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Crumbling Boundaries and the Risks to Central Bank Independence*

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The debate over the appropriate relationship between monetary policy and fiscal policy is an old one. However, it has taken on renewed significance since the crisis of 2007-2008 as both the Fed and the Treasury have initiated policies that breached accepted norms that had largely been in place since the Treasury-Fed Accord of 1951. My view is that these actions have undermined the institutional arrangements intended to support the independence of our central bank and frayed the boundaries between monetary and fiscal policies.¹

Sargent (2011a, 2011b) discusses the history and struggles of economists and economic theories to provide guidance as to where to “draw the lines between (1) markets for money and credit, and (2) monetary and fiscal policies.” He characterizes these challenges as trying to balance stability versus efficiency. As he says: “Ambiguities and uncertainties about the path forward arise partly because the choices are difficult and involve conflicts of interest that thrust us beyond macroeconomics and into politics.” I do not pretend to answer the deep conceptual problems that Sargent describes. But I do share the view that choices involve conflicts of interest and political economy issues that have important implications for how to “draw the lines.”

The economic historian, Douglass North, was recognized for his work on the role that institutions play in economic growth.² He argued that institutions arise as a way for heterogenous actors to constrain interactions among parties both public and private to ameliorate frictions and hard to resolve conflicts of interest. These institutional arrangements take the form of laws, contracts, business, and corporate

¹ In 2008 and 2009, Jeffery Lacker, my colleague at the Fed and now a colleague on the Shadow Open Market Committee (SOMC), and I began voicing concerns both inside the Fed and more publicly, of the longer-term dangers and risks of the policy approach that was being pursued. See, for example, Lacker (2008, 2009) and Plosser (2008, 2009, 2010a, 2010b, 2012a, 2013, 2017). Plosser (2022) presents overview of the evolution of Fed independence since the 1951 Treasury-Fed Accord and how actions by the Fed and the Treasury undermined the long-standing boundaries between monetary and fiscal policy and the institutional constraints that help ensure the Fed’s independence.

² See, for example, North (1991). Like 2011 Nobel Prize recipient Sargent, North was awarded a Noble Prize in Economics in 1993.

arrangements and even constitutions that establish the institutions of government. The institutions survive because, or as long as, they effectively resolve or manage these conflicts.

The evolution of central banks can be viewed in the same light. Central banks have been around for a long time and the institutional arrangements have evolved. Through much of their history central banks were often private or quasi-private enterprises that operated in a world where the price level was determined by a commodity or metallic standard of one kind or another. In such regimes the central bank, if one existed at all, was often involved with minting metallic coins or executing transactions to maintain the value of the currency in terms of a metallic standard. The gold standard was such a framework, serving as a commitment device that tied the hands of central banks, and the fiscal authorities, in ways that helped define the boundaries between monetary and fiscal policies by limiting the scope and potential conflicts for independent monetary policy actions.

Fluctuations in the international price of gold and war time demands for spending often spurred unwelcome fluctuations in the price level, including disruptive devaluations, often driven by constraints on government budgets and difficulties issuing debt or raising taxes. This fueled a desire by governments to discard the constraints imposed by the gold standard and move to fiat currency regime that permitted greater flexibility. The freedom to use the printing press (that is, to create fiat money) as a means to finance government spending freed governments from the constraints of the gold standard, yet it also heightened the “stability versus efficiency” tensions and exacerbated the basic conflict between the short-term political demands to finance the government’s budget and the longer-term demands for a stable currency. While technology and other innovations have changed over time, this fundamental conflict remains at the heart of the institutional design of the central bank and the desire to establish boundaries between fiscal policy and monetary policy.

Thus, the concept of an “independent” central bank has arisen as an institutional response to some of the conflicts of interest and political problems alluded to by Sargent and many others. Whether this is an optimal solution in some economic sense or merely a sufficient solution is not something that we know. The evidence, however, indicates that the more independent central banks have generally yielded better economic outcomes than other arrangements that have been tried in the fiat money era. For example, economies that have central bank functions tightly controlled by the Treasury more often experience episodes of high and unstable inflation and poor economic growth than those economies in which central banks acted with more independence.

In a democracy, an independent central bank does not and cannot mean that it has unlimited or unrestricted powers, nor does it mean that it is unaccountable. The desirable degree of independence is achieved by limiting the goals and the powers of the central bank, and of the fiscal authorities, in ways that seek to address the thorny conflicts of interest. Of course, government maintains the upper hand since it can change the law and thus the institution, but the goal is to make that solution a “costly” one. Put differently, the institutional arrangements seek to tie the hands of both the monetary and the fiscal authorities in ways that make the commitments and the boundaries more credible. Such commitment devices are almost always imperfect and the temptation to resort to discretion, or to violate the boundaries, can be tempting.

The new threats to Fed independence have arisen due to important changes in the use of the Fed’s balance sheet initiated by the Fed itself and, or in conjunction with, the fiscal authorities. Some actions were intended to influence the allocation of credit, such as purchases of MBS and various lending programs intended to support firms and businesses in the private sector. Such lending is a form of fiscal policy that transfers private risks into public or taxpayer risks.

Other actions by the fiscal authorities explicitly tapped the Fed’s balance sheet to fund off-budget spending. The Fed and the Treasury also used emergency provisions in the Federal Reserve Act (Section 13(3)) to support private institutions and investors in a manner it had never before exercised.³ Application of these lending programs, often characterized as “lender of last resort” operations, lacked systematic guidelines governing their use and limitations.

The Fed also adopted an important change in its operating regime. It did so to accommodate the extraordinary increase in its balance sheet due to credit policies and asset purchases in response to near zero interest rates. The new regime pays interest to banks on their holdings of reserves at the risk-free rate while flooding the banks with reserves. The new regime is often referred to as a “floor system” where the relevant interest rate for setting monetary policy is the interest rate paid on reserves (IOR). At that rate, the Fed can, in principle, flood the banking system with reserve without altering its policy rate. The old regime, referred to as a “corridor system,” required the Fed to control the quantity of

³ See Plosser (2022) and Lacker (2024) for a more detailed discussions of these lending activities and their consequences. It is noteworthy that the Fed did not resort to the discretionary powers of Section 13(3) during other episodes of severe financial stress such as the saving and loan crisis, the failures of Enron or WorldCom, the bursting of the so-called tech bubble or the financial turmoil surrounding the terrorist attack on 9/11.

reserves to keep the policy at the target.⁴ The changes permit Fed to use its balance sheet in different and unconstrained ways. In the context of Sargent's (2011) discussion, it eliminates the wedge between the markets for money and credit.

The highly discretionary actions of its lending activities contribute to moral hazard, incentivizing more risk-taking rather than stability. Along with the new operating regime these actions contribute to the breaking down of the boundaries between monetary and fiscal policy and place the independence of the Fed at risk as will be discussed further below.

I want to touch on three inter-related and familiar aspects of the institutional framework that help draw the lines between monetary and fiscal policies and how the events and policy choices adopted during and subsequent to the 2007-2008 recession are affecting the delicate balancing of the conflicts of interest that exist. These issues include (1) governance, (2) mandates or scope of responsibilities and (3) limitations or constraints on the authorities granted a central bank.

Governance. The political failures of the early attempts to establish a central bank in the U.S. were so distasteful that it took nearly three-quarters of a century after the closing of the Second Bank of the United States before the Congress created the Federal Reserve System in 1913. It was designed as a decentralized institution with a geographical dispersion of semi-private Reserve Banks and a Board of Governors in Washington. Part of the motivation was to support a more decentralized decision-making process, with a diversity of views with less focused on the financial centers and the short-run politics in Washington.⁵

After the collapse of the gold standard, changes were made in the Fed's governance structure. The Banking Act of 1935 removed the Treasury Secretary and the Comptroller of the Currency from the Fed's governing board, granted governing board members 14 year terms and established a new legal entity, the Federal Open Market Committee (FOMC), to govern the conduct of open market operations (the purchase and sale of government securities). These changes reduced the fiscal authority's direct participation in the governing board, but granted greater authority to the political appointed Board of

⁴ See Goodfriend (2002), and Kiester et al (2008), for a more detailed description.

⁵ See Lacker (2024a) for an interesting discussion of the evolution of the diversity of views at the Fed. He suggests that the decline in dissents by FOMC members reflects a shortage of diverse viewpoints within the Committee.

Governors in open market decisions relative to the Reserve Bank presidents. These changes are evidence of the struggle to establish boundaries between monetary and fiscal policy.

The Treasury-Fed Accord of 1951 was an important milestone in support of Fed independence. It was an agreement between the Fed and the Treasury that the central bank would control its own balance sheet rather than tailoring its purchases and sales of government securities at the behest of the Treasury.

Governance remains an important element of the institutional design of an independent central bank. In response to some of the criticisms of Fed policies during financial crisis and pandemic, you hear suggestions that the Fed needs to be held more accountable. To some, that translates into the Fed needs to be more political. For example, it is sometimes argued that Federal Reserve Bank presidents should be political appointees or that they not be permitted to vote on monetary policy matters. Others have suggested more direct involvement in monetary policy by the executive branch which would completely vitiate the boundaries and the spirit of the 1951 Treasury-Fed Accord. Such proposals undermine independence by inviting more political interference, exactly the sort of conflict of interest that independence seeks to address. As I argue below, a better way to promote more accountability is to limit or narrow the scope of responsibilities and authorities of the central bank rather than seeking greater political interference.⁶

Mandate or Scope of Responsibilities. An important mechanism to support central bank independence is to limit the breadth and scope of the central bank's mandate. Narrow mandates focus the central bank on limited well-articulated objectives that make it easier evaluate the institution's success or failure and thus to hold it accountable. Narrow mandates also serve to discourage or limit the central bank's discretion to use its powers or authorities to justify actions that are not clearly related to the mandate. This also helps provide the central bank with the grounds to resist requests to engage in activities that more appropriately rest with the fiscal authorities. Unfortunately, the trend in the U.S., and some other countries, is to expand the scope of central bank mandates, weakening the institutional framework that supports independence.

When establishing the longer-term goals and objectives for any organization it is important that the objectives be achievable. Assigning unachievable objectives is a recipe for failure. In the case of a

⁶ See Plosser (2008, 2013, 2016).

central bank, it could result in the loss of public trust and confidence and thus undermine its effectiveness in achieving its price stability objective. For example, the active pursuit of the maximum employment dimension of Fed's so-called "dual mandate" has been, and continues to be, problematic for the Fed.⁷ The FOMC notes in its statement on longer-run goals and objectives adopted in 2012 that "the maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market." The statement goes on to say this explains why the Fed does not specify a specific numerical target for the object. This acknowledges, appropriately, in my view, the weakness of case that maximum employment constitutes an achievable objective for monetary policy or that there is a mechanism for accountability.⁸

The risks and consequences of mission creep or expanding the goals and expectations of monetary policy is not just a recent concern. In his presidential address to the American Economic Association over 50 years ago, Milton Friedman (1968) warned us that "we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making."

Central Bank Authorities and Operating Restrictions. The authorities or powers granted a central bank are frequently aligned with the role and mandates it is assigned. Most countries today operate under a fiat money regime so central banks are typically given the responsibility to protect and preserve the value or purchasing power of the currency. To achieve this goal central banks are often given the authority to buy and sell assets to manage the growth of money and credit. The ability to buy and sell

⁷ The "dual mandate" terminology itself is a peculiar interpretation of the legislative language. In 1978 Congress amended Section 2A of the Federal Reserve Act. It instructs the FOMC to "maintain the *long run growth* of the monetary and credit aggregates *commensurate* with the economy's *long run* potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." (Italics added). Many discussions about the mandate seem to forget the emphasis placed on the "long run" and instead offer an interpretation that stresses short run employment and long-term inflation (rather than stable prices).

⁸ If this is not confusing enough the Fed revised the 2012 statement on longer run goals in 2020. It now reads that the "maximum level of employment is a broad based and inclusive goal that is not directly measurable and changes over time owing largely to nonmonetary factors that affect the structure and dynamics of the labor market." Levy and Plosser (2020, 2024), for example, discuss how the change in interpretation adopted by the Fed of this vague mandate influenced a significant revision in its monetary policy strategy and its consequences. See also Eggertsson and Kohn (2023) and Ireland (2014a)

assets gives the Fed considerable power to intervene in financial markets not only through the through the quantity of its assets it chooses to hold but also the composition of those assets.⁹

The Federal Reserve Act broadly constrains the Fed to purchases of U.S. government securities, bought and sold in the open market. The Fed does not have general authority to buy private sector securities, such as equities or corporate bonds, nor can it buy securities issued by state and local governments. The purpose of these limitations is to prevent the Fed from directly intervening in the allocation of credit, maintaining as neutral a stance as possible with respect to market outcomes. The logic behind this limitation is to protect the Fed from political pressure from private agents or Congress to provide special treatment for particular industries, sectors, or firms. Unfortunately, the willingness of the Fed to use its balance sheet to engage in large scale purchases of non-Treasury securities, opens the door for many parties to seek reasons to call on the Fed for credit support.¹⁰

Between 1951 and 2007 the Fed followed such a “Treasuries-only” policy. About 99 percent of the growth in the Fed’s balance sheet during this 56-year period is accounted for by outright holdings of U.S. Treasury securities. In August 2007, Treasuries accounted for 90 percent of the Fed’s assets. However, by 2015 Treasuries constituted just 55 percent of Fed assets. By June 2024 Treasuries still only comprised 62 percent of its portfolio. The big difference is accounted for by Fed holdings of MBS.

As mentioned earlier, another operational change adopted by the Fed was to pay interest on reserves. Sargent (2011b) and SOMC colleague Peter Ireland (2014b) offer inciteful discussions of the economic consequences that revolve around stability and indeterminacies of prices when there is no wedge between the markets for money and credit versus the efficiencies gained when that wedge is eliminated. Sargent argues that paying interest on reserves “subverts independence of the central bank and the fiscal authorities.” In Plosser (2010b, 2011) and in subsequent papers, I argued that the Fed should seek to shrink its balance sheet and return to a regime similar to it used prior to the crisis. Such a regime could still pay IOR as long as the rate was below market rates so a wedge was maintained between the markets for money and credit.

⁹ I follow Goodfriend and King (1988) when discussing variations in the central bank’s balance sheet. They associate monetary policy with changes in the size of the balance sheet and changes in the composition of assets held as credit policy.

¹⁰ Many, if not most, of the lending programs put in place by the Fed could have been done by the fiscal authorities, Treasury or Congress.

Many at the Fed and elsewhere cite as an advantage of paying interest on reserves at market rates is that it divorces the size of the balance sheet from the Fed's interest rate policy. This allows the Fed to buy and sell assets to pursue other objectives without altering its interest rate policy. The "excess reserves" will have to be held by the banking system at the risk-free market rate. This framework is ripe for political abuse and exploitation.¹¹ What rules would constrain the Fed or the government from flooding the banking system with reserves or allow its unconstrained balance to be used by politicians or the Congress to curry favor with one firm, sector or industry with government loans. What would prevent the Fed from purchasing large quantities of government debt? The perception or belief that the size and composition of the Fed's balance sheet represented a "new" free parameter to conduct credit allocation or support fiscal policy objectives is dangerous. The Fed would be dragged deep into a fiscal and political quagmire. It is a sure way for the Fed to lose its independence. Is that worth the expected gains in efficiency of a small wedge between the returns on money and the market's risk-free rate?

In Plosser (2022), I describe ways the Fed and Treasury could restore the boundaries. Among the suggestions are to require the Fed to return to a Treasuries-only portfolio; require the Fed to return to an operating regime that constrains the size of the balance sheet to avoid potential politicization; eliminate or rewrite the emergency lending provision, Section 13 (3), so that the fiscal authorities have full authority and accountability for any lending decisions and residual risk. Independence could also be strengthened if the Fed was more transparent by articulating a set of rules for conducting monetary policy as well as for any credit policies it was authorized to take.

Let me conclude by saying that an independent central bank continues to play an important role in balancing the conflicts of interests among the monetary and fiscal demands of our government. That independence is achieved through constraints placed on the central bank and on the fiscal authorities that draw lines or set boundaries between monetary and fiscal policies. Unfortunately, the boundaries are eroding slowly but surely and as a result independence will continue to fade.

¹¹ See Plosser (2017,2022), Mester (2024) and Nelson (2024).

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