The Federal Reserve as a "Political" Institution

Sarah Binder

When the Federal Reserve celebrated its centennial in December 2013, it bore only passing resemblance to the institution created by Democrats, Progressives, and Populists just a century before. In the wake of the devastating Panic of 1907, a Democratic Congress and President Woodrow Wilson enacted the Federal Reserve Act of 1913, overcoming Americans' long-standing distrust of a national bank. As its name implies, the original Federal Reserve featured a decentralized reserve system with mixed public and private control of a new, elastic currency. Its Washington board also included the president's top financial lieutenants. After the Fed failed to prevent the Great Depression of the 1930s, lawmakers rewrote the Act, centralizing control of monetary policy in Washington and taking tentative steps toward granting the Fed some independence within the government. Many decades later, the global financial crisis that began in 2007 tested the Fed's institutional capacity to prevent financial crises. Congress again responded by significantly revamping the Fed's powers – bolstering the central bank's authority as a financial regulator while requiring more transparency and clipping its exigent lending powers. By the end of its first century, the Federal Reserve had become the crucial player sustaining and steering the nation's economic and financial well-being – a remarkable progression given the Fed's limited institutional beginnings.

What explains the Federal Reserve's existential transformation? In ongoing work with Mark Spindel, former Deputy Treasurer and Chief Investment Officer at the World Bank's International Finance Corporation, I explore political and economic catalysts that fueled the development of the Fed over its first century. Economic historians have provided excellent accounts of the Fed's evolution and the successes and failures of monetary policy. Still, little has been written about *why* or *when* politicians battle with the Fed, each other, and the president over monetary policy and *who wins* these contests over the powers, autonomy, and governance of the Fed or *why*. Moreover, in the wake of economic and financial debacles in which the Federal Reserve is blamed, lawmakers often respond paradoxically by expanding the powers of the Fed and further concentrating control in Washington. Why do Congress and the president both reward the Fed with new powers and punish it for poor performance? In our research, we uncover the sometimes hidden role of Congress in historical efforts to construct, sustain, and reform the Federal Reserve. Contextualizing Congress's role in driving the evolution of the Fed, we explain when, how, and why lawmakers seek to rebalance the tradeoff between the Fed's independence and its accountability to Congress.

What does political science have to offer to a study of the Federal Reserve? After all, central banking is more often the preserve of macroeconomists and formal models of central bank decision-making. I would argue that studying the Fed from my vantage point as a student of American national institutions offers a new way to think about how politicians both empower and constrain the Federal Reserve. In short, digging up the Fed's political history and examining its relationship with Congress over the Fed's first century raises doubts about the Fed's autonomy as a policy-maker and highlights the Fed's reliance on political support for its policy choices, particularly in the wake of financial and economic crises when lawmakers blame the Fed for the economic morass. Here, I offer three contributions that political science can make to our understanding of the Fed and the politics of monetary policy in the United States.

First, acknowledging the Fed's placement within a broader polity alters how we conceptualize the Fed as an institution. It is tempting to think of the Federal Reserve as an apolitical, technocratic institution divorced from the normal politics of policy-making in Washington. That is certainly the mental image that Fed officials would prefer we hold about the central bank. But the tense relationship between Congress and the Federal Reserve in the wake of the most recent global financial crisis reminds us that the Fed is inevitably a *political* institution. By labeling the Fed as "political," I do not mean that the Fed's policy choices are *politicized*. To be sure, policy-making within the Federal Open Market Committee (the Fed's policy-making committee, more informally known as the FOMC) is rarely a matter of applying partisan prescriptions to generate FOMC positions, although accusations as such recur. Given internal frictions, especially during times of economic stress, the Fed chair faces the challenge of building a coalition within (and beyond) the FOMC to support a preferred policy outcome, just as committee or party leaders in Congress or Supreme Court justices

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work to secure majorities for their proposals or opinions. That said, the Fed is not a partisan body reflecting the views of presidents who appoint the Board of Governors or of boards of directors who select the reserve bank presidents who help craft monetary policy. Decision-making inside the Fed involves technocratic, macroeconomic policy expertise, even within a political institution.

Instead, I consider the Fed "political" because successive generations of legislators have made and remade the Federal Reserve System to reflect (often shifting) partisan, political, and economic priorities. Indeed, as the former chairman of the Fed's Board of Governors, Ben Bernanke, emphasized at a ceremony in 2013 commemorating the Fed's first centennial, the Federal Reserve's power derives from and depends upon the support of elected officials precisely because the Fed is a product of and operates within the political system. Institutions are political not because they are permeated by partisan decision-making but because politicians endow them with the power to exercise public authority on behalf of a diverse and at times polarized nation.

Second, this perspective of the Fed as a political institution encourages us to think differently about central bank independence. Politicians face a dilemma in allocating power to a central bank. Given the impact on output, inflation, and employment, macroeconomic decisions made by central banks are among the most important policy choices rendered in a democracy. Monetary policy affects interest rates, which in turn shape the public's borrowing costs, the availability of credit, and ultimately household wealth. As public demand for goods and services expands, economic growth ensues as businesses increase production and employ more workers. The dilemma arises from politicians' electoral incentives, which lead them to want to stimulate the economy – particularly in the run up to an election. That short-term strategy, however, has long-term costs: it increases the chances of inflation and brings an inevitable economic recessionary payback.

The solution worldwide has been to insulate central bankers from political interference that might otherwise induce monetary policy-makers to keep interest rates too loose for too long. Indeed, many theorists of central bank independence suggest that lawmakers design central banks to constrain themselves from opportunistically inflating the economy for near-term electoral gain. Knowing that the economy will be better off in the future if inflation is tamed, politicians place their nation's monetary printing press out of reach. And an added bonus: delegating monetary policy to an independent body prevents the opposition party from juicing the economy when it gains control of government. More autonomous central banks also offer convenient targets for politicians eager to avoid blame for a poor economy.

But a fully autonomous central bank is rarely politically optimal for legislators: independence precludes a role for lawmakers seeking re-election to oversee macroeconomic policy and to hold central bankers accountable for their policy choices. In short, lawmakers face a tradeoff between central bank independence and democratic accountability. Contrary to theory, lawmakers seldom sacrifice short-term interests for the longer view. The Federal Reserve Act has not been fixed in stone since its enactment in 1913: after sharp economic downturns, Congress routinely re-opened the Act to impose new responsibilities on the Fed, require greater transparency, and clip the Fed's powers.

Third, paying heed to the Fed as a political institution helps us to identify the dynamics that underscore the Fed's relationship with its congressional boss. In recent work, I show that congressional attention to the Fed is counter-cyclical. Efforts to rebalance the accountability and the autonomy of the Federal Reserve are directly tied to the Fed's performance in sustaining the economy. In good economic times, lawmakers have little incentive to pay much attention to the Fed. But when the economy weakens, the Fed serves as a near perfect legislative punching bag. Faulting the Fed allows lawmakers to try to deflect blame from their own performance when the economy sours.

The counter-cyclical nature of congressional attention to monetary policy may seem obvious to legislative scholars accustomed to the pervasive impact of electoral motives on legislative behavior and outcomes. If there is little direct credit to be claimed when the Fed delivers a robust economy, then there is little payoff for electoral minded lawmakers to spend time or resources examining the Fed's performance. But the counter-cyclical nature of congressional attention has an important, non-obvious implication for the nature of the Fed's independence within the political system: Fed independence is strongest when congressional interest in monetary policy sinks. So long as the Fed delivers sound economic growth and stable prices, lawmakers rarely focus on the Fed's conduct of monetary policy. Congressional indifference – not theory about economically optimal institutions – sustains central bank independence.

Ultimately, there is some irony in the Fed's partial independence. In 1913, the framers of the Federal Reserve created a central bank to focus on the nation's long-run financial and economic health. In writing the Federal Reserve Act, lawmakers devised a compromise intended to build durable political support for what was at the time a controversial idea: creating a central bank. Despite building an institution poised to secure financial stability in the longer term, legislators soon proved to central bankers that they were just as concerned about the short-term. The Fed found itself beholden to con-

gressional majorities who cared – and continue to care – at least as much about avoiding blame for a poor economy. Always a creature of Congress, the Fed has no choice but to ensure that it chooses policies broadly palatable to public and congressional majorities, lest Congress clip its powers or saddle it with even more responsibility.

As the Fed enters its second century, its leaders shoulder the burden of restoring the institution's political capital and reputation in the long wake of the global financial crisis and Great Recession. Doing so will require the Fed to help engineer a full economic recovery by deciphering the macroeconomic mystery of low inflation, demand, and productivity that currently bedevils the economy and Fed policy-makers. Until a robust recovery takes root, the Fed will face continuing, and often conflicting, congressional criticism about the Fed's preferred monetary policy path. All the while, the Fed's weakened reputation leaves the institution vulnerable to legislative attack, which further weakens the Fed in public and political eyes. Ultimately, Congress's counter-cyclical focus on the Fed endows it with independence when the economy is strong, but constrains it when the economy falters. At best, the Federal Reserve earns partial and contingent independence from Congress and therefore, some might reasonably conclude, barely any independence at all.

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