

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue cap at the top. The globe in the top bulb is dark blue, while the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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Economics of Federal Reserve Independence

Marc Labonte, Government and Finance Division

April 17, 2007

Abstract. This report gives a description of the structure of the Fed. It then discusses the economics of how Fed independence affects monetary policy. It then examines the probable economic ramifications of proposals to curb the independence of the Fed.

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Economics of Federal Reserve Independence

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Summary

The Federal Reserve System (Fed) is charged with responsibility for making U.S. monetary policy. Quasi-public in structure, overseen by a Board of Governors whose members are appointed to serve long terms, and reliant on its own source of funding, the Fed possesses a degree of independence that some argue is inimical to the spirit of democracy. Although this argument (and refutations of it) may be political or constitutional in nature, it is also rooted in certain notions about macroeconomic policy.

The power that the Fed wields is substantial. Along with fiscal policy, monetary policy is one of two kinds of policy that can be employed to influence aggregate demand. In the short run, both monetary and fiscal policy have the power to raise or lower employment. But they have opposite short-run effects on interest rates (expansionary monetary policy lowers interest rates and expansionary fiscal policy raises them), so that in concert they can achieve results that neither can in isolation. The long-run effects of the two policies are quite different from their short-run effects. Fiscal policy helps determine interest rates in the long run, but not the rate of inflation. Monetary policy largely determines the inflation rate, but cannot be used to fix interest rates in the long run. Policies based on the assumption that monetary policy can fix interest rates ultimately generate accelerating inflation or deflation.

Monetary policy affects inflation only after it affects employment. A policy structure that responds quickly to the immediate concerns of the public is thus more likely to generate inflation than one that allows policymakers to more easily weather bad times. A very responsive policy structure not only increases the likelihood of high inflation. It also tends to produce more business cycles if policy directed at reducing inflation is aborted before it is complete, only to be reintroduced again later when the renewed expansion makes inflation worse. On-again, off-again policies erode the credibility of the monetary authorities and make anti-inflation policy all the more costly and lengthy when it is undertaken in earnest.

Reducing the independence of the Fed either means reducing the ability to engage in discretionary policy or shifting economic power to the executive branch. This is an important consideration given the difficulty in calibrating policy. Because the legislative branch is not in a position to exercise day-to-day control of monetary policy, if it wishes to reduce the Fed's discretionary powers, it must choose between establishing policy rules to which the Fed must adhere or allowing the executive to administer policy. Economists who oppose rules fear that they would be too rigid to deliver economic stability in a highly complex economy.

Better coordination of monetary and fiscal policy is a double-edged sword. If "good" policy is pursued, it will be all that much better if simultaneously pursued with both tools. But if "bad" policy is pursued, using both tools to pursue it will make the result that much worse. Thus, the choice boils down to whether the policy structure should be one that maximizes the benefits that come from policy when it is well chosen or minimizing the costs that occur when policy is ill-advised. This report does not track legislation and will be update as events warrant.

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Introduction

The Constitution grants Congress the power to “coin money, and regulate the value thereof...” Congress has delegated responsibility for making U.S. monetary policy to the Federal Reserve System (Fed). This latter arrangement is one that many observers have criticized. Quasi-public in structure, overseen by a Board of Governors whose members are appointed to long terms, and reliant on its own source of funding, the Fed possesses a degree of independence that some argue is inimical to the spirit of democracy.

Although this argument (and refutations of it) may be political or constitutional in nature, it is also rooted in certain notions about macroeconomic policy. Debates concerning the ability of the Fed to control interest rates, the need for coordination of monetary policy and fiscal policy, or even the importance of monetary policy, underlie the arguments for and against independence, and are matters of economic analysis.

Thus, in undertaking a discussion of whether the Fed should have more or less independence or accountability, it is essential to understand how monetary policy works, and its role relative to fiscal policy. Without this knowledge, it is possible that a decision to change the structure of the Fed would fail to bring about the economic effects desired, or would bring about other, adverse, effects not expected by advocates of the change.

This report¹ gives a brief description of the structure of the Fed. It then discusses the economics of how Fed independence affects monetary policy. The report does not consider how Fed independence may affect the Fed’s other duties, such as its oversight of the financial system. It then examines the probable economic ramifications of proposals to curb the independence of the Fed.

Structure of the Federal Reserve System

Background

While there are many economic arguments supporting Fed independence, it is interesting to note that none of these arguments—nor the primary duties of today’s Fed that underlie these arguments—existed when the Fed was founded. Yet its structure today was largely determined in its earliest years.

The Federal Reserve System was created largely in response to the panic of 1907 and the many banking panics of the late 19th century. This is ironic, since the Fed later presided over the country’s worst series of banking panics in 1930-1933; federal deposit insurance would have to be created to prevent a reoccurrence of banking panics. Moreover, part of the Fed’s original mandate, to create an “elastic currency,” is believed to be an expression of the “real bills doctrine,” a notion held in low regard within the economics profession today. As one author states, it is “high on the list of longest lived economic fallacies of all time.”² Its job now, to

¹ This report revises and expands upon an earlier CRS report written by G. Thomas Woodward. His previous contribution is gratefully acknowledged.

² Mark Blaug, *Economic Theory in Retrospect*, Cambridge University Press (Cambridge: 1978), p. 56. The real bills (continued...)

conduct monetary policy, was not believed by most experts at the time of its creation to be a proper or even possible function of government. Before the 1930s, macroeconomic stabilization policy was not widely developed, and when it emerged from the Great Depression, monetary policy was seen as having little independent power to influence the economy and was just the helpmate of the more powerful fiscal policy. The Fed's principal method of undertaking monetary policy, open market operations, was not even envisioned at its creation; the technique of influencing the money supply through the sale and purchase of securities on the open market was inadvertently discovered during the early years of its existence as the Fed attempted to manage its portfolio of assets. For these reasons, it is not all that surprising that some observers believe that the Fed's structure is not well suited to its job.

Current Structure

The Fed's structure has been changed several times since it was established. Its current structure, however, is largely the same as that which emerged in the late 1930s. U.S. monetary policy is determined within the Federal Reserve System. At the top of the system is the seven-member Board of Governors appointed to staggered 14-year terms by the President with Senate advice and consent. No member may be reappointed to a new term after having served a full term. By the same appointment and approval process, a Chairman and Vice Chairman are selected from the seven to serve four-year terms. These terms do not coincide with that of the President. The President can remove Fed governors "for cause" before their term has ended, but not on the basis of policy differences or incompatibility.³ In practice, the President has never done so. The Chairman of the Fed, though considered quite powerful, has only one vote on the Board. His power derives principally from setting the Board's agenda, from his role as the Fed's representative in meetings with other government officials, and from his control of the Board's staff.

There are 12 regional Federal Reserve Banks, which were established in the belief that the system should safeguard against a concentration of power in New York or Washington. Each is set up as a private operation owned by member banks, with a nine-member Board of Directors. Six of the Board members are selected by member banks and three by the Board of Governors, including a chairman and deputy chairman. The Board of Directors then appoints the president and first vice president of its regional bank, subject to Board of Governors approval.⁴

The seven members of the Board of Governors sit with the president of the New York Federal Reserve Bank and four other regional bank presidents, who are selected on a rotating basis among the other 11 regional banks, on the Federal Open Market Committee (FOMC). The FOMC is responsible for determining the target for the federal funds rate, which is the inter-bank overnight lending rate. The target is maintained through open market operations, which is the principal tool of monetary policy. The discount rate, which is the rate at which the Fed lends to liquidity-constrained banks, is set by the Board alone upon application by a regional bank for a change.

(...continued)

doctrine claims that borrowing can be divided into two types—borrowing used for productive uses and borrowing used for speculative uses. According to the doctrine, only the latter type can be inflationary.

³ See Federal Reserve Act, Section 1-078.

⁴ For more information, see CRS Report RS20826, *Structure and Functions of The Federal Reserve System*, by Pauline Smale.

Money is placed into circulation through the purchase of U.S. Treasury securities. Because the system holds a large portfolio of securities, it earns income. Essentially, this is income from money creation and it is technically referred to as seigniorage. Member banks are the shareholders of the Federal Reserve Banks, and a dividend is paid to member banks corresponding to their stake in the system. After operating costs are deducted, and additions are made to its capital account (to maintain solvency), the rest is remitted to the Treasury, where it is recorded as “miscellaneous receipts.” In 2005, it was estimated that 92% of the Fed’s profits, or \$21.5 billion, was remitted to the U.S. Treasury. About 3% of its profits were paid in dividends to shareholder banks and 5% were added to its capital.

The way in which the Fed earns and passes on income means, first, that the government receives the revenue from money creation just as it would if, say, the Treasury administered monetary policy instead of the Fed. It means, second, that the Fed does not need a congressional appropriation of funds to operate. It has its own source of revenue and can conduct policy free of concern that budgetary pressure might be applied by those wanting to influence its decisions.

Although the Fed has great latitude in implementing monetary policy, the goals that it is mandated to achieve through monetary policy are determined by Congress. In this sense, monetary policy is neither independent nor undemocratic. Having said that, both opponents of the Fed’s independence and many economists would agree that the Fed’s current mandate is broad and vague, and, therefore, greatly enhances its independence for better or for worse. Its charge derives from the legislation that created it (Federal Reserve Act, P.L. 63-43), from which comes its responsibility to provide an “elastic currency”; the Federal Reserve Reform Act of 1977 (P.L. 95-188), which directs it to maintain stable prices, maximum employment, moderate interest rates, and sustainable growth; and the Full Employment and Balanced Growth Act of 1978 (P.L. 95-523), which requires it to relate its policy to the employment goals of the entire federal government set pursuant to the aims of the Employment Act of 1946 (P.L. 79-304).

As will be shown below, these goals frequently conflict. Collectively, they amount to telling the Fed that it is to make good economic policy. Given that these goals often cannot all be pursued simultaneously, and that some—even by themselves—can only be sustained temporarily, the Fed can usually find legislative authority for any monetary stance it assumes.

The Goals of Monetary Policy

Many recessions occur because aggregate supply exceeds aggregate demand. In other words, total spending is lower than what the economy is capable of producing. Economists attribute this phenomenon to the presence of price stickiness. When the demand for goods and labor falls, prices should fall to a point where adequate demand is restored. But because price adjustment does not happen quickly—due to the presence of contracts, menus, and uncertainty—output declines. This can lead to a vicious cycle where unemployment rises and resources fall idle—lowering aggregate demand further. In the long run, prices will adjust and the economy will return to its full potential. However, the examples of the Great Depression and the Japanese economy in the 1990s suggest that the long run can be very long indeed.

If the government does not wish to wait for this long run self-adjustment to occur, it has two primary tools at its disposal to boost aggregate demand. The favored tool at present is monetary policy. The Fed can inject newly printed money into the economy by purchasing U.S. Treasuries, a process referred to as expansionary monetary policy. Since prices do not adjust instantly, this

money will increase aggregate output if there are unused resources in the economy. The channel through which this spending increase occurs is lower interest rates. The cost of borrowing is lowered as the reserves available to the banking system expand. Thus, aggregate spending is boosted through higher investment spending on capital goods, equipment, and buildings and through higher consumption on interest-sensitive goods like automobiles, homes, and appliances. Aggregate spending is also boosted through the foreign trade sector. Lower interest rates attract less investment to the United States, and, other things being equal, this reduces demand for the dollar. As the exchange rate depreciates, foreign spending on U.S. exports and the U.S. production of import-competing goods will rise.⁵

In the long run, the printing of money can have no real effect on the economy—sustained inflation is a purely monetary phenomenon. Reductions in unemployment resulting from expansionary monetary policy are either temporary (if the economy was already at full employment when policy was changed) or would have eventually occurred anyway (if the economy was not at full employment). Prices will adjust to the increase in the money supply, causing inflation to rise. The closer the economy is to its full potential when monetary policy becomes expansionary, the more the increase in aggregate demand will be transmitted into higher inflation rather than greater output.

Differences Between Fiscal and Monetary Policy

Another stabilization tool at the government's disposal is fiscal policy. The government can boost its spending and finance it through an increase in its budget deficit (or a reduction in its surplus). This increases aggregate demand directly by increasing the government's purchase of goods and services. Similarly, the government can cut taxes through a smaller surplus or larger deficit, which boosts household spending by increasing disposable income (assuming that households spend the tax cut rather than save it). But unlike expansionary monetary policy, expansionary fiscal policy results in rising, rather than falling, interest rates, other things being equal. Interest rates rise because deficits are financed out of private saving. That results in the availability of less private saving for private capital investment. The demand for investment on a smaller pool of saving bids up the price of that saving, the interest rate. When the economy is deep in recession, the demand for investment may be very weak, and deficit spending will cause little upward pressure on interest rates. By contrast, if the economy is operating near full potential when expansionary fiscal policy is undertaken, then interest rates will rise substantially, crowding out most of the increase in aggregate demand caused by expansionary fiscal policy.⁶

When interest rates rise, foreign investment is attracted to the country, offsetting some of the decline in saving available for investment. However, this causes the dollar exchange rate to appreciate, which reduces foreign demand for U.S. exports and U.S. demand for import-competing goods. This also crowds out the boost in demand caused by expansionary fiscal policy to the extent that it causes interest rates to rise. Thus, as the U.S. has become more open to international capital flows and trade, monetary policy has become more powerful and fiscal policy less powerful. That is because exchange rate effects work to reinforce the effects of monetary policy on aggregate demand but offset the effects of fiscal policy.

⁵ See CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Gail E. Makinen and Marc Labonte.

⁶ See CRS Report RL31325, *The Federal Migrant Education Program as Amended by the No Child Left Behind Act of 2001*, by Jeffrey J. Kuenzi.

Unlike monetary policy, expansionary fiscal policy cannot lead to a sustained increase in the inflation rate—there is some limit beyond which the deficit will stop rising, even if it remains high. First of all, the deficit cannot exceed 100% of aggregate spending. Even before that point, the deficit must stop growing if the public can no longer reasonably believe that government bonds they purchase will be honored. But the money supply can keep growing as long as it is allowed to do so. As long as some people are willing to hold money, the money supply can grow; many historical examples of hyperinflation suggest that some people will hold money even at extremely high monetary growth rates.

While the ability of fiscal policy to raise or lower inflation is only temporary, monetary policy can only raise or lower (inflation-adjusted) *interest rates* temporarily. Using monetary expansion to push rates down in an economy that is fully employed will just stimulate higher prices. These higher prices will offset the initial depressing effect that expansionary monetary policy had on interest rates since the Fed has not changed the resources available in the economy for investment. On the other hand, fiscal policy can have a permanent effect on interest rates. A high level of government borrowing, even if the level is constant, can hold interest rates up indefinitely because of its effects on the saving available for investment.

Thus, in the short run both fiscal and monetary policy increase economic growth and inflation. But expansionary fiscal policy results in higher interest rates, whereas expansionary monetary policy results in lower interest rates. Likewise, contractionary fiscal policy lowers growth and inflation with lower interest rates as a result, whereas contractionary monetary policy leads to higher interest rates. In the long run, monetary and fiscal policy have very different influences, however. Fiscal policy helps determine the interest rate, monetary policy does not. Monetary policy determines the inflation rate, fiscal policy does not. Neither can permanently boost the long-run economic growth rate; this is determined by the growth rate of labor, capital, and productivity.

Policy Calibration, Lags, and the Role of Credibility

Obviously, not all the adjustments referred to above occur immediately. Otherwise there would be no short run imbalances and the economy would always be at full employment. Experience teaches that this is not the case. Historical evidence indicates that the full price effects from fiscal and monetary policy come roughly two years after the policy is implemented. Employment effects come much faster, within two or three quarters. The reason for this asymmetry in lags is price stickiness. Although hard to quantify, expectations play an important role here as well. If individuals expect inflation to accelerate or decelerate, it will do so more quickly, even if policymakers claim to desire otherwise.

The closer the economy is to full employment when demand management is undertaken, the faster the price effects will occur. But even in a fully employed economy, prices will not adjust quickly enough that output effects are zero and the full rise in inflation is immediate. Growth will be boosted, but the boom will be unsustainable and short lived. The legacy of expansionary policy will be higher inflation. Similarly, if faced with undesirably high inflation, contractionary policy will reduce output and increase unemployment in the short run. Only later will prices adjust to slow inflation.

Moreover, how long it takes inflation to slow down in response to contractionary policy, and how long higher unemployment must be endured, depend on the credibility of the central bank's anti-

inflation plan. If the public thinks that a contractionary policy will soon be abandoned, then prices will not be adjusted, and inflation and heightened unemployment will be slow to abate.

The role of credibility, expectations, and the state of the economy all result in variability in the length of the policy lag and the magnitude of the output response. Thus, it is difficult to design a policy with any precision that can systematically counteract the various pressures, which themselves are often poorly understood, that tend to generate swings in economic activity. This means not only is it impossible to calibrate policy well enough to avoid business cycles, but that attempts to do so may even make the cycles worse. In hindsight, some economists have blamed many recessions on monetary policy errors.

Criticisms of Independence

Criticisms of the Fed's structure break down to three notions. First, some believe the Fed is too independent in the sense that its decisions are too far removed from the will of the public. Second, critics say that monetary and fiscal policy are made in isolation from each other, so that there is no mechanism to guarantee their coordination. Third, others argue that as an institution, the Fed is insufficiently open or accountable, with its activities shrouded in secrecy and with little external supervision or examination of its outlays, management practice, and policy decisions.

In general, both those who argue for continued broad discretion and those who argue for change emphasize the importance of monetary policy for the economy and make it the center of their arguments. Basically, one side maintains that monetary policy is too important to be put into the hands of a few appointed officials. The other believes that it is too important not to do so.

While monetary policy is important, one must keep in mind how it is important. The short-run effects of monetary policy differ substantially from its long-run effects. Whatever argument is advanced to support or attack independence, it should not be predicated on the belief that the Fed's job is to control interest rates. The Fed's influence over the economy is short-term only. In the long run the Fed does not control real interest rates, and efforts aimed at controlling interest rates based on its short-run influence generally result in accelerating inflation or deflation.

Independence

Whereas fiscal policy is made jointly by the legislative and executive branches, monetary policy is influenced only indirectly by either. The long terms of Fed governors, the fact that they are appointed rather than elected, and the fact that the institution has its own source of funding means that Fed governors and other FOMC members are likely to be less responsive to swings in public opinion than are the makers of fiscal policy.

This does not automatically mean that the structure of the Fed is inconsistent with the traditional character of American government. For example, members of the federal judicial branch are appointed, in their case for life, and there is a constitutional prohibition on diminishing their salary while in office. It should again be stressed that the overarching goals of monetary policy are determined by Congress; it is merely the day-to-day implementation of those goals that has been delegated to an independent Fed. What makes monetary policy unusual is the fact that it is not implemented by the executive branch, whose chief is directly elected but is otherwise staffed by civil servants and appointees serving at the discretion of the chief. Thus, at issue is not

whether the Fed's independence is unique in our government—it is not—but whether its independence is appropriate or advantageous for the conduct of monetary policy.

Several elements of the earlier analysis bear on this issue. First, there is the difference in the short-run and long-run effects of monetary policy. The positive employment effects from an over-expansion of the money supply are temporary and experienced in the short run. The higher rate of inflation comes later—it would not even begin to be felt for a year or two, the length of a congressional term. The economic costs of high and variable inflation are well chronicled.⁷ Similarly, anti-inflation policy takes a long time to achieve its results; in the interim it causes an increase in unemployment. If elected officials seek short-term “gain” at the cost of long-term “pain,” this lag structure would impart an inherent bias toward inflation. It would also tend to produce more business cycles if policy directed at reducing inflation is aborted before it is complete, only to be reintroduced again later when the renewed expansion makes inflation worse.

By insulating decision-makers from the immediate effects of public pressure, proponents point out that independence may help offset that bias. The Fed may be better able than other institutions to resist the temptation to “gun” the economy in preparation for an election. Similarly, when attempting to reduce entrenched inflation, the Fed may more easily “tough out” criticism of a contractionary policy until inflation abates, thereby avoiding a premature policy reversal that renders the already-incurred unemployment costs pointless.

This argument in favor of independence is necessarily not one for total insulation of decision making. In fact, total insulation probably does not exist: many Fed critics believe there are many historical examples that suggest that political pressure led to incorrect decisions by the Fed. What it might suggest is putting monetary policy on a “slow fuse,” where outside judgement operates over a longer time horizon. Even then, the economic advantage of independence would have to be weighed against a number of non-economic factors favoring less independence.

Some proposals for change stop short of eliminating Fed independence. Whether it is worthwhile to decrease the Fed's independence by placing officials from the executive branch on the Board of Governors, or by subjecting the Fed's budget to congressional approval, is a matter of judgement of both a democratic and economic nature. But the economics of monetary policy is such that the cost of making the Fed more responsive to short-term public opinion would likely be an increased tendency to inflate the economy and to reverse anti-inflation policies before they have time to achieve their intended purpose. International evidence backs up this theory, at least when independence is broadly defined, since many central banks that do not enjoy a level of independence similar to the Fed have allowed higher inflation on average.⁸

The second element of independence, credibility, reinforces the first economic argument. In the short run, the responsiveness of inflation to changes in monetary policy depends in part on people's expectations of the Fed's behavior. Imagine that the Fed were to tighten monetary policy to reduce an uncomfortably high inflation rate. If people believed that the Fed would be unwilling to follow through with an anti-inflationary stance once unemployment rose, then people would reduce their inflationary expectations very slowly and cautiously. This would feed through into wage contracts and pricing decisions by firms that would cause inflation to be temporarily higher

⁷ See CRS Report RL30344, *Inflation: Causes, Costs, and Current Status*, by Marc Labonte and Gail E. Makinen.

⁸ See CRS Report RL31955, *Central Bank Independence and Economic Performance: What Does the Evidence Show?*, by Marc Labonte and Gail E. Makinen.

than expected given the change in monetary policy. Since it is sluggish price adjustment that causes unemployment to rise and output to contract in the short run, this suggests that the rise in unemployment caused by the contractionary policy would be greater and more persistent than if the central bank had greater credibility. Thus, even when a less independent central bank is resolved to pursue an anti-inflationary policy to its end, its lack of independence may lower its credibility, making the policy more painful and persistent in the short run than it otherwise would be.

Third, the alternative to an independent central bank has implications for the checks and balances of our government. Legislative bodies are not designed to administer policy; Congress could not fulfill the Fed's current task of setting discretionary policy on a day-to-day basis. Thus, Congress would have two choices: eliminate discretion through the adoption of a rule, an option considered below, or delegate the day-to-day administration of discretionary monetary policy to the administrative branch. The latter would tilt economic power significantly toward the executive. The checks and balances applicable to fiscal policy would not apply to monetary policy. Thus, eliminating the Fed's independence would not simply make the federal government more democratic; it would also have implications for the checks and balances of power that some might see as making the government less democratic.

To judge how important the economic benefits of Fed independence may be, it is useful to consider the example of fiscal policy. Like monetary policy, expansionary fiscal policy has short-run benefits, in terms of higher output and employment, and long-term costs, in terms of higher inflation and debt burdens. Perhaps the overwhelming reason why fiscal policy has fallen into disrepute with many economists as a stabilization tool is precisely because of the unwillingness of elected lawmakers to tighten fiscal policy (reduce a budget deficit) when aggregate demand is "overheating."⁹ A rule of thumb for effective fiscal policy is that the budget should be balanced over the business cycle—budget deficits in recession years should be offset by surpluses in boom years. In practice, the federal budget was in deficit in 36 of 37 years between 1961 and 1997, and returned to deficit in 2002 after four years of surplus.

Coordination

Some observers consider coordination an important element of Fed reform because under the current system monetary and fiscal policy are made separately. While coordination may take place, the Fed is free to follow a policy totally at odds with the fiscal stance taken by Congress and the President. It is entirely possible for monetary policy to be undoing what fiscal policy is doing with output and employment, or for monetary policy to be reinforcing the effect that fiscal policy is having on interest rates. Directed in concert, the two policies should be able to produce much more effective policy than if they are determined in isolation of each other.

In particular, using fiscal and monetary policy in concert allows aggregate demand to be influenced with minimal disruption to interest rates and the exchange rate, since fiscal policy pushes interest rates and the exchange rate in the opposite direction of monetary policy. This has several advantages. For example, if resources cannot be reallocated completely fluidly and costlessly, it may minimize the difference in output effects on particular sectors or regions of the

⁹ Other reasons why monetary policy is preferred by economists include the fact that the Fed's staff is more specialized, the fact that monetary policy can be altered more quickly because it does not go through the legislative process, and because of exchange rate and interest rate benefits to using monetary policy rather than fiscal policy.

economy in the short run. It may also prevent economic imbalances from forming or mitigate existing imbalances in the short run. Furthermore, it may make long-term business planning more predictable, since such planning is highly dependent on interest rates and exchange rates.

However, if fiscal and monetary policy were coordinated, they could also produce much worse policy. Just as a well-conceived fiscal policy can be enhanced by monetary policy designed to support it, an ill-conceived fiscal policy can become all that more damaging to the economy if reinforced by a monetary policy made to go with it. Hence, good policy can be much better if monetary and fiscal policy are coordinated, but bad policy can be made much worse.

The potential for ill-conceived coordination is particularly great due to the relative roles of the two policies in affecting interest rates and inflation. Large fiscal deficits frequently arise from a deadlock concerning whether to raise taxes or reduce spending. These deficits tend to hold interest rates higher than they would be otherwise. In systems amenable to coordination, the temptation thereby arises to use expansionary monetary policy to lower interest rates that have been forced up by fiscal policy. Since interest rates are not something that monetary policy can influence in the long run, the result is accelerating inflation, an outcome that large deficits could not achieve on their own.

In this regard, it is worth noting that studies of hyperinflations have consistently identified two essential components of the policies that ultimately brought such episodes to an end; one of them is an independent central bank capable of refusing a government's requests for money.¹⁰ Clearly, coordination has not always proven a recipe for sound demand management policy.

The fiscal situation of the government in the 1980s and early 1990s illustrates the dilemma well. Large budget deficits tended to keep interest rates high, and relatively little progress was made in bringing deficits down until the late 1990s. Had the Fed been under the control or influence of the Administration or Congress, they would have had the option of "coordinating" this fiscal policy with more expansionary monetary policy as a solution to the problem of high interest rate effects. Since such policy is short-run in its effect, the effort to coordinate policy in this way would be inflationary.

This observation does not imply that coordination is undesirable. Rather, it highlights the cost of coordination: the risk of putting all policy eggs in one basket. The current division of economic policy responsibilities, therefore, produces yet another check-and-balance arrangement. Because of this split in responsibilities, no stabilization policy is likely to be carried very far in one direction unless consensus is achieved among different policymaking bodies.

Proposals to better coordinate monetary and fiscal policy, including placing monetary policy under the control of the Treasury, putting a Treasury official on the Board of Governors, and matching the term of the Fed chairman with that of the President, raise this balance-of-power dilemma. Opting for more or less coordination therefore boils down to a trade-off between maximizing the benefits that come from policy when it is well-chosen and minimizing the costs that occur when policy is ill-advised.

¹⁰ For example, see Thomas Sargent, "The Ends of Four Big Inflations," in R. Hall, ed., *Inflation: Causes and Effects* (University of Chicago Press, 1982).

Accountability and Disclosure

The third area of concern to critics of the Fed's independence is the secrecy with which operations at the Fed are conducted. Transcripts of the FOMC's deliberations are not released for five years, and minutes of FOMC meetings are released only after the following FOMC meeting. The Board is audited by outside auditors. (Board staff audit the regional Fed banks.) The Government Accountability Office (GAO), already the auditor of a variety of sensitive government agencies and regulatory bodies, is limited in what kinds of audits it can conduct of the Fed. It is specifically prohibited from auditing the Fed's monetary policy activities.

The issue of accountability should be viewed as distinct from the issue of democracy. Democracy—in this case, the potential shifting of the powers of the Fed to elected officials—is one approach to increasing accountability, but it is not the only one. The next section considers an alternative method of increasing accountability, the use of rules. Hence, some may advocate greater Fed accountability without favoring diminished Fed independence.

There is little that economic analysis can contribute to this area of debate. Policy may be better or worse under greater public scrutiny, and whether it is or not must be judged in terms of what best makes for "good government." Accountability could have two economic effects worth exploring. First, what costs does secrecy impose on markets? Second, how would greater disclosure affect the Fed's behavior and Congress's oversight abilities?

Fed-watching engages real resources, albeit small in comparison to the overall economy, in the task of second-guessing monetary policy. In addition, costs may be imposed by market fluctuations caused by unfounded speculation over Fed policy. The rational expectations literature stresses the importance of information about both the present and the future in making efficient decisions. If the Fed's secrecy creates needless uncertainty, economic efficiency and welfare could be reduced. Presumably, if more information on Fed deliberations were available to the public these costs could be reduced.

The need to out-guess the Fed, however, does not so much result from Fed secrecy as much as from the use of discretion in monetary policymaking. The advantage in any market is in predicting events before someone else does; this is true whether market agents are trying to figure out what Fed policy is or what it will be. And as long as discretion is employed, there are limits on just how much policy can be spelled out in advance. Thus, proposals to increase disclosure (e.g., through immediate release of FOMC minutes or official statements concerning the Fed's intermediate targets) might not do much to diminish Fed-watching. Nor would a reduction in independence diminish Fed-watching if the new policy regime were based on discretion.

However, more complete disclosure might have a different benefit. It might produce better policy. The fact that the Fed can make pronouncements about policy in vague, qualitative terms allows the potential for policy to be made in an ad hoc or idiosyncratic way. Whether it does so in fact is not clear—indeed, it is impossible to judge objectively given that its pronouncements are vague. The members of the FOMC may have very definite models of economic behavior in mind when deciding whether to tighten or loosen policy. Whatever those models are, however, they are not always clear to outside observers.

Proponents of more complete disclosure believe it could promote more closely reasoned decisions about policy that reflect just what economic events are considered by the FOMC to be indicative of a certain policy, why that policy follows logically from those events, and what future events

would be accepted as evidence that the policy is no longer appropriate. This view holds that fuller disclosure would force the Fed to specify its picture of the economy and thereby help ensure that one actually exists.

Better accounting of the Fed's actions could also help Congress in its oversight of Fed performance. Congress has the Congressional Budget Office (CBO) and the Joint Committee on Taxation to help provide independent evaluation of fiscal and tax policy. But it must depend on the Fed itself in assessing monetary policy much more than it does on the Treasury or Office of Management and Budget (OMB) in tax and budgetary matters. Independent evaluation of the Fed's actions on a periodic basis could put Congress in a position more analogous to that it is in when studying fiscal and tax policy.¹¹

Other economists would argue that there is a limit to achieving adequate disclosure and oversight as long as the Fed explains its decisions qualitatively rather than quantitatively. For example, when reading the Fed's policy statements, some Fed watchers claim that the Fed's view of the potency of monetary policy—and hence personal culpability—sharply declines whenever there is an economic downturn. Ultimately, they argue, only rules that link hard data to policy decisions can be judged objectively.

What If Rules Replaced Discretion?

Critics of Fed independence cannot complain that the goals of monetary policy have been determined in an undemocratic fashion: the goals of the Federal Reserve are mandated by Congress. To a great extent, if the Fed's policymaking is vague and unaccountable, it is because Congress has given it a vague and oftentimes internally inconsistent mandate. Rather, opposition to Fed independence lies with the fact that unelected officials have considerable discretion in pursuing that mandate, and the fact that voters and elected representatives have limited institutional oversight to ensure that the Fed fulfills its mandate.

Since the economics of independence suggest considerable economic disadvantages would arise from shifting discretion to elected officials, most economists concerned with the status quo have focused instead on devising ways to remove discretion from monetary policy. Their efforts have focused on strengthening the Fed's mandate such that it ceases to be a fuzzy guideline and instead becomes a strict rule. With a precise enough rule, decision-making by the Fed would be largely unnecessary, and accountability would be straightforward. "Fed watching" would be unnecessary as markets would never need to second-guess what motivated policy decisions and what decisions would follow a change in economic conditions. Policy would change predictably and automatically as economic data became available.

The drawback to a rule-based policy regime lies in the fact that the Fed does not precisely or directly control the variables with which it is most concerned—notably, inflation or the growth rate of aggregate demand. Its interest rate decisions influence these variables, but imprecisely, variably, and with long lags in their effectiveness. Thus, rules based on the variables of ultimate concern cannot be applied in a straightforward and easily verifiable fashion. Alternatively, the

¹¹ Evaluations in this context should be distinguished from audit powers proposed for GAO in some proposals. Unlike the economic analysis performed by support agencies such as CBO or the Joint Tax Committee, audits of the type conducted by GAO are essentially checks of accounting and management procedures. Thus, granting of broader audit powers would not be expected to generate independent economic evaluations of Fed monetary policy.

variables that the Fed can control are not variables that influence society's economic welfare in and of themselves. A rule could direct the Fed to cause the money supply to grow at a certain rate, to fix short term interest rates at a certain level, to fix the exchange rate value of the dollar, or to keep the price of gold constant. But none of these rules would be directly related to economic stability. Targeting the growth rate of the money supply or the price of gold would not deliver economic stability because neither are predictably or systematically related to economic growth or inflation. Fixing interest rates would not provide economic stability because the Fed only controls the supply of short-term credit. Variability in the demand for credit means that different interest rates are appropriate at different times. Fixing the exchange rate may increase external stability, but is unrelated to internal stability. The other drawback to a rule is that since the Fed has only one tool, it can potentially target only one variable with any precision. But it is concerned with at least two variables, inflation and the growth of aggregate demand. More goals dilute the effect that its policy tool has on each particular goal.

This difference between policy goals and the policy tools available explains why discretion exists in the first place. If there were a simple relationship between the Fed's actions and their effect on inflation and unemployment, the Fed would not need to use its discretion in determining the proper policy. The minority of economists who see the Fed itself as the primary cause of economic instability in the 20th century would argue that any strict rule, regardless of how directly related to inflation and demand growth, would lead to greater economic stability than discretionary policy. But most economists accept that economic stability rests upon the use of monetary policy to stabilize inflation and demand growth. Those who accept this but oppose discretion have endorsed the "Taylor rule," developed by economist John Taylor, now Undersecretary of the Treasury. Under a Taylor rule, the Fed would automatically alter interest rates based on a simple equation that responds to changes in inflation and output growth. Detractors of this and other rules stress that interest rate changes do not always influence the economy predictably, uniformly, or promptly; thus, the use of a rule could potentially be destabilizing, particularly in times of crisis.¹²

Between the polar alternatives of complete discretion and strict rules lies a spectrum of looser rules that would reduce but not eliminate the Fed's discretion. The most famous of these is an inflation target, which has been adopted by several foreign central banks, including the European Central Bank and the Bank of England.¹³ An inflation target would mandate that the sole goal of monetary policy is to keep the inflation rate equal to a predetermined rate (or within a predetermined band) in the long run. But unlike a strict rule, central bankers would remain free to use their discretion to reach their target. If this rule were strictly interpreted, it would be quite strict indeed—even small increases in inflation would lead to sharp increases in interest rates under any circumstances, and vice versa. But it could be destabilizing since demand growth would be neglected entirely. For instance, an oil shock could simultaneously cause a recession and an acceleration in the inflation rate. A strict inflation target would require the central bank to raise interest rates, worsening the recession. In practice, foreign central banks have proven quite responsive to changes in demand growth, even when inflation is above its target. And their mandate has typically included many caveats and exemptions to ensure flexibility. This raises the

¹² For more information on monetary policy rules, see CRS Report RL31050, *Formulation of Monetary Policy by the Federal Reserve: Rules vs. Discretion*, by Marc Labonte.

¹³ For more information, see CRS Report 98-16, *Should the Federal Reserve Adopt an Inflation Target?*, by Marc Labonte and Gail E. Makinen and CRS Report RL31702, *Price Stability (Inflation Targeting) as the Sole Goal of Monetary Policy: The International Experience*, by Marc Labonte and Gail E. Makinen

criticism that inflation targets have not meaningfully reduced discretion—central bankers are still free to do as they see fit.

Viewed objectively, an inflation target strikes a balance between rules and discretion, and enjoys some of the benefits but suffers from some of the drawbacks of both. Under an inflation target, it seems unlikely that inflation would be allowed to get out of hand for long without ramifications.¹⁴ Central bankers could no longer justify any policy stance by pointing to conflicting parts of their mandate. In this way, accountability would be increased. On the other hand, an inflation target as practiced still lacks a quantifiable way to evaluate specific discretionary decisions. As economists Ben Bernanke and Frederic Mishkin (now Chairman and Governor of the Federal Reserve, respectively) argue, “constrained discretion” is probably a more apt description of the international experience with inflation targets.¹⁵

Would a rule-based monetary policy be a more democratic arrangement than discretionary control by unelected officials? The answer to that question is beyond the scope of this report. Economist Milton Friedman, for one, believed it would be more democratic. In Friedman’s eyes, the contrast between rules and discretion in monetary policy was analogous to the contrast between the Bill of Rights and leaving decisions of individual liberty in the hands of the legislature. He reasoned satirically,

Why not take up each (free speech) case separately and treat it on its own merits? Is this not the counterpart to the usual argument in monetary policy that it is undesirable to tie the hands of the monetary authority in advance; that it should be left free to treat each case on its merits as it comes up? Why is not the argument equally valid for speech?¹⁶

Conclusion

An argument against independence cannot be predicated on the belief that interest rates can be fixed or that inflation and recession could always be avoided if interest rates were never raised. Instead, an economically valid argument against independence can be made as long as it recognizes that the positive effects interest rate reductions have on output and employment come sooner than the negative effects interest rate reductions have on inflation. Similarly, anti-inflation policies bring short-term pain and only long-term rewards.

In such circumstances, independence, or partially insulating the Fed from short-term political pressures through institutional arrangements, is a way to make painful but necessary policies more likely to occur. There are also some possible economic drawbacks to independence that merit consideration. First, oversight is difficult in the current system, and this makes it difficult to prevent or reverse poor policy decisions by the Fed. Second, potential benefits of coordinating monetary and fiscal policy cannot be secured. While disallowing coordination means that the benefits of good policy cannot be maximized, it also means that the effects of bad policy can potentially be minimized.

¹⁴ In this vein, the recent Japanese experience of prolonged deflation suggests that an inflation target should also have a lower boundary to prevent the persistence of poor policy in the other direction.

¹⁵ Ben Bernanke and Frederic Mishkin, “Inflation Targeting: A New Framework for Monetary Policy?” *Journal of Economic Perspectives*, vol. 11, no. 2, spring 1997, p. 106.

¹⁶ Milton Friedman, “An Independent Monetary Authority,” in Leland Yeager, ed., *In Search of A Monetary Constitution* (Cambridge: Harvard University Press, 1962), p. 240.

If reducing or eliminating Fed independence were deemed too economically costly, are there alternative reforms that could be considered to address the issues that critics have raised? Monetary policy rules are another way to make policy immune from detrimental short term pressures, and they do not suffer from some of the drawbacks of independence. Rules would also boost accountability and some might view them as more democratic in the sense that they reduce the discretionary power of unelected officials. The economic tradeoff between rules and discretion is of a different nature. It boils down to a question of how well a highly complex economy can be stabilized by a blunt and simple rule. Economists are highly divided on this point. Many of those who support rules do so because they have little faith in the ability of the FOMC to make better discretionary decisions than a simple rule.

An inflation target, as it has been practiced abroad, is a modest middle path between strict policy rules and unlimited discretion, but only because it has not been implemented too literally. Congressional oversight suffers from having the Fed's goals as vaguely defined as they are at present. An inflation target would tighten those goals and increase accountability if persistently egregious policy errors were made. It would not, however, significantly reduce the Fed's independence as it attempted to devise discretionary monetary policy for a highly complex and changing economy.

The economic arguments for and against Fed independence evaluated in this report apply only to the Fed's monetary policy responsibilities. Arguments for and against reassigning the Fed's other duties, such as bank regulation, to a less independent entity are beyond the scope of this report.

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