PAGE ONE Economics®

Independence, Accountability, and the Federal Reserve System

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> "Congress has given us an important degree of independence so that we can effectively pursue our statutory goals based on facts and objective analysis. We appreciate that our independence brings with it an obligation for transparency and accountability."[1]
> —Jerome H. Powell, Chair of the Board of Governors of the Federal Reserve System

The year 1979 was a pivotal year in U.S. economic history. Inflation had been rising during the 1970s and was running over 11 percent by June of 1979. That summer, President Jimmy Carter nominated Paul Volcker to chair the Board of Governors of the **Federal Reserve System**. Volcker was a larger-than-life public servant whose experience as undersecretary of the U.S. Department of the Treasury and president of the Federal Reserve Bank of New York had prepared him for the difficult task of taming inflation. Volcker's (then controversial) strategy was to fix inflation by decreasing the growth rate of the **money supply**, even if that meant higher interest rates. And interest rates did rise. The **federal funds rate**, which was already 10 percent, reached 19 percent by mid-1981,[2] pushing mortgage rates as high as 18 percent. These higher interest rates discouraged borrowing for consumption and investment, contributing to back-to-back recessions and an unemployment rate that peaked at nearly 11 percent.[3]

Volcker's policies quickly made him one of the most unpopular people in the United States. Farmers protested the high interest rates by driving their tractors to blockade the Federal Reserve's headquarters in Washington D.C., and construction workers mailed two-by-fours to Volcker with pleas to reduce interest rates written on them (Figure 1). But it wasn't until the summer of 1982 that Volcker felt confident that the Fed had broken the back of inflation.

Today, many economists credit the long period of low and stable inflation since the Volcker years to his willingness to stand against popular pressure and deliver the powerful medicine needed to cure the nation's economic ills. While Volcker's persistence was necessary, the *Volcker Disinflation* (as it is now known), was only possible because the Federal Reserve had enough independence that its leadership could take the unpopular but necessary measures needed to reduce inflation.

GLOSSARY

Central bank: An institution that oversees and regulates the banking system and quantity of money in the economy.

Federal funds rate: The interest rate at which a depository institution lends funds that are immediately available to another depository institution overnight.

Federal Reserve Act: The 1913 act of Congress establishing the Federal Reserve System.

Federal Reserve System: The central bank system of the United States.

Maximum employment: The highest level of employment that an economy can sustain while maintaining a stable inflation rate.

Monetary policy: Central bank actions involving the use of interest rate or money supply tools to achieve such goals as maximum employment and stable prices.

Money supply: The quantity of money available in an economy. The basic money supply in the United States consists of currency, coins, and checking account (demand) deposits. Also known as money stock.

Open market operations: The buying and selling of government securities through primary dealers by the Federal Reserve in order to influence the money supply.

Price stability: A low and stable rate of inflation maintained over an extended period of time.

Figure 1
2 × 4 Wood Mailed in Protest to Paul Volcker

Home builders across the country were concerned about interest rates. This 2×4 sent to Fed Chairman Paul Volcker reads, "Help! Help! We Need You. Please Lower Interest Rates. Jackson Miss. Home Builders."

SOURCE: FRASER®, Federal Reserve Bank of St. Louis: https://fraser.stlouisfed.org/archival/5182/item/527430; https://fraser.stlouisfed.org/archival/5182/item/527431, accessed March 11, 2020.

Independence and Accountability

The Federal Reserve System was created as the **central bank** of the United States when Congress passed, and President Woodrow Wilson signed, the **Federal Reserve Act** in 1913. The Federal Reserve Act, and the resulting institution, reflect two foundational beliefs—independence and accountability Throughout its history, the Federal Reserve has felt the tension between these objectives—maintaining the independence necessary for sound policymaking while also remaining accountable to the electorate.[4]

Here's why independence matters: Elected officials serve relatively short terms; for example, two years for U.S. representatives and six years for senators. While short term lengths ensure that elected officials are accountable to the public, they can also create political incentives for politicians to pursue short-run outcomes over long-run outcomes. In other words, politicians are prone to focus on the next election—which creates what some refer to as the "political business cycle." For example, because many voters hold the economy as one of their primary voting issues,[5] elected leaders interested in winning their next election will likely resist efforts to increase interest rates in the short term, even if it would be a good long-term decision. In economic terms, this can lead to an inflationary bias (an ongoing preference for lower interest rates).

In contrast, effective economic policymaking often requires a focus on the medium to long run. For example, Volcker's policies resulted in job losses for many Americans in the near term. Over time, however, his policies restored people's confidence in the central bank's ability to maintain low and stable inflation rates and ushered in a period characterized by high employment and low inflation. This era is sometimes referred to as the *Great Moderation*.

As the Volcker era exemplified, creating an independent central bank allows governments to insulate **monetary policy** from short-term political motives. Evidence suggests that countries with central banks with high levels of independence also have lower average inflation rates.[6]

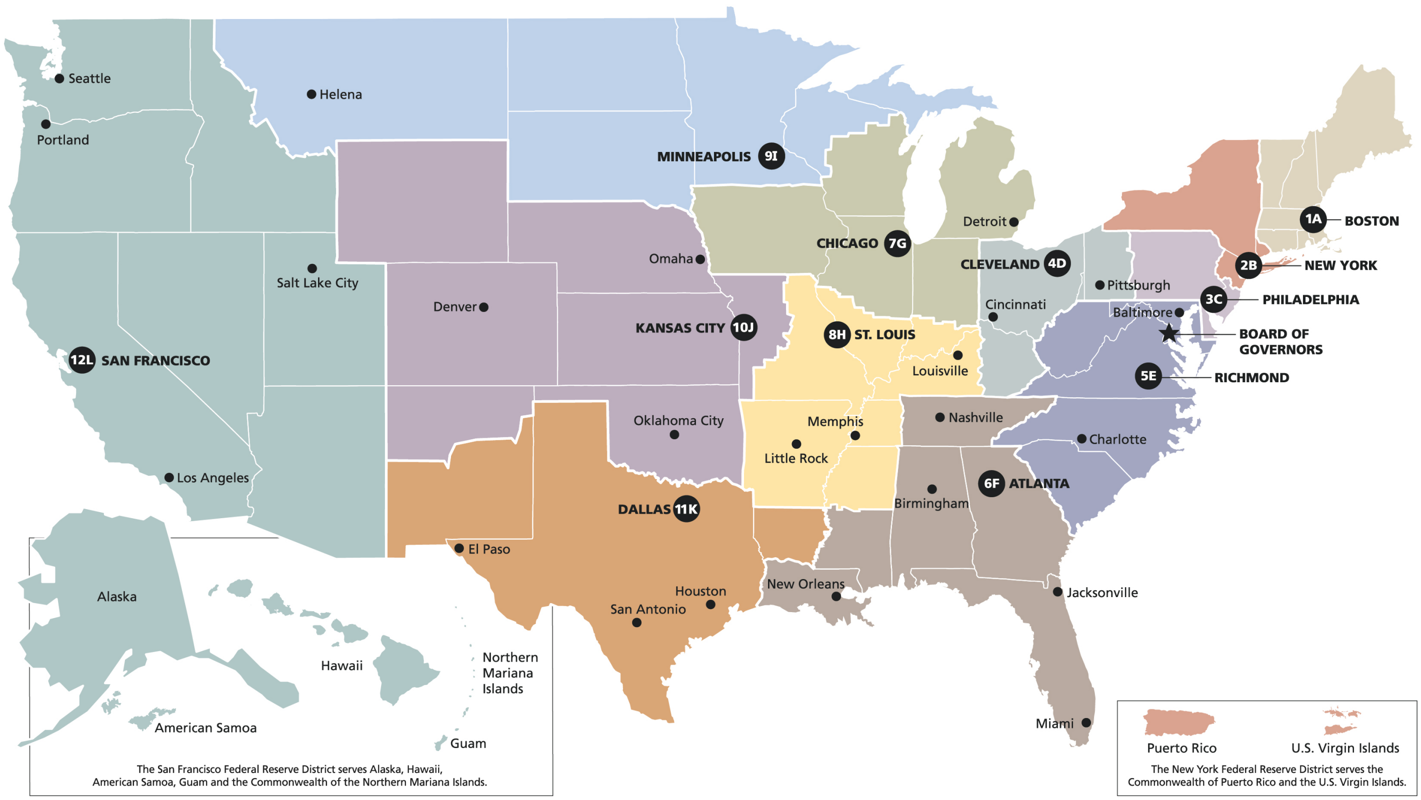
Representing Regional and National Interests

In many ways (not surprisingly) the structure of the Federal Reserve System is similar to the structure of the U.S. government. The economic power of the Federal Reserve is not concentrated in a single, or few, hands in Washington, D.C., or on Wall Street. Rather, monetary policies are made by policymakers distributed across the country.

The Federal Reserve balances national and local interests by having a centralized national Board of Governors and 12 decentralized regional Federal Reserve Banks.[7] The Board of Governors of the Federal Reserve System, located in Washington D.C., is the governing body of the Federal Reserve System. It is an agency of the U.S. federal government and directly accountable to Congress. The Board of Governors has broad oversight responsibilities for the operations and activities of the 12 Federal Reserve Banks. As such, the Board of Governors ensures that *national* interests are represented.

The 12 Regional Reserve Banks are the operating arm of the Federal Reserve System. They provide financial services, supervise and examine banks, and lend to depository institutions within their Federal Reserve District. The 12 Federal Reserve Districts span the country geographically (Figure 2) and gather information about

Figure 2
Districts of the Federal Reserve System



SOURCE: Federal Reserve Bank of St. Louis; https://www.stlouisfed.org/about-us.

the businesses and communities in their respective region. This information is used when making monetary policy, to ensure that *regional* interests ("Main Street") are represented.

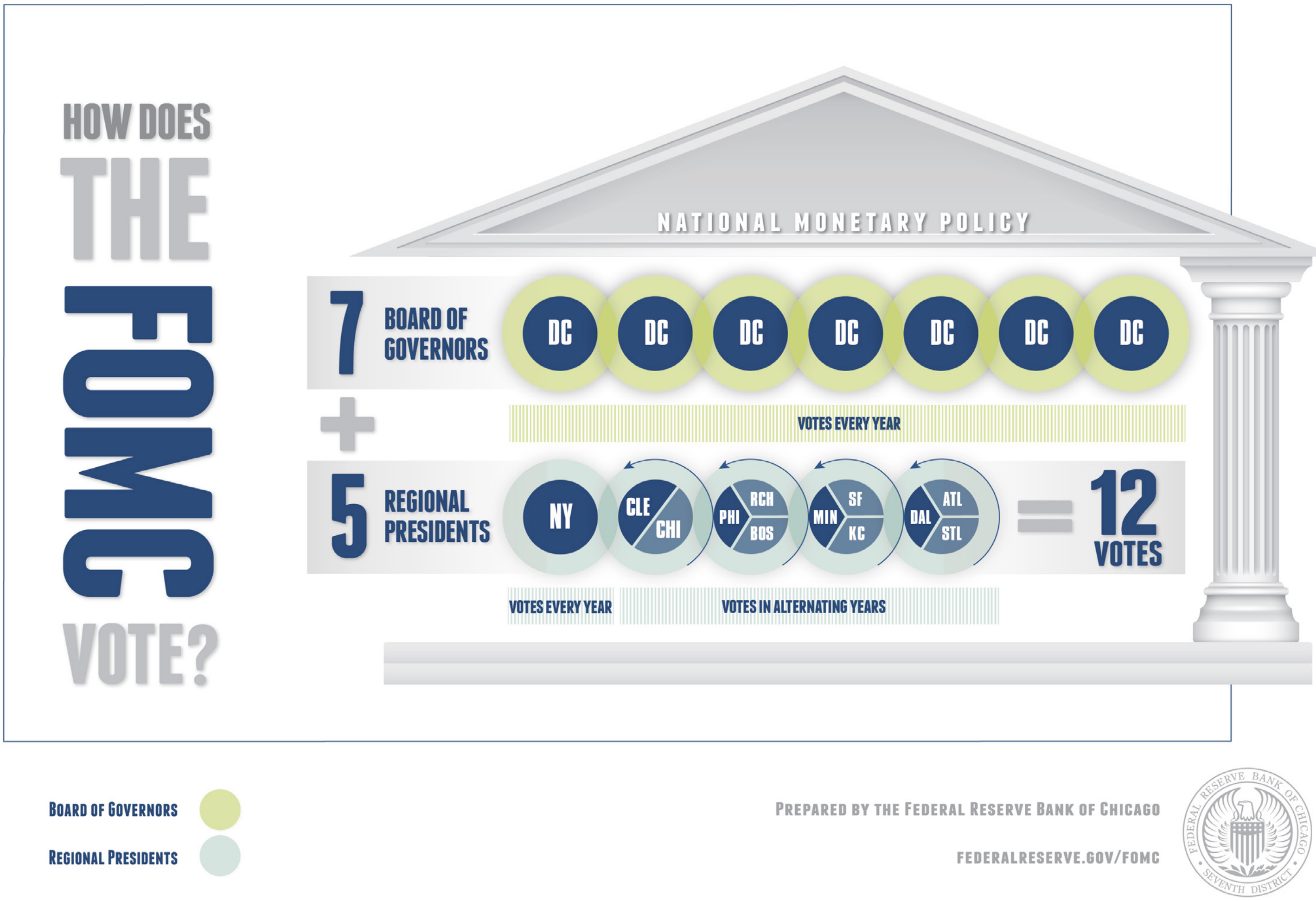
Checks and Balances

The Federal Open Market Committee (FOMC) is the body within the Federal Reserve System that determines monetary policy for the country. The committee consists of up to 19 participants—seven Federal Reserve Board governors (if all positions are filled) and the presidents of the 12 Federal Reserve Banks. The governors are political appointees: They are nominated by the president of the United States and confirmed by the Senate. Governors are appointed to 14-year terms so that appointees serve beyond the tenure of the presidents who nominate them, reducing the likelihood that one president appoints a majority of the governors. Because the seven governors are political appointees, they are intended to be the most directly accountable to the public.

The 12 Federal Reserve Bank presidents are not political appointees. Each Federal Reserve Bank has a local board of directors whose members select its regional Bank president. All members of local boards of directors are subject to Board of Governors approval. And, appointments of Federal Reserve Bank presidents are also subject to Board of Governors approval. Because they are not political appointees, the presidents of the 12 Federal Reserve Banks are intended to be insulated from politics and to represent regional interests.

The FOMC consists of 12 voting members—the seven members of the Board of Governors (if all positions are filled); the president of the Federal Reserve Bank of New York[8]; and four of the remaining 11 Federal Reserve Bank presidents, who serve on a rotating basis (Figure 3). All 12 of the Federal Reserve Bank presidents attend FOMC meetings, report on economic conditions in their respective districts, and participate in the policy discussions, but only the five presidents designated as voting members

Figure 3
Federal Open Market Committee: Who Votes?



SOURCE: Federal Reserve Bank of Chicago; https://www.chicagofed.org/education/fomc-infographic.

at the time vote on policy decisions.[9] This structure maintains centralized power but also makes sure that regional interests are represented in policy.

The Power of the Purse

In the Federal Reserve Act, Congress gave the Federal Reserve the power to earn its own income. This income comes primarily from the interest the Fed earns on the government securities it acquires through **open market operations**.[10] Because funding can be a way to wield influence, Congress did not give itself the "power of the purse" over the Fed. For example, if the Federal Reserve were dependent on Congress for funding, members of Congress could threaten to cut the Federal Reserve's budget to get the policy decisions they desired. The Fed does not keep all of its earning, however. After paying its expenses and legally mandated dividend payments to member banks,[11] the Federal Reserve turns the rest of its earnings over to the U.S Treasury.[12] For example, in 2019 the Fed sent the U.S. Treasury $54.9 billion.[13]

Is the Fed Audited?

The Board of Governors and the 12 Federal Reserve Banks undergo several levels of audit by the Government Accountability Office and outside independent auditors.[14] To ensure transparency, the audited financial statements are available on the websites of the Board of Governors and the Federal Reserve Banks.[15] In recent years, there has been an "audit the Fed" call supported by some legislators. The Fed already has regular traditional financial audits, so the intent here is something different. The call is for the Government Accountability Office to review the monetary policy decisions made by the FOMC. Other legislators, however, caution that such oversight could allow elected leaders to influence monetary policy—something Congress intended to guard against when they created an independent central bank.

The Fed Is Accountable to Congress and the Public

The U.S. Congress determines the goals of monetary policy (**maximum employment**, **price stability**, and moderate long-term interest rates), but it has given the Federal Reserve independence to achieve these goals.[16] Along with that independence, the Federal Reserve is accountable to Congress for meeting its goals. Part of that accountability includes providing information to Congress and the public about its policy actions and the rationale for those decisions. The Fed does this in a number of ways. First, the Board of Governors prepares an extensive Monetary Policy Report twice per year, and the Chair testifies to Congress on those occasions.[17]

And, to provide transparency in the policymaking process, the FOMC issues a statement immediately following each of its eight annual FOMC meetings, publishes full minutes three weeks after each meeting, and publishes transcripts five years after each meeting.[18] The Chair also holds a press conference after each FOMC meeting to explain (on behalf of the FOMC) its policy decisions.[19] These press conferences are streamed live from the Federal Reserve Board of Governors website, and they are recorded, archived, and available to the public. In addition, four times per year, the FOMC provides projections (forecasts) for economic growth, unemployment, and inflation, as well as information about each policymaker's projection of the appropriate level of the federal funds rate.[20] Further, Federal Reserve Board governors and Federal Reserve Bank presidents contribute to transparency by making frequent speeches about their policy perspectives. And, the Board of Governors and the Federal Reserve Banks all provide information, publications, and education materials on their websites to help inform the public about the structure and function of Federal Reserve System and its policy actions.

Conclusion

Central bank independence is desirable because the near-term political goals of elected leaders can conflict with policy consistent with a country's long-term economic health. Economists generally agree that this is best accomplished by giving the central bank clear policy objectives (such and price stability and maximum employment), the political independence necessary to accomplish those goals, and accountability for meeting the goals.[21] Congress included these characteristics when they created the Federal Reserve System as the nation's central bank. ■

Notes

[1] Powell, Jerome. "The Economics Outlook: Before the Joint Economic Committee, U.S. Congress, Washington, D.C." Board of Governors of the Federal Reserve System, November 13, 2019; https://www.federalreserve.gov/newsevents/testimony/powell20191113a.htm, accessed March 12, 2020.

[2] Lopez, David A. "The Great Inflation: A Historical Overview and Lessons Learned." *Page One Economics*®, October 2012; https://research.stlouisfed.org/publications/page1-econ/2012/10/01/the-great-inflation-a-historical-overview-and-lessons-learned/.

[3] Bryan, Michael. "The Great Inflation." Federal Reserve History; https://www.federalreservehistory.org/essays/great_inflation, accessed March 12, 2020.

[4] Waller, Christopher J. "Independence + Accountability: Why the Fed Is a Well-Designed Central Bank." Federal Reserve Bank of St. Louis *Review*, September/October 2011, *93*(5), pp. 292-301; https://doi.org/10.20955/r.93.293-302.

[5] Newport, Frank. "Top Issues for Voters: Healthcare, Economy, Immigration." Gallop, November 2, 2018; https://news.gallup.com/poll/244367/top-issues-voters-healthcare-economy-immigration.aspx.

[6] Waller, Christopher J. "Independence + Accountability: Why the Fed Is a Well-Designed Central Bank." Federal Reserve Bank of St. Louis *Review*, September/October 2011, *93*(5), pp. 292-301; https://doi.org/10.20955/r.93.293-302.

[7] Neely, Christopher J. "How Central Should the Central Bank Be? A Comment." *Economic Synopses*, 2010, No. 10; https://research.stlouisfed.org/publications/economic-synopses/2010/04/22/how-central-should-the-central-bank-be-a-comment/.

[8] The president of the New York Fed also votes at every meeting because the New York Fed conducts open market operations on behalf of the Federal Reserve System.

[9] Board of Governors of the Federal Reserve System. "The Federal Reserve System: Purposes and Functions." 10th edition. 2016; https://www.federalreserve.gov/aboutthefed/files/pf_complete.pdf.

[10] Board of Governors of the Federal Reserve System. "What Does It Mean That the Federal Reserve Is 'Independent Within the Government'?" FAQs; https://www.federalreserve.gov/faqs/about_12799.htm, accessed March 12, 2020.

[11] Board of Governors of the Federal Reserve System. "Who Owns the Federal Reserve?" FAQs; https://www.federalreserve.gov/faqs/about_14986.htm, accessed March 12, 2020.

[12] Board of Governors of the Federal Reserve System; see note 10.

[13] Board of Governors of the Federal Reserve System. "Federal Reserve Board Announces Reserve Bank Income and Expense Data and Transfers to the Treasury for 2019." January 10, 2020; https://www.federalreserve.gov/newsevents/pressreleases/other20200110a.htm.

[14] Board of Governors of the Federal Reserve System. "Does the Federal Reserve Ever Get Audited?" FAQs; https://www.federalreserve.gov/faqs/about_12784.htm, accessed March 12, 2020.

[15] Board of Governors of the Federal Reserve System. "Federal Reserve System Audited Annual Financial Statements." https://www.federalreserve.gov/about-thefed/audited-annual-financial-statements.htm, accessed March 12, 2020.

[16] Board of Governors of the Federal Reserve System. "Why Is It Important to Separate Federal Reserve Monetary Policy Decisions from Political Influence?" FAQs; https://www.federalreserve.gov/faqs/why-is-it-important-to-separate-federal-reserve-monetary-policy-decisions-from-political-influence.htm, accessed March 12, 2020.

[17] Board of Governors of the Federal Reserve System; see note 10.

[18] Board of Governors of the Federal Reserve System. "Is the Federal Reserve Accountable to Anyone?" FAQs; https://www.federalreserve.gov/faqs/about_12798.htm, accessed March 12, 2020.

[19] Board of Governors of the Federal Reserve System. "FOMC Meetings Are Not Open to the Public, So How Do I Know What the FOMC Is Doing?" https://www.federalreserve.gov/faqs/federal-open-market-committee-fomc-not-public.htm, accessed March 12, 2020.

[20] Board of Governors of the Federal Reserve System. "How Often Does the Federal Reserve Collect and Publish Policymakers' Economic Projections?" FAQs; https://www.federalreserve.gov/monetarypolicy/fomc_projectionsfaqs.htm, accessed March 10, 2020.

[21] Fischer, Stanley. "Central-Bank Independence Revisited." *American Economic Review*, 1995, *85*(2), pp. 201-06.

Name____ **Period**________

Federal Reserve Bank of St. Louis *Page One Economics*®:

"Independence, Accountability, and the Federal Reserve System"

After reading the article, answer the following questions:

1. Paul Volcker's strategy for reducing the high inflation rate of the 1970s was to
   a. increase the money supply, even if that meant higher interest rates.
   b. decrease the money supply, even if that meant lower interest rates.
   c. increase the money supply, even if that meant lower interest rates.
   d. decrease the money supply, even if that meant higher interest rates.

2. The Federal Reserve was created when
   a. a provision for the creation of the Federal Reserve was added to the U.S. Constitution.
   b. Alexander Hamilton created the first national bank, also known as the Federal Reserve.
   c. Congress passed, and President Wilson signed, the Federal Reserve Act.
   d. Paul Volcker became Chairman of the Federal Reserve System in 1979.

3. What two foundational beliefs that sometimes have tension are reflected in the structure of the Federal Reserve?
   a. Liberty and independence
   b. Centralized power and accountability
   c. Regional interests and independence
   d. Independence and accountability

4. Which part of the Federal Reserve System's structure ensures that national interests are represented?
   a. The Board of Governors
   b. The 12 Federal Reserve Banks
   c. The Federal Open Market Committee (FOMC)
   d. The Federal Reserve Bank of New York

5. Which part of the Federal Reserve System's structure ensures that regional (Main Street) interests are represented?
   a. The Board of Governors
   b. The 12 Federal Reserve Banks
   c. The FOMC
   d. The Federal Reserve Bank of New York

6. While all (up to) 19 FOMC participants attend meetings, discuss economic conditions, and share their views, the voting members of the FOMC include
    a. seven Federal Reserve Board Governors (on a rotating basis) and 12 Federal Reserve Bank presidents.
    b. seven Federal Reserve Board Governors and five Federal Reserve Bank presidents (on a rotating basis).
    c. seven Federal Reserve Board Governors and 12 Federal Reserve Bank presidents.
    d. seven Federal Reserve Board Governors and the president of the Federal Reserve Bank of New York.

7. Is the Fed audited?
    a. Yes, the Government Accountability Office and external auditors audit the Fed.
    b. Yes, but only the Federal Reserve Board of Governors is audited.
    c. Yes, but only the Federal Open Market Committee is audited.
    d. No, the Fed is not audited.

8. How are the seven Federal Reserve Board Governors appointed?
    a. They are selected by a local board of directors with approval by the full Board of Governors.
    b. They are nominated by the Senate and confirmed by the Federal Open Market Committee.
    c. They are nominated by the Federal Reserve Bank presidents and confirmed by the Senate.
    d. They are nominated by the president of the United States and confirmed by the Senate.

9. How might the relatively short political terms of elected officials (the political business cycle) create an inflationary bias?
    a. Elected officials might resist lower interest rates, fearing a rising inflation rate will reduce their chances of reelection.
    b. Elected officials might resist higher interest rates, fearing a slowing economy will reduce their chances of reelection.
    c. Elected officials might resist lower interest rates, fearing a slowing economy will reduce their chances of reelection.
    d. Elected officials might resist policies that encourage bank lending, fearing the economy might grow too quickly.

10. Evidence suggests that a country with a central bank with a high level of independence
    a. has lower average interest rates.
    b. has lower average inflation rates.
    c. has lower average unemployment rates.
    d. has lower average economic growth rates.