Testimony

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Federal Reserve independence

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Chairman Watt, Ranking Member Paul, and other members of the Subcommittee, I appreciate the opportunity to discuss with you the important public policy reasons why the Congress has long given the Federal Reserve a substantial degree of independence to conduct monetary policy while ensuring that we remain accountable to the Congress and to the American people. In addition, I will explain why an extension of the Federal Reserve's supervisory and regulatory responsibilities as part of a broader initiative to address systemic risks would be compatible with the pursuit of our statutory monetary policy objectives. I also will discuss the significant steps the Federal Reserve has taken recently to improve our transparency and maintain accountability.

Independence and Accountability

A well-designed framework for monetary policy includes a careful balance between independence and accountability. A balance of this type conforms to our general inclination as a nation to have clearly drawn lines of authority, limited powers, and appropriate checks and balances within our government; such a balance also is conducive to sound monetary policy.

The Federal Reserve derives much of the authority under which it operates from the Federal Reserve Act. The act specifies and limits the Federal Reserve's powers. In 1977, the Congress amended the act by establishing maximum employment and price stability as our monetary policy objectives; the Federal Reserve has no authority to establish different objectives. At the same time, the Congress has--correctly, in my view--given the Federal Reserve considerable scope to design and implement the best approaches to achieving those statutory objectives. Moreover, as I will discuss in detail later, the independence that is granted to the Federal Reserve is subject to a well-calibrated system of checks and balances in the form of transparency and accountability to the public and the Congress.

The latitude for the Federal Reserve to pursue its statutory objectives is expressed in several important ways. For example, the Congress determined that Federal Reserve policymakers cannot be removed from their positions merely because others in the government disagree with their views on policy issues. In addition, to guard against indirect pressures, the Federal Reserve determines its budget and staff, subject to congressional oversight. Thus, the system has three essential components: broad objectives set by the Congress, independence to pursue those legislated objectives as efficiently and effectively as possible, and accountability to the Congress through a range of vehicles.

Benefits of Independence to Conduct Policy in Pursuit of Legislated Objectives

The insulation from short-term political pressures--within a framework of legislated objectives and accountability and transparency--that the Congress has established for the Federal Reserve has come to be widely emulated around the world. Considerable experience shows that this type of approach tends to yield a monetary policy that best promotes economic growth and price stability. Operational independence--that is, independence to pursue legislated goals--reduces the odds on two types of policy errors that result in inflation and economic instability. First, it prevents governments from succumbing to the temptation to use the central bank to fund budget deficits. Second, it enables policymakers to look beyond the short term as they weigh the effects of their monetary policy actions on price stability and employment.

History provides numerous examples of non-independent central banks being forced to finance large government budget deficits. Such episodes invariably lead to high inflation. Given the current outlook for large federal budget deficits in the United States, this consideration is especially important. Any substantial erosion of the Federal Reserve's monetary independence likely would lead to higher long-term interest rates as investors begin to fear future inflation. Moreover, the bond rating agencies view operational independence of a country's central bank as an important factor in determining sovereign credit ratings, suggesting that a threat to the Federal Reserve's independence could lower the Treasury's debt rating and thus raise its cost of borrowing.[1] Higher long-term interest rates would further increase the burden of the national debt on current and future generations.[2]

The second way in which political interference with monetary policy can damage the economy is by promoting an undue focus on the short term. Because excessively easy monetary policy tends to boost economic activity temporarily before the destabilizing effects of higher inflation are felt, policymakers with a relatively short-term outlook may be tempted to ease monetary policy too much. The eventual result is higher inflation without any permanent benefit in terms of employment, an outcome that is inconsistent with the dual mandate for maximum employment and price stability. Thus the increase in inflation must be followed by policies to bring inflation back down--policies that have the side effect of temporarily reducing output and employment. The fixed, lengthy, and overlapping terms of Federal Reserve Board members, in combination with the other elements of operational independence, help ensure that the Federal Reserve appropriately considers both the short-term and long-term effects of its policy decisions.

Statistical studies have confirmed that countries with more independent central banks experience lower and more stable rates of inflation with no sacrifice of jobs or income.[3] Moreover, low and stable rates of inflation help to deliver strong economic growth and high rates of employment. The benefits of central bank independence appear to be a major explanation for the trend I mentioned earlier of countries moving to establish or to enhance the independence of their central banks. It is surely no coincidence that countries around the world have experienced sustained declines in the level and variability of inflation as they have moved to grant their central banks greater operational independence.

Monetary Policy Independence and the Mitigation of Systemic Risk
Is monetary policy independence threatened by giving a central bank other responsibilities, such as supervisory and regulatory authority for some parts of the financial system? Are there potential conflicts between a high degree of independence for monetary policy and accountability in supervisory and regulatory policy? I believe that U.S. and foreign experience shows that monetary policy independence and supervisory and regulatory authority are mutually compatible and even have beneficial synergies.

The current financial crisis has clearly demonstrated the need for the United States to have a comprehensive and multifaceted approach to containing systemic risk. The Administration recently released a proposal for strengthening the financial system that would provide new or enhanced responsibilities to a number of federal agencies, including the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission with respect to over-the-counter derivatives, the SEC with respect to hedge funds and their advisers, and several agencies, including the Treasury, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the SEC with respect to the resolution of systemically important failing nonbank financial institutions. In addition, the proposal would provide the Federal Reserve certain new responsibilities for overseeing systemically important financial institutions and payment, clearing, and settlement arrangements.

These incremental new responsibilities are a natural outgrowth of the Federal Reserve's existing supervisory and regulatory responsibilities. Through our role as consolidated supervisor of all bank holding companies (BHCs), the Federal Reserve has long been responsible for supervising many of the most important U.S. financial organizations, and in the current crisis several more large complex financial firms--including Goldman Sachs, Morgan Stanley, and American Express--have become bank holding companies. And the expanded regulatory authority of the Federal Reserve with respect to payment and settlement systems builds upon our existing responsibilities for supervising certain critical payment, clearing, and settlement systems, such as the Depository Trust Company and CLS Bank, as well as our historical efforts to reduce risk in such systems through, for example, our Payment System Risk Policy.[4]

The authorities that the Administration's proposal would provide the Federal Reserve with respect to systemically important non-BHC financial firms and payment, clearing and settlement systems also are similar in many respects to the authorities that the Federal Reserve currently has with respect to bank holding companies and payment, clearing, and settlement systems under our supervision. The Administration's proposal does call for a more macro-prudential approach to the supervision and regulation of systemically important financial firms and payment, clearing, and settlement systems, including the establishment of higher capital, liquidity, and risk-management requirements for systemically important firms. The Federal Reserve already has been moving to incorporate a more macro-prudential approach to our supervisory and regulatory programs, as evidenced by the recently completed Supervisory Capital Assessment Program. The Federal Reserve has also long been a leader in the development of strong international risk-management standards for payment, clearing, and settlement systems and has implemented these standards for the systems it supervises.

In our supervision of bank holding companies and our oversight of some payment systems, we already work closely with other federal and state agencies and participate in groups of regulators and supervisors such as the Federal Financial Institutions Examination Council and the President's Working Group on Financial Markets. These responsibilities and close working relationships have not impinged on our monetary policy independence, and we do not believe that the enhancements proposed by the Administration to the Federal Reserve's supervisory and regulatory authority would undermine the Federal Reserve's ability to pursue our monetary policy objectives effectively and independently.

Indeed, these enhancements would complement the Federal Reserve's monetary policy responsibilities. The Federal Reserve and other central banks have always been involved in issues of systemic risk, most notably because central banks act as lenders of last resort. Central banks, which operate in markets daily and have macroeconomic responsibilities, bring a broad and unique perspective to analysis of developments in the financial system. And, as we have seen over the past two years, threats to the stability of the financial system can have major implications for employment and price stability. Thus, the Federal Reserve's monetary policy objectives are closely aligned with those of minimizing systemic risk. To the extent that the proposed new regulatory framework would contribute to greater financial stability, it should improve the ability of monetary policy to achieve maximum employment and stable prices.

Accountability and Transparency

In a democracy, any significant degree of independence by a government agency must be accompanied by substantial accountability and transparency. The Congress and the Federal Reserve have established a number of policies and procedures to ensure that the Federal Reserve continues to use its operational independence in a manner that promotes the nation's well-being. The Federal Reserve reports on its experience toward achieving its statutory objectives in the semiannual *Monetary Policy Report*s and associated congressional testimony. The Federal Open Market Committee (FOMC) releases a statement immediately after each regularly scheduled meeting and detailed minutes of each meeting on a timely basis. We also publish summaries of the economic forecasts of FOMC participants four times a year. In addition, Federal Reserve officials frequently testify before the Congress and deliver speeches to the public on a wide range of topics, including economic and financial conditions and monetary and regulatory policy.

Our financial controls are examined by an external auditor, and Reserve Bank operations and controls are reviewed by each Reserve Bank's independent internal audit function and by Board staff who oversee Reserve Bank activities. We provide the public and the Congress with detailed annual reports on the consolidated financial activities of the Federal Reserve System that are audited by an independent public accounting firm. We also publish a detailed balance sheet on a weekly basis.

The Federal Reserve recognizes that the new programs we have instituted to combat the financial crisis must be accompanied by additional transparency. Americans have a right to know how the Federal Reserve is using taxpayer resources and they need to be assured that we are acting in a responsible manner that minimizes risk and maintains the integrity of our operations. We have increased the transparency of our actions while safeguarding our ability to achieve our public policy goals of fostering financial and economic stability. This year we expanded our website to include considerable background information on our financial condition and our policy programs. Recently, we initiated a monthly report to the Congress and the public on Federal Reserve liquidity programs that provides even more information on our lending, the associated collateral, and other facets of programs established to address the financial crisis. These steps should help the public understand the considerable efforts we have taken to minimize the risk of loss as we provide liquidity to the financial system in our role as lender of last resort. Altogether, we now provide a higher degree of transparency than at any other time in the history of the Federal Reserve System. Because of the large volume of information we publish, the Federal Reserve is among the most transparent central banks in the world.

Federal Reserve policymakers are highly accountable and answerable to the government of the United States and to the American people. The seven members of the Board of Governors of the Federal Reserve System are appointed by the President and confirmed by the Senate after a thorough process of public examination. The key positions of Chairman and Vice Chairman are subject to presidential and congressional review every four years, a separate and shorter schedule than the 14-year terms of Board members. The members of the Board of Governors account for seven seats on the FOMC. By statute, the other five members of the FOMC are drawn from the presidents of the 12 Federal Reserve Banks. District presidents are appointed through a process involving a broad search of qualified individuals by local boards of directors; the choice must then be approved by the Board of Governors. In creating the Federal Reserve System, the Congress combined a Washington-based Board with strong regional representation to carefully balance the variety of interests of a diverse nation. The Federal Reserve Banks strengthen our policy deliberations by bringing real-time information about the economy from their district contacts and by their diverse perspectives.

Oversight by the Government Accountability Office

On the topic of Federal Reserve accountability and transparency, the possibility of expanding the audit authority of the Government Accountability Office (GAO) over the Federal Reserve has recently been discussed. As you know, the Federal Reserve is subject to frequent audits by the GAO on a broad range of our functions.

For example, the supervisory and regulatory functions of the Federal Reserve are subject to audit by the GAO to the same extent as the supervisory and regulatory functions of the other federal banking agencies. Thus, the GAO has full authority to--and does in fact--audit the manner in which the Federal Reserve supervises and regulates bank holding companies on a consolidated basis. Moreover, if the Congress were to provide the Federal Reserve with responsibility for serving as the consolidated supervisor of systemically important financial firms that are not bank holding companies, the GAO would, under existing law, have full authority to audit the Federal Reserve's supervision and regulation of such firms as well. We would expect the GAO to actively use that authority, as it does today. Indeed, as of June 29, 2009, the GAO had 19 engagements under way involving the Federal Reserve, including 14 that were initiated at the request of the Congress. In addition, since the beginning of 2008, the GAO has completed 26 engagements involving the Federal Reserve, including engagements related to the Basel II capital framework, risk-management oversight, the Bank Secrecy Act, and the Board's Regulation B, which implements the Equal Credit Opportunity Act.

The Congress also recently clarified the GAO's ability to audit the Term Asset-Backed Securities Loan Facility (TALF), a joint Treasury-Federal Reserve initiative, in conjunction with the GAO's reviews of the performance of Treasury's Troubled Asset Relief Program (TARP). The Federal Reserve has been working closely with the GAO to provide that agency with access to information and personnel to permit it to fully understand the terms, conditions, and operations of the TALF so that the TARP can be properly audited. At the same time, the Congress granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to "single and specific" companies under the authority provided by section 13(3) of the Federal Reserve Act, including the loan facilities provided to, or created for, American International Group and Bear Stearns. These facilities are markedly different from the widely available credit facilities--such as the discount window access for depository institutions, the Primary Dealer Credit Facility, and the Commercial Paper Funding Facility--that the Federal Reserve either has historically used or has recently established to address broad credit and liquidity issues in the financial system. For this reason, the Federal Reserve did not object to granting the GAO audit authority over these institution-specific, emergency credit facilities.

The Congress, however, has purposefully--and for good reason--excluded from the scope of potential GAO audits monetary policy deliberations and operations, including open market and discount window operations, and transactions with or for foreign central banks, foreign governments, and public international financing organizations. By excluding these areas, the Congress has carefully balanced the need for public accountability with the strong public policy benefits that flow from maintaining the independence of the central bank's monetary policy functions and avoiding disruption to the nation's foreign and international relationships.

The same public policy reasons that supported the creation of these exclusions in 1978 remain valid today. The Federal Reserve strongly believes that removing the statutory limits on GAO audits of monetary policy matters would be contrary to the public interest by tending to undermine the independence and efficacy of monetary policy in several ways. First, the GAO serves as the investigative arm of the Congress and, by law, must conduct an investigation and prepare a report whenever requested by the House or Senate or a committee with jurisdiction of either body. Through its investigations and audits, the GAO typically makes its own judgments about policy actions and the manner in which they are implemented, as well as recommendations to the audited agency and to the Congress for changes or future actions. Accordingly, financial markets likely would see the grant of audit authority with respect to monetary policy to the GAO as undermining monetary independence--with the adverse consequences discussed previously--particularly because GAO audits, or the threat of a GAO audit, could be used to try to influence monetary policy decisions.

Permitting GAO audits of monetary policy also could cast a chill on monetary policy deliberations through another channel. Although Federal Reserve officials regularly explain the rationale for their policy decisions in public venues, the process of vetting ideas and proposals, many of which are never incorporated into policy decisions, could suffer from the threat of public disclosure. If policymakers believed that GAO audits would result in published analyses of their policy discussions, they might be less willing to engage in the unfettered and wide-ranging internal debates that are essential to identifying the best possible policy options. Moreover, the publication of the results of GAO audits related to monetary policy actions and deliberations could complicate and interfere with the communication of the FOMC's intentions regarding monetary policy to financial markets and the public more broadly. Households, firms, and financial market participants might be uncertain about the implications of the GAO's findings for future decisions of the FOMC, thereby increasing market volatility and weakening the ability of monetary policy actions to achieve their desired effects.

These concerns extend to the policy decisions to implement the discount window and broadly available credit facilities. These facilities are extensions of our responsibility for promoting financial stability, maximum employment and price stability. Indeed, unlike the institution-specific loans that the Federal Reserve has made that now are subject to GAO audit, these broader market facilities are designed to unfreeze financial markets and lower interest rate spreads in concert with our other monetary policy actions. It is important that, like other monetary policy decisions, the Federal Reserve remain independent in making policy decisions regarding these facilities.

An additional concern is that permitting GAO audits of the broad liquidity facilities the Federal Reserve uses to affect credit conditions could reduce the effectiveness of these facilities in helping promote financial stability, maximum employment, and price stability. For example, even if strong confidentiality restrictions were established, individual banks might be more reluctant to borrow from the discount window if they knew that their identity and other sensitive information about their borrowings could be disclosed to the GAO. Rumors that a bank may have used the discount window can cause a damaging loss of confidence even to a fundamentally sound institution. Experience, including experience in the current financial crisis, shows that banks' unwillingness to use the discount window can result in high and volatile short-term interest rates and limit the effectiveness of the discount window as a tool to enhance financial stability.

Overall, the Federal Reserve believes that removing the remaining statutory limits on GAO audits of monetary policy and discount window functions would tend to undermine public and investor confidence in monetary policy by raising concerns that monetary policy judgments in pursuit of our legislated objectives would become subject to political considerations. As a result, such an action would increase inflation fears and market interest rates and, ultimately, damage economic stability and job creation.

Thank you for inviting me to present the Board's views on this very important subject. I look forward to answering any questions you may have.

Footnotes

1. Standard & Poor's (2004), "Sovereign Credit Ratings: A Primer," March 15, www2.standardandpoors.com/spf/pdf/products/SovRatingsPrimer_sov.pdf. Return to text

2. The beneficial effects of central bank independence on a government's borrowing costs have been observed even when budget deficits are not unusually large. For example, on May 6, 1997, the U.K. government announced that the Bank of England would be given considerable operational independence. The yield on 10-year U.K. government bonds fell 30 basis points that day, even though the government made no change to the Bank of England's policy objectives and there was no other prominent economic or policy news. Market participants widely attributed the decline in long-term interest rates to the surprise announcement of independence and the consequent increased confidence in future price stability. Return to text

3. See, for example, the survey in Alex Cukierman (2008), "Central Bank Independence and Monetary Policymaking Institutions--Past, Present, and Future," *European Journal of Political Economy*, vol. 24 (December), pp. 722-36. Return to text

4. The Federal Reserve's Payment System Risk Policy can be found at http://www.federalreserve.gov/paymentsystems/psr/default.htm. Return to text

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