REMAPPING DEBATE
Asking "Why" and "Why Not"

The insiders-only world of the Federal Reserve

Original Reporting | By Greg Marx | Banking, Economy, Monetary Policy

December 14, 2010 — Few institutions in the country today are less loved than the Federal Reserve. At a time when disillusionment with Washington and Wall Street is rife, the Fed — which is quite literally a hybrid of the government and the banking sector — has come under widespread attack. And while there are important differences between the critiques offered by the right and the left, there are common threads, too. Vermont Senator Bernie Sanders, blasting the "veil of secrecy" surrounding the Fed's emergency lending program at the height of the financial crisis, struck a tone sounded by many Fed critics: the institution is unaccountable, opaque, and unduly responsive to entrenched interests.

> It might seem obvious that the country's most powerful economic institution would have a close relationship with people who hold formal training in monetary policy, banking, and its other areas of responsibility. But the extent to which the Fed is run by academics — and the extent to which the institution exerts influence in the academy — is a comparatively recent development.

To the extent that there's merit to this complaint, why might it be so? What elements of the Fed's formal and informal institutional design contribute to this situation?

There's more to the story than raw political power. Talk to people who have spent time thinking about the Federal Reserve — from the inside or the outside, and from either a sympathetic or critical perspective — and a picture emerges of a system that prides itself, with justification, on being rigorously technocratic and free of partisan disputes. But it's also one that has historically been shielded from public scrutiny not just by its formal independence, but by its connections to other elites.

"Everybody in the Federal Reserve system is an insider," says Steve Randy Waldman, a Ph.D. candidate in finance at the University of Kentucky and the author of the blog Interfluidity. But at the same time, Waldman notes, "it's a system that's designed to bring a lot of people to the inside" — a fact that may help to explain the political resilience of, and continued intellectual support for, a complex, oft-criticized institution.

‘A system that’s not designed to make room for outsiders’

What does it mean to say that the Fed is, in Waldman’s words, “a system that’s not designed at all to make room for outsiders”? At the most basic level, it means that there is no way for ordinary members of the public to agitate for change or express a preference through the most common democratic mechanism: an open election.

The Federal Reserve system is divided into two main parts: the twelve regional reserve banks, and a Board of Governors based in Washington, D.C. Each of the regional banks is overseen by a nine-member Board of Directors, whose chief responsibility is to hire a bank president. Six of those people are appointed by the executives of local member banks; three of those six are the executives of member banks. That’s about as “inside” as you can get.

Say you’re a consumer advocate or a supporter of alternative banking models, and you think you could bring a unique perspective to your regional Fed board. But because of your views, you suspect you may not catch the eye of your local bankers. What’s your strategy? Angling for an appointment from the national Board of Governors, which selects the last three members of each regional Board of Directors. And how do you get to be on the Board of Governors? You get appointed by the President, and confirmed by the Senate. Again, few outsiders need apply.

> The resulting dynamic between the Fed and academic economists may be self-reinforcing: an independent, technocratic central bank empowers economists, and empowered economists are persuasive in arguing for the necessity of an independent, technocratic central bank.

Meanwhile, once these appointees are in place, they are given a wide berth by the rest of the government. While the Chairman of the Board of Governors testifies before Congress several times a year, the bank’s policy decisions are not reviewable by other entities. The staggered 14-year terms given to members of the Board of Governors are also intended to protect the bank’s independence.

The closed nature of the system does not mean that concerns about the public good are ignored by the Fed’s design. The President, whose power to appoint the Chairman of the Board of Governors is substantial, is, after all, publicly elected. And one way to understand the system is as an attempt to balance political pressure for looser money in times of crisis — which should, theoretically, be reflected in the choices of the politically appointed Board of Governors — with creditors’ preoccupation with fighting inflation.

But it does mean that representations of the public interest are attenuated, and there is no ready-made channel for challenges to the prevailing model. Timothy Canova, a professor at the Chapman Univer-

sity School of Law and a critic of the modern Fed, pins some of the blame on the belief in technocratic expertise that prevailed during the Progressive period of the early 20th century, when the bank was founded. "It's supposed to send a signal to citizens that [the central bank's responsibilities are] too complicated for them, and they should just be happy with the delegation," he said.

That, of course, leaves an important question: to whom are we delegating? While the Fed is the product of the government and the banks, there is one class of people who have been taken comfortably into its embrace, and who exert increasing influence over the institution's policy choices: academic economists.

Forging closer relationships with economists

It might seem obvious that the country's most powerful economic institution would have a close relationship with people who hold formal training in monetary policy, banking, and its other areas of responsibility. But the extent to which the Fed is run by academics — and the extent to which the institution exerts influence in the academy — is a comparatively recent development. It wasn't until the 1970s that some of the regional reserve banks began to cultivate unique identities based on their research output, just as elite graduate programs develop distinctive reputations. Even after that period, many top policy-makers, even if they held Ph.D.'s, came from backgrounds in business or elsewhere in government. Laurence Ball, an economist at Johns Hopkins University who has held several positions within the Fed system, said an academic pedigree became increasingly important in the 1990s — and the shift has continued even within the past decade, as regional banks select presidents whose credentials measure up to the members of the Board of Governors.

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The closeness between the Fed and the economics profession is reflected in several ways. One is straightforward hiring: using data from 2002, Lawrence H. White, a professor at the University of Missouri-St. Louis, calculated that "the Fed employs full-time about 27 percent more macro/money/banking economists than the top 50 U.S. academic economics departments put together." The institution also hosts dozens more professors as visiting scholars, and provides key platforms for research through the many conferences it hosts annually. And economists with professional relationships with the Fed occupy important posts at academic journals: a 2009 story in The Huffington Post reported that 84 of the 190 editorial board members at seven leading journals were, or had been, affiliated with the central bank. "With regards to monetary economics, the Fed's reach is nearly universal," said Arpit Gupta, a research coordinator at Columbia University who focuses on consumer finance and banking.

The impact of this relationship on the Fed's policy choices is debated: Ball sees professional economists as partly to blame for what he called the Fed's preoccupation with inflation and its slowness in trying to address high unemployment, while other observers see academics as generally less tight-fisted than the bankers and businesspeople who are represented in the Fed system.

The flipside of that question — what is the impact of the Fed's influence on the academic research agenda — is even thornier. But to critics, one consequence of the Fed's outreach is to claim ownership of the debate, and to marginalize alternative views, both within and outside the institution.

How might this play out? Tales of direct censorship of research by Fed economists are rare (though, as McClatchy's Greg Gordon reported earlier this year, not unheard of). And while there are some instances of the bank's supporters pushing back against high-profile challenges to its handling of the economy — for example, the cool response to a now celebrated paper by Raghuram Rajan, presented at the Fed's showcase conference in 2005, warning that financial innovation had made the world riskier — "it's not usually the case that what happens is somebody tells truth to power, and they get publicly rebuked," said Waldman.

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Rather, he said, the issue is which questions the Fed asks academic economists to answer, and which academic research the Fed decides to fund. "They're most interested in stuff that will tell them how to do their jobs better," said Waldman. And their jobs, of course, consist of overseeing, and preserving, the system that now exists. One result may be that the very real intellectual debate over the best strategies to achieve the Fed's goals — in fact, recent months have been marked by public disagreements between top policy-makers — occurs only within well-defined parameters.

To illustrate the point, Waldman offered the example of "narrow banking." Under the existing system, known as "fractional-reserve," when you deposit money in a bank, the bank turns around and lends it out, while also making your money available to you on demand. This system expands the supply of money, facilitating investment and economic growth — but if everybody demands their money at the same time, bank runs or broader crises can ensue.

Government programs such as deposit insurance are designed to control the risk in the fractional-reserve system. In a narrow banking model, on the other hand, institutions defined as "banks" would simply be required to hold deposits in liquid or very safe assets such as government bonds, rather than reinvesting them as loans. These banks would offer very limited returns, but some commentators argue that creating such safe harbors would be an improvement on trying to devise fail-safe regulations that also allow banks to seek big profits. (In such a system, people could also place their money with other financial institutions that would be free to reinvest it, offering greater returns at greater risk.)

The case for the merits of narrow banking is contested. But either way, "I don't think you'll find the Fed funding that research," Waldman said, because even modest steps toward that approach would represent a sea change from the current model. (Indeed, a search for the term "narrow banking" on the Fed's website yields scant results.)

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Some observers believe these concerns can be overstated: the Fed may take a selective approach, but the diversity of opinion within the central bank, and the presence of many economists outside it, provide useful checks. "The Fed has no ability to censor someone outside," said Joe Peek, a professor at the University of Kentucky who worked for an extended period at the regional bank in Boston. Even the Fed's control over access to data about banks — a key bit of leverage over skeptics — has loosened over the years (though not completely so, as its resistance to disclose information about the emergency lending program shows). But critics see the risk of self-censorship as real, if hard to quantify. An economist who is not employed by the Fed, but hopes to be one day, wrote White, "faces a subtle disincentive to do regime-challenging research."

Balancing independence and accountability

But it would probably be a mistake to see the Fed's close relationship with economists as operating primarily through pressure, intentional or otherwise. At least as important is the way that the Fed raises the esteem of the profession, and creates that rare opportunity: a way for academic research to directly affect public policy. The resulting dynamic may be self-reinforcing: an independent, technocratic central bank empowers economists, and empowered economists are persuasive in arguing for the necessity of an independent, technocratic central bank.

There are sound theoretical reasons why an autonomous central bank is desirable. The concern is that voters and incumbent politicians will usually have a bias toward stimulating the economy in the short-term, which can be destructive in the long run, so some degree of insulation from the political process is necessary. And this is not just an abstract argument: one interpretation of the damaging inflation of the 1970s is that the Fed, while nominally independent, did not at that point truly have the authority to check rising prices and wages in the face of political pressure. The "Great Moderation" that followed that episode — during which economists assumed a greater role within the Fed, and the Fed assumed a greater role in shaping policy — helped validate the technocratic approach.

Still, the norm of independence is strikingly well-entrenched, even among economists who have been critical of the institution. Mark Thoma, a professor at the University of Oregon and an influential economics blogger, believes the Fed has strayed too far from its decentralized, even populist roots, and that far-reaching reforms — such as allowing regional bank presidents, or even the Chairman of the Board of Governors, to be elected by popular vote — should be on the table to restore public confidence. But a key reason to bolster the Fed's legitimacy is ultimately to allow the decision-makers at the bank greater freedom, Thoma said. "For me, it's about preserving independence."

Thoma's concern for the bank's independence is shared by Karl Smith, a professor at the University of North Carolina who was a vocal critic of the Fed's slowness, over the course of this year, in responding to high unemployment. The Fed has lately moved in the direction Smith advocated; in the process, it has come under withering public attacks. (In an ironic reversal of the usual fears, much of this criticism came from conservatives opposed to the bank's new expansionary policy, leaving liberals like Vermont's Sanders to defend the bank's right to act.) Recently, Smith said he had mixed feelings about his effort to open the debate. The whirlwind of criticism — which came from, among others, Sarah Palin — "is the kind of thing Greenspan always warned against: letting monetary policy become the topic of popular debate," he wrote in an email. In speaking out, he had concluded that an economist's role extended beyond "offer[ing] qualified endorsements of the Fed Chairman. Even that, however, seems to have opened the door for an all-out political assault."

Economists' preference for an autonomous Fed represents a sincere — and, quite possibly, correct — conviction that an independent, technocratic bank yields better results than one that is subject to outside review. But that independence also gives economists, as a class, a privileged position from which to influence policy. Unlike other social scientists, said Waldman, "they see a place where their good ideas have a direct effect on the economy" without having to first go through the meat grinder of Congress — and it's understandable that they would be protective of that privilege.

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Striking the right balance between technocratic expertise and public oversight is a daunting challenge in the design of any public institution. In the case of the Fed, though, it can be hard not to wonder whether the convention of independence, supported by most insiders, interferes with even a basic level of openness. One line buried in the official minutes of the latest meeting of the Fed's Open Markets Committee suggested, inadvertently, just how closed to outsiders the current arrangement is: "Participants," it read, "discussed whether it might be useful for the Chairman to hold occasional press briefings to provide more detailed information to the public regarding the Committee's assessment of the outlook and its policy decision-making than is included in Committee's short post-meeting statements."

What's next for the Fed?

In the wake of the housing bust and the financial crisis, and the midst of an ongoing recession, the Federal Reserve's basic design and function are up for discussion in a way they have not been for at least thirty years. The financial regulation bill passed earlier this year changed the process for selecting regional bank presidents; the three members of the regional boards of directors who represent local banks will no longer have a vote. The law also creates a new position of vice chairman for supervision on the Board of Governors, and directs the Government Accountability Office to study the system by which regional directors are appointed. Elsewhere, proposals for reform are rampant, from full-fledged alternative banking models to strategies that would keep the Fed in place but curb its discretion, making it an even more technocratic but less powerful institution.

But there is no guarantee that the bank will be opened up in any substantial way. Sarah Binder, a political scientist at George Washington University who is now studying the institution, noted that in times of economic crisis Congress often responds not by curtailing the Fed's powers, but by consolidating and centralizing them in order to deflect blame for economic woes. At the moment, of course, there is more than enough blame to go around — so if history is any guide, the Fed may end up stronger than ever.

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