First Draft
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Central Bank Accountability For Financial Stability and Economic Reconstruction

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Abstract

The recently heralded "new consensus" on monetary policy (Goodfriend, 2007) – inflation targeting, central bank independence and short-term interest rate manipulation – has now collapsed in failure. The consensus and the central banks that reflected it failed to anticipate or prevent the crisis, were slow to respond to financial meltdown and were therefore unable to prevent its spread to the real economy, and now have had to drive short-term interest rates toward zero while developing much broader and more extensive credit operations in order to try to do their part to prevent a further downward spiral toward a 1930's style great depression. This paper focuses on one aspect of this failed "new consensus", namely "central bank independence", and its opposite, central bank democratic accountability. Focusing on the Federal Reserve System (Fed) we ask whether a more democratic central bank would have performed better in the lead up and management of the current crisis. While such a counterfactual is impossible to address with certainty, we explore several ways in which a more accountable central bank would have performed better, especially with respect to enforcing and monitoring financial regulations in the bubble and in managing problem financial institutions as the bubble burst. More relevant, looking forward, we argue that, given the enhanced role of the Fed in credit allocation and bank rescue operations, the argument for much stronger Federal Reserve accountability is extremely strong. When billions of dollars of tax payer money is being allocated to particular sectors or even institutions, strong mechanisms of democratic accountability are of utmost importance. Furthermore, future monetary and financial policy to support fiscal policy and to help restore and restructure the U.S. economy will require significant coordination between monetary and fiscal policy and likewise calls for not only more transparent but also much more accountable central bank policy as well. How should the Federal Reserve accountability be enhanced? We have argue that the key is to **enhance the accountability of the Fed to the executive branch, to the Congress and to the public-at-large simultaneously.** This will make Federal Reserve monetary and credit policy more responsive to the needs of the public at large, create checks and balances between the executive branch and congress, while preserving enough independence to enhance expertise and longer term perspective.

I. Introduction

Major central banks – notably the Federal Reserve (the Fed) , the Bank of England (BOE) and the European Central Bank (ECB)- failed to prevent the financial crisis that is now engulfing the world's economies. Moreover, once the crisis broke out, they were slow to respond and therefore ultimately failed to prevent the crisis from spreading to the real economy. In recent months the BOE and the Fed (and to a much lesser extent, the ECB) have been innovative in their approach to conducting monetary policy and lender of last resort actions, but they have still not adequately confronted the financial and balance sheet carnage left behind by the crisis. Could these central banks have averted, or substantially reduced the severity of the crisis? More specifically, if central banks had been governed in a more democratically accountable fashion, would they have prevented or reacted more forcefully and effectively to the crisis?

Posed this way, this question is almost impossible to answer. For the root causes of the financial crisis are multi-faceted and deep. They reflect failures in the realm of economic theory and practice, in democratic governance - in policies and oversight by parliaments and executive branches - and are not just problems of central bank policy. With such a massive array of failures, how are we to assess changes in the operations of just one set of institutions, important as they are?

This crisis reflects not only a failure of monetary policy, but also a massive failure of monetary analysis. Using macroeconomic models imbued with rational expectations, strong market forces that automatically restore full employment in real time and assumptions of "efficient" financial markets, mainstream macroeconomists have transformed monetary policy analysis into analyses of "time inconsistency", and related discussions of the alleged benefits of "inflation targeting" and "central bank independence". This crisis was unforeseen by many market participants, revealed profoundly inefficient financial markets and unleashed economic forces that destroyed economic stabilizers, took place with highly independent central banks, and drove down economies with no apparent bottom in sight. Hence, these models and theories were unable to predict or confront the most important macroeconomic event of the past sixty years. To confront the crisis, mainstream economists had to return, almost without skipping a beat or admitting defeat, to the ideas of the economists they had abandoned or were never willing to embrace - most notably John Maynard Keynes and Hyman Minsky - for policy analysis and inspiration.

The crisis reflects not only failures by mainstream macroeconomists and by central banks. There were many failures due to actions (or inactions) of other financial regulators, by treasury departments, and by the inadequacy of the democratic oversight that did exist in parliaments and executive branches, including the U.S. Congress. The U.S. Treasury Department led by Treasury Secretary Paulson was insufficiently aggressive in attacking the financial crisis when it broke out, and then when he did act, with the TARP plan, Paulson did so in an ineffective manner. The U.S. congress failed to exert the authority it did have to insist on enforcement of currently existing financial regulations, to oversee the regulatory role played by Alan Greenspan and the Federal Reserve in the build-up to the crisis. Moreover, it played a prominent role in legislating the financial de-regulatory processes that greatly facilitated if not cause the financial crisis itself. (Essential Information, 2009).

In this context of failure at multiple levels – of economic theory and practice, of legislation and oversight by democratically elected officials and not just "politically independent" central banks - would more central bank accountability and transparency have prevented the crisis or made it less severe or easier to resolve? Posed this way, the question cannot easily be answered.

But there is a more enlightening way to ask the question. For, in fact, the new monetary consensus and its associated practice in macroeconomic governance, and in particular, its emphasis on central bank independence – are part and parcel of the same systems of thought and actions that led to the crisis. In this system, where financial markets were believed to allocate resources efficiently and "inflation fighting credibility" was king, the key role of central banks were to anchor the commodity price level, avoid time inconsistency and attain a lower NAIRU. To do this, central banks were to have political independence from elected officials and elected officials were to defer to the judgments of central bankers.

Thus, in this system, "central bank independence", and associated lack of democratic accountability were not just part of an entire apparatus of theory and practice. **Central bank independence and insulation from democratic accountability reinforced that practice, strengthened it and protected it.** Democratically elected officials in the congress could not exert their oversight roles too strongly because they might interfere with the "independence" of the central bank. Moreover, it was convenient for elected officials not to exert too much oversight, because if something went wrong, they could then "blame" the independent bank, since its mistakes were the Fed's responsibility, not theirs. **This norm of central bank independence and the theory that supported it thus scared off politicians who wanted to exert democratic control and gave political cover to those who did not.**

While economists provided the intellectual support for this central bank independence, what provided the political muscle to keep it intact? This blame game just mentioned was part of it. But this game is generally not sufficient, especially in times of economic stress. Milton Friedman, of all people, had it right. In a 1962 essay he wrote that "Politically independent Central Banks give undue influence to the interests of commercial bankers". (cite). Part of the reason for this is that in democratic societies, central bank "independence" is politically contingent: it can be taken away or greatly curtailed by politicians. As a result, central banks must cultivate and rely on political allies to protect and preserve their political independence from governments (Epstein, 1982). And, their most natural allies are the bankers: they regulate them, they interact with them on a daily basis, they can trade favors with them, and they often share the same outlook. There are plenty of historical examples in which central bankers rally the support of their financial allies to enhance, protect and preserve their political independence (see for example, our discussion of the Federal Reserve – Treasury Accord of 1951: Epstein and Schor, 1995). In short, there is no such thing as "central bank independence". Maintaining central bank independence from elected officials requires the central bank to become dependent on political allies, which are often financial institutions.

So, how should we think of the role played by central bank accountability in the lead up to and the solution to the economic crisis? Since we were faced with a whole system that failed, one change by itself – more democratic accountability of central banks – would not have been

sufficient, either to have prevented its onset or – perhaps, to have significantly reduced the severity of the crisis (though as we argue below, it would have helped on both fronts).
But establishing more norms of democratic accountability of central banks would have been extremely helpful as part of a larger set of reforms. It would have placed more responsibility in the elected officials hands for a range of monetary and financial policy issues, allowed more of them to take an oversight role and prodded others to stop "passing the buck" to the Fed.

Of more interest is a consideration of the role of central bank accountability moving forward. While more central bank accountability will not be sufficient to get us out of the crisis or to promote economic reconstruction, it will be necessary to do so. As the Fed and other central banks get more involved with credit easing (CE) or quantitative easing (QE), major bank rescue operations, decisions to allocate large quantities of public funds as well as manage large financial institutions, and engage in operations to support fiscal policy, the arguments for more coordination with treasuries and more tax-payer and public accountability, become overwhelming. Indeed, a recent Federal Reserve – Treasury Accord recognizes this, to some extent. (Federal Reserve/Treasury, 2009). But this accord is too vague with too many loopholes to guide actual practice. In addition, these issues become especially important in view of proposals to create one overarching financial regulator, possibly giving the Federal Reserve that role.

The rest of the paper is organized as follows. The next section details aspects of the build up to and management of the crisis. It discusses why central banks made significant mistakes and where more central bank accountability would have contributed to better policy. Section III discusses policy issues, moving forward, making a case for more central bank accountability. In both of these sections, I will mostly discuss the Fed, but will ask make some references to other key central banks, notably the BOE and ECB. In section IV, I discuss some proposals for institutional changes to promote more Federal Reserve accountability in the future. Section V summarizes and concludes.

II. Central Bank Failures Before and During the Financial Crisis: The Role of Central Bank Independence

Why, did the lender of last resort function fail in the crisis of 2007 – 2009, and could more accountability have helped?[1] I believe the key reason for the failure is this: the Federal Reserve (Fed), the Bank of England (BOE), the Financial Services Authority (FSA) and other financial authorities had allowed the financial system to get so complex and so opaque, that the authorities undermined their own ability to implement the lender of last resort function. **That is, the financial authorities allowed the financial institutions to become too big too fail, but too complex and opaque to save.**

This problem did not arise overnight. We reached this point as a result of a forty year dynamic of financial de-regulation, financial expansion, crash and then, government bailout. Following each major crisis and bailout, financial de-regulation was expanded and the cycle began anew but at a higher level of size and complexity. The crash of 2007 – 2009 was simply a

[1] This section draws on Crotty and Epstein, 2009b.

continuation of this dynamic. But this time, the system had gotten so large and so complex that the bail-out could not work. (Crotty and Epstein, 2009b)

Fostering this cycle of financial liberalization and bail-out was the ultimate "policy mistake" that led to the crisis. But many other problems beset the attempts to deal with the crisis once it broke out. Specifically, with ample support of the economics profession, the financial authorities made four fatal mistakes in dealing with the crisis: commodity inflation obsession; the surrender to fiscal policy straight jackets; ignorance of the functioning of the financial structure including the role of toxic products; a fatal over-commitment to the prerogatives of private finance and financiers along with an associated allergy to increasing the role and power of the state.

First, central bankers – persuaded by years of misleading arguments by much of the macroeconomics profession - were obsessed with maintaining their "inflation fighting" credibility. As a result, throughout the key first year of the crisis, they engaged in LOLR actions to help increase financial liquidity, but these were creatively designed to allow them to continue fighting a perceived threat of inflation; as a result, these early actions were insufficiently expansionary and did not slow the economies' descents into a major recession. Second, and more importantly, the hard-fought Keynesian lesson of the need for counter-cyclical fiscal policy even at the expense of running large fiscal deficits, had been virtually lost in macroeconomic thought, and in Europe, buried in the structure of economic institutions of the European Union and Euro area. This led, in the early stages of the crisis, policy makers in the U.S. and Europe to attempt purely monetary solutions to the crisis. But by this time it was too late because the financial crisis had destroyed many financial institutions and markets and had also become a "real" crisis, rendering standard monetary policy ineffective. Third, the central bankers did not understand the key role of the housing and property bubble and bust in bringing down the banks, because they did not fully understand the complex financial instruments that linked the banks to each other and financial markets generally. Nor did they understand how to deal with financial asset bubbles because of their obsession with commodity prices (i.e., inflation targeting). Neither they nor the fiscal authorities developed a strategy for dealing with the crash in housing and property values. Fourth, the central bankers and treasury officials went to excessive lengths to preserve the prerogatives of the bankers as the financial crisis deepened; this greatly limited their willingness to seize the banks, re-organize them, and intervene in their operations to make sure they helped the real economies to recover.

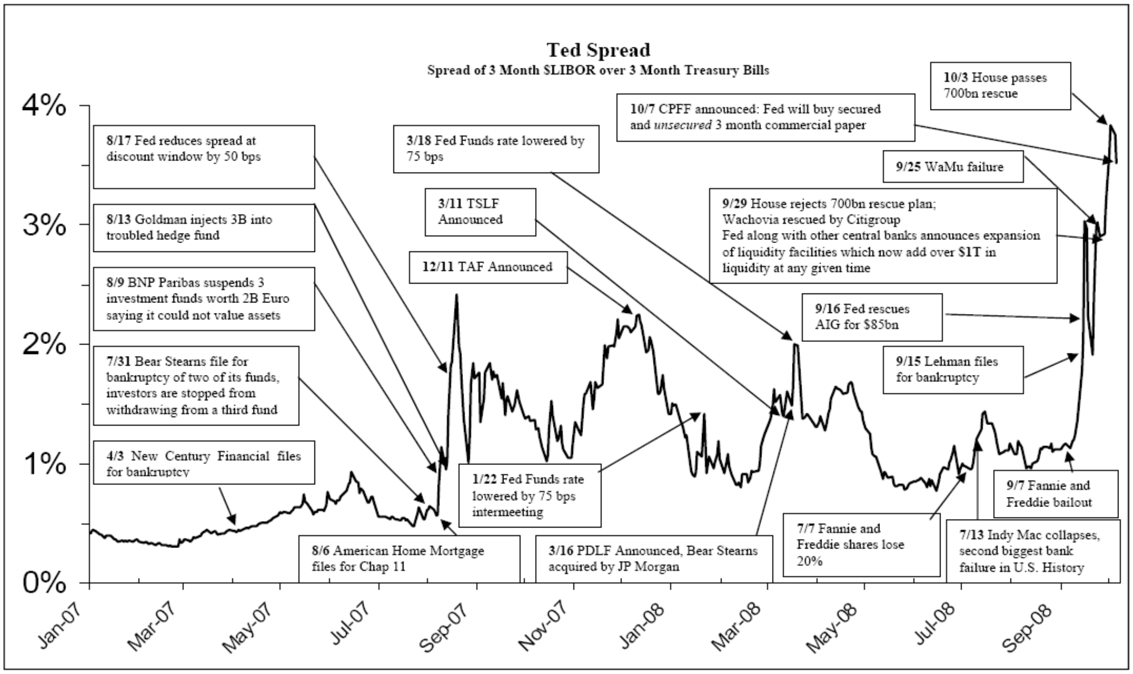
A few data charts will illustrate some of these key points.

Slowness to Respond

Figure 1 shows the responses of the Federal Reserve in the early stages of the crisis super-imposed on the so called TED spread, the 3 month $Libor minus the 3 month U.S. Treasury Bill rate. Though serious signs of financial problems were visible as early as the spring of 2007, the Fed did not respond with interest rate reductions till the late summer of 2007 or with substantially new efforts until late fall of 2007.

Figure 1

Federal Reserve Actions
January, 2007 – October, 2008



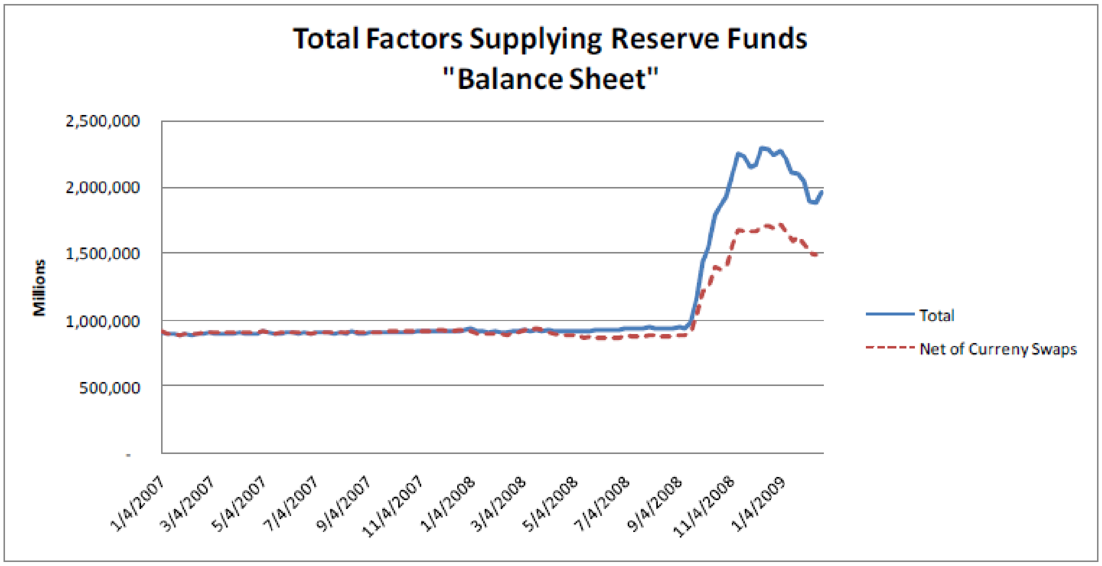
TAF: Term Auction Facility
TSLF: Term Securities Lending Facility
PDLF: Primary Dealers Lending Facility
CPFF: Commercial Paper Funding Facility
Sources: Wall Street Journal, New York Times, Financial Times, Economagic

By the early winter of 2008, though the Fed was implementing aggressive declines of its federal funds rate, engaging in bigger and more innovative policies of broadening access to the discount window and implementing international swap arrangements, a key focus was still on maintaining its inflation fighting credibility by limiting increases in its overall balance sheet.

Inflation Obsession

Figures 2 and 3 which show the Fed's balance sheet over this period, illustrate this point.

Figure 2
Federal Reserve Balance Sheet

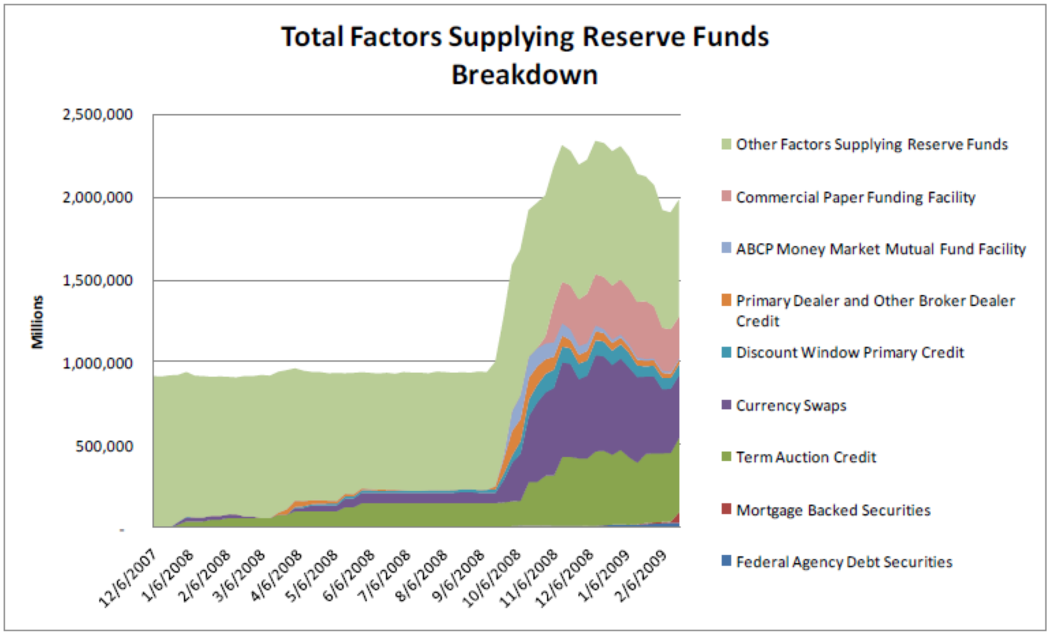


Source: Federal Reserve.

As figure 2 shows, from the beginning of January 2007 until the crisis of September, 2008, the Fed kept total credit relatively constant, presumably because of its over-riding concern about inflation. Only after the Lehman Bankruptcy and the AIG bail-out in September, 2008, did the balance sheet expand, and then, of course, it exploded in size. Note the importance of the Currency Swaps, the key initial component of the international lender of last resort role played by the Federal Reserve. It later came to light that the AIG bail-out which began at this time also gave billions of dollars to fill the holes of foreign bank balance sheets.

Figure 3 gives more detail on the Fed's balance sheet, indicating the growth of a variety of innovative programs designed to increasingly substitute Federal Reserve and Treasury financial actions for those of the private financial sector. These reflect the extreme breadth and innovation of the Fed's actions following the Lehman collapse. Still, the absence of any major credit expansion prior to the collapse is striking.

Figure 3
Total Factors Supplying Reserve Funds: Breakdown



Source: Federal Reserve

During, the spring and summer of 2008 as commodity and oil prices increased, the Fed (along with the other key central banks) was gripped by inflation fears, and were lulled by declines in some spreads (Figure 1), even as the pace of decline in the real economy was accelerating at truly alarming rates. During this period, the Fed and the Treasury department lost precious time to dramatically confront the accelerating crisis. "Indymac" failed in July, the second largest bank failure in U.S. history up to that time, a sign that things were not getting better. But the Fed and the Treasury did not truly spring into action until the debacles of September, 2008. (Figures 1, 2, and 3). By way of international comparisons, we can briefly note that one finds similar responses by the BOE and even more desultory actions by the ECB. (See Crotty and Epstein, 2009b for more details.)

Lax Enforcement of Financial Regulations

These failures by the Fed to quickly and dramatically respond to the emerging crisis were accompanied by a failure in the previous years to promote and enforce financial regulations that could have protected the economy from the financial bubbles and toxic assets that ultimately brought the economy down. Much has been written about the Greenspan "put" -- the expansionary monetary policy by Alan Greenspan to allegedly designed to maintain the stock market and then housing bubble, and the failure to use interest rates and/or margin requirements to slow down or stop the bubbles from forming. (Parenteau, 2005). These are clearly important issues and will be continued to be debated. But here I want to focus on another issue: namely, the failure to enforce financial oversight and regulation of financial institutions, which allowed them to create and sell toxic products, leading to the opaquely interconnected and fragile financial institutions that ultimately have brought down the system.

It is well known that Greenspan ignored warnings about the housing bubble and about financial "irregularities" that were leading to and feeding off of it. Also well known is

Greenspan's alleged surprise at discovering the "flaws" in de-regulated financial markets and the power of self-interest that prevented them from protecting financial shareholders. Much evidence is now surfacing that illustrates how poorly the Federal Reserve did in monitoring financial institutions and enforcing financial regulations.

According to an audit by the Government Accountability Office (GAO), (2009b) the Federal Reserve, (as well as the OCC, OTS and SEC) maintain continuous contact with large, complex institutions that have been at the heart of the crisis, "using a risk-based examination approach that aims to identify areas of risk and assess these institutions' risk management systems…" (p. 3). In examining how the regulators behaved in the period leading up to the crisis and after the crisis became apparent, the GAO found quite disturbing facts: "…we found that regulators had identified numerous weaknesses in the institutions' risk management systems prior to the beginning of the financial crisis; however, regulators did not effectively address the weaknesses or in some cases fully appreciate their magnitude until the institutions were stressed." For example: "Some regulators found that institutions' senior management oversight of risk management systems had significant shortcomings…yet some regulators gave the institutions satisfactory assessments until the financial crisis occurred." (p. 3) More specifically, the Federal Reserve:

" A 2006 Federal Reserve horizontal review of stress testing practices at several large, complex banking institutions revealed that none of the institutions had an integrated stress testing program that incorporated all financial risks enterprise-wide, nor did they test for scenarios that would render them insolvent…..the review was particularly critical of institutions' inability to quantify the extent to which credit exposure to counterparties might increase in the event of a stressed market risk movement….It also found that institutions' senior managers were confident in their current practices and questioned the need for additional stress testing, particularly for worst case scenarios that they thought were implausible…."

The regulators' failures stemmed from a number of factors, according to the GAO (2009b). First, like the banks themselves, they often did not understand the risks involved, especially with respect to major shocks affecting complex and opaque products.[2] Second, they either did not have the authority or were reluctant to strongly confront financial institutions' management about their risky behaviors. Part of this stemmed from the third factor: in the boom, the regulators, like the managers, thought that problems could be relatively easily worked out as asset prices were going up and liquidity seemed to be plentiful. "In hindsight, officials told us that the current crisis had gone beyond what they had contemplated for a worst-case scenario, and they said that they would probably have faced significant resistance had they tried to require the institutions to do stress tests for scenarios such as downgrades in counterparties' credit ratings because such scenarios appeared unlikely. (GAO, 2009b, pp. 33 – 34.)

Fourth, regulations hamstrung the regulators in a number of ways: letting some institutions, such as dealer-brokers, fall through the cracks; exempting offshore entities from

[2] "In these instances, regulators told us that they did not fully appreciate the risks to the institutions under review or the implications of the identified weaknesses for the stability of the overall financial system. One regulator told us it was difficult to identify all risk management weaknesses until these systems became stressed by the financial crisis." (p. 4)

regulatory over-sight, where, many of the riskiest assets were booked[3]; reducing the ability of the same regulator to look at the whole picture of a complex organization, but rather having to share oversight with multiple regulators. Fifth, they lacked independent expertise in some of the risk management areas such as model validation and stress testing, so they often had to take management's word on the nature of the risks involved. And, finally, regulators sometimes just seemed to lack the will to do anything about the problems.

It is clear that a regulatory framework that prevents the system from getting too complex in the first place, that gives more power, tools and resources to regulators, will be necessary to prevent a crisis like this from happening again. But – and this is the key point that is relevant to the questions addressed here – giving the regulators adequate tools will not be enough. In addition, there must be transparency and democratic mechanisms of accountability to make it more likely that these tools will be used effectively.

Models of Federal Reserve Accountability: A brief detour

Would more central bank accountability have solved or at least ameliorated these problems? To address this issue, we must briefly describe three broad approaches to more Federal Reserve accountability, which I will return to in section IV, below.[4] In evaluating the impact of more Federal Reserve accountability below, it may be useful to specify which broad model of accountability we have in mind. The first model is an enhanced congressional control, and an enhanced executive branch control over the Federal Reserve. This de-centralized model builds on the regional structure that already exists in the Federal Reserve System (see Pollin, 1993 and Schlesinger, 2004). Pollin suggests, for example, that the regional banks be given more powers and that the boards of these banks be elected by those living in each bank's district. The second model would enhance Congressional control over the Federal Reserve. A number of suggestions have been made along these lines (Schlesinger, 2004; Galbraith, 1993). These include placing the Federal Reserve's budget under the normal budgetary process, whereas now it is not subject to direct congressional oversight. Some would also make the Regional Reserve Bank Presidents subject to the same nomination approval processes as other federal officials. The third approach would be to make the Fed under more control of the executive branch. This could involve a variety of alternatives, including making the Fed much more subject to the control of the Treasury Department as it was during the Second World War, and/or making the appointment term of the Fed chairman coterminous with that of the President.

Most of these approaches would also entail ending the odd structure under which the Fed is officially "owned" by the commercial banks operating in the regional bank districts. This "private ownership" creates a number of legal anomalies and also feeds "conspiracy" theories about private banker control of the Federal Reserve. Under these schemes, publicly owned stock would replace the stock of the commercial banks, effectively "nationalizing" the Regional Banks.

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[3] "First they noted that FINRA's regulatory authority extended only to U.S. broker-dealers and that related transactions generally are booked in other legal entities. FINRA noted that the riskiest transactions were usually booked in legal entities located offshore." (P. 29).

[4] See more extensive discussion below. Here, we draw here on our own work, as well as on the work of Schlesinger, 2001, 2004; Pollin, 1993; Grabel, 1989; and Galbraith, 1993.

Would More Accountability Have Helped to Prevent the Crisis or Have Ameliorated its Severity?

We now return to the question at hand. We have identified three key problems: first, there was too much focus by the Fed on inflation fighting early on and insufficient focus on fighting the gathering deflationary forces; second, was the Fed's unwillingness to promote and enforce financial regulations which allowed the financial system to become too complex and opaque for the Fed to manage or save; and third, as a related matter, the Fed has paid too much deference to the interests and prerogatives of the financial sector which both reduced the Fed's willingness and ability to regulate the system and which also hampered its ability to resolve the massive banking problems that have resulted.

First, would more accountability have reduced the inflation obsession of the Fed and led it to pursue expansionary policy more aggressively, earlier? We have some indirect, comparative evidence that bears on this issue. As Crotty and Epstein show, the ECB has been even less aggressive and effective in combating the crisis that has the Fed. (Crotty and Epstein, 2009b). This partly stems from the fact that the ECB is far more strictly oriented to "inflation targeting" than is the Fed, and that it is more politically independent. As a result, it is under less pressure to adopt expansionary policy than the Fed has been. As a result, one might infer that in an economic and financial crisis like the one we are experiencing, more accountability would have led to a more aggressive stance earlier on the part of the Fed as well. In this case, Bernanke may have felt less pressure to establish his "inflation fighting" credentials on taking over as Chair of the Board of Governors, and more immediate pressure to confront the financial crisis head on. This may have been true under any of the three models of Fed accountability discussed earlier. It might have been especially true under a more decentralized accountability with more publically elected board members of the regional banks and more accountable regional bank presidents. As the crisis hit and people on the ground began feeling the strong impacts, there very likely would have been stronger pressure earlier on to fight the emerging crisis. A less strong norm of Federal Reserve independence might have also led Congress to push harder, earlier, for more action. This would likewise have been true in the Eurozone and the UK.

A related point refers to the role of the Regional Bank Presidents, some of whom serve on the Federal Open Market Committee (FOMC) on a rotating basis, are directly appointed by the boards of the Regional Reserve Banks which to be dominated by bankers or by appointees who are chosen by bankers (Schlesinger, 2004, 2006). This may tend to lend an anti-inflationary bias to monetary policy orientations; if, the Fed were made more democratically accountable by making the regional banks more democratically accountable and by reducing the "ownership" prerogatives of the commercial banks, then this might have made a difference in the Fed's orientation early on.

Second, would more accountability have led to more serious enforcement and advocacy of more effective financial regulations by the Fed, thereby leading to more financial stability and more effective lender of last resort actions? This is closely related to the third issue: would more accountability have reduced the central banks' deference to financial interests and thereby made its interventions more effective?

For the reasons described earlier about the nature of "contingent" central bank independence in a democracy, and the connections forged between central banks and the financial industry in this context, we can say that have a more accountable central bank would loosen these bonds and make it more likely that the Fed would buck the pressures coming from finance and be more likely to engage in stricter oversight and promote better regulation. This seems to be more likely to be true in the case of more congressional accountability and more regional accountability, because it creates a more dispersed and multi-faceted set of interests and points of access. Simply making the Fed more under the control of the Treasury Department is unlikely to enhance, in general, the Fed's regulatory powers. The Treasury has also developed into a strong advocate of financial interests, where as a more democratically and empowered regional system, and stronger accountability mechanisms by Congress would be more likely to counter these forces.

For this kind of accountability by Congress to have worked, the "presumption of Federal Reserve Independence" would have to have been strongly curtailed or eliminated. Congress would have had to have the tools to receive timely and detailed reports on regulatory matters and must establish mechanisms to ascertain that regulatory policies are being properly enforced.

Here too the issue of the anomalous position of the regional reserve banks in the current system and the appointments processes of regional reserve bank presidents is highly relevant. Timothy Geithner, then President of the Federal Reserve Bank of New York, played crucial roles in the key lender of last resort actions and highly controversial actions taken with respect to "bailing out AIG", merging Merrill Lynch and Bank of America. Geithner was subsequently appointed Treasury Secretary under the Obama administration, at least partly because of his intimate experience with these actions as President of the New York Fed. Yet, in this crucial role, Geithner did not have to undergo any confirmation hearings by congress. He was chosen to be head of the New York Fed by major banks and corporations that sit on the New York Federal Reserve's board. His successor was likewise chosen in this way without virtually any public discussion. Given the important role played the head of the New York Fed, one would presume that its president should be accountable to a broader constituency.

This deference to the power of finance became especially important in the nature of the lender of last resort bail-outs that occurred and the proposals for dealing with bank balance sheets that have resulted since then. The bail-out of AIG for example, in which billions of dollars were paid to banks in Europe and the U.S. but were kept hidden under presumptions of Federal Reserve secrecy, could not have occurred behind the cloak of secrecy had they been done in a more accountable central bank. Even with so-called accountability, of course, problems arise, as has been apparent with the lack of transparency in the TARP operations. But at least here, there is oversight established by Congress which does not exist to the same extent with respect to operations under the cover of Federal Reserve secrecy. The need for transparency and accountability of these operations becomes even more important moving forward.

Still, the ultimate problem is the financial power of finance. As the report: "Sold-Out: How Wall Street and Washington Betrayed America". (Essential Information/Consumer Education Foundation. 2009 www.wallstreetwatch.org) showed, the financial industry spent over 5 billion dollars over ten years in campaign contributions and lobbying fees to influence members of congress and the executive branches of both major parties, in order to get the financial de-regulation they wanted, and which ultimately brought down the financial system. Unless there is a major reform to reduce the influence of this kind of money, then wherever the accountability is lodged in the political system, this kind of money will attempt to buy and undermine it.

III. Federal Reserve Accountability In the Future

While there is evidence that more accountability of the right types, in combination with other changes, would have reduced the likelihood of the massive economic crisis that did occur, we can be even more confident of the need for and desirability of substantially more accountability moving forward. This is because: 1) The Federal Reserve (and other central banks) will continue to be extensively involved with bank restructuring operations, placing at risk billions of tax payer dollars, and significantly intervening in/managing the operations of financial institutions. 2) The Federal Reserve's monetary policy, as it operates around the zero bound and is engaged in credit easing (CE) operations will be making multiple credit decisions affecting particular securities, particular institutions, and particular markets.[5]. 3) The Federal Reserve's CE operations are designed to support a number of government goals in reviving the economy, including supporting fiscal policy by, among other policies, conducting open market operations in long dated treasuries. In such circumstances, close cooperation and coordination between the Federal Reserve and the Treasury is not only desirable but also necessary. 4) A number of the large, unorthodox operations undertaken by the Fed involve credit risks for the Fed, and therefore to the public. The Fed has received lines of credit from and guarantees from the Treasury for some of these credit risks (see Bernanke, 2009). In these circumstances, the Fed must be held accountable to tax payers for these operations.

Many of these issues have come to a head in the development of the new financial rescue package, the so-called PPIP program. This program uses substantial resources from the Federal Reserve and the FDIC to finance and guarantee private acquisition of bank "legacy" assets. It is commonly understood that the government is using this approach to avoid having to go to Congress to get billions of more direct taxpayer dollars to underwrite the program.
In this situation, lack of accountability on the part of the Fed allows the executive branch to operate a "shadow financial system" reminiscent of the shadow financial system that got the economy into this mess in the first place.

In this new world of massive credit intervention to attempt to save and resurrect the financial system, there are multiple dangers of accountability:

1. That the Federal Reserve will be insufficiently cooperative with the fiscal authorities to engage in the actions that need to be undertaken.

[5] See Bernanke, 2009, for a discussion of CE operations, and his concern NOT to engage in credit allocation operations. However, these will be virtually inevitable given the nature and scale of the credit easing programs.

2. There is a danger that the Fed will be sufficiently cooperative, BUT that the executive branch will be able to use the relatively unaccountable Fed to make its actions less accountable to Congress.

Both of these dangers must be avoided. The way to do this, as we argue below, is to enhance the accountability of the Fed not just to the executive branch, but also to the Congress and the public at large.

In recent months the Federal Reserve and the Treasury department signed a new "accord", intended to apply during this period of "financial exigency" in which the Federal Reserve agreed that it must coordinate credit policies carefully with the Treasury, while maintaining its independence with respect to monetary policy. Following the Great Depression of the 1930's, the Federal Reserve, Bank of England an other central banks lost their previous levels of central bank independence and became, to a lesser or greater extent, arms of Treasury departments as they attempted to manage the finances of war and recovery. Previously proud and independent central bankers chafed at their subservient political positions.[6] The Fed, Bank of England and other central banks waged campaigns with the help of their political allies following WWII in order to re-establish their political independence. Naturally, the Fed is now anxious to maintain its independence and loathe to return to its position after the depression and before 1951.The following paragraph underline's the Fed's insistence on it "independence" with respect to monetary policy, even in these times of economic crisis:

"While the Federal Reserve has traditionally collaborated with other agencies in efforts to preserve financial stability, it alone is responsible for maintaining monetary stability. The monetary policy-making arm of the Federal Reserve, the Federal Open Market Committee (FOMC), determines monetary conditions in the United States, subject to its congressional mandate to foster maximum sustainable employment and stable prices. The Federal Reserve's independence with regard to monetary policy is critical for ensuring that monetary policy decisions are made with regard only to the long-term economic welfare of the nation." Federal Reserve/Treasury Joint Statement, 2009).

At the same time, the Fed and Treasury agree that the massive credit operations conducted by the Fed increase the need for Federal Reserve cooperation with the Treasury. In outlining this "Accord II" the Fed and the Treasury agreed on the following broad points:

"*1. Treasury-Federal Reserve cooperation in improving the functioning of credit markets and fostering financial stability*
The Federal Reserve's expertise and powers are indispensable for preventing and managing financial crises… As long as unusual and exigent circumstances persist, the Federal Reserve will continue to use all its tools working closely and cooperatively with the Treasury and other agencies as needed to improve the functioning of credit markets, help prevent the failure of

[6] Montagu Norman, the Governor of the Bank of England during most of the war, wrote New York Federal Reserve President Alan Sproul that he had been reduced to being a "bonds salesman". (Letter from Montagu Norman to Alan Sproul, New York Federal Reserve Archives, reported in Epstein and Schor, 1995).

institutions that could cause systemic damage, and to foster the stabilization and repair of the financial system.

2. The Federal Reserve to avoid credit risk and credit allocation
The Federal Reserve's lender-of-last-resort responsibilities involve lending against collateral, secured to the satisfaction of the responsible Federal Reserve Bank. Actions taken by the Federal Reserve should also aim to improve financial or credit conditions broadly, not to allocate credit to narrowly-defined sectors or classes of borrowers. *Government decisions to influence the allocation of credit are the province of the fiscal authorities.*(emphasis added)

3. Need to preserve monetary stability
Actions that the Federal Reserve takes, during this period of unusual and exigent circumstances, in the pursuit of financial stability, such as loans or securities purchases that influence the size of its balance sheet, must not constrain the exercise of monetary policy as needed to foster maximum sustainable employment and price stability. Treasury has in place a special financing mechanism called the Supplementary Financing Program, which helps the Federal Reserve manage its balance sheet. In addition, the Treasury and the Federal Reserve are seeking legislative action to provide additional tools the Federal Reserve can use to sterilize the effects of its lending or securities purchases on the supply of bank reserves."[7]

In addition, the Fed, clearly uncomfortable with the massive role it has played in bailing out institutions such as AIG, and concerned about the credit risks such bail-outs imply, worked to get a commitment from the Treasury Department to buy this assets from the Fed's balance sheet.

"In the longer term and as its authorities permit, the Treasury will seek to remove from the Federal Reserve's balance sheet, or to liquidate, the so-called Maiden Lane facilities made by the Federal Reserve as part of efforts to stabilize systemically critical financial institutions."

What are we to make of this agreement? On the one hand, it recognizes that the new responsibilities undertaken by the Fed implies the need for much broader accountability and coordination with the government, and in particular the executive branch, through the Treasury Department. On the other hand, it attempts to create a clear line –which is almost certainly not supportable – the Federal Reserve does not engage in credit allocation policies, does not put at risk tax payers money, and can separate its monetary policies from its credit policies. The Fed

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[7] They also agreed to a fourth point: "*Need for a comprehensive resolution regime for systemically critical financial institutions*
The Treasury and the Federal Reserve remain fully committed to preventing the disorderly failure of systemically critical financial institutions. To reduce the risk of future crises, the Treasury and the Federal Reserve will work with the Congress to develop a regime that will allow the U.S. government to address effectively at an early stage the potential failure of any systemically critical financial institution. As part of the framework set forth, the legislation should spell out to the extent possible the expected role of the Federal Reserve and other U.S. government agencies in such resolutions. "

and the Treasury attempt to draw these distinctions in order to protect the Federal Reserve's independent political structure to the greatest extent possible and avoid the trap of the 1930's and 1940's.

In particular, the agreement attempts to maintain the overall-all formal structure of Federal Reserve Independence, including the unaccountable role of the Regional Reserve Banks and the independent role of monetary policy. This means that there is nothing in the agreement that would enhance the oversight abilities of Congress, or make more democratically accountable the role of regional banks or regional Presidents. We have suggested hat that there were significant problems with the Fed's structure even prior to the crisis; but now with the new roles played by the Fed, roles that cannot be easily "ring-fenced" from much more risky and interventionist policies that the Fed takes under normal circumstances, the arguments for avoiding significant structural reforms in the governance of the Federal Reserve become even harder to sustain.

The agreement is also quite vague with respect to how the Federal Reserve's cooperation will be gauged and monitored. Despite these assurances of cooperation with respect to credit policy (if not monetary policy), it is important to note that there is nothing in the agreement that:

1) Enhances Congressional authority to oversee the massive layouts of credit
2) That holds the Regional Reserve Banks more accountable, despite the fact that, among other things, they make decisions about broader collateral that is accepted at the discount window and other new and expanded credit operations.
3) That enhances the transparency and accountability of operations connected with the newly proposed PPIP operations, in which loans from the Federal Reserve will be significantly involved.

With respect to monetary policy, the agreement is equally problematic. It implies that the Fed can separate monetary policy from credit policy, but does not specify how this can be done. For as long as the Fed has committed to keeping interest rates near the zero bound, and is committed to supporting the government's recovery policy, then it is unlikely it can operate an independent monetary policy. Hence the agreement on monetary policy is primarily forward looking. The Federal Reserve-Treasury Accord II is designed to keep the Fed free to raise interest rates in the future when the current economic emergency ends, so that it does not have to negotiate a new accord, as it did in 1951. With respect to monetary policy, then, there is no change in structural accountability. Instead, the Federal Reserve's goal is to preserve the possibility of hitting the restart button when the economic crisis is resolved, and return to the structure of independence that prevailed before the crisis.

Rather than hit the restart button with respect to monetary policy, or base Federal Reserve accountability on credit policy with a vague accord with the Treasury Department in which Congress played no obvious role, we should instead use this opportunity of obvious need for cooperation and coordination and obvious tax payer risks to advance a genuine agenda for enhancing Federal Reserve Accountability both with respect to monetary policy and credit policy.

IV. An Agenda for Enhanced Federal Reserve Accountability

The arguments for more central bank accountability implicit in the foregoing are:

1) Principles driven: in a democracy, public decisions should be based on principles of equal representation of interest. This principle fails with respect to independent central banks which are not accountable to a broad swath of the public.

2) Utilitarian driven: independent central banks tend to make policies that are biased toward a subset of the economy rather than in the interests of the economy as a whole.

On the other side, arguing for some insulation from day to day politics, there are issues of expertise, and checks and balances that are also important. These can be addressed by limiting inappropriate partisan impacts and insuring that those conducting monetary policy have appropriate expertise, while encouraging longer run considerations in macroeconomic policy making (along with appropriate short-term considerations). While it is not easy to design macro institutional frameworks to balance these various concerns, it is no solution to implement excessive "central bank independence" based on flawed macroeconomic theory as has become the common practice.

How should the Federal Reserve accountability be enhanced? We have argued that the key is to **enhance the accountability of the Fed not just to the executive branch, but also to the Congress and the public-at-large.** This will make Federal Reserve monetary and credit policy more responsive to the needs of the public at large, create checks and balances between the executive branch and congress, while preserving enough independence to enhance expertise and longer term perspective.

Here some basic suggestions for reforming Federal Reserve governance that can improve accountability and performance as we attempt to resolve this crisis, promote economic recovery and restructure the financial regulatory system. (Schlesinger, 2001, 2004; Pollin, 1993; Grabel, 1989; Galbraith, 1993; Kutner, 2009).

1. Enhance Democratic Control of the Regional Reserve Banks

As Tom Schlesinger has pointed out, the Fed is unique in its governance structure among central banks as well as within American government itself. "Alone among a huge array of agencies, commissions and government corporations, the Fed combines a broad economic-management mandate with a public-private structure that reserves ownership and governance rights to a single segment of the private sector while allowing individuals who aren't public officials to create government policy." This system thus contains a number of anomalies and governance problems. For example, the Fed has key exemptions from the Freedom of Information Act and Sunshine Laws. There are restrictions on GAO audits of monetary policy operations. It has special treatment under the Federal Advisory Committee Act – shared only by the CIA – that permits the Board's banking industry advisory group to meet with it behind closed doors and withhold records of sessions. It has an Inspector General who serves at the pleasure of the Fed Chair, rather than being appointed by the President of the United States as is the case with the rest of the government.[8]

There have been numerous proposals and attempts over the years to alter this system – all without success. Many reformers have tried to make the Reserve Bank Presidents public officials, or to remove them from the FOMC all together. Chairman Marriner Eccles in the 1935 and House Banking Committee Chairman Wright Patman, among others, tried to alter the public private character of the Fed more directly. For example, the Commission on Money and Credit – organized by the Committee for Economic Development (CED) and financed by the Ford Foundation focused on "expanding the degree of independence of the Federal Reserve from the banking community which it both serves and regulates" (quoted in Schlesinger, 2001). "The report recommended retiring member banks' stock in the Reserve Banks, eliminating the FOMC, replacing the Board's banking industry advisory council with a more broadly constituted group, and relegating the Bank presidents to a consultative role at the Board of Governors". (Schlesinger, 2001). These recommendations of the Commission on Money and Credit are worthy of revisiting and should be strongly considered today.[9]

Progressive critics have argued against eviscerating the role of the regional banks, however, on grounds of maintaining more de-centralized power and broader representation in the system. Schlesinger advocates using Section 11 of the Federal Reserve Act to retire the commercial banks stock and then issue " a single share of a new class of stock to every eligible voter in their districts….Like the stock currently held by member banks, these would be non-marketable….(but would entitle the holder to elect directors of the district Bank).

This is consistent with Pollin's proposal for citizen election of Federal Reserve Bank officials (see Pollin, 1993). Of course there are many details to work out, but the point would be to enhance democratic control over the regional banks as a way of enhancing democratic control over the Fed as whole (see Schlesinger, 2001 and Pollin 1993 for more details on their proposals; see Kutner, 2009, for a recent discussion of this issue)

2. Clarify The Fed's Agency Status

As discussed above, the agency status is the Fed is murky. Altering the banker stock ownership of the regional banks, as discussed in point 1, would help to rectify this.
In addition, a straightforward change of its statutory basis is also needed. Therefore: To bolster accountability, the central bank’s agency status could be clarified. Section 1 of the Federal Reserve Act might be changed to clearly designate the Board, the Banks and the FOMC collectively as an independent agency within the executive branch, thereby placing the central bank within the ambit of laws and regulations that currently exempt or do not specifically cover it. (Schlesinger, 2004).

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[8] Schlesinger notes that: "Not coincidentally, the central bank’s agency status remains 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 important statutes like the Civil Rights Act of 1964 and the Federal Labor Relations Act." (Schlesinger, 2004).

[9] The Appendix to this paper also contains a table that summarizes a detailed proposal for enhancing democratic governance of the Fed which is developed by Tom Schlesinger and is worthy of consideration as well.

3. Increase Accountability to Congress and the Public

Clarifying the Fed's agency status, as in 2 above, would facilitate and even imply many of these points here (Schlesinger, 2001; 2004).

Federal Reserve Budget Appropriation: The Federal Reserve's Budget Should be Appropriated through the normal budget appropriations mechanisms.

Audits: The General Accountability Office should have Authority to Audit every aspect of Federal Reserve operations without exception.

Inspector General: Consistent with the practice at other federal agencies, the Fed's inspector general should be appointed by the President and confirmed by the Senate, rather than serving at the pleasure of the central bank's chairman.

4. Enhance Accountability to the Executive Branch

Terms of the Appointments of top Fed Officials: The term of the Chairman and Vice-chairman of the Board of governors should expire within six months of Presidential election, so that Fed Officials and the President may serve on roughly coterminous basis. These or similar proposals, fully fleshed out and developed, would go a long way to both enhancing Federal Reserve accountability and, most likely, improve the quality of monetary and financial policy as well.

V. Conclusion

We cannot say with certain whether more central bank accountability would have greatly reduced the likelihood of the massive economic crisis we are now experiencing, but there are strong reasons to believe that, along with other important reforms, it would have significantly helped. Moving forward, as the Fed and other central banks become more deeply involved in financial market and institution rescue operations, credit policy and financial regulation and reform, more democratic accountability is essential, both on grounds of democratic procedures and on grounds of improving the over-all quality of monetary and financial policy. In this paper, I have outlined some proposals for enhancing both the accountability and quality of Federal Reserve policy. These suggestions draw on the work of many policy makers and economists over a number of years. We would be well served by revisiting this work in detailed fashion, and establishing a Congressional commission to evaluate, develop and propose reforms such as these.

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Appendix

Reforming the Regional Federal Reserve Ownership and Governance Process: One Idea (due to Tom Schlesinger, Director of The Financial Markets Center)

Regional Reserve Banks have three types of Directors. "Each of the 12 Reserve Banks is governed by a nine-member board that includes three banking industry representatives and six representatives of "the public". Member banks elect the three banking members (class A directors) and three of the six "public" members (class B). The Fed's board of governors select the remaining 3 "public members" (Class C directors). (Schlesinger, 2006).

As table 1 reports, very few of these representatives are really labor, consumer or community representatives.

Table 1: Labor, Consumer & Community Representation on Reserve Bank Boards

Labor, Consumer & Community Reps	2006	2005	1991-1994	1995-1998	1999-2002	2003-2006
As a Pct. Of All Directors	6.5%	5.6%	6.3%	8.8%	8.6%	7.6%
As a Pct. Of Class B & Class C Dirs.	9.7%	8.3%	9.4%	13.2%	12.8%	11.5%
As a Pct. Of Class B Directors	8.3%	11.1%	0.7%	5.6%	12.5%	13.2%
As a Pct. Of Class C Directors	11.1%	5.6%	18.1%	20.8%	13.2%	9.7%

[Percentages based on years of service, with 2006 service projected through end of year]
SOURCES: Federal Reserve Banks; Board of Governors; previous FMC analyses

Source: Tom Schlesinger, Financial Markets Center. "Reserve Bank Boards in 2006; Regional Boardrooms Get a Makeover", April 16, 2006.

Schlesinger's Proposal For Restructuring Governance:

OWNING & GOVERNING THE RESERVE BANKS

	CURRENT SYSTEM	NEW SYSTEM
Ownership	Member banks of Federal Reserve System	All eligible voters in U.S.
Electorate for Board of Directors	Groups of stockholders select 6 directors on a rotating basis – see "Nomination Process" below. Board of Governors also names 3 directors.	All stockholders elect directors
Composition of Board	9 directors: 3 representatives of member banks, 6 representatives of public	9 directors, all representatives of public
Main Powers of Board	"Supervise and control" activities of the Reserve Banks, including budget and audit authority. Hire Bank presidents, subject to Board of Governors approval. Make biweekly discount rate recommendations to Board of Governors.	Same
Structure of Directors' Terms	Staggered 3-year terms, with 3 directors selected each year. Terms may be renewed (2 full terms customary maximum)	Staggered 4-year terms, with groups of 4 (Class A) and 5 (Class B) directors elected in alternate cycles after the initial election. Service limited to 2 full terms.
Nomination Process	Any member bank may nominate a board candidate. Member banks are organized into 3 groups by amount of their surplus capital; each of the 3 groups elects directors from the slate of nominees on an annual rotating basis. No limit on the size of the slate, though only a handful of candidates typically vie for each seat	After consulting with their legislatures, governors of all states in the District submit a combined slate of no more than 25 and no fewer than 15 candidates for directorships in each Federal Reserve District on January 1 of every presidential election year
Criteria for Nominations	Public directors must be chosen with "due but not exclusive consideration for the interests of agriculture, commerce, industry, services, labor and consumers." No member of Congress may be selected	Each slate includes an equal number of candidates affiliated with each major political party and independents. Each slate also must include a balanced mix of candidates identified with the interests of labor, consumers, finance, industry, commerce, services and agriculture. No public officials may be nominated
Election Process	Reserve Banks distribute ballots providing background information on the candidates and identifying the member bank that nominated them. Member banks mail in their votes over a 15-day period.	Candidates may not be identified by partisan affiliation. Neither candidates nor any other individuals and entities may expend funds on campaign-related activities. Reserve Banks set aside a portion of their earnings to: a) finance traditional and electronic forums in which candidates present their qualifications and goals; b) enforce campaign standards; and c) cover all costs related to printing and tabulating ballots for Reserve Bank directors
Vote Tabulation	Preferential voting. Second-, third-, etc.-place votes determine winner if no candidate wins outright majority of first-choice votes	Preferential voting.
Main Restrictions on Director Activities	Most forms of electoral activity are prohibited (except campaign contributions) as are stock ownership in and employment by member banks (for some directors)	Directors may not use their office to attempt to advance legislation or the interests of political parties, political candidates or public officeholders. Directors may not directly hold debt or equity instruments issued by firms subject to supervision by the Federal Reserve System
Selection of Chair and Deputy Chair	Appointed annually by Board of Governors	Elected annually by Reserve Bank board of directors

Source: Tom Schlesinger, Financial Markets Center, FOMCALERT, March 20, 2001, Vol. 5. Issue 2.