Federal Reserve Accountability

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Abstract: Since its founding, the Federal Reserve has occupied a unique place in American government and has been shielded from standard levels of accountability. The current financial crisis illustrates the need for removing that shield and this brief proposes several steps that would bring the monetary authority into line with public-sector norms. These proposals include a statutory clarification of the Fed's agency status, the strengthening of disclosure and oversight mechanisms, and a series of ownership, governance and education reforms intended to enhance the central bank's accountability to the public.

In April 1926, an exasperated Louis McFadden gazed at the witness testifying before the House Banking Committee he chaired. "There are many decisions which you arrive at of which the public have no knowledge," he told Adolph Miller, a University of California economist who had served on the Federal Reserve Board since its inception. Perhaps, McFadden suggested, Miller and his colleagues might "improve your situation by giving some kind of an utterance or an expression, so that the public and those interested in the various situations might know what these decisions are." After all,

> there is much of the inner discussions…that would be helpful to the country generally in guiding them and keeping them away from speculative tendencies if they knew exactly what those conclusions were. In other words, it seem to me much of the activities of the Federal Reserve Board are kept under cover and more good might result from letting the sun's rays in and publishing them broadcast.[1]

Cornered, the windy and didactic Miller hedged furiously. "I myself," he declared "am a great believer in the saving force of publicity under our form of government" even though "every now and then" openness "may perhaps paralyze a public body" or lead it "to ill-advised action" in an attempt to "accommodate…what it conceives to be public sentiment." Overall, said Miller, "a public body invested with broad discretionary powers ought to give an indication pretty frequently of the background against which its decisions are taken" and he was "not prepared to say it should not be done in the Federal Reserve." Indeed, he noted, the Board was already publishing regular accounts of its thinking and actions, most famously the 1923 annual report Miller coauthored – a document hailed at the time as a landmark in central bank communication. But the Fed kept running up against a conundrum. "It seems hard," Miller concluded plaintively, "to get the public to pay attention to what we are doing."

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Eighty three years later, the Federal Reserve does not lack for attention. The unprecedented expansion of its emergency powers and refusal to disclose critical details of its rescue operations have put the Fed firmly in the public spotlight and prompted demands that it account for years of regulatory minimalism, lax supervision and an indulgent approach both to asset bubbles and growing concentration and complexity in financial markets. More than 290 members of the House of Representatives have cosponsored **a bill** that would eliminate longstanding restraints on the Government Accountability

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Office's authority to audit the central bank and instruct the GAO to conduct a full-dress examination of the Fed. **Other measures** before Congress would require the monetary authority to obtain Treasury's approval before exercising its ad hoc bailout authority and would relocate crucial regulatory responsibilities from the central bank and its sister agencies to a new Consumer Financial Protection Agency. Political support for vesting new systemic-risk oversight authority in the Fed ebbed quickly in favor of placing such power in the hands of a multi-agency council.

None of these measures would fundamentally alter the Federal Reserve's architecture, main functions or statutory goals for monetary policy. But collectively they represent the latest echo of Rep. McFadden's encounter with Adolph Miller and many subsequent debates about the central bank's prerogatives, performance, communication practices and accountability. The durability of these disputes – and the frequency with which they reopen seemingly settled questions about the Fed's underlying legitimacy – can be traced largely to the central bank's odd place in American government and the methods by which it has been perpetuated.

Due to a series of Wilsonian compromises, the monetary authority represents an unusual amalgam of public and private characteristics, the most unique of which reserves to commercial banks sole ownership of stock in the regional Federal Reserve Banks. Though these shares confer only limited ownership rights, member banks also control the selection of six directors on each Reserve Bank's nine-person governing board. The board's power to hire the Reserve Bank president (subject to approval by the Board of Governors) and the Bank president's power to participate in Federal Open Market Committee deliberations make the FOMC a unique creature. Alone among a huge array of U.S. agencies, commissions and government corporations, it combines a broad economic management mandate with a public-private structure that formally grants individuals who are not public officials a central role in creating government policy. While defenders of these structural features view them as safeguards against the popular allure of pro-inflation sentiments, a wide variety of capitalist democracies have managed to maintain low inflation and independent central banks without one part of the private sector owning or governing their monetary authority.[2]

Not coincidentally, the Federal Reserve's agency status has remained uniquely murky. While the Board of Governors is clearly a part of the federal government – and designated as a federal executive agency in the Federal Tort Claims Act – it is either exempted from or not specifically covered by statutes like the Civil Rights Act of 1964 and the Federal Labor Relations Act. The regional Reserve Banks are considered instrumentalities of the federal government for purposes of immunity from state or local taxation and the Banks' employees belong to a Systemwide retirement fund the IRS certified as a government pension plan in 1976. But when dealing with information requests, employment opportunity complaints and other intrusions, the Reserve Banks usually claim to be private corporations.[3]

Meanwhile, features of the System that seemed explicable in 1913 have grown less and less defensible. Although the demand for check processing and other services once justified the sprawling scale of the regional Reserve Bank system, that demand has diminished radically with the growth of paperless transactions. The Banks have downsized, repurposed or closed a number of their check-handling facilities. But overall, the regional system remains organized exactly as it was when paper checks were ubiquitous and cities like Philadelphia, Chicago, Dallas and San Francisco were commercial banking centers. Moreover, the railroad-era division of the U.S. into Federal Reserve Districts has left the central bank with an antiquated and wildly unequal representation scheme for different areas of the country and components of the economy. Today, the three largest Reserve Districts contain nearly half the country's population while the three smallest contain barely 10 percent. From year to year, the five Reserve Banks with a vote on the FOMC may account for as much as two-thirds of U.S. population or as little as one-third.[4]

In addition, new anomalies developed on top of encrusted ones. During debate over the Federal Reserve Act, senators claimed the new monetary authority would require "special talent" and shouldn't be forced "to take incompetent people who have passed some kind of an examination prescribed by a civil-service board who know nothing about banking."[5] As a result, Section 11 of the Act excluded central bank staffers from the civil service and authorized the Board to establish its own rules for "employment, compensation, leave and expenses." Among other things, these provisions deprived Fed employees of basic safeguards, such as whistleblower protection, afforded to almost all other federal workers.[6] They also established a pattern for Fed exceptions to future good-government measures. Over time, the central bank insisted upon and received key exemptions from the Freedom of Information and Government in the Sunshine Acts, the aforementioned restrictions on GAO audits of monetary policy operations, an inspector general who serves at the pleasure of the Fed chairman, rather than being appointed by the president as is customary in the rest of government, and special treatment under the Federal Advisory Committee Act – shared only by the CIA – that permits the Board's banking industry advisory group (the Federal Advisory Council, or FAC) to meet with it behind closed doors and withhold records of the sessions.

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Almost from the start, these eccentricities have excited conspiracists and spurred reformers to make the Fed more accountable to the public it serves – either by altering the central bank's structure or through other means. Their efforts have included high-profile congressional inquiries (beginning with the 1921 Joint Commission on Agricultural Inquiry), government-sponsored commissions (notably the 1948 Hoover Commission and its Fed report by former Board economist George L. Bach), private initiatives (like the 1961 Commission on Money and Credit), periodic litigation (most recently the Appointments Clause suits of the 1980s) and numerous legislative proposals (many of which since the early 1920s have equated greater accountability with tying monetary policy to specific price-stability or money supply-growth targets).[7]

On a handful of occasions, reformers succeeded. Drafted at the initiative of New Deal chairman Marriner Eccles, the 1935 Banking Act enabled the Fed's Washington-based Board to lead what had been a fractured System dominated by its private interests. In addition, Eccles's assistant Lauchlin Currie authored a provision in the 1935 Act that compelled the modernized central bank to make public its policy decisions and the reasoning behind them. Propelled by the same spirit, a series of congressional initiatives between 1975 and 1978[8] formalized the full employment-price stability mandate that is supposed to guide monetary policy, established a framework for regular central bank reporting to Congress and required the System to make Reserve Bank directors more representative of the general population.

Over the past two decades reform efforts persisted episodically. But during most of this period, the legislative and executive branches treated the monetary authority with extraordinary deference. Thus, like capital standards and deposit insurance premia, the political environment for Fed decision-making tended to be highly procyclical over the course of the "Great Moderation" – indulgent (if not celebratory) in good economic times, critical (if not punitive) in bad. With hindsight it seems clear that many factors contributing to the current financial crisis might have been moderated and responses to the emergency rendered more transparent and palatable had the central bank been subjected to aggressive countercyclical scrutiny rather than being shielded from standard levels of accountability.

The removal of that shield is long overdue and should proceed from a simple principle: the Federal Reserve is neither above public-sector norms nor entitled to arbitrage their gaps. Perhaps the most direct way to implement this principle would be to change Section 1 of the Federal Reserve Act by designating the Board, the Banks and the FOMC collectively as an independent government agency, thereby placing the central bank within the ambit of laws and regulations that currently exempt or do not specifically cover it. Legitimate reasons may exist for keeping the Fed's main functions free of partisan interference and conventional short-term political considerations. But the Board's history clearly shows that institutional protections such as the six decade-old Treasury Accord, autonomous budgeting authority and long terms for governors provide adequate means for such independence and would continue to do so were the entire System designated an independent agency.

Embracing the public-norms principle would trigger other changes as well. For example, there is simply no compelling reason why the Fed's **inspector general** should not be appointed by the president, the Fed's full gamut of operations should not be audited by GAO or the FAC should not expose itself to the same public scrutiny as other government advisory bodies. Congress should eliminate or narrow to a sensible minimum the central bank's exemptions from FOIA and the Government in Sunshine Act. Complete records of official Board, FOMC and Reserve Bank business should be freely available without an excessive lag; mindful of the 1975 *Merrill* ruling,[9] legislation establishing this requirement should cleanly preempt judicial deference to future Fed claims of secrecy prerogatives. Congress also should insist that a representative of the Reserve Banks' Conference of Presidents – preferably the president of FRB New York – participate routinely in the System's semi-annual report to Congress in order to discuss the state of the Reserve Banks.

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Once implemented these types of change would both strengthen the machinery for Federal Reserve oversight and reduce its procyclical bias. But cautionary lessons from the past suggest that reformers also need to address Adolph Miller's old complaint about "public attention." Despite the legislative wave that produced the 1935 Act, public records of Board and FOMC actions quickly turned terse, self-referential and uninformative by the late 1930s.[10] Once the Board responded to pressure from Congressman Henry Gonzalez by releasing old transcripts of FOMC meetings, subsequent policy discussions became largely a scripted exchange of prepared statements. And over time, Congress's semiannual monetary policy hearings and confirmation of Fed nominees – the most important formal means of overseeing the central bank's actions – devolved into little more than ritual displays of bluster and evasion.[11]

In each of these instances, well-intentioned initiatives fell short of producing genuine accountability because they were not designed or were not executed with the public primarily in mind. Like Lauchlin Currie in 1935, latter-day proponents of improved Federal Reserve communication generally have shared the Progressive goal of enabling experts to hold other experts accountable.[12] Mechanisms designed for broader participation – such as Congress's semiannual monetary policy hearings – have proved susceptible to modes of explanation, inquiry and journalistic coverage that subvert rather than build public comprehension or curiosity. (The Fed's own public relations activities have often been driven by feelings of defensiveness or despair but rarely by the desire for sustained give-and-take with the citizenry.)

Experience demonstrates that accountability is an empty concept without a broad base of shared understanding and a robust means of continuing education, evaluation and interaction between governing institutions and the governed. Absent these qualities, even the most rigorous disclosure requirements and oversight tools may disappoint. At worst they can simply result in new rounds of familiar questions about how the Fed averted public scrutiny or why the public tuned out.

Fortunately, solutions to this problem do not lie beyond the imagination. One innovation conducive to deeper levels of accountability could begin with the American people owning their central bank. By retiring the existing stock of the Federal Reserve Banks and issuing a single share of a new class of stock to each eligible voter in the U.S. on a Reserve District-by-Reserve District basis, the System could be transformed into a genuinely public entity. Like the stock currently held by member banks, the new shares would be non-marketable, pay limited dividends and entitle the holder to elect directors of the district Bank. All Bank directors could be chosen directly by the public in a clean-election system and abide by rules designed to prevent partisan influence, conflicts of interest and sectoral dominance of decision-making.[13]

Under such a system, the selection of Reserve Bank directors would become an important exercise in civic engagement that educated voters about the central bank's governance, performance and future policy choices. Equally important, it would promote accountability for the Reserve Banks, which would have stronger incentives to explain their actions to the public and incorporate a wider range of economic perspectives into their policy calculus. Administered properly, the new voting system actually might expand, not truncate, the Fed's long time horizons. It also would preserve the dispersed authority that is a valuable feature of the Fed's architecture.

Another deep-accountability mechanism could be created by dramatically expanding study of the Federal Reserve in history, government, civics and social studies classrooms in secondary schools. To the extent K-12 students learn about the Fed today, their instruction takes place mostly in economics courses in which macroeconomic and regulatory content is covered late (and often fleetingly) in the school year and is wedged into the framework of neoclassical axioms upon which the **standards**-and-**assessment** edifice of pre-college economic education is built. The System itself has a longstanding involvement in public schools and generates a wide array of **products and activities** tailored to educators and students. While some of these resources are quite good, most K-12 pedagogy promoted by the Fed and other econ ed groups offer scant historical perspective on the central bank and little about the institution's role in civic life. However, the current financial crisis and the Fed's upcoming centennial in 2013-14 offer continuous opportunities over the next half-decade to make study of the monetary authority a more universal component of pre-college citizenship education. Equipping Americans with these types of educational, ownership and governance opportunities may or may not ensure the central bank does a better job of preventing future financial crises. But such reforms would continuously challenge the Fed to earn the informed consent essential to any successful democratic institution.

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[1] "Stabilization," Part 2, Hearings on H.R. 7895 before the Committee on Banking and Currency, U.S. House of Representatives, 69th Congress, First Session, April 20-22, 27, 30, May 3-6, June 10, 1926 and February 4, 1927, pages 676-678.

[2] A few nations like Switzerland and Austria have organized their central banks as joint stock companies. In these cases, however, all nationals, individuals and businesses alike, may own shares in the bank.

[3] Sometimes, the Banks simply try to have it both ways. In 1994, for example, a district court judge hearing an employment case admonished FRB Chicago for serially claiming in state and federal proceedings that it was and was not a federal entity (***Linda Katsiavelos v. FRB of Chicago***).

[4] Section Two of the Federal Reserve Act foresaw this problem and authorizes the Board to readjust the Reserve District map. When a committee of the Board proposed consolidating some of the Reserve Districts in 1915, however, its recommendation produced bitter divisions within the System and arguably helped shape a century-long aversion to adjusting the boundaries.

[5] Cited in Howard H. Hackley, "The Status of the Federal Reserve System in the Federal Government," Board of Governors of the Federal Reserve System, unpublished manuscript, January 1972, pages 55-57.

[6] In a similar vein, courts have interpreted the Federal Reserve Act to mean that Reserve Bank employees are subject to summary dismissal under employment-at-will language in Section 4 of the statute.

[7] "Report of the Joint Commission of Agricultural Inquiry," 67th Congress, First Session, House Report 408, 1922; G.L. Bach, *Federal Reserve Policy-Making: A Study in Government Economic Policy Formation*, Alfred A. Knopf, 1950; *Money and Credit: Their Influence on Jobs, Prices and Growth*, The Report of the Commission on Money and Credit, Prentice-Hall, 1961; Mark F. Bernstein, "The Federal Open Market Committee and the Sharing of Governmental Power with Private Citizens," *Virginia Law Review*, Vol.75: 11, 1989; Irving Fisher, *Stable Money: a History of the Movement*, Adelphi Company, 1934; Joseph E. Reeve, *Monetary Reform Movements: A Survey of Recent Plans and Panaceas*, American Council of Public Affairs, 1943; Robert Keleher, "**Price Stability and Inflation Targets: a Legislative History**," Joint Economic Committee of the U.S. Congress, July 2004.

[8] These measures included House Concurrent Resolution 133 (1975), the Federal Reserve Reform Act of 1977 and the 1978 Humphrey-Hawkins Act.

[9] In *Merrill, et al v FOMC* the federal courts upheld the Federal Reserve's right to withhold Open Market Committee records from the public under FOIA. An even-handed account of the 1975-1981 litigation and its ramifications can be found in Marvin Goodfriend, "**Monetary Mystique: Secrecy and Central Banking**," FRB Richmond Working Paper 85-7, August 1985.

[10] A review of annual reports since 1935 indicates that by 1938, the following sentence had become a familiar refrain in FOMC policy records: "This action was taken in continuation of the existing policy of the Committee, the reasons for which have been stated in connection with resolutions adopted at previous meetings." [Board of Governors of the Federal Reserve System, *1938 Annual Report*.]

[11] The Senate's approach to its advise and consent responsibilities stands out as especially perfunctory. Of the 14 Board nominations confirmed since 2000, virtually all have been summarily approved without a floor debate or a recorded vote following brief, honorific hearings before the Banking Committee.

[12] In a 1934 book that presaged Fed reforms contained in the 1935 Act, Currie championed the benefits of "much greater publicity" for the monetary authority. "A full discussion of policy" by the Fed, he wrote, would "enable the professional economists to make their criticisms much more informed than at present." By withholding this type of discussion, the System "deprive[d] itself of a valuable source of informed criticism." Currie's amendment requiring publication of a "full account" of FOMC actions was submitted by Adolph Miller, who told the Senate Banking Committee that such disclosures would allow observers to "judge…who has the best batting average," and ensure "more circumspection, less indiscretion in the exercise of the open-market powers." But Miller openly represented the proposed reporting requirement as a protective barrier as well as a window. When a senator asked whether the grant of broader powers should compel the Board to conduct its business in public, Miller replied, "No…I think that would be a fatal mistake." Exposing the Fed to public view or more stringent reporting standards would impose "political control" over the institution, he insisted, and "influence the atmosphere in which the delib-

erations went on." [Lauchlin B. Currie, *The Supply and Control of Money in the United States*, Harvard University Press, 1934; Roger J. Sandilands, *The Life and Political Economy of Laughlin Currie*, Duke University Press, 1990; "Banking Act of 1935," Hearings before a Subcommittee of the Senate Banking and Currency Committee on S. 1715 and H.R. 7617, 74th Congress First Session, April 19-June 3, 1935, pages 694-697.]

[13] A more complete version of this proposal can be found in Financial Markets Center, "**The Golden Anniversary Gift: Six Ideas for Introducing the Federal Reserve to the 21st Century**," *FOMC Alert*, March 20. 2001, pages 8-10. Key details include: a candidate selection process that ensures equal access for varied interests; full financing of election-related activities by the Reserve Banks and prohibitions on election-related expenditures by other parties; preferential voting and nonpartisan ballots (both features of the current system by which member institutions elect Reserve Bank directors).

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