. Words and phrases like: autonomous, neutral, free to do what one wants to do with no need for another, the conduct of affairs without interference, the ability to stand alone, freedom from control, influence, external forces, and/or constraint may have initially come to mind.

However, due to a compromise, the Federal Reserve has a unique structure; it is private yet public, and operates within the Federal government. This is why the Federal Reserve is described as relatively independent. The term independence does not mean that the Federal Reserve System is separate from government. Central banks are more often than not a part of the government. For that reason, Robert P. Bremner explains (and the Federal Reserve Board agrees) that it is more accurate to describe the Federal Reserve System “as independent within the government, not independent of the government.”¹ Thus, with all due respect, this thesis refers to the Federal Reserve’s relationship with the government as an oxymoron, because the Federal Reserve System is altogether, yet separate from, the government or altogether separate.

Nevertheless, the Federal Reserve is considered an independent central bank. The Fed is independent in the sense that it has broad policy discretion, it can act quickly to avoid financial crisis and panics, and the Federal Reserve is financially independent. In addition, One of the Federal Reserve’s own publications says, “It is

¹ Bremner, Chairman of the Fed, 295.
considered an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive or legislative branch of government, it does not receive funding appropriated by Congress, and the terms of the members of the Board of Governors span multiple presidential and congressional terms.”² The Federal Reserve System has been often referred to as the fourth branch of government due to its independence.

However, the definition is a bit more complex as it relates to the Federal Reserve System. To illustrate, John T. Woolley provides two definitions related to the Fed’s independence:

In one sense, a government agency may be said to choose a course of action independently if it does so without yielding to the pressures of others as to what that action should be. In another sense, a government agency may be said to be independent if its ability to achieve its objectives is not affected by the actions of others.³

On the other hand, Blinder says, “To me, central bank independence means two things: first, that the central bank has freedom to decide how to pursue its goals and, second, that its decisions are very hard for any other branch of government to reverse.”⁴ Blinder also borrows the terminology of Stanley Fisher, former Deputy Managing Director of the International Monetary Fund, to define independence this way:

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³ Woolley, Monetary Politics, 13.

⁴ Blinder, Central Banking in Theory and Practice, 54.
If it is to be independent, the bank must have a great deal of discretion over how to use its instruments to pursue its legislated objectives. But it need not have the authority to set the goals itself and, indeed, I would argue that giving the bank such authority would be an inappropriately broad grant of power. The elected representatives of the people should make such decisions. The central bank should then serve the public will. In the terminology suggested by Fischer (1994), the bank should have *instrument* independence but not *goal* independence.⁵

Various definitions of independence as it relates to the Fed support Allan Meltzer’s statement, “The monetary and political authorities have not agreed on a definition of independence.”⁶

So, is the Fed’s independence a bad thing or a good thing? In reference to the Federal Reserve’s independence, Mishkin argues:

There is yet no consensus on whether Federal Reserve independence is a good thing, although public support for independence of the central bank seems to have been growing in both the United States and abroad. As you might expect, people who like the Fed’s policies are more likely to support its independence, while those who dislike it policies advocate a less independent Fed.⁷

In order to come to a consensus as to whether or not the Federal Reserve’s independence is a good thing or a bad thing, there must first be a consensus as to what Federal Reserve independence is and is not. Besides that, there must be a consensus as to whether or not monetary policy should be placed in the power of an elite few independently without the checks and balances of another branch. Should the Federal Reserve System be independent of politics? The reasonable answer is no only because

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⁵ Ibid.


something could go wrong. Since history has shown that the Fed has not always used its freedom or power to perform successfully and history has demonstrated what could happen as a result (the Great Depression), there must be a provision to remove monetary policy leaders who do not meet their targets or err.

Furthermore, the title of this thesis is, *The Independence of the Fed: In the Fed We Trust or Are We Just Fed Up?* However, in order to fairly answer this question, the Federal Reserve System would have to be completely independent. Yet, the Federal Reserve System could never be fully independent of politics or truly consider itself independent of government. How could the Fed consider itself fully independent if (though very difficult to do) its decisions could be reversed? No one can be truly independent if the decisions they make could be changed by another entity. The Federal Reserve System must always have checks and balances and the Fed’s independence must always correlate with accountability, transparency, and oversight.

Those who dislike the Fed’s policies may be fed up or less apt to trust the Fed due to its actions, decisions, obfuscation, structure; the fact that the Federal Reserve has not voluntarily undergone comprehensive audits and reviews or, due to conspiracy theories related to the Fed. As American citizens, we may never know how beneficial the Fed is or what the Fed’s actions and decisions averted during the 2007/2008 financial crisis. But there is a chance that if the Fed did not exist or was unable to act independently as needed, that the nation may have found itself in something far worse than another Great Depression. After a evaluation of the Federal Reserve System and
its independence, this thesis finds that the Fed does the nation some good. For that reason, with increased accountability, transparency, and oversight this nation could begin to trust in the Fed but never more than they should trust themselves to make wise financial choices.
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