Should central banks be politically independent?

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The case for central bank independence from the political branches of the government is simple. Central banks control the amount of money in the economy. For example, by selling short-term government securities for cash, they reduce the amount of money in the economy and this drives up short-term interest rates, while by buying such securities for cash they increase the amount of money in the economy and that drives down short-term interest rates. (Long-term interest rates are also affected, and in the same direction.) Politicians like the money supply to increase before elections, because a reduction in interest rates stimulates economic activity; consumers borrow more to consume, and businesses borrow more to invest in production. In principle, consumers and businesses should anticipate inflation (if the money supply is increasing faster than the output of goods and services), resulting in higher long-term interest rates and various distortions in economic activity, and take preventive measures that will reduce the stimulative effect of the central's bank low-interest-rate policy. But we know from the reaction of consumers and producers to the very low interest rates of the early 2000s that the effect of very low rates on consumption and production are not fully and immediately offset by anticipation of future consequences.

Thus if a nation's central bank is controlled by politicians, it can be expected to reduce short-term interest rates at particular phases in the electoral cycle, and this tendency, because unrelated to any economic reasons for low interest rates, can be expected to have an inflationary effect. Moreover, inflation can easily get out of hand. When inflation is anticipated, the amount of money in circulation increases; people hold smaller cash balances because inflation erodes the value of cash. The more rapidly money circulates, the higher the ratio of money to output and therefore the higher the rate of inflation. (Money that does not circulate—money that people keep under their mattresses, for example—are not really part of the money supply because they are not exchanged for goods or services.)

As inflation mounts, the cure—a sharp reduction in the money supply and concomitant increase in interest rates—becomes more painful. When Paul Volcker, the chairman of the Federal Reserve, pushed short-term interest rates to 20 percent in August 1981 to break an inflation rate that had reached 15 percent, he precipitated a very sharp recession. President Reagan was furious but Volcker stuck to his guns. A politically dependent Federal Reserve probably would not have done so.

In fact the Federal Reserve is not completely independent from politics. Unlike the Supreme Court, its independence is not dictated by the Constitution. The United States did not have a central bank when the Constitution was promulgated, and the Constitution didn't require the creation of one. The Federal Reserve dates only from 1911, and before then experiments with central banking in the United States had been sporadic. The Federal Reserve's independence—which is a function of the long terms of the members of the Federal Reserve Board (14 years, though the chairman's term is only four years, albeit renewable), the fact that they cannot be removed before the expiration of their terms, the fact that the Federal Reserve is self-financed rather than financed by annual congressional appropriations, and the fact that the members of the Open Market Committee (the organ of the Federal Reserve that controls the money supply) include presidents of the local federal reserve banks, who are chosen by private banks rather than by the President—is a gift of Congress; and what Congress has given, Congress can take back. Hence Federal Reserve chair-

men and members can't just thumb their nose at Congress.

Particularly not in an economic crisis, such as hit the country and the world in September 2008. Essentially the Federal Reserve recapitalized the banking industry by buying its mortgage-backed securities (and other bank debt as well), thus pouring cash into the banking system. (As did the Treasury Department.) By greatly expanding the money supply, the Fed sowed the seeds of a future inflation—but in times of economic desperation the attitude is: let the future take care of itself.

The Supreme Court is the best example of a government institution that is outside political control. The Justices can as a practical matter be removed from office only if they commit crimes, and their decisions on matters of constitutional law can be nullified only by the very cumbersome process of amending the Constitution. Also, there is widespread public respect for the Supreme Court, and for courts and judges in general. The Federal Reserve has neither constitutional standing nor the enthusiastic support of the people. Its close links to the banking industry are noted and very few people have even the slightest understanding of the Fed's role and responsibilities. It performed ineptly in the run up to the financial crisis and in refusing to bail out Lehman Brothers. Bernanke's reappointment drew sharp opposition in the Senate, and there is some indication that Senate Majority Leader Reid extracted from Bernanke during the confirmation process a quasi-promise not to raise short-term interest rates too soon, lest by doing so the Fed choke of an economic recovery.

So the Fed is best described as quasi-independent rather than independent. A constitutionally independent Fed—an institution parallel to the Supreme Court—would create something close to a dictatorship over the business cycle, and this is too much power for a democratic society (perhaps any society) to cede to a bevy of economists and financiers. But the quasi-independence of the Fed, by giving it a great deal of discretion over monetary policy (even if the discretion is not complete), worries some economists, who think the Fed apt to misuse it, whether because of unsound economic theories or in an effort to mollify the political branches. But occasional proposals, as by Milton Friedman, to tie the Fed to a precise formula for increasing or decreasing short-term interest rates seem too rigid, because a formula cannot prescribe the correct response to unpredictable shocks to the economy, as we experienced in the financial collapse of 2008.