Federal Reserve Independence: Reality or Myth?

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The Federal Reserve was founded in 1913 during the Wilson administration to end banking panics and depressions, and was part of the Progressive agenda for a more activist role of government (see Kolko 1963). By the 50th anniversary, the conventional wisdom was that the Fed's performance was overall satisfactory, especially after the Treasury-Federal Reserve Accord of 1951 that permitted independent monetary policy. While the decision to double reserve requirements in 1937 was judged a policy error, the Federal Reserve was not held responsible for the Great Depression.

Federal Reserve independence was judged important for optimal monetary policy outcomes. After the end of World War II through 1951, the Federal Reserve was unable to deal with inflation because of the commitment to support government bond rates. By contrast, the central bank pursued a successful monetary policy aimed at price stability in the 1950s after the Accord.

The 50th anniversary ironically was the year Milton Friedman and Anna J. Schwartz's monumental *A Monetary History of the Federal Reserve: 1867–1960* (Friedman and Schwartz 1963) seriously challenged the conventional wisdom about Fed

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Cato Journal, Vol. 33, No. 3 (Fall 2013).

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performance, especially during the Great Depression.[1] By the 1980s, the conventional wisdom of a well-performing central bank came under serious question. Research showed the Fed's restrictive policy in the 1930s contributed to the collapse and stagnation of the economy, while the expansionary policy in the late 1960s through the late 1970s contributed to the Great Inflation. Monetary policy performance after the disinflation of the early 1980s and price stability through the end of the 20th century was viewed in more positive terms. However, easy monetary policy during the run-up in real estate prices from 2001 through 2005 and the unprecedented increase in Federal Reserve assets starting in late 2008 have brought new criticism of Fed performance (see Selgin, Lastrapes, and White 2010; Taylor 2009).

Although the belief that the Fed has performed as promised no longer holds sway, the conventional wisdom holds that the Fed is independent, and that independence is important for price stability. The IMF and the OECD place high priority on de jure central bank independence; central bankers emphasize the importance of independence in the conduct of policy (Kohn 2009); references to the importance of independence in news accounts are extensive (*Wall Street Journal* 2012); and the inverse correlations between measures of central bank independence and inflation are widely accepted and are now becoming standard in textbooks.

The conventional wisdom with regard to Fed independence is not convincing. First, the Federal Reserve, considered to be one of the world's more de jure independent central banks, played a key causative role in the Great Inflation from 1965 to 1985. Allan H. Meltzer's history of the Federal Reserve (Meltzer 2003, 2009) demonstrates the sensitivity of the Fed to political institutions despite its de jure independent status. Moreover, the diary of former Fed chairman Arthur F. Burns from 1969 to 1974 (Ferrell 2010) reinforces Meltzer's analysis and presents a challenge to the modern view.

Second, the methodological and statistical foundation of the widely accepted inverse correlations between measures of central

[1]Clark Warburton and several others had challenged the conventional wisdom regarding the performance of the Federal Reserve, but they did not initiate a broad debate as did Friedman and Schwartz (see Cargill 1979).

bank independence and inflation are flawed. The juxtaposition between the historical postwar record of the Federal Reserve and the stable and high indexes of independence assigned to the Federal Reserve are difficult to reconcile.

This article argues that Federal Reserve de jure independence is far too uncritically accepted as a foundation for a stable financial and monetary environment. Not only is the foundation weak but its widespread acceptance permits central banks like the Fed to engage in suboptimal policy with political undertones. Independence is more myth than reality.

The Misunderstood 1951 Accord

The 1951 Accord has generated a misconception about Fed independence and established a misdirected concept of central bank independence in general for decades that emphasized de jure independence. The conventional view is that once the Fed regained its independence, and was thus freed from political pressure, it was able to pursue price stability as judged by the inflation record of the 1950s. That view was adopted elsewhere because the United States was the most powerful and influential country in the world and the Fed was the predominant central bank, given the key role of the dollar as a global reserve currency.

The conventional view of the 1951 Accord is incorrect. In no sense was the Federal Reserve freed from political pressure despite dropping the requirement to support government bond prices. Indeed, President Truman forced Fed chairman Thomas B. McCabe to resign several days after the 1951 Accord despite the fact his term as a board member legally extended until 1956 (Meltzer 2003: 712).

The Accord provided the foundation for the modern view of independence—namely, that once the Federal Reserve was no longer required to support government bond prices it was able to focus on price stability. That view, however, ignored the fact that the Fed operated with multiple policy targets, and it failed to recognize that monetary policy was mostly nontransparent (Santoni 1986). The Fed was able to pursue whatever targets seemed appropriate at the time, and there was no guarantee the choice would be invariant to the wishes of politicians. Consequently, there was no guarantee the "independent" Federal Reserve would achieve price stability.

The Post-Accord Federal Reserve: Martin and Burns

Federal budget deficits shrank to comparatively small amounts after the end of the Korean War in 1953. The budget deficit of fiscal year 1955 was half that of 1953. There were budget surpluses in 1956–57 and 1960. Spikes in budget deficits were associated with recessions and did not represent shifts in the structural deficit (Buchanan and Wagner 1977: 43–47).

The era of Keynesian growth-enhancing spending, major social programs, and political pressure on the Federal Reserve did not come until the Kennedy and Johnson administrations (Buchanan and Wagner 1977: 47–50). Meltzer's detailed history clearly shows the increasing politicization of the Fed under Chairman William McChesney Martin from the early 1960s to his retirement in 1970. The 1950s were not much of a challenge to any Fed chairman, or a test of the institution's independence, because that era was one of small budget deficits (or even surpluses) and a relatively non-activist government. Martin was able to use countercyclical monetary policy ("leaning against the wind") to maintain economic growth and keep inflation low (Friedman and Schwartz 1963: 631, 631n33). He was not seriously tested until President Johnson implemented the Great Society program and launched the Vietnam War. Deficits ballooned, which the Federal Reserve at least partially accommodated. Meltzer's history provides ample references to illustrate Martin's vision of independence that placed a rather low priority on price stability. The result was an increase in inflation after 1965 that became the Great Inflation in the 1970s.

Martin's term as chairman ended by statute on January 31, 1970, and President Nixon replaced him with Arthur F. Burns, who had served as chairman of the Council of Economic Advisers in the Eisenhower administration and advised Nixon in his failed run for the presidency in 1960. Nixon trusted Burns and brought him into the administration to serve as counselor to the president. In that position, he attended cabinet meetings and met frequently with the president. On January 31, 1970, Burns was sworn in as the new chairman of the Federal Reserve.

The Fed's performance under Burns has been heavily criticized. Our focus is not on the technical issues of the failure of monetary policy in the 1970s, which have been reviewed in many places. Rather, we are interested in *why* Burns acted the way he did.

If any scholar had remaining doubts about whether Nixon and Burns politicized the Federal Reserve, Burns's diary is a strong antidote. We now have an account of what happened in Burns's own words. The diary was secret, or as secret as anything is these days, and only opened to the public in 2008 at the Gerald R. Ford library in Ann Arbor (Ferrell 2010: xi). Those who adhere to the modern view of central bank independence will be seriously challenged after a review of the diary.

Not surprisingly, Burns casts his role in the best possible light. In his view, the president is surrounded by men of weak character and intelligence. Martin was a "pathetic slob" (Ferrell 2010: 14). Though he later revised his opinion, he initially held George Shultz in low esteem. Then there was the "poor and wretched [Paul] Volcker—never knowing where he stood on any issue" (Ferrell 2010: 65). And, of course, there were Ehrlichman and Haldeman, who would not likely have fared well in any diaries but their own.

Burns remained an integral part of the Nixon administration, continuing to function in some ways as counselor while serving as Fed chairman. He attended cabinet meetings and was a frequent White House visitor. Some of those meetings involved the Quadriad: the Fed chairman, the chairman of the Council of Economic Advisers, the director of the OMB, and the Treasury secretary. Burns also participated in many political discussions, including the president's re-election prospects. After a meeting with President Nixon on March 21, 1971, Burns wrote in his diary that the president "agreed with my policy [and] preferred a slow start of the recovery which may then gather momentum in 1972." Burns continued that the president "wants to rely primarily on me and [John] Connally in monitoring policy, that McCracken and Shultz—while able economists—did not understand politics, that I could handle both economics and politics, and that Connally was good at politics and therefore a great asset" (Ferrell 2010: 40).

The Nixon White House was under sway of what can be called "political monetarism." The president's aides accepted Milton Friedman's arguments on the power of monetary policy. However, Friedman wanted monetary policy to be employed to control inflation and maximize long-term economic growth while the Nixon White House understood that suitably timed monetary surprises could temporarily boost economic growth and help the president's re-election prospects. Consequently, Nixon's staff was repeatedly pressuring Burns to boost money supply growth. Burns expressed no problems with that pressure other than he was on top of things and it was a matter of timing.

In an entry dated February 29, 1972, referring to a meeting with Nixon on February 14, Burns recounts that he told the president: "I was looking after monetary policy and that [the president] need not be concerned about the possibility that the Federal Reserve would starve the economy" (Ferrell 2010: 74–75). Burns also noted "personnel problems" at the Board. Federal Reserve Board member Andrew Brimmer had spoken his mind independently in public. Burns wanted him out and asked Nixon to find a position for him outside of the Federal Reserve. They discussed ambassadorships and Burns observed wryly that "I expressed strong doubt about Brimmer [a black] accepting an African post" (Ferrell 2010: 75).

Those who adhere to the modern view of independence are encouraged to study the history of the Federal Reserve under both Martin and Burns. The price stability of the 1950s did indeed appear consistent with an independent central bank focused on price stability; however, Martin had little problem shifting to a more supportive role of the government as the government shifted to a more activist-Keynesian orientation in the Kennedy and Johnson administrations. Burns who came to the board with strong academic credentials continued the Martin tradition of viewing Federal Reserve independence as "independence within government." Throughout the 1970s, Burns conducted monetary policy during the Nixon, Ford, and Carter administrations with the same political sensitivity. Many observers have noted that Nixon played politics with the Federal Reserve but dismiss the general importance of the episode by presenting Nixon and Burns as aberrations. We regard this as selective elimination of information. In contrast, we believe that the Fed's independence to pursue price stability is the aberration, and not the norm as in the modern view of central bank independence. The norm is for the Fed to be sensitive to political pressure.

It should be noted in passing that advocates of the modern view also dismiss the Bank of Japan's record of price stability from 1950 through the 1980s (the early 1970s being an exception) as an aberration of the view that dependent central banks generate higher inflation than independent central banks. The BOJ has always been a problem for the modern view (Cargill 1989, 1995a, 1995b, 2013) because as one of the world's most de jure dependent central banks from 1882 through 1998, the BOJ achieved an impressive record of price stability throughout much of the postwar period. The "aberration" explanation provides a weak reed to support the modern view of central banking.

The Post-Burns Federal Reserve

Paul Volcker took over from G. William Miller, who served briefly as chairman in 1978–79. Volcker restored the Fed's reputation and its image as an independent central bank focused on long-run price stability. He was able to do so because he had the backing first of President Carter and then of President Reagan, who had been convinced by his economic advisors, like George Shultz, that ending inflation was critical to restoring prosperity (Pollock 2012: A11). Volcker gained the operational independence to end inflation by making price stability the most important policy target. President Reagan's firing of the air traffic controllers in 1981 convinced markets the Fed would be permitted to continue with its disinflation policy.

The contrasts between Martin, Burns, and Volcker are critical to understanding the weakness of the modern view. Independence to pursue price stability is conditioned on the political environment irrespective of the de jure institutional relationship between the central bank and the government. The episodes illustrate that, in discussing central bank independence, one must always ask "independent" of whom and in what time frame?

The Volcker Federal Reserve arguably gained operational independence of Congress to end inflation, but this political acquiescence was not permanent. The Fed accomplished this by becoming more politically dependent on the executive branch. The only thing President Reagan asked in return was sound monetary policy. That strategy was in the country's best interest, but political support even in the right direction is no foundation for a price-stabilizing central bank.

Political pressure is political pressure even if it happens to lead to correct policy.

The Volcker Fed was relatively independent, certainly more so than under Martin, and especially under Burns, and more so than today. Volcker was succeeded by Alan Greenspan, who in turn was succeeded by Ben Bernanke. All are still living, and Bernanke still serves as chairman, which complicates rendering an objective assessment.

In Greenspan's case, time has passed since he completed his term. We have no diary, only a self-serving defense of his tenure.

Analyzing Greenspan's tenure's involves answering a two-part question. First, is the Greenspan Federal Reserve partly culpable for the housing boom and bust? Second, if the first answer is affirmative, is there evidence politics played a role?

Greenspan has been praised from many quarters for guiding the Federal Reserve through what is now termed the Great Moderation. From the early 1980s to around 2007, the growth rate of real GDP was more stable than in other years in the postwar period (Taylor 2009: 34–35 and 66–67). There is controversy over why the macro economy was more stable (despite great Schumpeterian creative destruction). Taylor (2009: 2–3) argues that Fed policy followed the Taylor Rule throughout much of the period. Beginning in 2002, however, and continuing into 2006, the federal funds rate was pushed below the level predicted by the Taylor Rule; for instance, in 2004 the rate was 1 percent when the Taylor Rule indicated the rate should be 4 percent. In short, the Federal Reserve kept short-term rates too low for many years. That contributed to the housing boom and subsequent bust. Taylor (2009: 4–6) sums up the counterfactual of the Federal Reserve following the Taylor Rule: "No Boom, No Bust."

There are variants of Taylor's analysis (Schwartz 2009, O'Driscoll 2009). However, all agree the Federal Reserve contributed to the housing boom and subsequent bust. This might not have occurred had the increased liquidity occurred in the context of a structurally stable financial system, but it did not. The U.S. financial system was fundamentally flawed because much of it was politically designed to encourage homeownership, and government sponsored enterprises (Freddie Mac and Fannie Mae) played a major role in the socialization of private risk taking in the mortgage market. Hence, the answer to the first question is yes—the Fed's easy monetary policy from 2001 through 2004 played a major role in the run up of house prices.

Is there evidence Greenspan did more than make a serious policy error by deviating from his own successful implementation of the Taylor Rule? To our knowledge, there is no documentary evidence that he acted politically in the manner of Burns. But following his April 7, 2010, testimony to the Financial Crisis Commission, Greenspan argued "that if the Federal Reserve had tried to slow the housing market amid a 'fairly broad consensus' about encouraging homeownership, 'the Congress would have clamped down on us'" (*New York Times* 2010).

Greenspan's tantalizing tidbit supports the point of this article. We are not focused on tawdry episodes in which an errant chairman put the Federal Reserve into the service of a president's re-election campaign as under the Burns Federal Reserve. Our thesis is that the Federal Reserve does not operate independently of other parts of government. Greenspan's remarks, admittedly not fleshed out, reveal that the Federal Reserve is not de facto independent. The Greenspan period also amplifies Friedman's warning (Friedman 1962: 50) that vesting so much power in the hands of so few, whether they are motivated by political or nonpolitical considerations, is not consistent with a central bank aimed at achieving price stability.

Bernanke became chairman on February 1, 2006. He had served for a little less than three years as a governor, 2002–05. He then moved to the Council of Economic Advisers before moving back to the Federal Reserve. The housing boom was already under way. Indeed, in retrospect housing peaked in early 2006. Housing finance was being driven by refinancings, and interest rates were on the rise. As Greenspan's successor, Bernanke would normally be held accountable only for how he handled the collapse and not for the prior monetary-driven boom. But during his tenure as governor, he strongly supported Greenspan's expansionary monetary policy. Indeed, by some accounts, he was the policy's architect.

Let us turn, however, to his handling of policy beginning in 2006. We reviewed his semi-annual monetary reports, testimony to Congress, other testimony, and speeches. We came away with the sense that he was always about six months behind events. Private-sector analysts were calling a major downturn in housing and problems in the financial sector before the chairman recognized them.

Considering Bernanke's academic background, we looked for an emphasis on the long run and the fundamental economic determinants of sustainable growth and low inflation. Instead we saw a focus on the short run and even ephemera. As an example of the latter, we point to his commentaries in 2006 on the hurricane season of the previous year and the federal payments to victims. It is difficult to imagine a more transitory event, and we marveled that the head of a central bank would get into such a discussion.

The short-run focus suggests to us that the chairman has been captured by the Board of Governors' staff, whose forecasts assume a temporary tradeoff between inflation and unemployment, rather than bringing much-needed changes to the bureaucracy. It is likewise difficult to understand the decision of the Fed to adopt an industrial policy to support the housing market with open market purchases of almost $1 trillion in Freddie and Fannie debt and mortgage-backed bonds representing almost 50 percent of the Fed's securities portfolio.

The decision by the Federal Open Market Committee at its September 2012 meeting to initiate another round of purchases of mortgage-backed securities is difficult to understand in the context of almost four years of unprecedented easy monetary policy. In the context of a mortgage market in which 90 percent of the new mortgages are being purchased or guaranteed by the government and in which at least 50 percent of the government deficit is being monetized by bond purchases, the concept of central bank independence to pursue price stability is becoming a quaint concept of an earlier age.

By contrast, both Volcker and Greenspan on multiple occasions chided Board staff for their forecasts based on the supposed short-run tradeoff between inflation and unemployment. Bernanke has apparently embraced the Phillips Curve and staff forecasts based on it (Meltzer 2012: A13). Most importantly, Bernanke was late to the game on the housing downturn and crisis in housing finance. For instance, in his July 2008 report to Congress, he certainly acknowledged problems in subprime mortgages and the bailout of Bear Stearns. But he also observed that in the second quarter "financial market conditions improved somewhat." That turned out to be excessively optimistic as it came on the eve of what amounted to conservatorship for Fannie Mae and Freddie Mac; the September 15, 2008, bankruptcy filing of Lehman Brothers; and the collapse and federal takeover of Fannie Mae and Freddie Mac. This was a sad performance for the head of an institution that prides itself on its knowledge of the financial sector and believes it has superior forecasting abilities. How is such an institution to serve as regulator of systemic risk when it failed to predict the Great Recession?

The Fed's emphasis on the short run is a systemic policy failure, long noted by monetary historians such as Friedman, Schwartz, and Meltzer. By focusing on the short run, policymakers *inevitably* subject themselves to political pressures to address short-run economic phenomena, which the central bank is ill-equipped to do. Friedman's analysis of long and variables lags in monetary policy

(Friedman 1961) and his 1967 AEA presidential address on the role of monetary policy (Friedman 1968) are as relevant today as they were almost a half century ago. Bernanke from time to time acknowledges lags in monetary policy but has ignored them in practice.

The failure to forecast the biggest financial crisis since the Great Depression undermines any claim by the Federal Reserve to be able to engage in discretionary, macroeconomic stabilization policy. That failure (and many others) is the practical argument for the kind of long-run policies advocated by Friedman, Meltzer, and Taylor—as well as by former Federal Reserve bank presidents such as Lee Hoskins and Jerry Jordan, and current presidents such as Charles Plosser, Jeffrey Lacker, and Richard Fisher.

It is difficult to overestimate how the focus on the short run exposes the Federal Reserve to political pressure and puts it in the bind that Greenspan described. The Fed under Bernanke has become more focused on quick economic fixes for long-term problems. After being behind the curve in 2008, Bernanke supplied multiple rounds of liquidity to the financial sector. True liquidity crises are relatively short-lived, measured in days and weeks rather than months and certainly not years. There was a serious liquidity crisis after Lehman's failure and the Federal Reserve responded appropriately. QE1 was not even implemented until November 2008, however, and ended only in March 2010. Then QE2 was implemented in November 2010 and lasted through June 2011. Now an open-ended QE3 is being implemented. The liquidity crisis was likely over before the first QE was put in place.

What is in short supply today is not liquidity, of which there is abundance in the financial system, but capital and solvency. Banks and other financial institutions were severely damaged by the financial crisis. Their balance sheets have yet to be completely repaired and they continue to deleverage. Liquidity is not a substitute for capital. Neither the Bush nor Obama administration has wanted to take the serious measures needed to address weakened and insolvent financial institutions. Short-term lending becomes the substitute for long-term solutions.

The problem is even more acute at the moment in Europe, notably Spain, but our focus is the United States. The Troubled Asset Relief Program (TARP) was political theater, not a serious effort at recapitalizing U.S. banks. A serious effort would have more resembled the Reconstruction Finance Corporation of the 1930s, in which taxpayers got a serious stake in bailed-out banks, on businesslike terms. The Federal Reserve was pushed into "doing something" when Congress or the administration would not act. Successive rounds of targeted lending to particular banks, particular sectors (e.g., housing), and even nonfinancial firms (e.g., automakers) is a form of fiscal policy (Lacker 2012). It is a covert way of transferring real resources to favored recipients without an appropriation. It is a dangerous precedent for the Fed because the Fed will only be called on to do more of it in the future. It is moral hazard in monetary policy. Moreover, whatever the original motivation for targeted lending, public choice theory tells us that it will be transformed into giveaways to favored constituencies. The central bank then becomes complicit in crony capitalism. That is how central banks operate in banana republics, not a constitutional republic. And the central bank's actions are always in the furtherance of the interests of the current administration, which makes the Fed not only political but partisan.

We do not question either Bernanke's motives or good intentions. In our judgment, however, he has moved the Federal Reserve institutionally into politics more than any other Federal Reserve chairman. Burns was an unusually politically sensitive individual who allowed his self-interest to dominate his public responsibility; however, the institution survived because of a shift in the political environment. Part of the reason is that the Burns Federal Reserve never strayed from conventional monetary policy into fiscal policy as the current leadership of the Federal Reserve has been so willing to drift. The Federal Reserve eventually got Paul Volcker as chairman, who broke the back of inflation, restored the institution's stature, and began the policy that resulted in the Great Moderation. Under Volcker and Greenspan, the Federal Reserve regained a degree of operational independence because it followed an implicit rule. The fact that it was not an explicit rule left it exposed to the risk of being politicized once again. And it has been.

The requirement to follow a rule is what gives a central bank independence from political pressures. Paradoxically, being bound by a rule is what makes a bank independent. If it wants the "freedom" of discretion, it will lose its independence. The rule can be a price rule (e.g., zero inflation), a rate rule (inflation targeting), or a commodity standard. The gold standard was a rule and helped the Federal Reserve resist congressional demands in the 1920s for a phony price rule to stabilize this or that price (typically agricultural prices). In fact, the Federal Reserve was pursuing a policy resembling one of price stability in the modern sense (stable prices overall). Meltzer (2003:181–92) provides much insight into that episode.

Central bank independence is intimately tied to rules that constrain the central bank to focus on price stability, preferably a legislated rule. Focus on the short term inevitably leads the central bank into the political thicket and the loss of de facto independence. Central bank independence is more easily lost than restored.

The Statistical Foundation of the Modern View Is Flawed

The conventional view of central bank independence has become widely accepted because of publication of a large body of statistical evidence based on measures of central bank de jure independence that report statistically significant inverse correlations between the measures and inflation (e.g., Bade and Parkin 1982, 1988; Cukierman 1992; Cukierman, Webb, and Neyapti 1992; Alesina and Summers 1993; and Carlstrom and Fuerst 2009). Those results are now widely accepted and have become part of the normal presentation of central bank topics in macro and monetary economics textbooks. They constitute an important foundation of the modern view of central bank independence (e.g., Blinder 1998). A close review of the measures and the statistical evidence, however, suggests the empirical foundation is flawed and cannot be realistically be used to support the modern view.

A small but growing literature challenges the conventional view of central bank independence (Campillo and Miron 1997; Cargill 1995a, 1995b, 2013; Fujiki 1996; Goodfriend 2012; Issing 2012; Oatley 1999; Posen 1998). The following problems can be identified:

1. Correlations between de jure measures of central bank independence and inflation lack statistical robustness.
2. De jure measures are not as accurate as alleged. For example, in the case of the BOJ, there is a disconnect between some of the measures and de jure independence defined by the charter.

3. De jure independence in many cases is a poor predictor of monetary policy outcomes. For example, the comparative inflation records of Japan and the United States through the 1980s contradict the conventional wisdom that independent central banks generate lower inflation rates.
4. The de jure relationship between the central bank and the government is frequently a misleading indicator of the de facto relationship (Mayer 1976). A de facto measure of independence is the appropriate foundation to determine the relationship between institutional design and central bank policy outcomes.
5. The widely cited measures of de jure independence are of limited use in establishing a relationship between central bank institutional design and price stability because they do not measure or even approximate de facto independence.
6. There are a small number of researchers attempting to differentiate between de jure and de facto independence (e.g., Cukierman 1992; Cukierman, Webb, and Neyapti 1992; and Fry et al. 2000). However, de facto independence is difficult to quantify, and even if one can generate a de facto measure—such as presented in Fry et al.—the measure is necessarily time dependent.
7. The low level of econometrics used in estimating the correlations between de jure based measures of central bank independence and inflation pales in comparison to the normal econometric standards used by researchers in monetary economics, especially given the broad generalizations drawn from the empirical literature for the modern view of central banking.

Conclusion

A small group of scholars has been critical of the conventional view of central bank independence, especially the widely accepted correlations between measures of central bank independence and inflation. Cargill (2013), in particular, argues the literature has conflated de facto and de jure independence and, from a de jure perspective, misidentified the degree of independence. De facto independence changes over the sample periods, and as such the use of indexes that are constant over long periods of time lack empirical power.

This article focuses on de facto Fed independence over its postwar history relying on the excellent history provided by Meltzer and extended to include material drawn from the diary of Arthur Burns and the recent actions of the Bernanke Fed.[2]

The Fed was appropriately constrained by fiscal dominance in both great wars. It was independent under the modified gold standard in the 1920s because of a rule. It gained operational independence after the 1951 Accord, but lost that independence starting with William McChesney Martin in the early 1960s and especially Burns in the 1970s. Paul Volcker and Alan Greenspan reestablished de facto independence in terms of focusing on price stability with an implicit adoption of the Taylor Rule. It has surely lost any meaningful independence under Ben Bernanke.

At no time has the Federal Reserve or any central bank been entirely free of political pressure. Sometimes it seeks the protection of one branch of government to shield it from pressure by another. That happened under Volcker and President Reagan. It thus makes itself more dependent in one sense, in order to preserve its independence in another and, as a result, there is no possibility of uniquely categorizing the Fed as independent or dependent over a period as comparatively short as the post-Accord era. Any measure of independence must be time- and personality-dependent, but such a time variant measure is not readily apparent. The Fed was a different institution under Martin, Burns, Volcker, and Greenspan—and is clearly different under Bernanke.

Indeed, this reality gives credence to Milton Friedman's condemnation of the idea of an independent central bank. He noted that the system inevitably makes "important policy actions highly dependent on accidents of personality," a point we have tried to document. Friedman (1962: 50) further argued that "any system which gives so much power and so much discretion to a few men . . . is a bad system."

More than 50 years since Friedman offered that judgment, many researchers still adhere to the view that independent central banks have superior performance. There are two problems with this view. It is inconsistent with a close review of the history and political

[2]Cargill (2011) reviews Meltzer's history.

environment in which central banks conduct policy, and the statistical foundation of the view is fundamentally flawed. In the case of the Fed, despite its high measure of de jure independence, the years in which the Fed might be said to have operated independently of government are comparatively few in number and certainly do not encompass the entire post-Accord era as is frequently presented in the literature.

The idea that the Fed was independent in any coherent or consistent sense over the entire post-Accord era is a myth. We suggest the myth of independence also applies to central banks in general. It is difficult to accept central banking independence in the absence of a price or inflation rule. Hence, the modern view of central bank independence is more myth than reality.

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