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Why the Fed Is Not Independent

The Fed's foray into fiscal policy makes for a volatile political mix that all but guarantees control from without.

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In the wake of the financial crisis and the Federal Reserve's response, the central bank has come under increased scrutiny and criticism. Fed supporters put up a spirited defense, emphasizing the need to save the institution's independence. Chairman Ben Bernanke says the Fed's independence protects the central bank from short-run political pressure.

Lost in the debate is the precise meaning of "independence," and whether the supposed independence is really an accurate characterization of the Fed's situation today.

In the first place, the Fed is certainly not independent of political oversight—it is a creature of Congress. To be sure, the Federal Reserve Act crafted in 1913 did insulate the Fed from responsibility to fund the federal government, unlike the Bank of England. But the Fed's insulation quickly eroded a few years later, with the requirements of World War I finance, when the central bank was called upon to finance a massive increase in government debt.

The modern meaning of Fed independence came about as a consequence of war finance during World War II. The central bank had agreed to support the price of government bonds by pegging interest rates. Postwar recovery brought on the risk of inflation, and the Korean War increased inflation fears. But the bond-support program tied the bank's hands in fighting inflation, because it could not raise interest rates.

The Fed, in short, could not conduct monetary policy independent of fiscal policy. It had to finance the government's deficit at fixed interest rates.

In 1951, the Fed and Treasury reached an accord in which the Fed got back the power to run a monetary policy independent of fiscal policy. And that is the historically correct and economically sensible meaning of independence: It is the Fed's policy that is independent.

But not even the policy is really independent, because the policy goals are governed by the Full Employment Act of 1946 (later amended). As a result of that law, the Fed ended up with the operational freedom to implement a policy of macroeconomic stability—full employment and price stability as mandated by law.

Today, however one parses the term, the Federal Reserve is not now independent. It has voluntarily relinquished the very independence it secured in 1951 by entering into a modern version of the bond support program. That is what the so-called zero interest rate policy amounts to, reinforced by the quantitative easing implemented through QE1 and QE2.

The Fed is committed to holding interest rates at a very low level by purchasing as much Treasury debt as necessary to maintain those interest rates. That is precisely the position the Fed found itself in before the 1951 accord.

Monetary policy once again is not independent of fiscal policy. None of the Fed's critics can do as much harm to the institution's independence as it has done to itself.

How might the Fed regain its independence? Ending QE2 is the first step. Ending the zero-rate policy would be the next step. The federal-funds rate needs to be allowed to rise into single digits.

But as former Fed Governor Lawrence Lindsey noted on this page on June 28, the precarious fiscal position of the federal government is ill-prepared for a return to normal interest rates. So the central bank's independence will require the federal government to return to fiscal sanity.

Even that is not enough to return the Fed's independence. The plethora of special lending facilities and programs instituted by the Fed in the wake of the fiscal crisis of 2008 put the central bank in the business of credit allocation. This is a species of fiscal power. It is very hard to imagine an institution of unelected officials exercising this power independently for very long.

If the Fed wants to preserve its structure, it must give up that power. The only way to do so would be repeal of Section 13 (3) of the Federal Reserve Act, the emergency lending provision under which the Fed wielded plenipotentiary credit powers.

Milton Friedman opposed Fed independence for a number of reasons, including that no institution as powerful as the Fed could operate outside democratic constraints. Friedman doubted that there could be laissez-faire in banking (no central bank). A number of academics have reopened that possibility. In the meantime, the Fed's foray into fiscal policy combined with its expanded use of emergency lending make for a volatile political mix that I predict cannot survive.

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