

THE FEDERAL RESERVE'S INDEPENDENCE AND FINANCIAL REFORM

Introduction

- Recent Federal Reserve policy failures
- Expansion of Federal Reserve assets and security holdings
- Costs and related risks of current Fed policy
- Current attacks on Fed's "independence" and exercise of discretion
- Proposals to constrain or eliminate independence
- Such proposals are not new
- They have not been successful

Origins of Federal Reserves Independence

- Central bank 'independence' generally based on need to constrain inflation
- Development of Federal Reserve independence
- Federal Reserve organized as joint venture to assist banks under stress, not as a "central bank"
 - Established itself in World War I as auxiliary to Treasury
 - Post-war policy mistakes excused by Congress
- Independence to promote stabilization derived from outcome of congressional investigation
- Service to Treasury in emergencies--a critical function

RECENT CHANGES

- Dodd-Frank Restraints

 - Reserve Bank presidents to be elected by Class B and C directors

 - GAO audit of some functions

 - Changes unlikely to be significant in curbing independence and discretion

- Continued Growth of Federal Reserve Authority

 - Interest on excess reserves

 - Principal regulatory of large, systematically important financial institutions

 - New programs and techniques for expanding bank reserves

- Summary: Despite criticism, Fed has grown and independence not compromised

Secrets of Federal Reserve's Organizational Success

- Federal Reserve has repeatedly served to meet political and economic emergencies
- Unique capacities make it valuable asset to government
- Errors in policy viewed as repairable by filling gaps in authority
- Phenomenon of 'failing upward' has been repeated in major crises
- Uphill battle for those wanting to constrain Fed independence

Conclusions: Old Learning

- “...the System...will not establish itself with its members and with the country...until it has met the test of a real crisis.”
Benjamin Strong, 1916
- “We must persuade.....[Secretary of the Treasury McAdoo] to permit the Reserve Banks to become the real, active and effective fiscal agents for the Government. If he does that, our place in the country’s banking system will be established for all time....”
» Benjamin Strong, 1916
- “Must we blindly worship a theory, close our eyes to practical and political considerations, set up a goddess, which we will call the quantity theory, and in the blind worship of this goddess close our eyes to the gathering storm and run the risk of being swept away? If one goes so far...then do we not set ourselves above the Congress, above the Administration, and constitute ourselves the last court of resort in all matters affecting the economic welfare of the country, even though political issues intervene?..[T]he men who would pursue such a policy [are like] the famous surgeon who undertook to perform an operation in the face of almost unsurmountable obstacles, and at the conclusion...stated...that the operation was successful but the patient died.”
» Benjamin Strong, 1922

Conclusions (cont.)

- Whether or not current Federal Reserve policy turns out to be right for the economy, remains to be seen
- It is clear that it's right for the Federal Reserve