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The Federal Reserve: Recurrent Public Policy Issues

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Summary

Congress has delegated the task of implementing monetary policy to the Fed, but retains oversight responsibilities and overarching control of the Fed's mandate and structure. Hence, issues surrounding monetary policy are frequently the subject of congressional debate. This report provides an overview of the many issues surrounding the Federal Reserve and monetary policy, and refers the reader to relevant CRS reports for more detailed analysis. These issues include debates over the proper goals of monetary policy, the possible adoption of an inflation target or a "Taylor rule," the economics of Federal Reserve independence, the role of asset bubbles in monetary policy, the role of the monetary aggregates in the formulation of monetary policy, and the debate surrounding the payment of interest on required bank reserves. This report will be updated as new CRS reports become available.

The Basics of Monetary Policy

The Federal Reserve System (Fed) is mandated by Congress to influence credit market conditions through its control of the money supply to maintain low inflation, low unemployment, and moderate interest rates. To do so, the Fed targets the federal funds rate (the overnight inter-bank lending rate) to alter the amount of reserves available for lending in the banking system. It targets this interest rate by buying and selling U.S. Treasury securities. In the long run, inflation, or increases in the general level of all prices, is a purely monetary phenomenon. Thus, sustained price stability is a goal for which the Fed is solely responsible. In addition, in times of financial crisis, the Fed acts as lender of last resort to the financial system.

The Federal Reserve system is composed of 12 regional banks and the Board of Governors, located in Washington, DC. Seven governors, appointed by the President and confirmed by the Senate, serve on the board. Ben Bernanke replaced Alan Greenspan as Chairman of the Board of Governors on February 1, 2006. Monetary Policy decisions are made by the Federal Open Market Committee, which consists of the seven Fed governors, the New York Fed president, and four of the other regional bank presidents; the latter serve on a rotating basis among the eleven regional presidents. The Fed is self-financed; it does not receive appropriations from Congress and its profits are largely remitted to the Treasury.

For more detailed information, see the following:

CRS Report RL30354, *Monetary Policy: Current Policy and Conditions*, by Gail Makinen and Marc Labonte.
CRS Report 98-856, *Federal Reserve Interest Rate Changes: 2000-2005*, by Gail Makinen and Marc Labonte.
CRS Report RL30344, *Inflation: Causes, Costs, and Current Status,* by Gail Makinen and Marc Labonte.
CRS Report RS20826, *Structure and Functions of the Federal Reserve System*, by Pauline Smale.
CRS Report RS22271, *Chairman Greenspan's Retirement From the Federal Reserve*, by Marc Labonte.
CRS Report RS21986, *Federal Reserve: Lender of Last Resort Functions*, by Marc Labonte.

What Goals Should the Fed Be Mandated to Accomplish?

Some economists and policymakers have criticized the Fed's mandate as being overly broad and vague. A more precise mandate, they argue, would lead to more accountability, more transparency, and better economic performance. Many different goals have been suggested as alternative mandates. The proposal that has received the most attention is the adoption of an inflation target. Under this proposal, which several foreign countries adopted in the 1990s, the sole goal of monetary policy would be "price stability," to ensure that the economy attained a certain inflation rate (or maintained a rate within a specific band.) This proposal has been supported on the grounds that inflation is the only goal that the Fed can control in the longer run, that other policy goals have allowed inflation to rise to unacceptable levels in the past (particularly in the 1970s), that high inflation imposes economic costs that lower efficiency, and that a single goal would make the Fed's actions more accountable and transparent. By contrast, opponents of an inflation target claim that inflation is not the only important goal of monetary policy, monetary policy may be able to affect other variables for very long periods of time, policy lags and imprecision imply that good policymaking requires the maximum flexibility, and that achieving an inflation target may not be a realistic goal.

Another proposal with similar aims, known as the "Taylor rule," would replace discretionary policy with a mathematical rule that changed interest rates when economic data changed. This rule can also be used for oversight purposes to evaluate the current stance of monetary policy.

Some argue that monetary policy should react to the price of assets as well as the prices of goods and services. For instance, proponents believe that the stock market was overpriced in the late 1990s, and this reflected an economic imbalance which should have been countered by a tightening of monetary policy. Indeed, declining equity prices paralleled a general economic weakening in 2000-2002. In recent years, the pattern of rapidly increasing asset prices has been echoed in the housing market, causing concern among some economists.

CRS Report 98-16, *Should The Federal Reserve Adopt an Inflation Target?*, by Marc Labonte and Gail Makinen.
CRS Report RL31702, *Price Stability (Inflation Targeting) at the Sole Goal of Monetary Policy: The International Experience*, by Marc Labonte and Gail Makinen.
CRS Report RL31050, *Formulation of Monetary Policy by the Federal Reserve: Rules vs. Discretion*, by Marc Labonte.
CRS Report RS21821, *Evaluating the Current Stance of Monetary Policy Using a Taylor Rule*, by Marc Labonte.
CRS Report RL33666,*Asset Bubbles: Policy Options for the Federal Reserve*, by Marc Labonte.

Federal Reserve Independence

The fact that the Fed is quasi-public in structure, overseen by an unelected Board of Governors who are appointed to serve long terms, and reliant on its own source of funding causes some commentators to argue that the Fed enjoys a unique degree of independence that is inimical to the spirit of democracy. Although this argument is political in nature, other observers believe that there are economic reasons why independence is desirable, as are the economic consequences that stem from its independence. Most importantly, they point out that an overly stimulative monetary policy may increase economic growth and lower unemployment in the short run, but it also increases inflation in the longer run. Independence from popular pressures may thus be necessary to prevent monetary policy from being consistently overly stimulative. It may also enhance the credibility of the Fed in ways that make policy changes less costly from a macroeconomic perspective. On the other hand, independence may decrease accountability in ways that allow policy errors to go unchecked and may cause monetary policy to be poorly coordinated with the efforts of fiscal policy.

CRS Report RL31056, *The Economics of Federal Reserve Independence*, by Marc Labonte.
CRS Report RL31955, *Central Bank Independence and Economic Performance: What Does the Evidence Show?*, by Marc Labonte and Gail Makinen.

Technical Aspects

Role of the Money Supply. Since monetary policy involves changes in the supply of money, it might seem appropriate to target the growth rate of the money supply in order to control the growth of money spending, or aggregate demand. For this to occur, there must be a stable and predictable relationship between the money supply and money spending. While there is a relationship, unfortunately it is neither stable nor predictable. That is because the Fed controls only the supply of money, while the demand for money is determined by the decisions of private individuals. Over the past 25 years, this relationship has been highly variable for the three measures of the money supply recorded by the Fed. Part of this instability is due to the widespread use abroad of American currency as a medium of exchange and store of value. Because of this instability, the Fed no longer targets the growth rate of the money supply. Instead, it targets short-term interest rates.

CRS Report RL31416, *Monetary Aggregates: Their Use in the Conduct of Monetary Policy*, by Marc Labonte and Gail Makinen.

CRS Report RL30904, *Why Is the Amount of Currency in Circulation Rising?* by Gail Makinen.

Should the Fed Pay Interest on Required Reserves? The Fed requires banks to hold a certain percentage of their deposits as reserves, either as vault cash or with the Fed. These reserves do not earn interest, whereas other deposits are lent at a profit. Hence, reserve requirements impose a cost on banks and give them an incentive to minimize their reserve holdings. Through the process of multiple-deposit creation, these reserves play a role in determining how changes in monetary policy influence the money supply. Some policymakers have proposed that the Fed should pay interest on required reserves out of their profits. They argue that this would reduce the cost imposed on banks and increase the predictability that changes in monetary policy have on the economy. Opponents claim that the Fed's profits are better used by the Treasury, where these profits are now remitted.

CRS Report RL30874, *Proposals to Allow Federal Reserve Banks to Pay Interest on Reserve Balances: the Issues Behind the Legislation*, by Walter Eubanks.

The Federal Reserve and Official U.S. Gold Holdings. There is a common mis-perception that the Federal Reserve intervenes in private gold markets to manipulate the price of gold. In fact, the Federal Reserve does not own gold and does not have the authority to buy and sell gold on behalf of the federal government.

CRS Report RS21204, *Gold: Uses of Official U.S. Holdings*, by Craig Elwell.