POLITICS SYMPOSIUM

Why Study Monetary Politics?

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> Every governmental faculty…has a political element and every governmental agency a political phase. No system of banking will long succeed which does violence to a great fraction of the wishes of the people of this country.
>
> —Dallas, Texas bankers (Reserve Bank Organization Committee 1914, 120)

> If I had learned one thing in Washington, it was that no economic program can succeed, no matter how impeccable the arguments supporting it, if it is not politically feasible.
>
> —Ben S. Bernanke, *The Courage to Act* (2015, 304)

In the course of the Federal Reserve's first century, central bankers and the bankers they supervise recognized that the American financial system relies on political support to succeed. At the same time, economists highlighted the attraction of insulating central banks from politicians: that is, delegate monetary policy to technocratic experts to secure economic growth while constraining politicians from illusory inflation for electoral gain (Alesina and Stella 2010). Remarkably, both Federal Reserve officials and congressional lawmakers have sustained this "myth of independence." Central bankers are eager to keep politicians at bay, and legislators seek to escape blame whenever the economy sours.

The disjuncture between economic and political views of the Fed is important. As suggested in our book, *The Myth of Independence: How Congress Governs the Federal Reserve* (Binder and Spindel 2017), political scientists too often have ceded study of the Fed to economists and economic historians. There is a robust focus on the politics of central banking in the field of comparative political economy (Fernandez-Albertos 2015). However, relatively few students of American politics concentrate on the Fed, thereby limiting our understanding of the dynamics of the American political economy. This article explores the concept of the Fed as a political institution and underscores the implications and efficacy of studying monetary politics.

THE FED AS A POLITICAL INSTITUTION

It is tempting to view the Federal Reserve as an agnostic body of technocratic, macroeconomy experts, detached from the normal politics of policy making in Washington. This is certainly the mental image that Fed officials often prefer that we hold about the central bank. Indeed, they often dismiss political motivations for their actions (Puzzanghera and Lee 2016). However, the elemental relationship between Congress and the Federal Reserve reminds us that the Fed, inevitably, is a *political* institution. In the wake of the global financial crisis, monetary politics have been particularly vivid. Claims of unconventional monetary policy encroaching on fiscal policy compelled lawmakers to fiercely criticize the Fed for its bold lending, interest-rate, and balance-sheet decisions.

Given internal and external frictions over monetary policy, especially during times of economic stress, the Fed chair faces the challenge of building a coalition within (and beyond) its central policy-making committee, the Federal Open Market Committee (FOMC), to support a preferred policy outcome—just as committee or party leaders in Congress or Supreme Court justices work to secure majorities for their proposals or opinions. Former Fed Chair Ben Bernanke once described a central challenge of leading the Fed in precisely this way: "In Washington or any other political context, you have to think about: how can you sell what you want to do to others who are involved in the process" (Dubner 2015). In that vein, the Fed historically has avoided simply reflecting the policy views of presidents who appoint the Board of Governors or district-bank directors who select the reserve-bank presidents. Moreover, rather than applying partisan prescriptions to generate monetary policy, decision making inside the Fed involves technocratic, macroeconomic-policy expertise—even within a political institution.

Instead, we consider the Fed "political" because successive generations of legislators made and remade the Federal Reserve System to reflect a shifting set of partisan, political, and economic priorities. Indeed, as Bernanke emphasized at a ceremony in 2013 to commemorate the Fed's first centennial, the Federal Reserve's power derives from and depends on 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 rather because politicians endow them with the power to exercise public authority on behalf of a diverse and, at times, polarized nation.

By concentrating on the relationship of Congress with the Fed in *The Myth of Independence*, we challenge the most widely held tenet about the modern Fed: central bankers independently craft monetary policy, free from short-term political interference. Instead, we suggest that Congress and the Fed are *interdependent* political institutions. From atop Capitol Hill, Congress depends on the Fed to both steer the economy and absorb public blame when the economy falters. During the Fed's first century, Congress increasingly empowered the Fed by delegating to the central bank more responsibility for managing the economy. By centralizing power in the

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hands of the Fed, lawmakers can more credibly blame the Fed for poor economic outcomes, insulating themselves electorally and potentially diluting public anger at Congress.

In turn, the Fed depends on legislative support. Because the Federal Reserve Act—the governing law for the Fed—is revised frequently, central bankers recognize that Congress circumscribes the Fed's alleged policy autonomy. Fed officials often claim independence to set monetary policy. However, Fed power—and its capacity and credibility to take unpopular but necessary policy steps—is contingent on securing and maintaining broad political and public support. Fortunately for the Fed, compromises made in constructing the Fed in 1913 scaffolded a substructure of public support for it. By embedding 12 regional reserve banks in communities across the country, Congress's organization of the reserve system hardwired support for the Fed far from Washington. To be sure, populist anger at the Fed in the wake of the crisis—amplified by politicians on the Left and the Right—tested that baseline of support for the Fed. However, existential challenges such as former Representative Ron Paul's "End the Fed" campaign came to naught.

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PATTERNS OF MONETARY POLITICS

Acknowledging the Fed's legislative dependency opens the door for political scientists to scrutinize forces that drove its development from a decentralized and relatively weak organization into the world's preeminent macroeconomic policy maker. Furthermore, unlike the first two short-lived US experiments in central banking (i.e., the First and Second Banks of the United States), the Fed (thus far) appears to be an enduring political institution. It would be a mistake, however, to confuse durability with stability: the Fed's powers, organization, and governance have changed markedly over the central bank's first century.

The legislative history of the Fed reveals 18 episodes of major overhaul to the original Federal Reserve Act (Binder and Spindel 2017, chap. 2). Some empower the Fed (Brainard 2014), others limit its autonomy (Zhu n.d.), and some—like the post-crisis Dodd–Frank Wall Street Reform and Consumer Protection Act—do both. Controlling for the duration of recessions, Congress is more likely to amend the Federal Reserve Act when inflation and unemployment tick substantially higher. Congress also is more likely to act when electoral rewards are greatest. If one party controls both the White House and Congress, voters know whom to reward or blame. If the parties divide power, voters have a more difficult time.

Congress is more likely to threaten action than to take it. Using legislative records to document lawmakers' attention to the Fed, we examined all of the bills introduced in the House and Senate between 1947 and 2014 that address the power, structure, and governance of the central bank. In nearly seven decades, 333 House and Senate members introduced 879 bills. Figure 1 arrays the number of bills introduced each year (1947–2014) against the "misery index"—that is, the sum of inflation and unemployment rates. The pattern is clear. When the economy hums, lawmakers leave the Fed alone. For example, congressional attention decreased markedly during Alan Greenspan's Great Moderation beginning in the 1980s, when the Fed tended to achieve its mandates. However, when the economy sours—most recently in the wake of the global financial crisis—reactive lawmakers pummel the Fed.

The countercyclical pattern of congressional attention highlights several dimensions of monetary politics. First, legislative changes to the Federal Reserve Act are not one-off episodes of reform: a recurring, political–economic cycle seems to drive congressional efforts to reshape the goals, structure, and governance of the Fed.

Second, decisions to create and then delegate power to the Fed are clearly political—but not in the way suggested by classic theories of central-bank independence. Such accounts typically suggest that lawmakers create independent central banks to thwart their inflationary biases, thereby constraining their electoral impulses. However, reform episodes during the Fed's first century only rarely come on the heels of rising inflation: deflation—not inflation—has been the more frequent macroeconomic challenge for the Fed. Delegating more power to the Fed in the wake of crisis thus *advances* lawmakers' electoral interests: lawmakers empower the Fed knowing they will blame it in the future.

Third, the Fed's institutional evolution offers a classic case of path dependency. In investigating the development of the Fed, we discovered that by creating a reserve system that spread control of credit far beyond Washington and Wall Street, Congress engineered lasting political and financial support for the Fed on Main Street. Even today, when there are few federal-style reserve systems around the world, legislative reformers have never fully centralized the Fed—despite periodic calls to do so. Long after the demise of the political coalitions that created a decentralized central bank, regionalism and quasi-public/private control remain unique features of the Federal Reserve System. How successive compromises about the powers and organization of the Fed shaped the Fed's capacity to manage the economy and regulate and supervise the financial industry remain ripe for investigation by political scientists eager to understand how and why the

distribution of power in political institutions shapes the formation of policy.

WHY MONETARY POLITICS MATTERS

Lawmakers design the institutional context in which monetary policy is made, setting the terms of membership, organizational detail, and broader governance rules. Legislation further creates and revises monetary-policy tools in reaction to how the Fed has deployed them. For instance, several times in the Fed's history, Congress revamped the Fed's power to make emergency loans. Most recently, in the wake of the financial crisis, Congress revised the Federal Reserve Act to constrain the Fed's future use of its lender-of-last-resort power (Wallach 2015). In addition, lawmakers often criticize the Fed's use of

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dictates the Fed's mandates and determines policy tools available to the Fed for pursuing congressional mandates. Granted, structural features of the Fed—including its budgetary autonomy, long-staggered terms of board members, and private-sector bank participation—buffer central bankers from their congressional overseers. Furthermore, central bankers are prone to distinguish goal dependence from instrument independence (Debelle and Fischer 1994). Economists argue that Congress sets the Fed's goals and instruments but gives the Fed control over how to use the policy instruments—while holding the Fed accountable for meeting its goals.

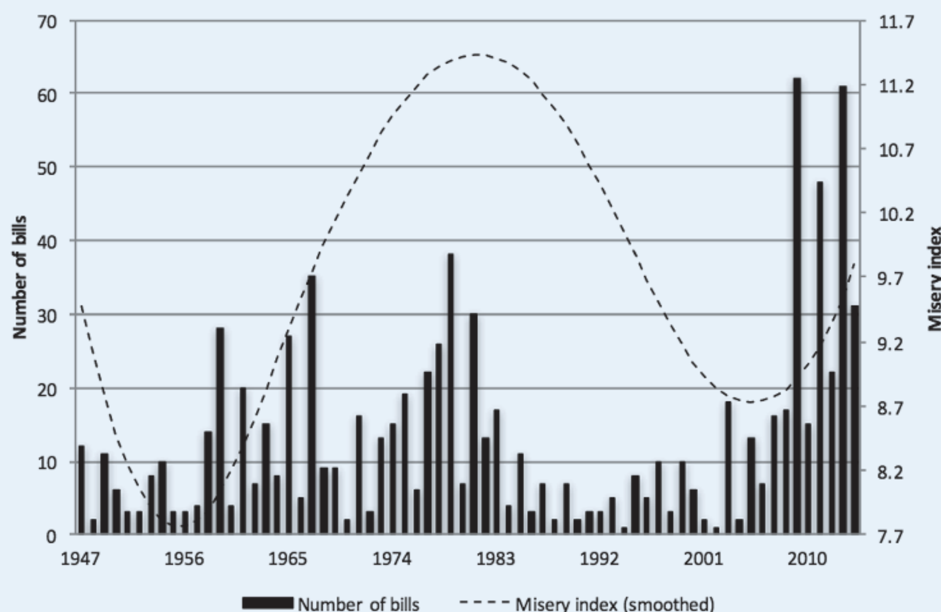
Drawing neat lines between goals and tools and how they are used, however, is easier in theory than in practice. In writing and revising the Federal Reserve Act, Congress does not limit itself to crafting the Fed's mandates. Congress also periodically particular instruments, even though Congress created them in the first place—such as the Fed's power to pay interest on reserves. In summary, the Fed rarely has an entirely free hand to craft monetary policy.

We consider first the Fed's 2012 adoption of an inflation target. Ben Bernanke, then the Fed chairman, first broached the subject with his colleagues a decade earlier. Fed transcripts reveal acute sensitivity to securing congressional support. As Donald Kohn, then the Fed vice chairman, argued in 2008: "[h]aving an inflation target won't have any effect if it is repudiated by the Congress" (Federal Open Market Committee 2008, 68). In the immediate wake of the financial crisis, the perceived political risk of setting a target again deterred Fed action. The Fed did not adopt its target until unemployment finally subsided, years after the crisis—and only after the chairman of the House Financial Services Committee essentially consented to the Fed's move (Bernanke 2015). Even recently, when former Fed officials recommended raising the inflation target to generate greater growth, GOP lawmakers directed then-Chair Janet Yellen to maintain the 2% goal (CQ Congressional Transcripts 2017). The Fed's reaction function (i.e., the path of interest rates) would be altered if/as their inflation target changed.

Second, a decade after the financial crisis and near-generational lows in unemployment, the Fed seems eager to drop Bernanke's crisis prescriptions. The Fed is finally unwinding its four-plus-trillion-dollar balance sheet of assets purchased

Figure 1

Legislative Attention to the Fed Waxes and Wanes with Economic Conditions



Note: The figure shows the number of bills introduced that address the powers and/or governance of the Federal Reserve, 1947–2014. For bill-introduction data, see Adler and Wilkerson n.d.; Proquest n.d.; and http://congress.gov. For economic data, see https://research.stlouisfed.org/fred2.

during and after the crisis, gradually raising interest rates, and keeping an eye on inflation that has been below the previously mentioned target. At a Fall 2017 press conference, Yellen reminded market participants that future policy makers would have a free hand to follow the Bernanke playbook the next time the country faces a financial crisis (Federal Open Market Committee 2017). Rates could return to zero, the balance sheet could be expanded, and so-called forward guidance could provide clear communication about future policy. That sounds good, but monetary politics cautions against such certainty. Republican legislators in particular have been on record for years opposing the Fed's unconventional crisis-era policies, warning that inflation was just around the corner. Whether the Fed will have a free hand to rerun the Bernanke playbook remains to be seen. In any case, the Fed's future policy choices will all but assuredly consider degrees of support within the public and market communities.

Third, Congress has repeatedly imposed transparency requirements on the Fed. In the 1970s, Congress mandated audits of the Fed's books, ordered the Fed chair to report semiannually to Congress, and required Senate confirmation of Fed chairs and vice chairs. More recently, Congress demanded that the Fed reveal the names of emergency borrowers during the crisis and created a new board vice chair for supervision. These types of provisions are at once mechanisms of "sunshine" and levers for Congress to hold the Fed accountable for its performance (Kettl 1986). Either way, transparency requirements illustrate the interdependence of the two institutions. Requiring the Fed to report on its progress in lowering inflation in the 1970s, for example, forced the central bank to balance its own views of appropriate policy against the policies that it believed Congress and the broader public would support. Transparency and accountability requirements make plain who governs the Fed.

ROADS AHEAD FOR STUDENTS OF MONETARY POLITICS

Political scientists should rejoin economists and economic historians in the study of American central banking. Several paths forward are offered by other participants in this symposium, as well as by past political science scholarship on the Fed. Jacobs and King's (2016) *Fed Power: How Finance Wins* interrogated the impact of the Fed on economic inequality in the United States. Adolph's (2015) *Bankers, Bureaucrats, and Central Bank Politics: The Myth of Neutrality* examined the political forces that shape the selection and careers of central bankers. There also is robust new work on the creation and evolution of the Fed by historians of American finance, including Conti-Brown (2016) and Lowenstein (2015). Political science work by Woolley (1984) and Morris (2002) also offered institutional approaches to the study of the Fed. Woolley placed the Fed within the broader political system and examined how an array of institutional actors and organized interests influence the conduct of monetary policy, whereas Morris deployed a game-theoretic model to explore the Fed's relationships with both Congress and the president.

Based on our work on Congress–Fed interdependence, we offer two—of many potential—paths forward for future study. First, in *The Myth of Independence: How Congress Governs the Federal Reserve*, we focused primarily on the institutional evolution of the Fed as a monetary policy maker. However, Congress has always delegated to the Fed the responsibility for regulating banks and other financial institutions—the "plumbing" by which monetary policy operates. Fed officials recognize that expectations and, indeed, the myth of Fed independence circumnavigate the regulatory sphere (Kohn 2014). Given the fragmented nature of financial regulation in the United States, the macroprudential oversight inevitably requires the Fed to collaborate with other financial regulators. The legislative politics driving the century-long evolution of the Fed's regulatory powers remains relatively understudied. Why, when, and how does Congress rewire the architecture of financial regulation and with what consequence for the Fed's relationship with its legislative bosses?

Second, the failure of central banks around the world to anticipate the global financial crisis generated national and international efforts to rethink how central banks can prevent future economic panics. Policy in the past was primarily microprudential: regulation targeted at ensuring the safety and soundness of individual financial firms. In contrast, reactions to the global financial crisis included a renewed focus on macroprudential regulation: new institutions and regulation aimed at mitigating risk and instability across the broader financial system. As central bankers and economists debate how macroprudential policies and institutions should be structured, macroprudential politics are ripe for study.

Why, when, and how does Congress rewire the architecture of financial regulation and with what consequence for the Fed's relationship with its legislative bosses?

In many ways, Congress and the Fed are on unchartered grounds. Both monetary and macroprudential policies can mitigate systemic financial risk. However, within the Fed's unique structure, responsibility for monetary policy is held by the FOMC, whereas regulation is set by the Board of Governors. Which entity will control the use of macroprudential policies? How will Congress react to the Fed's use of such tools? Echoing long-serving Fed Chair William McChesney Martin, former Fed Vice Chair Donald Kohn (2016) argued that macroprudential policy—like monetary policy—requires public support: "Effective countercyclical macroprudential policy will be preemptive—taking away the credit punch bowl as the party gets going and making sure it is full when the party dies down." As such, the Fed's use of macroprudential policy tools—in concert with its conduct of monetary policy—faces potential political risk if it provokes opposition on Capitol Hill. How politics and economics interact to shape

the health of financial markets and the overall economy remains an open question.

CONCLUSION

The Fed is similar to many institutions that "have been around long enough to have outlived not just their designers and the social coalitions on which they were founded but also the external conditions of the time of their foundation" (Streek and Thelen 2005, 28). Given the difficulty of eliminating organizations once they are embedded in statute, political actors try to adapt old rules and authorities to new purposes or to meet new demands (Pierson 2004). Indeed, reformers frequently target old organizations mismatched to new environments by seeking to remold them for new times. In other words, bureaucracies originally created to address past sets of interests can be transformed to serve the purposes of newly empowered coalitions. Old institutions become proving grounds for politicians eager to secure policy goals without having to invest time and resources to create new organizations.

The Federal Reserve is a prime example of historical "conversion" (Streek and Thelen 2005, 26) or, more colloquially, "mission creep." Even in writing the original Federal Reserve Act in 1913, lawmakers were constrained by existing banking institutions and practices. In his first inaugural address, Woodrow Wilson (1913) warned that it would be impossible to wipe the slate clean in designing a central bank: "We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step, we shall make it what it should be." Wilson's admonition foreshadowed a century of congressional efforts to remold the Fed in the wake of recurring economic disasters and electoral change. Each time, previous institutional choices affected new campaigns to revamp the Fed—yielding today's highly unusual federal-style central bank that still endows private- and public-sector actors with influence over the shape of the economy. The impact of monetary politics on economic policy, institutions, and financial markets remains an untilled field ripe for explanation. ■

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