The History of Fed Independence: Learning From Adversity?

Michael D Bordo Rutgers University, Hoover Institution. Stanford University and Griswold Center Princeton University

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Background : History of Central banking and Bank of England

- Early European central banks were private joint stock banks with government charters
- BoE 1697 bank of issue to aid in government finance, evolved into a bankers' bank and LOLR, managed the gold standard
- Did not conduct stabilization policy
- Independence made accountable by periodic charter renewals

Background: Federal Reserve

- Federal Reserve created in 1913 to consolidate the currency, to stabilize seasonal fluctuations and achieve financial stability, act as LOLR, and preserve the gold standard peg
- Real bills doctrine with passive discount policy to automatically guarantee economic stability
- Established by Congress as a public private partnership with limited operational independence
- 12 regional regional banks governed by local boards of directors (mainly commercial banks)
- Coordinated by Fed Board of Governors in DC appointed by the Executive branch, included the Secretary of the Treasury, hence not completely independent of the fisc

Background: History of the Fed

- During WWI Fed subsumed under UST fiscal expansion
- 1920-21: first policy mistake not tightening fast enough to stem post war inflation because of UST pressure
- 1920s Fed learned stabilization policy—Benjamin Strong and the High Tide of the Fed- Fed learned to coordinate the regional banks which had followed destabilizing regional discount policies
- 1929-33 policy debacle, Fed failed to prevent 4 big panics
- Friedman and Schwartz (1963) attribute it to bad governance; after Strong’s death, Meltzer (2002) blames it on bad doctrine—real bills

Background: History of the Fed

- Major Reform in 1935 shifts power from the regional banks to the BOG
- Fed independence clipped by the UST’s ESF and the Thomas Amendment
- WWII Fed sustains a low interest rate peg and becomes engine of inflation
- Fed operational independence restored with 1951 Accord
- McChesney Martin successful in maintaining price stability (Bretton Woods peg) and real output stability until early 1960s

Milton Friedman(1962) and his case against Central Bank Independence

- Milton Friedman’s 1962 case against CBI:
- 1. Unchecked power to unelected officials inconsistent with a liberal society
- 2. Diverse sources of monetary authority between Fed and UST works against good monetary policy
- 3. Interconnection between monetary and credit policy
- 4. Idiosyncratic policy outcomes depending on the personalities of the Fed leaders eg Harding and Meyer versus Strong pre-WWII

Friedman 1962 against CBI

- MF makes the case for automatic rules over authorities (discretion) following classical tradition back to the Currency school in 1810
- Makes the case for his k% rule
- His solution was to put the Fed into an office at the UST to just print M at the rate sufficient to finance real growth adjusted for the trend of V
- Meltzer (2002, 2009) also criticized Fed independence based on his reading of the Fed's record.
- His critique of Fed discretion was: a) the pursuit of bad doctrine—real bills b) short-termism including Presidential interference

The Modern Case for CBI

- The Great Inflation 1965-1982 began with pressure by LBJ on Fed Chair Martin to accommodate expansionary fiscal plans and keep interest rates low
- Pressure by Richard Nixon on Chair Arthur Burns to keep rates low to guarantee his reelection
- The Great Inflation was vanquished by Chair Paul Volcker tight monetary policies
- Volcker and his successor Alan Greenspan restored the Fed low inflation credibility last achieved by Martin

The Modern Case for CBI

- The Great Inflation experience led to major advances in monetary theory – rational expectations--that resuscitated the case for CBI
- Kydland and Prescott (1977) and Barro and Gordon (1983) posited that a credible commitment (rule) was required to prevent CBs from following time inconsistent behavior
- Others made the case for CBI, especially with a conservative chair, following transparent, well communicated policies to maintain credibility for low inflation
- John Taylor (1993) made the case for an instrument policy rule to succeed Friedman's k% rule
- Many CBs adopted inflation targets in the 1990s followed by the Fed in 2012 that had a good track record in keeping inflation low

But What about Friedman 1962?

- The new case for CBI became widely accepted by the CB community and was successful during the Great Moderation
- But since the early 2000s a series of unforced errors by the Fed (and other CBs) in may have made Friedman’s argument more pertinent again
- GFC 2007-2008: many argue was partially caused by the Fed keeping rates too low for too long in the early 2000s to prevent a Japan style deflation, thereby fueling the debt-financed housing boom and bust leading to crisis
- Pandemic of 2020-21: expansionary fiscal and monetary policy fueled very high inflation which the Fed was several quarters late in stemming
- This was based on the misperception that the inflation was largely caused by transitory supply shocks rather than by war like surge in aggregate demand
- These Fed errors occurred despite the new achievements and understanding in economics and policy making

How to strengthen the case for CBI

- At present the Fed's independence is being threatened by the Executive branch's pressure for it to lower policy rates below what policy rules and economic analysis suggest is appropriate
- Charles Plosser (2016) proposed steps to improve the Fed's communications and accountability to ensure independence
- 1. He proposed simplifying its mandate to primarily focus on low inflation within the 1978 dual mandate to get back to Volcker and Greenspan's view that the Fed's best contribution to healthy economic growth and maximum employment is low inflation

How to strengthen the case for CBI

- 2. He opposed the Fed taking on other mandates such as macro prudential policy, climate change, and inequality, and prioritize the Fed's focus on its main mandate which is preserving the value of money
- 3. The Fed should simplify its balance sheet and go back to bills only and not stray into credit policy
- 4. The Fed should be more systematic and adopt a policy rule of its own to serve as a benchmark for accountability

How to strengthen the case for CBI

- The Fed's performance with respect to a rule would be part of a periodic review of its policy actions to Congress
- Departures from the rule would need to be justified by the Chair
- This strategy would have resonance to the Financial Choice Act of 2017
- A final improvement to communications would be for the Fed to use scenario analysis (Bordo, Levin and Levy 2020)