INTRODUCTION

ULYSSES AND THE CHAPERONE

> We must examine the system on which these great masses of money are manipulated, and assure ourselves that it is safe and right.
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> —*Walter Bagehot, 1873*

In the United States or any other country, one would be hard-pressed to identify a governmental institution whose power is more out of sync with the public's level of understanding of it than the U.S. Federal Reserve System. Even as the Fed influences the economic decisions of individuals and institutions the world over, it operates shrouded in mystery, cultivating a "peculiar mystique" that even experts mischaracterize and miscomprehend. A central part of that mystique is its curious location within government itself. Citizens do not interact with the Fed in the same way they do with other political institutions, so it can be difficult to put the Fed, its policies, and its power into our usual frames of discussion.

We are given a reason for this difference. The Fed is "above politics," as President Obama has said, protected by statute from the rough-and-tumble of our political process. It is, in a word, "independent."[1]

That word: *independent*. It is everywhere in discussions of the Federal Reserve. But what does it actually mean? Independent how? To what end? From whom? And while we are asking questions, who or what do we even mean when we say "the Fed"?

Scholars and central bankers have answers to these questions. In economics and to a lesser extent political science, the concept of central bank independence has been so extensively studied as to earn its own acronym: CBI. In 2004, Alan Blinder, an academic and former central banker, called the study of central bank independence a "growth industry," and the growth has only accelerated in the years since. Although there are about as many precise definitions of central bank independence as there are authors who describe it, in reference to the Federal Reserve, we can gather from these studies a rough consensus of what central bank independence means. That consensus goes something like this. Fed independence is the separation, by statute, of the central bankers (specifically the Fed chair) and the politicians (specifically the president) for purposes of maintaining low inflation. The idea is that citizens in a democracy naturally prefer a prosperous economy. Politicians please us by giving us that prosperity, or at least trying to take credit for it. But when there is no prosperity to be had, politicians will resort to goosing the economy artificially by running the printing presses to provide enough money and credit for all. The short-term result is reelection for the politicians. The long-term result is worthless money that wreaks havoc on our economic, social, and political institutions.[2]

The widely invoked metaphors of central banking come tumbling forth from here. In the Homeric epic the *Odyssey*, when Odysseus—referred to in central banking circles by his Latin name Ulysses, for reasons that are unclear—ventured with his men close to the seductive and vexing sirens, he devised a scheme to allow his men to guide their ship past their seduction in safety, while he experienced the short-term joys of hearing their songs. Central bank independence is our Ulysses contract. We write central banking laws that lash us (and our politicians) to the mast and stuff beeswax in the ears of our central bankers. We enjoy the ride while the technocratic central bankers guide the ship of the economy to the land of prosperity and low inflation. (We are, by the way, the sirens

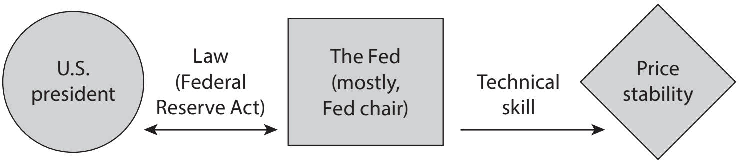

Figure 0.1. The Ulysses/punch-bowl account of Fed independence.

in this metaphor, too.) The other commonly invoked metaphor is even more colorful. In the oft-repeated words of William McChesney Martin, the longest serving Fed chair in history, the Federal Reserve is "in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up." The subjects of the metaphors differ by millennia, but the idea is the same: the partygoers and Ulysses alike want something in the near term that their best selves know is bad for them in the long term. Central bank independence is the solution.[3]

This view—which I will reference throughout the book as the Ulysses/punch-bowl view of Fed independence—suggests more or less five features. First, law does the work of separation—the lashes and beeswax are written into the Fed's charter, the Federal Reserve Act of 1913. Second, under this view, the Fed is a singular entity, even a single person: the Fed chair. In most discussions of Fed independence, little attention is paid to the internal governance of the rest of the Federal Reserve System. Third, the outside audience is a political one, usually the president, the only politician facing a national electorate. We seldom analyze which other actors attempt to shape Fed policy. Fourth, the reason for an independent central bank is to keep politicians away from the temptation to use the printing press to win reelection on the cheap. Fifth and finally, the reason the Fed can accomplish this task is that its work is technocratic: it requires special training but not the exercise of value judgments under uncertainty. Figure 0.1 presents the idea graphically.[4]

The Ulysses/punch-bowl model of Fed independence has taught us a lot about central banks and their institutional design. It has also motivated an extraordinary rise of a specific kind of central bank throughout the world. There is much insight to be gained by studying central banks and their legal relationships to politicians for purposes of combating inflation along the lines of this model.

The problem is that the standard account of Fed independence—the story of Ulysses and the sirens, of the dance hall and the spiked punch bowl—often doesn't work. Sometimes politicians whip up popular sentiment *in favor* of taking away the punch bowl—precisely the opposite of what we expect in a democracy. Sometimes the central bankers make headlines not for being boring chaperones but for bailing out the financial system. And in every case the creaky, hundred-year-old Federal Reserve Act leaves a governance structure that makes it so we barely know who the chaperone is even supposed to be.

This book takes a different approach. Instead, I argue that each of the five elements of that standard account—that it is law that creates Fed independence; that the Fed is a monolithic "it," or more often an all-powerful "he" or "she"; that only politicians attempt to influence Fed policy; that the Fed's only relevant mission is price stability; and that the Fed makes purely technocratic decisions, devoid of value judgments—is wrong.

To understand why, we must refocus our gaze not on one narrow feature of institutional design, but on the Federal Reserve as it actually is. We must understand the space within which the Fed operates. This space reflects a different orientation depending on the issue before it (inflation or not), the internal actor making the decision (Fed chair or not), the external actor interested in the outcome (the president or not), the tools Fed officials use to accomplish their goals (legal or not), and the values that inform their policy-making decisions (technocratic or not). This structural, geographic account allows the exercise of Fed power to tell its own story, even if and especially when that story has little to do with the Ulysses/punch-bowl narrative. Figure 0.2 illustrates the argument.[5]

More specifically, the geographic view of the Federal Reserve breaks down into five arguments.

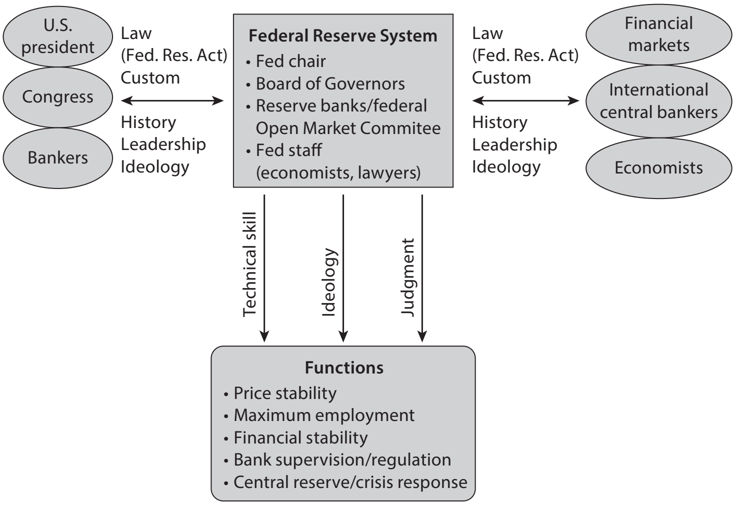

Figure 0.2. The policy-making space of the Federal Reserve.

First. The Fed is a "they," not an "it." While we fixate on the Fed chair—Alan Greenspan or Ben Bernanke or Janet Yellen—in fact the Fed is organized as a series of interlocking committees that all participate in various ways to make Fed policy. Putting these many and varied internal actors in their context is crucial to understanding how the Fed's policy-making process occurs.[6]

Second. We cannot understand the Federal Reserve System's structure without a close, historically sensitive reading of the Federal Reserve Act of 1913, as it has been amended over the last hundred years. Too few people who study the central bank take on this task. At the same time, the statute is also not enough. Law in practice differs in sometimes surprising, contradictory ways from law on the books. The argument is not that law is irrelevant; it is that the law is incomplete. As Rosa Lastra—a pioneer in the legal study of central banks—has written, "[c]entral banks inhabit a 'world of policy'. This does

> not mean there is no law. It means that the law has generally played a limited role in central banking operations."[7]
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> Third. Nearsighted presidents anxious to inflate away their electoral problems aren't the only outsiders interested in influencing the Fed's policies, even among politicians. Members of Congress, bankers, economists, international central bankers, and others all influence the shape of the space within which the system operates. How and to what effect they succeed are essential questions for understanding the Federal Reserve.
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> Fourth. The Fed's policy makers have, over the last hundred years, become much more than defenders against inflation. They are also, by statute and practice, recession fighters, bankers, financial regulators, bank supervisors, and protectors of financial stability. A theory of independence that accounts for but one function (price stability) among so many others is not a very good theory.
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> Fifth. These many missions are not the bailiwick of technocrats and mathematicians alone. The Fed's policy makers are people. They have values and ideologies, like the rest of us. And the policies they formulate and implement require the exercise of value judgments under uncertainty.

In this reconceptualization, "independence" fails to capture where the Fed fits within government, how it exercises its authority, and to what end. The Fed doesn't glow green with independence or red with political domination. Political scientist John Goodman got close to this proposition when he wrote that "[i]ndependence is a continuous, not dichotomous, variable. In other words, there are degrees of central bank independence."[8]

This book goes further still: independence is not really a quantifiable variable at all, but more of a sleight of hand that reveals only a narrow slice of Fed policy making at the expense of a broader, more explanatory context where Fed insiders and interested outsiders form relationships using law and other tools to implement a wide variety of specific policies. To understand more, we need to specify the insider, the outsider, the mechanism of influence, and the policy goal.

Looking at the power, governance, and purpose of the Federal Reserve in these terms, a new theme emerges. Rather than the site of a constant battle between populists and technocrats, the Fed's policy-making space becomes a balance between democratic accountability, technocratic expertise, and the influence of central bankers' own value judgments. Independence as an all-or-nothing proposition rings false. Instead, we see central bankers that are deeply embedded in their legal, historical, social, ideological, and political contexts. Pure separation from the political process was never a possibility, whatever the law said or says. And in the century since the Fed's founding, it has become only more embedded in a set of traditions all its own.

Once we have this view of Fed policy making, a view better informed by law, history, and practice, we will have an easier time finding a common frame for debating any question about the Fed's past and present, even when we disagree about what we would hope for the Fed's future. As Bagehot said of his own central bank, it is our duty to "examine the system on which these great masses of money are manipulated, and assure ourselves that it is safe and right." Settling on a more coherent and authentic frame for analyzing that system is the first step.[9]

PLAN OF THE BOOK

To reach the goal of providing that understanding, the book is structured around the following questions. What do we mean by the Fed, and how did it take the shape it has taken? What does the Fed do? Who influences the Fed's policies? And is the Fed we have the Fed we want?

In part I, we look at the first two questions: what is the Fed, and where did it come from? When people describe the Fed, they usually do so in one of two ways: as a single monolith ("the Fed announces a change in interest rates," or "the Federal Reserve bails out AIG") or as the institutional shadow of a single individual ("Yellen announces a change in interest rates" or "Bernanke bails out AIG.") The common assumption is that the Fed chair equals the Federal Reserve, and the Federal Reserve is an indivisible whole.

This assumption is false. The Fed is not a single individual, and the view that the Fed's power is concentrated into the hands of one is not correct. In fact, the Fed is one of the most organizationally complex entities in the federal government and has been from the very beginning. Part I tells the story of how the Fed took the curious shape that it took not only at the beginning in 1913 but through what chapter 1 calls the Fed's "three foundings": in 1913, 1935, and 1951.

My argument that the Fed is a "they," not an "it," can be exaggerated. Not all actors within the Fed are equal. The influence of Fed chairs, especially in the second half of its history, has been important, often decisive. Part of the Fed's institutional change occurs through the exercise of individual leadership by Fed chairs, even though the Federal Reserve Act gives them no particular legal claim for that authority.

But even when the Fed chair dominates, the Fed remains a complicated, multidimensional institution. Part I looks beyond the chair to these other features of Fed's governance. It analyzes the role of the Fed's two powerful committees: the seven-person Board of Governors, consisting of presidential appointments (confirmed by the Senate), and the Federal Open Market Committee, consisting of the Board of Governors plus the presidents of the twelve regional Federal Reserve Banks (only five of whom vote at a given time), who are appointed through a convoluted process almost completely outside the public eye. The president of the Federal Reserve Bank of New York is a permanent member of the committee; the other eleven Reserve Banks rotate as voting members in the other four seats. All twelve of the Reserve Bank presidents are in the room for FOMC meetings, though, and can make their views heard without restriction. By statute, the FOMC determines the Fed's monetary policies; the Board of Governors determines the rest. (As we will see, this oversimplification is part of the Fed's governance problem.) Figure 0.3 presents a graphical display of these committees.

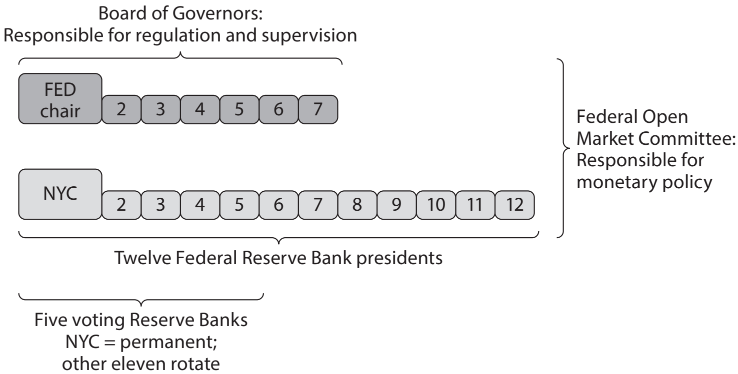

Figure 0.3. The structure of the U.S. Federal Reserve System.

Part I also confronts the expansive influence that two other actors have on the Fed's policy-making space: the Fed staff (especially economists and lawyers) and the twelve regional Federal Reserve Banks. The banks are perhaps the most controversial and least defensible aspect of the Fed's governance structure. They present a seat at the table for private bankers' representatives to make essential economic policy decisions. There are policy, constitutional, and governance problems with the Reserve Banks and not enough of value to justify the current structure given those serious costs.

Part II then turns to the question of the Fed's many missions. The logic of the Ulysses/punch-bowl view of the Federal Reserve depends on the idea that politicians will mismanage a nation's currency with an undesirable inflationary bias. The story of the development of that understanding is fascinating and important in its own right. But that account suffers from two weaknesses: the politics of money and inflation are not so straightforward, and the Fed is not now and never has been exclusively concerned with managing price stability. Part II explores the Fed's varied missions by asking and answering the surprisingly difficult question: What does the Federal Reserve do? The answer: many things beyond controlling inflation. The Ulysses/punch-bowl theory of Fed independence doesn't hold up for most of them.

In part III, we look at the outsiders who influence Fed policies. The Ulysses/punch-bowl view of Fed independence focuses on the president, and there we will begin. Part III then moves on to Congress, an essential audience for influencing Fed policy. It discusses the influence that individual members of Congress can have in defining the institution. Most of the focus, though, is on an especially curious quirk of the Fed's policy-making space: Congress does not use its traditional spending power to control the Fed. Instead, the Fed has that power on its own. It essentially creates the money with which it funds itself. What's more, this power is not directly authorized by statute. Part III explores the history and legal structure of the Fed's budgetary autonomy. Part III also continues to develop one of the primary themes of the book: law as written in the Federal Reserve Act matters, but not in the way that scholars, politicians, central bankers, and even lawyers have assumed.

The book concludes with part IV, a single chapter that discusses how the comprehensive approach to Fed power advanced here translates into a concrete program for Fed reform. That program focuses on preserving the best of the Ulysses/punch-bowl account of Fed independence: we really do want a central bank that will protect the currency from the winds of electoral politics, without losing the benefits democratic legitimacy and without indulging the myth that all central bank policy is purely technocratic. We can and should be comfortable with the reality that central bankers, like everyone else, are people whose life experiences—including their technical training—give them an ideological frame of reference through which they evaluate the world. The key to reforming the Fed is to know as much about the values of those central bankers as possible.

The watchword in this pragmatic approach is *governance*. Governance refers to the institutional decisions about who inside the Fed gets to establish which policies. As it stands today, the Fed's governance is, simply put, a mess. It can and should be clarified without sacrificing the essential tasks of regulating inflation and employment, free from the overwhelming influence of electoral politics. Consistent with these goals, chapter 11 highlights a few positive recent developments in reforming the Fed (including the creation of a separate Consumer Financial Protection Bureau) and recommend a few new changes to the Fed's structure and governance (including the reform of the twelve Federal Reserve Banks).

Two of the themes in this book permeate each chapter. First, any conversation about the Fed's power must recognize law's inability to remain what its authors intended it to be. That is not to say that we should abandon the enterprise of statutory central bank design. It means, instead, that we should tailor those efforts to minimize new legal rules that might well subject future generations to too many dead hands of the past. And second, an inescapable reality of central banking is that central bankers are people who bring with them ideologies and values that shape how they exercise their authority over the economy. Those values are also not fixed: interaction with others inside and outside the Federal Reserve System shape how central bankers think about the problems they confront. For both reasons, focus on understanding and simplifying Federal Reserve governance is an essential task to studying and reforming the Federal Reserve.

The U.S. Federal Reserve System has had an extraordinary century. In the words of one scholar, "the Fed's evolution into an economic power of first-rate importance is the most remarkable bureaucratic metamorphosis in American history." This book's challenges to the prevailing view of Federal Reserve power and independence is meant to invite greater understanding into that remarkable metamorphosis while grappling with the Fed's full, practical, historical context. The Fed's mystique is a function of both a lack of public knowledge of its inner workings, and a tangled governance structure that misleads even the experts. This book seeks both to increase public understanding of the Fed's many moving parts and to reconceive them in a way that allows for a better, more fruitful understanding of this essential institution.[10]