Fed Independence

In the wake of the turmoil in Washington, DC, over his performance in Helsinki, President Trump also took a sideswipe at the Federal Reserve, criticizing the FOMC's recent efforts to normalize policy.

He argued that raising rates threatens the expansion and on top of it has contributed to the rise in the value of the dollar, just when the euro was shrinking, the effect of which is to further disadvantage US producers.

Most presidents – though not all – have understood that Fed independence ensures separation from the Treasury and serves as a check on fiscal excesses. When a central bank takes orders from the fiscal side of government, history shows that inflation and economic decline soon follow. Witness the German inflation of the Weimar Republic, the 1992–1994 experience in Yugoslavia, the 1990 experience in Peru when inflation doubled every 13 days, the persistent problems in Venezuela, and the hyperinflation of Zimbabwe, just to name a few.

There have been many times in the past when presidents expressed frustration with Federal Reserve actions, but those criticisms lacked teeth when it came to actually affecting the Fed’s conduct of monetary policy. One noteworthy period when there was a cozy relationship between Fed leadership and the president was during the chairmanship of Arthur Burns. Burns steered policy in such a way to accommodate the fiscal interests of President Nixon, and the result was stagflation in the 1970s and a disastrous experiment with wage and price controls. We experienced an unprecedented inflation that took courageous action by then-Chairman Paul Volcker to break the back of inflation at the cost of a recession, thus proving that the lack of independence represents a severe threat to economic stability and prosperity. Similarly, President George H. W. Bush blamed the Fed for not cutting rates, and that reluctance to act he alleged cost him the election.

Interestingly, the issue of independence came up last week, on Wednesday, in two entirely different contexts and different venues, in both instances during hearings by the House Financial Services Committee. The first occurred during Chairman Powell’s semiannual testimony on monetary policy before the full House Financial Services Committee, when Congressman Hensarling suggested that the size of the Fed’s balance sheet in itself might pose a threat to its independence because of the temptation on the part of Congress to induce or cause the Fed to purchase private sector assets. As evidence he also referenced the fact that raiding the Fed’s balance sheet has already taken place. Two examples he gave were the use of Fed resources to fund the Consumer Financial Protection Bureau and the deployment of some of the Fed’s surplus to fund the Highway Bill. While Congressman Hensarling’s concern is valid, neither congressional action was related to the size of the Fed’s balance sheet per se. The Fed doesn’t act like a private bank, attracting deposits and then making loans. Rather, it purchases assets – in the present case Treasuries and mortgage-backed securities (MBS) – by simply creating reserves. That is, it purchases assets and pays for them with high-powered money – which ends up as reserves on commercial bank balance sheets.

The real threat is simply that Congress has viewed the Fed more and more as a piggy bank whose resources can be tapped to fund pet projects, seemly at zero cost to the budget. This temptation has been stoked, in part, by the Fed's willingness to purchase newly issued MBS – which in this case were liabilities of another set of now-government entities, Freddie and Fannie, which are in conservatorship and whose liabilities are effectively guaranteed by the Treasury.

If Congressman Hensarling and his colleagues are truly interested in protecting the independence of the Fed, to counter this trend they should restrict the Fed's asset purchases to US Treasury obligations – except in extreme emergencies, such as envisioned in the Dodd-Frank Act – and encourage the rundown of the Fed's holdings of MBS as soon as feasible.

The second time the issue of Fed independence was implicitly raised was in an entirely different context during a hearing on digital currencies that took place that same Wednesday before the House Financial Services Subcommittee on Monetary Policy and Trade. The discussion was wide-ranging, but some participants argued that if digital currencies proved to be a more efficient means of payments than cash, then such currencies should be made legal tender. Furthermore, the Fed should get into the retail digital currency business. But what was lost in their brainstorming was the logical implication of the Fed's getting into retail payments. Fedcoins, by virtue of the government's backing, would likely dominate private sector digital currencies and would surely supplant demand deposits as a component of payments as well. However, the advent of Fedcoins would also imply a huge increase in the Fed's balance sheet on the liability side, an increase that would have to be balanced with assets – presumably Treasuries. But banks rely upon demand deposits to fund their lending activities; and to the extent that this funding source was significantly reduced or disappeared, then banking as we know it would also be adversely impacted. The political fallout from this disruption would be large, and we do not know what implications such a change would have for financial stability or the implementation of monetary policy. Worst case is that the Fed would be dragged into consumer lending. So the role of digital currencies in the US economy is, as of this writing, not clear; nor is the structure of Bitcoin and similar currencies as anonymous or safe as proponents would have us believe [1].

The threats to Fed independence from the legislative branch have a long history. Congressman Wright Patman (in Congress from 1929–1976) was longtime chairman of what was then the House Committee on Banking, Finance, and Urban Affairs [2]. A populist, he favored low interest rates and continually threatened to subject the Fed to appropriations and/or audit [3]. His main concern was that the Fed was too independent and lacked transparency in its operations and decision-making [4]. Remember, during that period the Fed did not reveal its decisions, nor did it produce meeting minutes. Furthermore, Fed chairmen and governors made only infrequent appearances before Congress.

Patman’s crusade was picked up by Henry Gonzales, another Texan, who rose to the chairmanship of the House Banking Committee in 1989, and who vigorously sought to make the Fed more accountable [5]. Under Gonzales it was revealed that the Fed kept secret minutes of its meetings, destroyed many meeting records, and concealed information on a fleet of airplanes it operated, just to mention a few examples of covert Fed actions [6]. Gonzales even initiated an unsuccessful proceeding to impeach Fed Chairman Paul Volcker. Under Gonzales’ tenure the Fed began publishing minutes of its meetings.

So attacks on the Fed from both the executive and legislative branches of government are real but have mainly succeeded – appropriately so – in making the Fed’s decision process more transparent. But those efforts have had minimal influence on actually policy decisions. The president may not appreciate that the Fed is a creature of Congress and not the executive branch, and that he has little or no power to force either the chairman of the Board of Governors or the FOMC to do his bidding. Nor can he fire them.

How will the Fed respond to these recent pressures? Some have speculated that attempts to influence the Fed will cause the Fed to overreact and accelerate its tightening policy just to demonstrate its independence. If the past is any guide, however, there is little evidence that the Fed has deviated from what it deems to be the appropriate policy path just to stick it to its critics. While most of the FOMC participants and governors are relatively new to the table, the best guess is that Fed's culture and history will provide them with the backbone to steady the course and not bow to outside political pressures. The bigger risk is that the economy could weaken sufficiently towards the end of this year to cause a change in policy, especially if this slowdown occurs before the election. A backtrack on policy in that economic scenario would pose a formidable communications challenge for the Fed – to explain the change while not appearing to be bowing to outside pressure, especially from a president who is likely to claim credit for the change in policy. This is where the real short-term threat to Fed independence will come from. Over the longer run, however, the real threats may come from a Congress tempted to look for cheap financing for projects, and we can only hope there that the true issues are understood.

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[1] Anyone who doubts this assertion should just read the recent indictment handed down by the Justice Department in the

case of 12 Russians accused of meddling in the US 2016 election. See https://www.vox.com/2018/7/13/17568806/mueller-russia-intelligence-indictment-full-text.

[2] I concentrate here on the period after the 1951 Treasury-Fed Accord and after the Fed stopped pegging interest rates, a policy instituted during WWII that made the Fed effectively subservient to the Treasury.

[3] Having been at the Board of Governors during part of Patman's tenure in Congress, I can attest to the fact that the mere threat of appropriations or an audit instilled more financial discipline in the Fed's operations than could be observed in agencies that were subject to appropriations and audit.

[4] See Harrison, William B., "Annals of a Crusade: Wright Patman and the Federal Reserve System," American Journal of Economics and Sociology, Vol. 40, No. 3, July 1981.

[5] The Committee's name has changed several times, so for simplicity it is simply referred to as the House Banking Committee.

[6] See history.house.gov/People/Detail/13906.

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