

The Importance of Central Bank Independence

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Thank you for the opportunity to join you and to take part in this conference on central bank independence. History has shown that insulating central banks from the inevitable pressure of political dynamics is an important aspect of achieving economic stability for a country's citizens, even as domestic priorities support a variety of different institutional frameworks and structures.

In my remarks today, I'll focus on central banking in the United States, beginning with some historical context on the Federal Reserve's governance structure and institutional mandate. I will also describe the evolution of the Federal Reserve's approach to achieving its mandate, including some thoughts on the role of financial stability considerations in the setting of monetary policy.¹

The Governance Structure of the Federal Reserve

At the time of the Federal Reserve's founding, the United States had already witnessed two unsuccessful attempts at establishing a central bank, the First Bank of the United States and its successor, the Second Bank of the United States. There was intense political debate around the creation of these two banks, as many Americans were skeptical about creating such a powerful and centralized institution. As a result, neither was able to outlast their initial 20-year charter.

In the early 1900s, after a series of financial crises, a third effort was launched to establish a central bank. Two overarching themes emerged during the deliberations of structure and governance: On one side were those who supported a decentralized structure under the control of the private sector; on the other side were those who believed that the system should be highly centralized under government control.

Eventually, Congress accepted a compromise proposal from President Woodrow Wilson to create a central bank with a combined public and private structure with those roles filled respectively by the Board of Governors of the Federal Reserve System and the 12 regional Federal Reserve Banks. In this design, the Federal Open Market Committee (FOMC), the monetary policy-making body of the Federal Reserve, consists of 12 voting members: seven members of the Board of Governors and five Reserve Bank presidents. This unique public/private structure is designed to provide a full representation of national interests in the

¹ I thank Kansas City Fed Research and Policy Officer Huixin Bi for her assistance in preparing these remarks.

formulation of monetary policy, and it is my view that the Federal Reserve has been well served by the diversity of views inherent to its unique structure.

The Independence of the Federal Reserve

I also believe that the Federal Reserve can best achieve its mandates as an independent agency that makes decisions based on the best available evidence and analysis, free of political interference. That is, Congress sets the monetary policy goals for the Federal Reserve, but also provides the central bank independence in achieving those goals. A careful reading of Federal Reserve history, however, will find episodes when the independence of the Federal Reserve was undermined and that these were often periods when government spending was elevated.

Pressure on the Federal Reserve to implement policy supportive of government spending dates back to the early years of the central bank. During the First and Second World Wars, the Federal Reserve assumed a subservient role to the Treasury, and viewed its primary duty as “the financing of military requirements and of production for war purposes.”² The Treasury made decisions on debt management and the interest rate it would pay to investors, and then the Federal Reserve would absorb any public debt that was not purchased by investors at the fixed rate. After World War II, the Federal Reserve became increasingly uncomfortable with this arrangement as inflation started to rise while interest rates remained fixed at a very low level.

Eventually, the Federal Reserve’s resistance to continually supporting government spending led to a formal accord with the Treasury in 1951. The Accord eliminated the obligation of the Federal Reserve to monetize the debt of the Treasury at a fixed rate. It did not however eliminate political pressures on the Federal Reserve to hold rates low. The list of events includes such high-profile instances as pressure from President Lyndon Johnson to hold rates low as a means of supporting his proposals during the Vietnam War and to calls for Federal Reserve Chairman Paul Volcker’s resignation during the Federal Reserve System’s successful, but painful, battle against high inflation in the early 1980s. Nevertheless, the Treasury-Fed Accord became essential to the independence of central banking and how monetary policy is pursued by the Federal Reserve today.

² See “[The Federal Reserve System: Its purposes and functions](#)” (1947).

The Mandate of the Federal Reserve

The Federal Reserve operates under a directive from the U.S. Congress that is widely known as the Fed's dual mandate: to foster economic conditions that achieve stable prices and a maximum level of sustainable employment. The mandate, however, has evolved considerably during the past century.

At its founding in 1913, the Federal Reserve's central purpose was to "furnish an elastic currency" and "to establish a more effective supervision of banking in the United States."³ In the 1940s, with the Great Depression in mind and the U.S. economy transitioning out of the production of wartime goods, Congress passed the Employment Act of 1946, which called for federal government policy to "promote maximum employment, production, and purchasing power."⁴

By the 1970s, reports of sustained inflation and high unemployment led to the enactment of the Federal Reserve Reform Act of 1977. It explicitly set price stability as a national policy goal and directed the Federal Reserve to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote the goals of maximum employment, stable prices, and moderate long-term interest rates."⁵

In general, the Federal Reserve's dual mandate for maximum employment and price stability is complementary. A strong commitment to price stability reduces fluctuations in economic activity and helps achieve maximum employment and sustainable economic growth in the long run. Occasionally, there are times when the goals are not complementary. For example, the economy saw both high inflation and high unemployment in the 1970s. Not surprisingly, the Fed came under intense political pressure during this period as it weighed the balance between its inflation and employment mandates.

The Recent Federal Reserve's Framework Review

As economic conditions have changed over time, the conduct of monetary policy also has changed. Most recently, in August 2020 the Federal Reserve concluded a monetary policy

³ See "[Federal Reserve Act: Public Law 63-43, 63rd Congress, H.R. 7837.](#)"

⁴ See "[Employment Act of 1946.](#)"

⁵ See "[Federal Reserve Reform Act of 1977.](#)"

framework review that was launched prior to the pandemic. The purpose of the review was to reassess how to conduct monetary policy and achieve its dual mandate in a low interest rate environment.

In recent years, interest rates have fallen to historically low levels, not just in the United States, but around the world. These lower rates, at least partially, reflect structural changes to the economy, including higher savings by households and businesses in an aging society. Low interest rates can pose a constraint on a central bank's ability to stabilize the economy during an economic downturn.

In addition, the link between the pace of economic activity and inflation appears to have weakened. In the years leading up to the pandemic, inflation remained persistently low even as the unemployment rate neared record lows. This led some to be concerned that persistently low inflation could lead households and businesses to shift down their inflation expectations, potentially setting inflation on a downward spiral and further constraining policy space for the Federal Reserve.

In response to those changes, the Federal Reserve revised its monetary policy framework last year along two important dimensions. First, in the absence of signs of sustained upward pressure on inflation, the FOMC will not tighten its policy stance in response to low unemployment rates alone. Second, the Committee will aim to target an inflation rate that averages 2 percent over time. That is, in the case of inflation falling persistently below 2 percent, the FOMC will allow inflation to run moderately above 2 percent for a period of time.

It is important to note that even with these revisions, monetary policy is conducted by way of a "framework" rather than a "rule." This is important because the structure of the economy evolves over time in ways that can be difficult to anticipate. The flexibility of the framework allows the FOMC to adapt to new circumstances and strengthen its credibility.

This is certainly true now, as the United States economy recovers from an unprecedented shock. With extraordinary fiscal support, as well as potential structural changes to the economy and labor markets stemming from the pandemic, economic dynamics could evolve quite differently now than in the past. The Fed is likely to best maintain its credibility by remaining nimble and attentive to economic conditions as we seek to achieve our dual mandate.

Financial stability

Essential to the conduct of monetary policy and the achievement of the Federal Reserve's mandated objectives is a stable financial system. Prior to the creation of the Federal Reserve, U.S. banking panics were a frequent occurrence. To the founders of the Federal Reserve, the paramount goal was to create a monetary system that could respond effectively to stresses in the banking system and serve as lender of last resort in a banking crisis.

Today, financial stability isn't in the Federal Reserve's statutory mandate, unlike the explicit mandate provided to the Central Bank of Chile. However, even without a mandate, it is well understood that financial system risks can impede the attainment of the FOMC's objectives for inflation and employment. A prolonged low-rate environment can increase risk appetites and raise asset values. Incorporating financial stability concerns into monetary policy deliberations can help to build a more resilient system and to better achieve mandated goals.

Identifying financial system risks is clearly important; and difficult, given the constant evolution of the financial system and associated vulnerabilities. Technological change and financial innovation introduce new risks that require monitoring. From stablecoins to the risks associated with climate change, judging the vulnerabilities that can derail financial stability requires flexibility and nimbleness on the part of central banks. Equally important is understanding what tools exist to address financial stability concerns. Monetary policy settings are not well suited, in my view, to be the primary tool for maintaining financial stability, although the stance of monetary policy clearly has implications for financial stability. And while macroprudential approaches are desirable in theory, deploying macroprudential policy in a timely and potent manner, at least in the United States' experience, has been challenging.

Conclusion

Even as economies and financial systems evolve, the case for central bank independence is likely to remain strong. Domestic considerations and priorities will undoubtedly dictate the context and parameters of independence, but the benefits of separating decisions regarding the stance of monetary policy from political considerations are likely to serve the long-term interests of governments and their citizens.