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Abstract

Many commentators on Federal Reserve policy over the past decade devote little attention to the experience of other central banks and especially the experience of Japan and the Bank of Japan. In fact, there is very little that is new in the U.S. situation that had not already been experienced by Japan and the Bank of Japan over a decade earlier. Many commentators view Federal Reserve policy as unique and special with regard to other central banks; however, the differences between the financial and economic stress experienced by Japan and the United States pale in comparison to the similarities. In many respects, the Federal Reserve is in the shadow of Bank of Japan and a better understanding of the comparative records of the two central banks offers important insight into central bank policy.

The paper explores three aspects of the relationship between the Bank of Japan and the Federal Reserve . First, the asset bubbles and bursting of those bubbles in Japan (1985 to 1991) and the United States (2001 to 2006) were both the result of central bank policy errors combined with a flawed financial structure. Second, the political economy of the operating environment of the Bank of Japan and the Federal Reserve ensures continued suboptimal monetary policy regardless of institutional redesigns of the central bank. Third, the Bank of Japan and the Federal Reserve together present a serious contradiction to the conventional wisdom that legal independence is the foundation for optimal central bank policy outcomes.

A concluding section brings together the main points of the discussion. These suggest that a better understanding of Federal Reserve policy since the start of the new century might start with a review of Japan and the Bank of Japan.

JEL Codes: E52, E63, G18, N20

Keywords: Federal Reserve, Bank of Japan, Abe's three arrows, central bank independence

1: Introduction

The Federal Reserve has been following in the shadow of the Bank of Japan. Since the 2000s, Federal Reserve officials have been mimicking policies that the Bank of Japan has implemented to no avail. For reasons we examine in the paper, Federal Reserve officials have largely ignored the Japanese experience. Yet the consequences of Federal Reserve policy have been disappointing. The bursting of the dotcom bubble was followed by a period of then-extraordinary low interest rates. Those inflated a housing bubble, which also burst, resulting in the Great Recession. The Federal Reserve then engaged in rounds of Large Scale Asset Purchases (LSAP), or Quantitative Easing Policy (QEP). That was part of a zero-interest rate policy (ZIRP).

Not so differently from the Japanese experience, the U.S. recovery has been weak by almost any measure. To name just one, the U.S. economy has gone a decade without one year of 3-percent real-GDP growth until 2017. That is an historical record of economic weakness. There are a number of proposals for institutional redesign of the central bank (e.g., Cochrane and Taylor 2016, and H.R. 3189, the Fed Oversight Reform and Modernization [FORM] Act of 2015). These discussions and legislative proposals would benefit from considering the Federal Reserve in the shadow of the Bank of Japan. Though not well known, many of the fundamental issues of Federal Reserve policy and institutional redesign, as well as political economy of constraints on central bank policy, have been experienced by the Bank of Japan well before they became issues in the United States. In fact, the policy discussion in Japan about central bank policy in the context of other policies has been far more transparent than in the United States.

The Bank of Japan was at the forefront of a strategic focus on price stability before the Federal Reserve and, as a result, avoided the Great Inflation and stagflation that characterized

Federal Reserve policy in the 1970s. The Bank of Japan contradicts the "conventional wisdom" that independent central banks generate lower inflation outcomes (Alesina and Summers 1993; Carlstrom and Fuerst 2009; Yellen 2015; and especially, Lohmann 2006: 536). The Japanese experience reveals how flaws in financial regulation and the structure of the financial system amplify central bank policy errors when the strategic focus shifts away from price stability; that occurred in Japan almost two decades before the same occurred in the United States. The Bank of Japan experience illustrates how legal independence is a wall between government and the central bank that can be easily breached. And, the Bank of Japan provides an understanding of how the political environment constrains central bank policy regardless of any reforms.

The raise of the Japanese economy after WWII through the 1980s, and fall into economic distress starting with the collapse of real estate and equity asset prices in 1990/1991, is remarkable and well documented (e.g., Cargill, Hutchison and Ito, 1997 and 2000; and, Cargill and Sakamoto, 2008) . What is seldom appreciated however, is the role of the Bank of Japan in this economic performance. Understanding that casts light on recent Federal Reserve policy and U.S. economic performance.

We explore three aspects of the relationship between the Bank of Japan and the Federal Reserve . First, the asset bubbles and bursting of those bubbles in Japan (1985 to 1991) and the United States (2001 to 2006) were both the result of central bank policy errors combined with a flawed financial structure. Second, the political economy of the operating environment of the Bank of Japan and the Federal Reserve ensures continued suboptimal monetary policy regardless of institutional redesigns of the central bank. There are flaws in the financial and real sectors supported by political considerations; politicians continue to run budget deficits, thus increasing outstanding debt; and there is an implicit "crony" relationship between government and the

"independent" central bank in which the central bank accommodates government budget deficits. Third, the Bank of Japan and the Federal Reserve together present a serious contradiction to the conventional wisdom that legal independence is the foundation for optimal central bank policy outcomes.

2: Monetary Policy, Financial Policy and the Structure of the Financial System

The ability of central bank policy to focus on long-run price stability can be constrained by the government's financial and industrial policies. That, in turn, provides a channel for the politicization of monetary policy and amplifies policy errors on the part of the central bank. The comparative records of the Bank of Japan and the Federal Reserve illustrate these points.

Japan's economic development after 1945 is remarkable. Like the fabled Phoenix, Japan emerged from the ashes of war to become the second largest and one of the richest economies in the world by the early 1970s. Even though, in terms of size, it has since moved to third or fourth place, Japan remains an important part of the world economy. During the first three decades of development, Japan's economy was internationally isolated; its industrial structure dominated by a close relationship between politicians, bureaucrats and client industries referred to as the *Iron Triangle*; and, its financial system was rigidly controlled and regulated. In the mid-1970s, Japan commenced a financial liberalization process and began to open its economy to the rest of the world. Japan's liberalization process was successful, especially compared to the financial distress experienced in Europe and the United States during the 1970s and 1980s. This was accomplished in part because the Bank of Japan, despite being *de jure* dependent on the government, achieved price stability and narrowed the difference between market and regulated interest rates. It avoided the stagflation that characterized European and U.S. economies in the 1970s and early 1980s (Cargill and Royama, 1988).

Japan's impressive economic progress began to unravel in the second half of the 1980s as a result of the asset bubbles in real estate and equity markets. Japan has yet to recover from the collapse of the bubbles in 1990/91. Many regard Japan's bubbles and their bursting as a special case offering few lessons for the rest of the world or for the United States. Katz (2009), for example, was quick to point out that the cause of the U.S. economic and financial distress that started with the collapse of house prices in early 2006, and the Lehman Brothers bankruptcy in September 2008, was different than in Japan. Further, the U.S. response would prevent the U.S. from experiencing anything close to a "lost" decade.

These predictions were clearly overoptimistic. Not only is the Federal Reserve in the shadow of the Bank of Japan, the U.S. economy has been in the shadow of the Japanese economy. Samuelson (2012) noted the United States should not be so sanguine about avoiding a lost decade like Japan and that both countries face similar debt problems and parallels are also being drawn between Japan and Europe (Evans-Pritchard, 2012).

Central bank policy errors in the context of flawed financial policies and structure of the financial system are the common link. In both Japan and the United States, monetary policy errors, combined with a flawed financial policy, generated asset bubbles. Their bursting was followed by intense economic and financial distress. These events have generated unprecedented monetary policy responses in the form of QEP and ZIRP, provided new responsibilities over the financial system to central banks and, at least in the early part of the Great Recession, led to overoptimistic views of the power of central banks to resolve the economic and financial distress. Central banks gain new powers and responsibilities after major policy errors. We return below to the reasons for this counterintuitive outcome.

Japan experienced simultaneously an equity and real-estate price bubble from 1985 to 1990/1991 the collapse of which set the stage for the "lost decades" in Japan's economic and financial development that has yet to be resolved. The United States exhibited two successive asset bubbles, the first in equities (1995 to 2000) and the second, in house prices (2001 to 2006). The bursting of the equity bubble around March 2000 had a relatively minor impact on the U.S. economy, but the bursting of the housing bubble set the stage for the Great Recession.¹ In both cases however, easy monetary policy by the Bank of Japan and the Federal Reserve played a major role in greatly expanded liquidity. The reasons for each central bank's policy differ, however.

The Bank of Japan's easy monetary policy was largely designed to limit yen appreciation. Some claim that had, the Bank of Japan been more *de jure* independent of the government, monetary policy would not have been as expansionary. That is debatable. We return to the issue in the section on central bank independence.

The Federal Reserve's easy monetary policy was partly the result of not wishing to repeat the Bank of Japan's delayed response to the collapse in asset prices in 1990/1991, as well as efforts to offset the economic shock of 9/11. In both countries, the inflation rate was low and each central bank assumed they had the flexibility to pursue extremely easy monetary policy without adversely impacting the economy.

The problem was that each central bank failed to consider the impact of easy monetary policy on a flawed financial structure. The flaws in the financial structure differed between Japan and the United States, but the easy monetary policy provided the foundation for a bubble economy in both Japan and the United States.

¹ Asset bubbles financed by debt have far greater consequences than does one financed by equity.

In 1976 Japan commenced a financial liberalization process by officially recognizing the *gensaki* or repurchase market in government bonds that had been in existence for over a decade. During the next 25 years Japan achieved major institutional redesign of its financial system. Interest rates were deregulated, competition between different financial institutions was permitted, money and capital markets were established, foreign financial institutions were permitted to participate, and capital inflows and outflows were liberalized. These were remarkable achievements.

The fundamental characteristics of the old financial regime remained in place, however, in the form of nontransparency. There were close relationships between government and financial institutions. There were close relationships among bank lending, bank capital, intermediation in the form of the Fiscal Investment and Loan Program and the Postal Savings System (Cargill and Yoshino, 2003). The latter is unique to Japan and represents a financial budget that is developed in tandem with the government expenditures/revenue budget much of which is financed by an extensive system of postal deposits. There were also extensive implicit government deposit and loan guarantees and, a belief that administrative guidance would be able to limit any systemic risk that arose from increased competition in the financial system. This set of relationships essentially made Japan an accident waiting to happen.

Asset prices began to increase in 1985, at first by favorable economic fundamentals, but eventually these prices became more dependent on expected future price increases fueled by expansionary monetary policy. Higher equity and land prices increased bank capital and lending because of increased “hidden reserves in the banking system” and the widespread use of land as collateral. Hidden reserves represent the unrealized capital gain on equities held by banks to solidify the relationship between banks and nonfinancial corporations as part of the main bank

system (Aoki and Patrick, 1995). Combined with extensive government deposit and loan guarantees, government financial intermediation and unwillingness to impose penalties in the form of bankruptcy, asset prices quickly moved from the “displacement” to the “irrational exuberance” phase (Minsky, 1982). All asset bubbles burst and Japan’s was no exception (Hayek 1935 [1966]). Japan’s flawed financial system was the outcome of an incomplete financial liberalization process and resistance to depart from key elements of the old financial regime. Superimposed on a fragile financial system, an expansionary monetary policy generated an asset bubble. Its bursting continues to constrain Japan’s growth.²

The U.S. financial system was institutionally more liberalized than Japan when it began an official deregulation process with the 1980 Monetary Control and Deregulation Act³. The focus of U.S. liberalization was to improve monetary control, gradually eliminating interest rate ceilings on deposits and loans, and allow thrifts and credit unions to offer checkable deposits. Like Japan’s unwillingness to depart from key elements of the old regime, however, the U.S. liberalization process continued to expand government guarantees in the form of deposit insurance and loan guarantees primarily in mortgage lending. The U.S. commitment to residential home ownership was supported by a system of government incentives and institutions (Freddie Mac and Fannie Mae) to direct credit to support residential home ownership. Government guarantees and support were pervasive and greatly expanded in the 1990s under both Democratic and Republican administrations.

In the 1990s the government’s commitment to housing was expanded to include promotion of home ownership for low to moderate income households. Lending standards were

² The narrative on Japan is drawn from Cargill and Royama (1988), Cargill, Hutchison and Ito (1997 and 2000) and Cargill and Sakamoto (2008).

³ The start of official deregulation in the United States usually attributed to the 1980 Act; however, some argue that the elimination of the interest rate ceilings on large CDs in the early 1970s was the start of official deregulation.

reduced, Freddie and Fannie were encouraged to expand their operations and support of subprime lending, and specific goals of homeownership that increased each year were specified by the government (Acharya et al, 2011 and Wallison, 2015). The unprecedented expansionary monetary policy in the first half of the new century, combined with a financial system designed to allocate significant credit to households not able to service such loans, initiated the bubble in residential real estate prices. When housing crashed, the Great Recession followed. Had there been no artificial boom in housing, there would have been no bust and no Great Recession. (Taylor 2009 and O’Driscoll 2009).

Hence, the bubble economies in both Japan and the United States have common ground. Both bubbles were the outcome of easy monetary policy in the context of a flawed financial system that directed imprudent lending to specific sectors of the economy supported by government guarantees and incentives. In both cases financial regulation and supervision failed to appreciate the feedback between increasing asset prices and lending. And, in both cases, central bank officials failed to appreciate the interaction between structural flaws of the financial system and monetary policy.

As long as government financial policy and the structure of the financial system go unchanged, central bank policy errors are amplified. The asset bubbles, their bursting, and the subsequent economic and financial distress illustrate the problems faced by central banks. When their respective governments use the financial system to pursue industrial and social policies, central banks cannot pursue price stability without inflating asset bubbles. The behavior of spot prices no longer provides reliable information about the stability of the economy (Leijonhufvud 2007).

And, as we will argue in the final section, central banks cannot be construed to be politically independent. While many reasonable reforms to Federal Reserve policy can be made, the anticipated outcomes may not be realized as long as financial policy is used to socialize risk to achieve certain credit objectives.

3: Abe's Three Arrows

In December 2012 the Japanese people returned the Liberal Democratic Party to power and Abe was elected Prime Minister. He announced a "Three Arrows" approach to ending Japan's two decades of slow growth and deflation and/or very low inflation -- expansionary monetary policy, fiscal stimulus and structural growth-oriented reform. The government had little difficulty letting the first Arrow fly, but in the process, the Bank of Japan lost *de facto* independence. The fiscal Arrow is easy in terms of increased government spending, but Japan continues to resist reforming the spending regime to reduce the influence of special interests. The structural reform Arrow is likely the most important, but for all practical purposes remains in the quiver.

The Bank of Japan in the run up to the election resisted the government's effort to double down on expansionary monetary policy (Cargill and Dwyer, 2015). The Bank of Japan had argued publically that recovery could not be achieved by a new QEP program and continued ZIRP. Rather than follow through with a threatened repeal of the Bank of Japan's legal independence granted in 1997, Abe simply appointed a new management team in March 2013 that would support the his program with an aggressive QEP based on purchasing government long-term bonds. Thus, while the Bank of Japan retained its legal or *de jure* independence, it has become completely dependent on the government. In early 2016, the Bank of Japan shifted to a negative interest rate policy in which a fee is charged on bank

reserves held by the Bank of Japan. The new QEP, ZIRP and move toward negative interest rate policy have not generated the promised outcomes.

In terms of fiscal reform, the Abe program has been disappointing. Government spending as a percent of GDP is now slightly over 20 percent and higher than at any time since 1960. The budget deficit has declined in recent years to 6 percent of GDP, in part because of an increase in the consumption tax from 5 to 8 percent in 2014 with a planned increase to 10 percent in April 2017 (now postponed until late 2019). Japan continues to operate with large budget deficits and a gross debt to GDP of 230 percent. There is no serious effort to reform government spending to reduce the role of long-standing special interests; and relying on increased taxes is not a growth policy.

The third Arrow was intended to restructure both the private and public sectors to increase competition and productivity. It sought to restructure the labor market to slow the decline of the labor-force participation rate. It envisioned fiscal reforms ranging from reducing the debt/GDP percentage to reducing government regulations that limit competition and innovation. The third Arrow remains in the quiver.

Unfortunately, the third Arrow is the most important and long recognized as the problem preventing Japan from returning to sustained economic growth. This is not an unexpected outcome. Fiscal stimulus spending is popular, especially when the government has an accommodating central bank willing to purchase government debt. Structural reform is politically very difficult. Successful structural reforms can stimulate economic growth. Initially such reforms entail taking away from privileges from vested interests, however.

The outcome of the three Arrows policy has been disappointing. Real GDP growth is currently around 0.3 percent, measured inflation remains barely above zero, and, given

inherent measurement error, deflation continues to be a problem. As with the Federal Reserve, never has so much effort by the Bank of Japan been made to increase economic growth with so few tangible results. The Bank of Japan in the process has lost any semblance of actual independence, and lost public confidence. Any discussion of Bank of Japan reform or institutional redesign must consider the political economy environment in which the Bank operates. And that is also true for the Federal Reserve.

Meanwhile, the U.S. recovery after the Great Recession has been slow by historical standards. It also illustrates the limits of monetary policy if financial services reform and structural economic reforms are not implemented. Despite the claims the Dodd-Frank Act effectively dealt with the flaws in the financial system that contributed to the Great Recession, no serious changes were made to the financial system. The cause of the financial crisis, subsidies to housing finance, was not even addressed in Dodd-Frank. The various federal housing agencies continue to boost home ownership. The Federal Reserve continues to channel credit to the housing industry with its large holdings of mortgage-backed securities. The central bank thereby channels credit to politically favored sectors (Hummel 2011).

And to emphasize the point of this paper, like Japan, the U.S. government runs large deficits that are financed by the central bank. The Federal Reserve, like the Bank of Japan, thereby channels credit to the government at the expense of the private sector. A monetary policy of low interest rates enables continued deficit spending and the build-up of the national debt.

Likewise, America is beset by regulations impeding economic growth. Many regulations are the product of lobbying by special interests. These create rents for the special

interests and impede competition by others. They slow business formation and economic growth (Lindsey 2015). Occupational licensure is a particularly obnoxious case of regulatory barriers. They prevent ordinary people from working in their chosen fields. Many of those adversely affected would have started new businesses. Small business formation is engine of economic growth. Friedman (1962 [2002]) raised the issue more than five decades ago. Since then, occupational licensure requirements have multiplied like locusts.

So, America is now beset by its own Iron Triangle of politicians, bureaucrats and protected industries, which together stifle creativity, entrepreneurship and economic growth. No change in monetary policy, no reforms to Federal Reserve governance and structure, can offset the effects of the flawed financial structure and regulatory barriers. The danger is that monetary reformers, if they ignore these other problems, may succeed at implementing monetary reforms but fail to improve economic growth. That would undermine their credibility.

Abe's insight was that monetary policy alone cannot restore economic growth rates to historical levels. His political failure has been his inability implement his own vision. But the Japanese leader did at least identify the problems. We can only hope that new leadership in America will not only identify the need for structural reforms but also be able to implement them.

4: Central Bank Independence

The comparative records of the Bank of Japan and the Federal Reserve suggest that institutional independence is not critical for monetary policy outcomes. Cargill (2013), Cargill and Dwyer (2015), Cargill and O'Driscoll (2013) argue that central bank legal independence from government does not generate better monetary policy outcomes, and, on balance,

conventional wisdom to the contrary, is and has largely been a myth. In the case of the Bank of Japan (Cargill, Hutchison, and Ito, 1997 and Cargill and Dwyer, 2015) and in the case of the Federal Reserve (Meltzer, 2003 and 2009), central bank policy, irrespective of institutional design, can only be understood from the perspective of the political economy environment of the central bank, especially the size of the government deficit, the structure of the financial system and the interventionist attitude of the government.

The Bank of Japan was one of the world's most legally dependent central banks from its establishment in 1882 until the Bank of Japan Law was revised June 1997. Yet, the Bank of Japan generated an impressive price stabilization record from 1950 through the late 1980s, which rendered the Bank of Japan a "model central bank" by many observers.

In contrast, and over much of the same period, the Federal Reserve was, and is regarded, as one of the world's more legally independent central banks. Its record, however, hardly accords with what the literature predicts from an independent central bank. In fact, the "independent Federal Reserve" was responsible for the Great Inflation from 1965 to 1985 that generated stagflation and the importantly contributed to the collapse of the S&L industry. It racked up an enviable record during the Great Moderation from the mid-1980s into the early 2000s. Then, as already detailed, it generated two bubbles and the Great Recession. All this time, the status of its legal independence remained the same.⁴

To further illustrate the point, the Bank of Japan achieved a rather significant increase in legal (*de jure*) independence in 1997 and yet, has been unable to achieve the same price stability record that characterized its performance in the previous four decades. Then, for all practice purposes, it lost any degree of *de facto* independence when the Abe Administration in early 2013

⁴ Elsewhere we express our doubts about whether the Federal Reserve has ever been legally independent. Our conclusion would remain the same, however. Federal Reserve performance has varied greatly but with no change in its legal independence.

appointed new management to the Bank of Japan willing to double down on QEP policy as part of Abe's "Three Arrows" solution to ending Japan's third "lost" decade.

The comparative policy outcomes have either been ignored or, when addressed, regarded as an aberration. The Great Inflation in the United States is regarded as due to special circumstances, such as the politicalization of policy under the administration of Arthur Burns in the 1970s (Ferrell 2010). In the conventional wisdom, the Burns Federal Reserve only temporarily suspended Federal Reserve independence. The Burns inflation was an aberration.

Japan's far more stable and lower inflation record is considered a special case because of Japan's rapid reindustrialization, international isolation and government administration of the economy in the decades following the end of WW II. That is, relative price stability was due to special circumstances and as a result did not reject the conventional wisdom that independent central banks bring superior inflation performance.

The willingness to ignore or dismiss the two comparative records as an aberration is difficult to rationalize. The advocates of central bank independence are willing to accept the widely published statistical studies that report a significant and inverse correlation between measures of central bank independence and inflation, despite the fact that many of these studies are based on small sample sizes of less than 20 observations. It is a straightforward matter to show that there are serious methodological and statistical problems with this widely accepted literature. The statistical association between independence and inflation is fundamentally flawed (Cargill, 2013 and Cargill and Dwyer, 2015). The reported results in fact provide little meaningful information as a guide to central bank reform.

The Federal Reserve, as is the case with central banks in general, embraces the conventional wisdom. "Independence" is a valued attribute in government, and Federal Reserve

officials jealously guard it. This is clearly illustrated by the Federal Reserve's response to the FORM Act of 2015:

"Most importantly, the provisions effectively cast aside the bipartisan approach toward monetary policy oversight developed by the Congress in the late 1970s. Under that approach, the Congress establishes the long-run objectives for monetary policy but affords the Federal Reserve a considerable degree of independence in how it goes about achieving those statutory goals, thus ensuring that the conduct of monetary policy is insulated from political influence. This framework is now recognized as a fundamental principle of central banking around the world" (Yellen 2015:1-2).

Let's deconstruct Yellen's statement. The last sentence is hyperbolic, as our discussion of just two major central banks illustrates. The meaning of independence and its implications for central bank performance are difficult to pin down. Consider what Yellen is saying in this excerpt. The Federal Reserve and Congress made a political deal, and now Congress needs to leave us alone.

Kane (1980) examined how the Federal Reserve's structure and governance serve identifiable political goals.⁵ Kane (1980: 210) focused on the Federal Reserve's independence, its willingness to accept impossible policy assignments and its "murky lines of internal authority" as special bureaucratic features. To state it simply: if macroeconomic outcomes are good, politicians claim credit for them. If outcomes are bad, politicians blame the Federal Reserve. Central bank discretion and "independence" benefit both politicians and Federal Reserve officials.

Politicians grant discretion to the Federal Reserve because it allows them to scapegoat it. If it were effectively rule-bound, then politicians could be blamed for choosing the rule if things were to go badly. The last thing politicians want, however, is to be held accountable for bad outcomes. They need to be able to scapegoat the Federal Reserve. In return, politicians tolerate

⁵ This discussion draws on O'Driscoll (2017).

ambiguity in Federal Reserve governance, nontransparency in policymaking, long tenure for Federal Reserve officials, etc. Both the Administration and Congress get plausible deniability. Federal Reserve officials get power and prestige, valuable nonpecuniary returns. Politicians and Federal Reserve officials are engaged in symbiotic rent seeking. Yellen's ire was directed at a Congress threatening to change the terms of the cozy or "crony" arrangement. In this game between the government and the central bank, the central bank becomes a "prisoner of its own independence".

Extending Kane's analysis, we can now explain why the Federal Reserve is rewarded with more powers after major policy disasters. That occurred after both the Great Depression and the Great Recession. Politicians certainly chastise the Federal Reserve officials, and those officials accept the slings and arrows hurled at them in Congressional hearings. They thereby demonstrate their renewed willingness to be scapegoated. Politicians, in turn, witnessing the dire economic outcomes, determine to create even more distance between themselves and bad macroeconomic outcomes. The solution is to give the central bank even more power. Dodd-Frank illustrates the dynamic perfectly.

Any discussion of potential reform and institutional redesign of the Federal Reserve needs to recognize the public choice dynamic if genuine monetary reforms are to be successfully implemented. Congress, especially the House of Representatives, has shown a willingness to change the dynamic and reform Federal Reserve governance. It has done so with the passage of H.R. 3189 in the last Congress, the FORM Act. That act requires the Federal Reserve to institute a monetary rule.

With respect to central bank performance and independence, the following lessons must be kept in mind. (1) Legal independence is neither necessary nor sufficient for good policy

outcomes. (2) Measures of legal independence and the statistical correlations based on those measures provide no meaningful information about the optimal design of the central bank. (3) Legal or *de jure* and actual or *de facto* independence frequently differ and failure to distinguish between the two generates much confusion in the literature. (4) Legal independence not only provides a convenient defense by the central bank for proposal reforms with which it disagrees, but permits the central bank to engage in greater *de facto* dependent policies and avoid accountability.

5: Conclusion

We have covered a lot of ground in this paper, and it is appropriate to summarize our major arguments.

First and foremost, the Federal is operating in the Shadow of the Bank of Japan. It is repeating the error of trying to stimulate economic growth without regard to flaws in the financial system and large, structural fiscal deficits. The microeconomic details of the problems in the United States and Japan differ, but the overall macroeconomic problem is the same. Monetary policy cannot overcome structural impediments to economic growth. And expansionary monetary policy, implemented in disregard of those problems and their consequences, can lead central banks to generate asset bubbles. When those bubbles burst, there can be serious economic consequences. In the case of Japan, they are entering their third lost decade. In the United States, it was the Great Recession and an historically slow economic recovery.

The comparative performance of the Bank of Japan and the Federal Reserve seriously undermine the accepted wisdom on central bank independence. During the long period when the Bank of Japan successfully targeted inflation, it was a legally dependent central bank. When it

attained legal independence, its control over inflation deteriorated. The Federal Reserve's performance has waxed and waned, even in the post-Accord period, with no change in the status of its legal independence. It is bewildering to us that commentators continue to describe the Federal Reserve System as politically independent. It acted as the financial facilitator of Fannie and Freddie in pursuit of politically motivated housing policy. Perhaps a public policy argument can be made to support the social contract for home ownership. We doubt this can be done, but irrespective, the social contract is a political agenda and the Federal Reserve has been at least a junior partner in the enterprise.

In the wake of the housing bust, the Federal Reserve implemented the LSAP program. It ballooned its balance sheet in part with purchases of mortgage-backed securities. Once again, it was engaged in support of the politically connected housing industry (and the banks owning the securities). If not central planning, it is certainly credit allocation (Hummel 2011). And that is an inherently political activity. Requiring the Federal Reserve to adopt a rule is a good first step in monetary reform. But a whole series of other actions are needed to depoliticize the Federal Reserve, likely starting with a freeze on and then downsizing its balance sheet (O'Driscoll 2017).

Reform of the financial system is needed, eliminating credit allocation and the array of subsidies provided to favors institutions. Too big to fail is one of these, along with bailouts of individual banks. We share Conti-Brown's doubts that Dodd Frank has solved the bank bailout problem (Conti-Brown 2016: 156 and 300n14).

A strong dose of deregulation in the broader economy to stimulate economic growth should be part of any broad reform effort. That must be the subject of another paper, however.

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