



FEDERAL RESERVE BANK *of* ST. LOUIS
CENTRAL TO AMERICA'S ECONOMY®

Central Bank Independence and Accountability

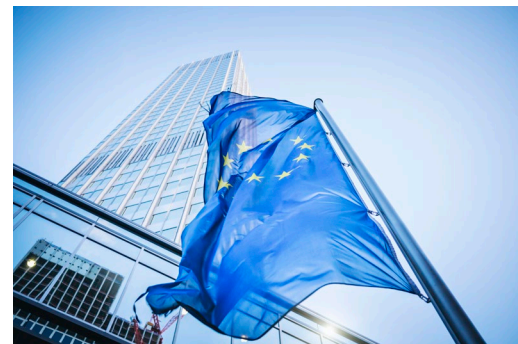
David C. Wheelock
Senior VP and Policy Advisor

Dialogue with the Fed

May 5, 2021



The Federal Reserve Bank of St. Louis



The European Central Bank

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Presentation Outline

- What is central bank independence and why is it important?
- How about a gold standard?
- How independence was built into the Federal Reserve System
- How the Fed lost and then regained independence
- Making tough decisions in a politically charged environment: Can a central bank be both independent and accountable?

As always, these are my views and not necessarily official positions of the Federal Reserve Bank of St. Louis or Federal Reserve System.

Central Bank Independence

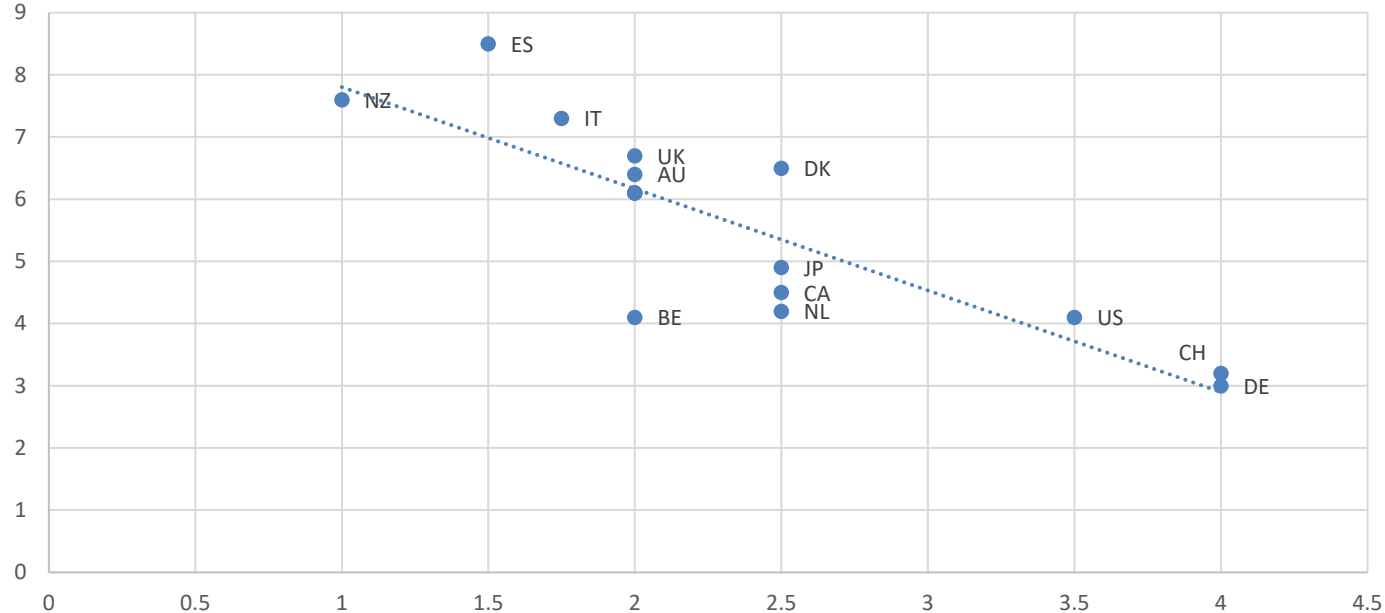
- Independent from what?
 - From political interference, but also from the banking industry or others with special interest in policy decisions
- Independence about what?
 - Monetary policy or other actions in the performance of assigned responsibilities (e.g., banking supervision)
- Operating independence vs. goal independence
 - Congress assigns the goals (“dual mandate”); consistent with the law, the Fed determines how to execute policy to achieve those goals.
- No central bank is fully independent

The Case for Central Bank Independence

- Good policymaking often requires a focus on the medium-to-long run.
- The election cycle encourages politicians to focus on the near-term, which gives rise to a “political business cycle” (short-run political focus applies not only to monetary policy but to other long-term problems, e.g., Social Security and climate change).
- Countries with independent central banks have:
 - Lower average and less variable inflation
 - Higher average growth of real GDP (esp. developing countries)

Central Bank Independence and Inflation

Average Inflation Rate, 1955-88 (percent)

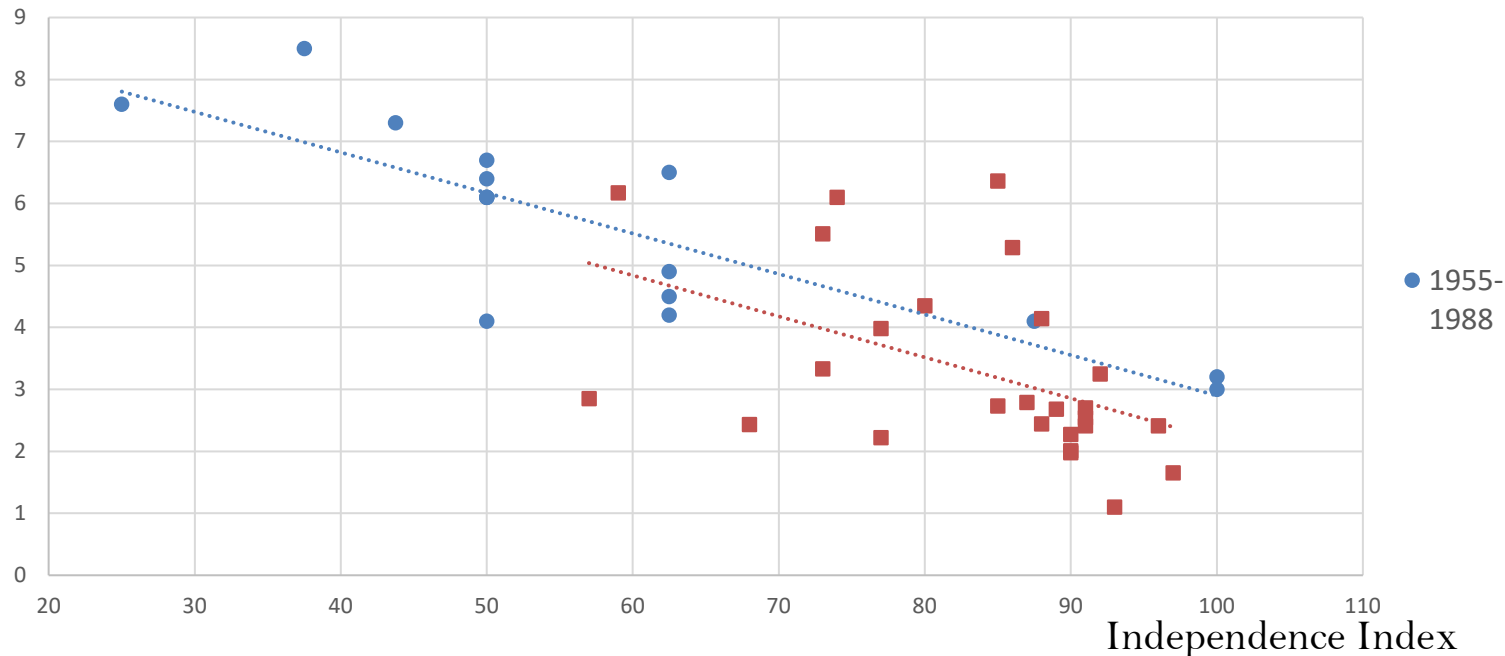


Alesina and Summers' Independence Index

Sources: A. Alesina and L. Summers. "Central Bank Independence and Macroeconomic Performance." JMCB 25 (May 1993).

Central Bank Independence and Inflation

Average Inflation Rate (percent)



What about the Gold Standard?



1851 United States Twenty Dollar Coin

© Image by princessdlaf/iStock/Getty Images Plus



This 90-ton steel cylinder set in a 140-ton steel-and-concrete frame protects the only entrance into the vault.

The gold vault at the New York Federal Reserve Bank

Photo Credit: FRB New York

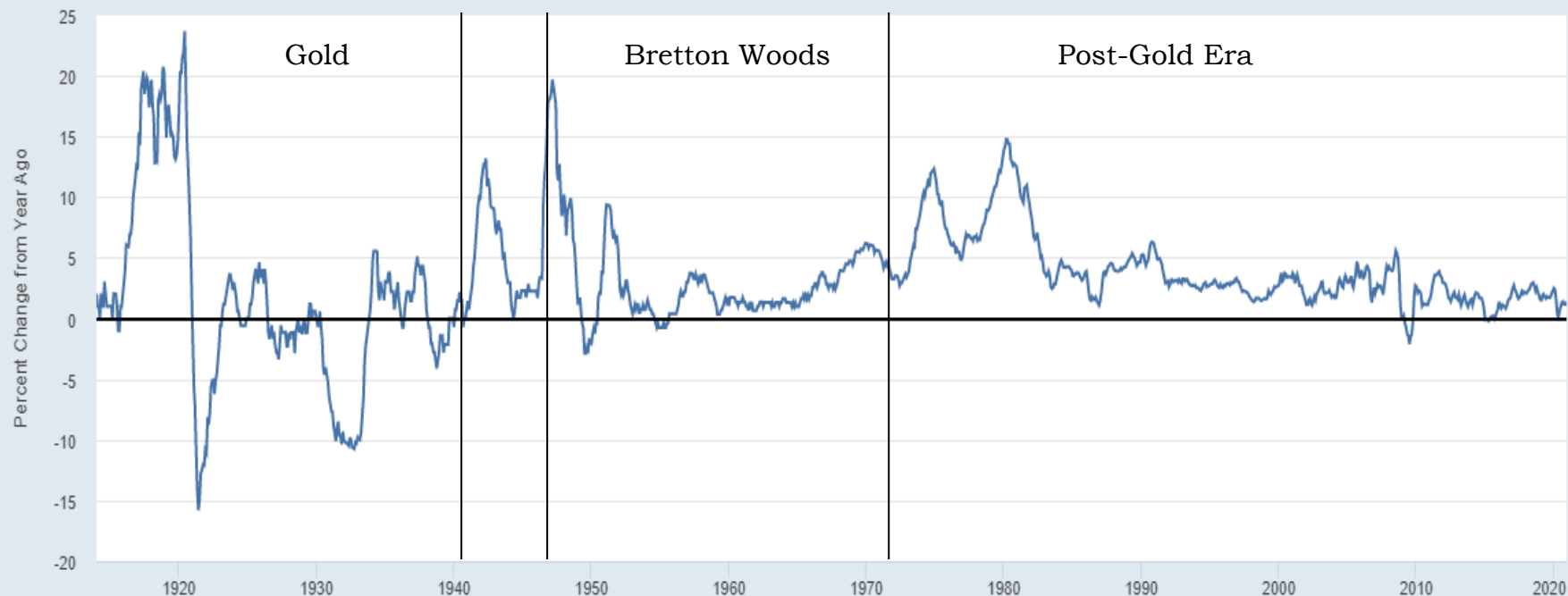
Is CBI as Good as Gold?

- Gold emerged as a dominant form of money long before there were central banks. Governments invented central banks partly to get around the constraints of a gold standard (gave the central bank monopoly privileges in exchange for loans).
- But gold standards i) don't ensure price stability (check out the next chart!), and ii) waste economic resources. A gold standard would cede monetary policy to the largest producers (China, Australia, Russia – top 3 in 2018) and vagaries of the gold market.
- An independent central bank with a mandate for price stability can achieve price stability without the resource costs or risks.

Price Stability?

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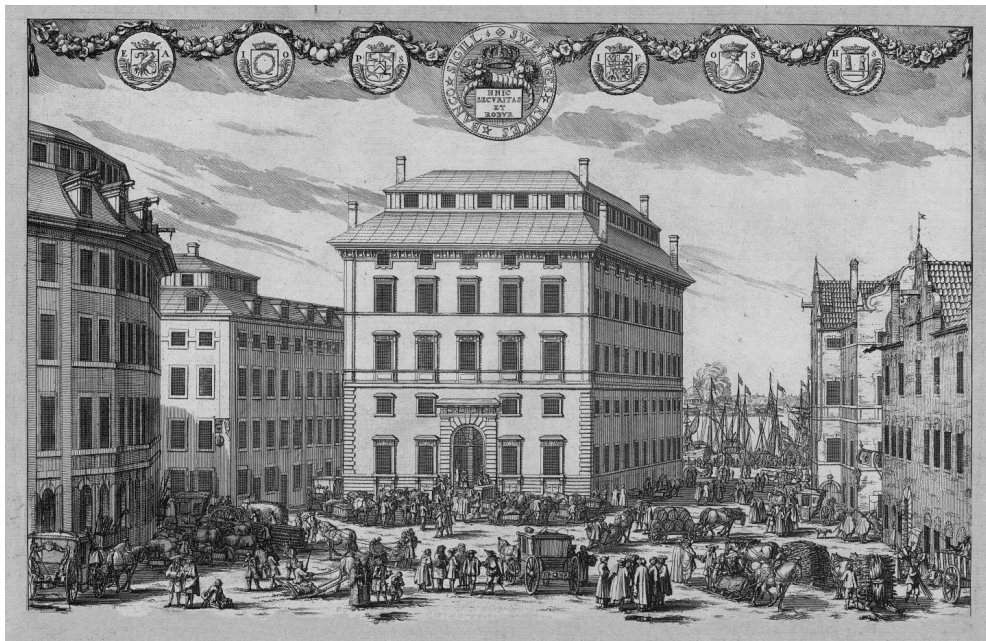
— Consumer Price Index for All Urban Consumers: All Items in U.S. City Average



Source: U.S. Bureau of Labor Statistics

fred.stlouisfed.org

World's First Central Bank (The Riksbank, 1668)

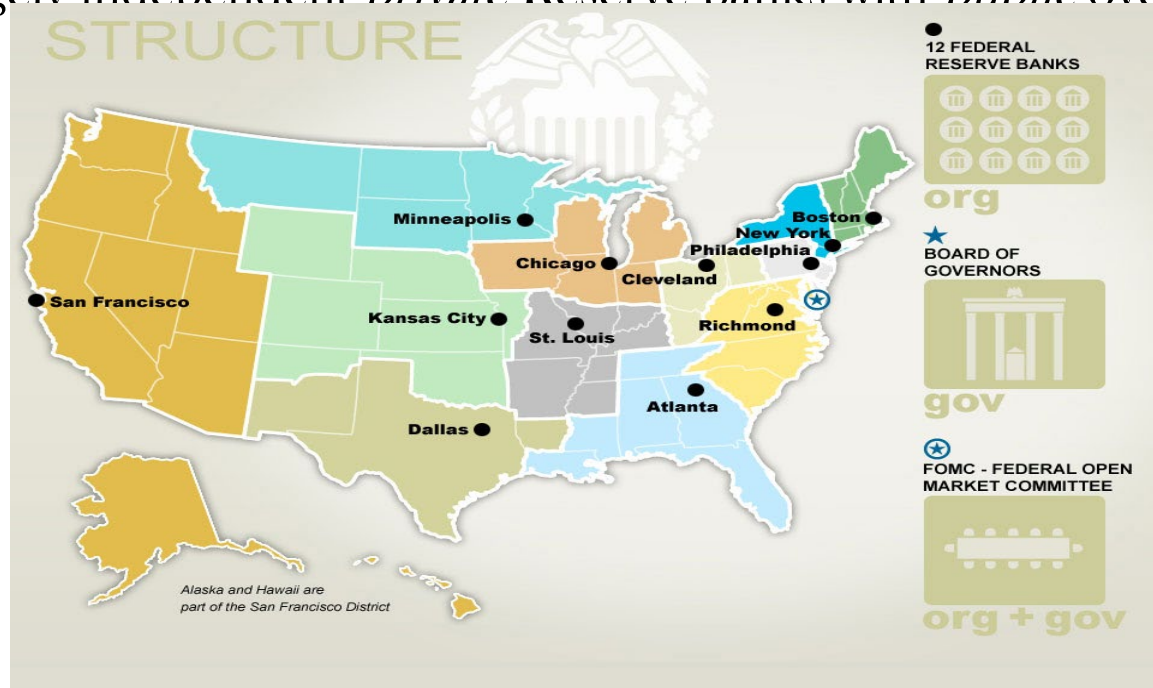


Independence and the Founding of the Fed

- The Fed was established in 1914 — long after 1776 because politicians and bankers could not agree on the need for a central bank or how it should work.
- Banking panics indicated a need for a central bank, but in what form?
 - Wall Street banks wanted a European-style, private central bank.
 - Progressives wanted a federal government-run central bank.
 - Main Street banks feared a Wall Street-dominated central bank, but most did not want a government-run central bank.
- The Fed, with 12 Reserve Banks (private) and government oversight (the Board, public) was the compromise.

The Solution: Not A “Central Bank”

The Federal Reserve Act of 1913 established a system of *regional*, largely independent *private* Reserve banks with *public* oversight



The Fed Has Never Been Fully Independent

- The Treasury secretary was a member of the Federal Reserve Board until 1935, but the Reserve Banks largely determined monetary policy.
- The Great Depression: Fed mistakes brought calls for reform. The Banking Act of 1935 gave the Board a majority on the FOMC. The Fed also became subservient to the Treasury *de facto* as the Treasury received new powers that could override the Fed (although the Treasury secretary was removed from the Board).
- World War II: The Fed agreed to peg the yields on Treasury debt. The Fed remained committed to financing government debt at low interest rates until 1951.

Independence!

The Accord (March 1951): The Fed and Treasury agreed to free the Fed to pursue monetary policy. McCabe is out; Martin is in as Fed chair.

RELEASE MORNING NEWSPAPERS,
Sunday, March 4, 1951.

S-2614



Thomas B. McCabe
© Harris & Ewing

The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.



William McChesney Martin Jr.
Photo: Public Domain

Independence Since the Accord

- The Fed's independence comes from the long terms of Board members (14 years), the selection and role of the Reserve Bank presidents, and budgetary autonomy. Congress could change or eliminate independence through legislation.
- Political forces and incentives might preserve Fed independence:

“What saves the Federal Reserve in the long run is that the Congress doesn't want the Administration to have control of the Fed, and the Administration doesn't want Congress to have control of the Fed.” -
Paul Volcker

Political Pressures Since the Accord

Since the Accord, Fed Chairs have sometimes had uneasy relationships with the Presidents who appointed them, or with members of Congress.



**Fed Chair William McChesney Martin Jr. &
President Lyndon Johnson**
Photo Credit: FRB Atlanta



Fed Chair Arthur F. Burns & President Richard Nixon
Photo Credit: Ford Library



Fed Chair Jerome H. Powell & President Donald Trump
Photo Credit: The White House

If you can't stand the heat...

“The Fed interest rate way too high, added to ridiculous quantitative tightening! They don't have a clue!” “China is not our problem ... Our problem is with the Fed.” “My only question is, who is our bigger enemy, Jay Powell or Chairman Xi.” – *President Donald Trump, tweets of June 11, Aug. 14, and Aug. 23, 2019.*

“Mr. Martin, I submit that the Federal Reserve has failed miserably and is continuing to fail in meeting its obligations to the economy in a wartime period. Outside of the Vietcong, I do not know of any institution that has done more damage to the American economy in the past few years.” – *Rep. Wright Patman, Feb. 14, 1968.*

The Ebbs and Flows of Political Pressure

- Truman put his choice, Martin, at the Fed. Martin believed that the Fed is “independent *within* government,” not “independent *of* the government.”
- Most presidents have used their Treasury secretaries and others to apply pressure. An example from 1965
- LBJ’s direct approach
- Nixon-Burns. The Great Inflation
- Reagan to Obama: mostly hands off the Fed. The Great Moderation
- The financial crisis fueled a new debate about Fed independence: “Audit the Fed!”

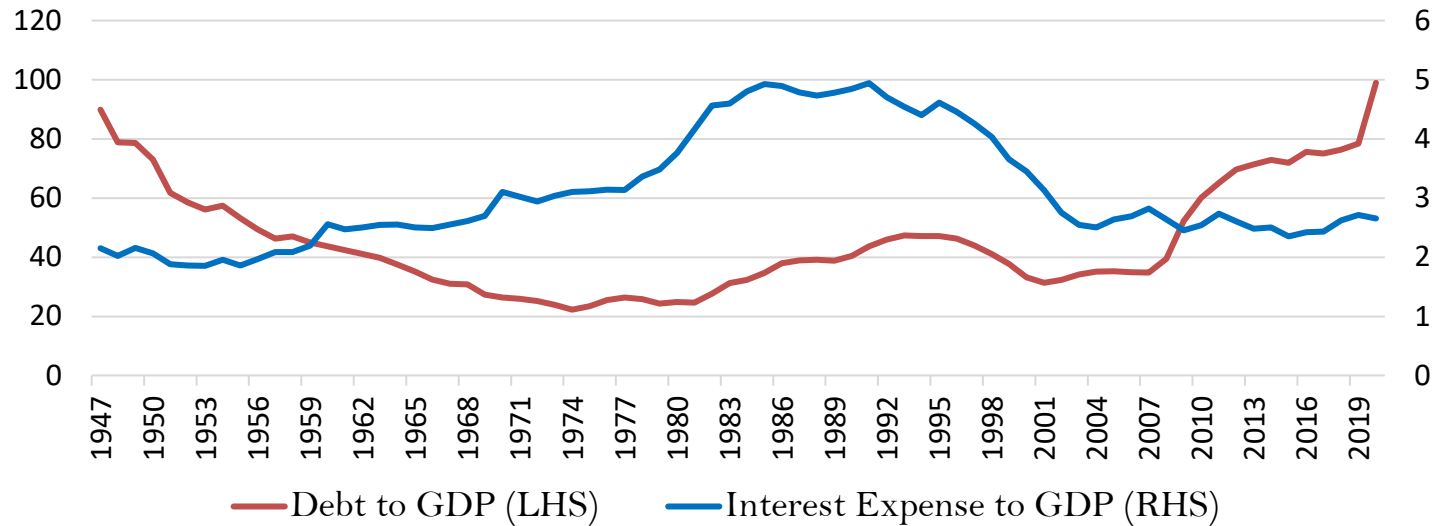
Are Big Deficits a Threat to Fed Independence?

- The Fed was subservient to the Treasury during World War I and II.
- Deficit spending during the Korean and Vietnam wars increased pressure on the Fed to hold down the government's borrowing cost.
- Volcker was subject to heavy pressure when deficits increased in the early 1980s, but Reagan mostly tolerated Volcker.
- Relative to GDP, the federal debt is back to WWII levels and projected to grow further, but interest expense is currently low. Implications for the Fed's independence and for inflation?

National Debt Measures

Debt and Interest Expense Relative to GDP

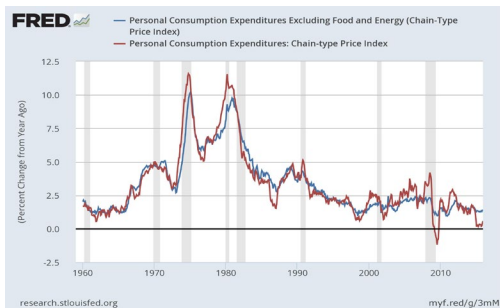
United States 1947 - 2020 (percent)



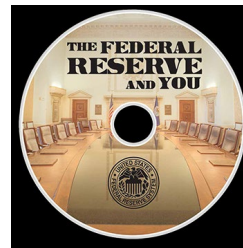
Sources: U.S. Bureau of Economic Analysis.

Independent but Accountable

Independence requires accountability and transparency. The Fed is accountable through congressional testimony, press conferences, published minutes and transcripts, etc. Ultimately, a central bank should be judged on its performance toward achieving the goals set by the public through their elected officials.



Fed Chair Jerome H. Powell
Photo Credit: Public Domain



Annual Report



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Questions?

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