Introduction to "Characteristics of the Fed's Independence and Accountability"

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The title of this morning's panel is "Characteristics of the Fed's Independence and Accountability." Our topic reminds me of one of the most intriguing and surprising papers that I recall in my time as a member (more than 20 years!) of the SOMC.

In 2009, Anna Schwartz, an exceptional scholar of monetary and fiscal institutions and their histories, as well as an original member of the SOMC, wrote a paper entitled "Boundaries Between the Fed and the Treasury."[1] In this article, she pointed to an area of disagreement between herself and her long-time co-author, Milton Friedman. She writes [page 4]:

> *It may be of some surprise that Milton Friedman, a believer in limited government, proposed subordinating the Fed to the Treasury department not as an ideal but as an improvement of existing arrangements. He contended that it would result in a single locus of power on monetary and fiscal policies, and would establish accountability for mistakes in policy that otherwise leave each institution free to blame the other for policy errors.*

Dr. Schwartz concludes by writing

> *I do not agree with Friedman's definition of the optimal relationship between the Treasury and the Fed. ....*
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> *I believe the Treasury's policies during peacetime are not necessarily preferable to monetary policies that give priority to maintaining the purchasing power of the currency over the long run. The Fed is more immune to political pressure than the Treasury is. Political control in the hands of uninformed legislators is hardly the summum bonum[2] of a monetary system that provides financial stability and public trust of financial activity.*

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[1] https://www.shadowfed.org/wp-content/uploads/2010/03/anne_schwartz_042009.pdf

[2] Latin for "the highest good."

Dr. Schwartz's sharp insights continue to identify key concepts for today's conference and today's markets. Importantly, in the period just prior to the 2008 financial crisis, many monetary policy and central bank experts placed minimal importance on the democratic political framework in which the Federal Reserve resides. Subsequently, these experts have had to re-learn that for the Fed to maintain its political independence and thereby deliver its dual mandate, it will have to accept constraints (even self-constraints) in its actions and decision-making so that it remains politically accountable in a democratic system that is based on a system of checks and balances. These constraints include an appropriate rule-based framework, and limits on the size and composition of its asset purchases and sales as well as to its lender of last resort function. Indeed, this lesson is even more critical now, during periods of financial crises or of low interest rates, where the Fed can too easily unintentionally, or intentionally, engage in fiscal and credit actions as part of its monetary policy and central bank decisions.

Fortunately, the members of the SOMC have remained focused on our principles which are stated in The SOMC and Its Core Beliefs. [3] I believe that a Fed that adheres to our core beliefs can sustain its political independence by embedding constraints on its actions that enhance its political accountability. In turn, this will maximize its ability to achieve its dual mandate.

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[3] https://www.shadowfed.org/wp-content/uploads/2014/10/SOMC-CoreBeliefs2014.pdf