NOTE

THE NEUTRAL ROAD: TOWARD COMPLETE INDEPENDENCE OF THE FEDERAL RESERVE SYSTEM

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INTRODUCTION

Arguably one of the most powerful governmental institutions in the world,1 the Federal Reserve System (the Fed) controls U.S. mone-

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1 See, e.g., Allan H. Meltzer, A History of the Federal Reserve 1 (2003) (noting that the United States underwent an “enormous shift in political and economic power” during the twentieth century and that the Federal Reserve System “is now [its] powerful central bank”); William Greider, Dismantling the Temple: How to Fix the Federal Reserve, Nation, Aug. 3, 2009, at 11, 11 (arguing that the Fed is a powerful organization as demonstrated by the fact that it has distributed “trillions of dollars to banks, financial markets and commercial interests” during the recent financial crisis without presidential or congressional authorization to print this money).
tary policy, “supervises” and regulates domestic banking institutions, and provides “financial services” to the U.S. government and foreign institutions, all with the ostensible tripartite goal of achieving “maximum employment, stable prices, and moderate long-term interest rates.” Since its creation by the Federal Reserve Act on December 23, 1913, the Fed has been a source of controversy in the American polity and continues to supply political ammunition to partisans today. The methods by which the Fed achieves its tripartite goal, rather than the goal itself, generate much of the debate surrounding the institution.

Most recently, critics of the Fed point to its role in the financial collapse of 2008 as evidence of the flawed nature and methods of this modern institution. These critics often fall into one of two oppositional groups: the first group advocates disestablishing the Fed and replacing it with market mechanisms; the second group advocates augmenting the Fed by adding democratic mechanisms to its operations. While Fed policies certainly did contribute to the 2008 cri-

4 Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.); Meltzer, supra note 1, at 65.
5 See, e.g., Meltzer, supra note 1, at 73–81 (detailing the “contentious” and “political” decisions that had to be made immediately after the Fed’s inception); Paul Krugman, Op-Ed., G.O.P. Monetary Madness, N.Y. Times, Dec. 16, 2011, at A43.
6 See John T. Woolley, Monetary Politics: The Federal Reserve and the Politics of Monetary Policy 105–06 (1984) (“[P]olicy making increasingly has been dominated by . . . specialists who blur previously stable lines of political division and complicate policy debate . . . . The conflict between democratic control and domination by technical experts has been a long-standing source of tension in the case of the Federal Reserve.”).
8 Of course, some people would advocate maintaining the current structure of the Fed, but rebuttal of their arguments falls outside the scope of this Note, which is primarily concerned with solving the problem. For an introduction to their arguments, see William J. McDonough, An Independent Central Bank in a Democratic Country: The Federal Reserve Experience, FRBNY Q. Rev., Spring 1994, at 1, 4–6 (defending the structure and supervision of the Fed and arguing that such structure and supervision allow the Fed “to meet its monetary policy responsibilities and contain or forestall crises”).
9 See, e.g., White, supra note 7, at 460–61 (promoting constraint of the Fed and arguing that “doing without a central bank” would be the “ultimate restraint on central banking”).
10 See, e.g., Greider, supra note 1, at 13–15.
the solution to this problem is neither the institution’s wholesale privatization nor its conversion to a democratically beholden administrative agency.

Indeed, both of these solutions engender significant negative externalities that substantially outweigh their benefits in addressing the Fed’s problems. Privatization is defective as a solution because it would vest monetary policy in an institution (the market) whose sole motivation is profit. Generalizing the tripartite goal mentioned above to the minimization of human suffering demonstrates that profit motivation, while sometimes aligned with that goal, is often independent of or even contrary to it. Likewise, democratization as a solution is defective because it would eliminate the efficacy of Fed actions by vesting monetary policy in the legislative branch, which lacks the expertise, efficiency, and political independence required to prescribe effective monetary policy in response to macroeconomic trends.

In sum, the United States requires policy prescriptions that address the Fed’s problems but that lack the negative externalities of the solutions discussed above. This Note proposes a solution, entitled the “Neutral Road,” that provides such a prescription. At its core, the Neutral Road suggests that to function properly, the Fed must be independent of all undue influence from both the private and public sectors. It proposes that the United States maintain the wall of separation between the Fed and the political landscape in order to maximize the accuracy and value of the Fed’s decision-making process, resulting in sound policy results. It also suggests that the United States substantially increase the potency of the veil that separates Fed decisions from the private sector, thereby preventing the undue influence of large private financial institutions over Fed policy and ensuring that such policy complies with the Fed’s tripartite goal.

To construct this argument, Part I of this Note asserts that the Fed, by its nature, requires separation from both the political and pri-

11 See, e.g., Roger C. Altman, The Great Crash, 2008: A Geopolitical Setback for the West, FOREIGN AFF., Jan./Feb. 2009, at 2, 2–4 (suggesting that the Fed’s decision to decrease the federal funds rate to around one percent in 2001 and to maintain that level for three years was one of the two “underlying cause[s]” leading to the 2008 financial crisis).

12 See generally Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. TIMES MAG., Sept. 13, 1970, at 32 (arguing that a private business’s sole responsibility is to make a profit).

13 I employ “profit motivation” to indicate the incentives for businesses to maximize revenues and minimize costs without consideration of other, perhaps incompatible, goals such as social welfare. For further discussion on how profit motivation can be inconsistent with social welfare for businesses, see generally Friedman, supra note 12, at 33 (arguing that it is in the best interest of businesses to concern themselves solely with profits and ignore “social responsibility”).

14 See infra note 30.

15 See infra Part I.B.2.
vate spheres of influence. In so arguing, Part I elaborates on the Fed’s operational problems and further examines the two oppositional groups mentioned above. Part II provides an alternative solution, the Neutral Road, which avoids the defects in the two oppositional groups’ positions. Part III proposes the means to achieve the Neutral Road, including statutory changes, impermissible contact rules, meritocracy, and transparency.

I

THE PROBLEM AND PROPOSED SOLUTIONS

A. The Problem

The problem with the Fed’s operations lies in its haphazard approach to monetary policy, which the structure of the Fed’s components exacerbates. Recent experience shows that the Fed’s components have significant private interests at their core and that each of those interests exercises varying degrees of influence over actual Fed policy creation. As a result, Fed monetary policy does not merely favor the private sector, but affirmatively benefits private actors unequally.18

The central policy-making components of the Fed are the Board of Governors, the Federal Open Market Committee, and the Federal Reserve Banks. A piece-by-piece examination of this system’s structure demonstrates the private sector’s influence. The President nominates and the Senate confirms the members of the Board of Governors, drawing a number of these members from the ranks of private sector financial institutions. The Federal Open Market Committee consists of the members of the Board of Governors as well as five representatives from the regional Federal Reserve Banks. Each of the governing boards of the regional banks consists of three bank-

\[\text{\textsuperscript{16}} \text{See, e.g., 12 U.S.C. \textsection 241 (2006) (establishing the Fed’s Board of Governors and expressly commanding the President to have “due regard to a fair representation of the financial, agricultural, industrial, and commercial interests” in nominating its membership); id. \textsection 263 (establishing the Federal Open Market Committee and defining its membership as the Board of Governors along with five representatives from the Federal Reserve Banks).}\]

\[\text{\textsuperscript{17}} \text{See infra notes 19–25 and accompanying text.}\]

\[\text{\textsuperscript{18}} \text{See, e.g., Greider, supra note 1, at 15 (“[Bankers] profit enormously from the present system and share in the money-creation process. When the Fed injects more reserves into the banking system, it automatically multiplies the banks’ capacity to create money by increasing their lending . . . “).}\]

\[\text{\textsuperscript{19}} \text{See 12 U.S.C. \textsection\textsection 241, 263, 302.}\]

\[\text{\textsuperscript{20}} \text{Id. \textsection 241.}\]

\[\text{\textsuperscript{21}} \text{See Board Members, BOARD GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/aboutthefed/bios/board/default.htm (last updated Sept. 5, 2012) (providing links to biographies of current and past board members).}\]

\[\text{\textsuperscript{22}} \text{12 U.S.C. \textsection 263(a).}\]
ers and six nonbankers drawn from nonbanking enterprise and the public.23 “Primary dealers” are important private member banks that, while subject to Fed policies, nonetheless consult with the institution’s governing bodies in crafting those policies.24

Given this level of inclusion of the private sector (and especially large financial institutions) in the Fed’s decision-making process, it is no wonder that the resulting policies often favor institutions that exercise significant influence over Fed policy.25 And while this structure does not always give rise to policies contrary to those that would result absent such influence—that is, policies in the best interest of the national economy—the structure has at least the capacity to do so.26 It is this structure that critics of the current system often point to in asserting that reform is necessary for a fully functional monetary policy to exist.27

B. Proposed Solutions

Critics often propose one of two solutions, each sourced from opposite ends of the American political spectrum. Each of these solutions is problematic in its potential effects on the American populace’s economic welfare for different reasons, and each fails to provide a solution that does more good than harm.

1. Privatization

The first of these two positions argues, in line with the American political Right, that the Fed’s failings demonstrate the institution’s failed mission as a more general matter, and that the United States therefore ought to devolve the Fed’s policy-making powers to the pri-

23 Id. § 302.
27 See Greider, supra note 1, at 14–15 (calling for greater congressional supervision of the Fed); Boettke & Smith, supra note 7, at 31–32 (arguing for institutional change in order to apply the concept of robust political economy to the Fed).
private sector. This sort of privatization would in effect place U.S. monetary policy-making power with the large financial institutions that now act as mere participants in the Fed’s governance system—namely, the private banks. These entities, whose central motivation is profit, would then have control over an important governmental tool that should be employed to maximize the American populace’s welfare. While maximizing profit and increasing the general welfare are not always diametrically opposed motivations, they often substantially diverge.

The most visible component of the privatization proposal would be private control over the money supply—that is, the disestablishment of government-issued currency. Even ignoring the transaction costs associated with the multiple nonuniform currencies that this policy would create, the proposal’s drawbacks substantially outweigh its benefits. Indeed, allowing the money supply to depend on the will of the banks, which are subject to market forces and their attendant risks, injects significant risk into a system that cannot afford instability.


See supra notes 21–23 and accompanying text.

The widespread exploitation of lower wages and minimum working conditions in the developing world easily demonstrates that profit motivation can diverge significantly from improving human welfare. See generally ARTURO ESCOBAR, ENCOUNTERING DEVELOPMENT: THE MAKING AND UNMAKING OF THE THIRD WORLD (Sherry B. Ortner et al. eds., 1995) (discussing this phenomenon).


See generally Allan Borodin et al., On the Competitive Theory and Practice of Portfolio Selection (Extended Abstract), in LATIN 2000: THEORETICAL INFORMATICS 173 (Gastón H. Gonnet et al. eds., 2000) (acknowledging that trading in different countries involves transaction costs (i.e., spreads)).

For an example of the risks that attend the profit motivation associated with market forces and the results of those risks, see William Poole, Causes and Consequences of the Financial Crisis of 2007–2009, 33 HARV. J.L. & PUB. POL’Y 421, 424–26 (2010).

ity, as the American banking industry’s high-risk lending practices under profit-maximizing incentives contributed to the collapse.35 Similarly, where banks supply money, they will, as creditors, be motivated to restrict their issuance of currency so as to prevent any and all inflation, which is bad for creditors and good for debtors.36 During boom periods, when demand for money is high, a bank would act overly conservatively in supplying private currency in order to maximize profits from its role as creditor. The Fed’s motivation is key to the difference in institutional suitability here: because the Fed’s motivation lies in maximizing the economic welfare of the American people in the long run, rather than maximizing its own profits in the short run,37 it is better situated to exercise control over the supply of money than are banks.

The disestablishment of government-issued currency is merely one example in which a profit-motivated monetary policy could create policy results inferior to those created under an ideal-motivated regime, but that example demonstrates the significance of the two regimes’ potential divergence. Because of situations such as these, the vesting of monetary policy making—or even mere components of that power—purely in the private sector implicates a cost that no attendant benefit can overcome.

2. Democratization

The second position—that in line with the American political Left—advocates an increase in democratic control over the Fed’s operations.38 The proposals that advocate such “democratiz[ation]” of the Fed vary in scope and structure, but in general seek to vest increased oversight of the Fed and control over monetary policy in Congress and its ancillary institutions.39 Such vesting could in theory

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35 See Poole, supra note 33, at 424–26.
36 See G.L. Bach & Albert Ando, The Redistributional Effects of Inflation, 39 REV. ECON. & STAT. 1, 1 (1957) (stating that leading economists hold that debtors gain while creditors lose during inflation); Greider, supra note 1, at 15 (noting that creating greenback currency to finance public projects can lead to inflation). The notion that banks would hold back from issuing currency rests on the assumption that banks, like other actors in the private sector, have short-run perspectives relative to the perspectives of the Fed and other governmental actors. The banks demonstrated the truth of this assumption in the aforementioned lending practices that effected the most recent financial collapse. See Poole, supra note 33, at 424–26 (arguing that ultimate blame lies with private banks because the banks, not the federal government, engaged in the risky lending practices that contributed to the financial crisis).
38 See, e.g., Greider, supra note 1, at 14–15 (arguing that Congress should have greater control over the Fed and should restrain the Fed’s power to set monetary policy).
39 See id. at 13–15.
reign in the Fed’s inconsistent practices and augment Americans’ sense of its legitimacy as a governmental instrument, but in practice it is unlikely to bear its promised fruit.

Indeed, democratic interference in monetary policy making, like the privatization solution above, is highly problematic. Few members of Congress have educational backgrounds in economics, and fewer still have expertise in that field.\(^{40}\) Of course, Congress is free to consult those who do have such expertise, but it is under no obligation to either solicit that advice or heed it.\(^{41}\) Moreover, in a significantly polarized political climate,\(^{42}\) a Congress vested with authority over monetary policy would be unlikely to agree on the content and wisdom of that power, resulting either in a monetary policy so haphazard as to be counterproductive or in a profound and injurious lack of policy in this area. Even if it were able to agree on comprehensive monetary policy prescriptions, Congress’s glacial pace of action would frustrate any beneficial effects of monetary policy,\(^{43}\) which depends on the accuracy—and thus timeliness—of the data on which it relies.\(^{44}\)

As a more general matter, central banks most effectively combat inflation (and thus successfully champion economic stability and growth sustainability) when they are independent of the political branches of their national governments.\(^{45}\) Nations that substantially insulate their central banks’ structures and operations from the political process show statistically significant lower rates of inflation than do

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\(^{40}\) See Most Lawmakers Don’t Have Economic Education, Wall St. J. Blog (Oct. 1, 2008, 3:54 PM), http://blogs.wsj.com/economics/2008/10/01/most-lawmakers-dont-have-economic-education/ (stating that 6.7% of members of Congress have economics degrees and 14% have degrees related to economics).


\(^{44}\) The Fed has research departments tasked with “analyze[ing] literally thousands of data series from disparate sources,” and yet the incorporation of larger data sets would still improve forecast accuracy. Ben S. Bernanke & Jean Boivin, Monetary Policy in a Data-Rich Environment, 50 J. Monetary Econ. 525, 525–26, 544–45 (2003). Congress could not match the Fed’s resources and expertise in analyzing this economic data without significant expenditures.

\(^{45}\) See Sylvester C.W. Eijffinger & Jakob de Haan, The Political Economy of Central-Bank Independence 54 (Princeton Special Papers in Int’l Econ., Paper No. 19, 1996), available at http://www.princeton.edu/~ies/IES_Special_Papers/SP19.pdf (“[W]e must agree with the theoretical literature and previous empirical studies that a country with an independent central bank will, ceteris paribus, have a lower rate of inflation than will a country where politicians can steer the central bank’s policy.”).
nations with central banks that have little such insulation.46 This correlation is due to the fact that elected politicians are unlikely to approve restrictions of the money supply during boom periods, as doing so would appear “too conservative on the inflation front,” resulting in loss of elected office.47 Indeed, avoiding this kind of political influence is the main justification for central bank independence, for without political independence in a democratic system, the Fed and other central banks would be less able to effect the long-term economic stability that is their raison d’être.48

II
ANOTHER POSSIBILITY

Neither privatization nor democratization is an ideal proposal to implement, leaving a problem with no obvious solution. But by considering the criticisms of those proposals, it is possible to craft an answer that avoids the proposals’ downsides while addressing the problems inherent in the modern Fed. Such an approach combines the opposites of each criticism. That is, instead of eviscerating the Fed by devolving its functions to the market, the United States could divorce its structures and operations from the private sector; and instead of “democratizing” the Fed by subjecting its decisions to congressional or other political oversight, the United States could maintain the wall of separation that currently exists between the Fed and the American political landscape, perhaps even supplementing that wall to eliminate structural inconsistency. This Neutral Road would in effect harmonize the nature of the Fed’s relationships with all outside forces, subjecting both politicians and private sector actors to the same rigid rules of independence when dealing with the Fed and its agents.

Implementing these two channels of the Neutral Road requires legislation amending the Federal Reserve Act to create a Fed independent of private and political influence. In legislating here, Congress would act as a watchmaker God to the Fed’s universe—49—that is, Congress would pass legislation that complies with the Neutral Road’s pre-

47 See id. at 151–52.
48 See id. at 152 (“[A]n independent central bank that is free from political pressure may behave more predictably, promoting economic stability . . . .”); Mission, supra note 2.
49 This analogy characterizes Deism’s conception of the divine. For the most famous discussion of this analogy, see generally William Paley, Natural Theology: Or, Evidences of the Existence and Attributes of the Deity, Collected from the Appearances of Nature (Boston, Gould, Kendall & Lincoln 1841) (stating that the universe is too complex to be without a designer).
scriptions and thereafter remove itself (per the statute it passes) from the Fed’s decision making and operation.

A. Independence from the Private Sector

The first component of the amending legislation—under which the Fed would act independently of the banks that now serve as much of the institution’s policy-making constituency—would assert that the significant influence that large private financial institutions currently exert over the Fed is in part responsible for both its ad hoc monetary and lending policies, and its permissive attitude toward and resigned acceptance of private financial institutions’ risky behavior. The Neutral Road therefore prescribes elimination of private influence through a structural separation whose mechanisms this Note will discuss later. The benefits of such a separation are myriad, but the ultimate aim is to center Fed policy on achieving a result that comports with the Fed’s ultimate goal: maximizing national economic stability. Pursuit of this goal necessitates a shift away from profit maximization as a policy focus, which, as discussed earlier, varies between tangential to and divergent from what ought to be the Fed’s goal. Because the incentives that motivate the private sector are often inconsistent with those that should drive the Fed’s policy making, the United States should not allow such incentives to infect one of the federal government’s most powerful institutions. The Neutral Road therefore proposes that the Fed limit profit motivation by separating from the private sector.

A natural objection to this line of reasoning argues that because private financial institutions are a significant component of the nation’s economy and their deposits constitute a relatively significant proportion of the Fed’s liabilities, the Fed should hear and consider those institutions’ counsel prior to implementing policy. But this objection errs on two grounds. First, it ignores the profit motivation that infects the reasoning and advice the private financial institutions.

50 See supra notes 21–27 and accompanying text.
51 See infra Part III.
53 See supra Part I.B.1.
54 See supra Part I.B.1.
55 See Eduardo Porter, The Modest Worth of Big Banks, N.Y. TIMES, May 23, 2012, at B1 (“Value added by the financial industry, its direct contribution to the economy, topped $1.2 trillion in 2011, according to government statistics.”).
57 See supra notes 12–14 and accompanying text.
give and thus conflates these institutions’ self-centered profit seeking with the pursuit of broader economic stability that should be the Fed’s central goal. In other words, what is good for these institutions is not necessarily good for society as a whole. Second, the objection incorrectly relies on the idea that the mere fact that private financial institutions deposit significant sums into the Fed’s coffers means that they deserve a say in the Fed’s course of action because the Fed will utilize those deposits in implementing policy. This reasoning conflates shareholders with customers. Those who deposit money in an account with a commercial bank are not shareholders of that bank; they are its customers. The private financial institutions that deposit funds with the Fed should have no more de jure right to influence Fed policy than commercial bank customers have to influence private bank operations.

Thus, there is no reason that such institutions should have, by right, any influence over the Fed’s structures or policy making. Indeed, such influence, because of its source, is inherently biased, bringing it into conflict with what ought to be, and what ostensibly is, the central policy goal of the Fed: the maximization of economic stability.

B. Political Independence

The political independence of the Fed is equally, if not more, important than its independence from private sector influence. As discussed above, central banks generally operate more effectively when fully insulated from the political branches of government. Moreover, Congress lacks the skills and efficiency to decide and implement monetary policy in an effective and timely manner. For these reasons, the United States should maintain the Fed’s current wall of separation from Congress and its agents.

A natural objection to separating the Fed from the political process stems from the worry that an institution so far outside the control of the legislature or elected government more generally would lack both legitimacy and restraint, accumulating and retaining virtually unlimited power for itself. This worry, however, ignores both historical

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60 See supra Part I.B.2.
61 See Eijffinger & de Haan, supra note 45, at 54. But cf. Alesina & Summers, supra note 46, at 159 (“[R]esults [of empirical studies] suggest that . . . central bank independence reduces the level and variability of inflation but does not have either large benefits or costs in terms of real macroeconomic performance. This observation represents at least a fragment of evidence in support of theories emphasizing the neutrality of money.”).
evidence and judicial controls over the Fed’s exercise of power. The Fed has not seized unchecked control over the nation’s finances.\textsuperscript{63} It has not sought to circumvent the checks on its own power included in its organic statute; in fact, it has bowed to congressional and presidential pressures several times throughout its history.\textsuperscript{64} Moreover, 12 U.S.C. § 1848 provides that any party aggrieved by the Board of Governors may obtain review in a circuit court of the United States.\textsuperscript{65} Finally, if the Fed took action that clearly exceeded the bounds of its organic statute, federal courts would invalidate that action.\textsuperscript{66}

These checks, combined with the Fed’s historical respect for the attitudes and shifting loyalties of the political branches, militate against the realism of a slippery slope argument as applied to the Fed. Moreover, the evidence that political independence creates a more effective central bank is sufficiently strong to overcome an ill-founded worry that the Fed will continually seek and retain power for itself. Thus, in practice, the benefits of political independence far outweigh its illusory drawbacks.

All of the above arguments taken together indicate that a Fed independent of both private sector actors (specifically the banks and other private financial institutions that currently exert significant influence over the Fed’s operations) and the American political landscape—that is, a Fed divorced from the vacillating majorities in Congress and insulated from the will of the American electorate more generally—will both avoid the problems that critics raise concerning the modern Fed’s policy making and operations and will create a Fed that is more effective in achieving its tripartite goal.

III

IMPLEMENTATION

Having established that the Fed’s independence from both the private sector and the political sphere is a good idea, the next step is to find mechanisms to implement the Neutral Road’s channels effec-

\textsuperscript{63} Rather than acting independently, the Fed has demonstrated compliance with pressure from the political branches. See generally Boettke & Smith, supra note 7 (detailing the Fed’s compliance with political pressure throughout its history).

\textsuperscript{64} See id. at 13.


\textsuperscript{66} See, e.g., Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984) (“If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.”). Of course, for courts to overturn Fed action, Congress’s intent, as expressed in the Federal Reserve Act’s language, must be clear. See id. Thus, Congress, in amending the statute to comport with the Neutral Road, should carefully limit the Fed’s powers outside of its role as the national bank. The exact language of such careful drafting, however, is outside the scope of this Note and is better placed with administrative law experts.
tively and without unintended negative externalities. While the wall that separates Fed policy making from the political landscape is already significant relative to such barriers in other countries, the Fed has virtually no separation from the private sector, which constitutes a significant and influential part of the institution’s governing and policy-making organs. This is the problem that requires an answer.

In providing that answer, the Neutral Road applies its tenets to both aspects of the Fed’s independence, despite the Fed’s preexisting insulation from political influence. The first justification for such an approach stems from the fact that the mechanisms constituting this proposal would change little in the relationship between the Fed and the political branches. Indeed, the mechanisms that this approach adopts operate with most force on the relationship between the Fed and the private sector and do relatively little to affect political influence. The second justification for this approach is a harmonizing one—that is, applying the Neutral Road to all actors outside the Fed is more efficient in operation by virtue of its simplicity and provides Fed and non-Fed actors clear guidelines for their interactions with each other. This harmony also facilitates judicial review (where it is available) by providing courts with rules that apply to all relevant parties engaged in cross-barrier communications. These dual justifications guide the Neutral Road’s implementation of the particular type of policies it prescribes.

Thus, with the general scope of the Neutral Road’s mechanisms in place, the following sections of this Note turn to the mechanisms themselves. Each will be taken in turn, starting with structural alterations to the Fed’s organic statute, moving to impermissible contacts, discussing the establishment of meritocratic structures, and ending with transparency.

67 See, e.g., Alesina & Summers, supra note 46, at 155 fig.1a (indicating that the U.S. central bank’s degree of independence is higher than most other developed countries except Germany and Switzerland).

68 See supra notes 20–26 and accompanying text.

69 See McDonough, supra note 8, at 4–6 (defending the structure and supervision of the Fed and arguing that such structure and supervision allow the Fed “to meet its monetary policy responsibilities and contain or forestall crises”). For an examination of the relative effectiveness of the political independence-creating mechanisms in the Federal Reserve Act in practice, see generally Vittorio Grilli et al., Political and Monetary Institutions and Public Financial Policies in the Industrial Countries, 6 ECON. POL’Y 341 (1991) (stating the positive effects of an independent central bank on inflation and budgetary control).

70 The efficiency that this justification references is that the harmony provides Fed actors, relevant outside actors, and courts with bright-line rules to determine what is and what is not permissible. In so doing, it collapses analysis to a single set of actors operating under a single set of rules.
A. The Current Structures

The structures that now govern Fed policy intimately combine politics and the private sector with Fed decision making,71 eviscerating much of the “independence” that the Fed should have. To create a truly independent Fed, the United States must alter these structures to eliminate private sector participation and remove Congress’s political appointment power.72

The Federal Reserve Act weaves private sector actors into the Fed’s policy-making bodies.73 As discussed earlier,74 many of the most powerful Fed structures—including the Board of Governors, the Federal Open Market Committee, and the Federal Reserve Banks—incorporate private sector representatives.75 To eliminate the influence that those representatives wield over Fed policy, Congress must bar current employees of substantially related private sector institutions from filling positions of power in the Fed. Additionally, Congress must eliminate those positions on each of the governing bodies that are reserved for representatives of member banks. These measures will at least eliminate the private sector’s direct influence over Fed policy. Similarly, to eliminate politicians’ structural influence, the United States should abolish the President’s appointment and Congress’s approval powers over Fed positions.76 Doing so will prevent Fed policy that is beholden to a particular political interest and thus divorce, at least structurally, politics from the Fed.

Taken together, these measures will eliminate much of the private and political influence over Fed policy-making structures, but they will leave behind a policy-maker void that will require correction.

B. Meritocracy

Once Congress abrogates the provisions of the Federal Reserve Act that facilitate outside actors’ influence over Fed policy, the United States must seek suitable replacements for the structures that those provisions originally established. This challenge leads to the ideas and structures associated with meritocracy. “Meritocracy,” a term coined by Michael Young in the mid-twentieth century,77 commonly

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71 See supra Part I.A.
72 I use the term “exercises” loosely. As of this writing, two vacancies exist on the Fed’s Board of Governors because Congress has failed, until recently, even to discuss the President’s nominees to fill those vacancies. See Annie Lowrey, 2 Federal Reserve Nominees Make It to a Confirmation Hearing, N.Y. Times, Mar. 21, 2012, at B3.
73 See supra notes 21–26 and accompanying text.
74 See supra Part I.B.
75 See supra notes 21–23 and accompanying text.
77 See Amartya Sen, Merit and Justice, in MERITOCRACY AND ECONOMIC INEQUALITY 5, 7 (Kenneth Arrow et al. eds., 2000). Young is critical of meritocracy; one source describes
describes a system that assigns appointments and responsibilities to individuals based on merits, which generally include intelligence and ability. The Neutral Road proposes the use of meritocratic principles at two levels: selection and placement. In this structure, the Fed would consist of a permanent bureaucracy selected through a set of threshold criteria. The members of that bureaucracy would then be subject to automatic promotion and demotion based on performance and experience.

1. The Bureaucracy

The benefits of a permanent bureaucracy in control of the Fed are myriad, but for purposes of the Neutral Road, the relevant advantages of such a bureaucracy are its independence and effectiveness.

If well crafted through careful application of selection and placement mechanisms, a permanent bureaucracy in the Fed can avoid the problems associated with current Fed operations while creating an institution that maximizes its positive policy impacts. In conjunction with rules both barring communication with outsiders and ensuring public knowledge of a bureaucrat’s actions, bureaucrats well grounded in theoretical and practical monetary policy knowledge with strong incentives to advance within the structure of the Fed will seek to fulfill their duties in ways that maximize their candidacy for higher positions. And because such advancement will depend on the success of their decisions as applied to the real world rather than
outside political advancement or remuneration, the Fed at an aggregate level will automatically select the best actors to decide and implement the most effective Fed policy.

2. Selection

Selection of this bureaucracy’s members would depend on several criteria, including educational credentials, practical experience, and performance on objective tests. These measures would serve as threshold requirements for entry into the Fed’s permanent bureaucracy and would form a composite measure—rather than a checklist—of a candidate’s suitability for entry. In this way, the Fed will select candidates with diverse strengths and backgrounds to be part of its operations and policy-making structures, resulting in a broader and deeper pool from which to choose the most effective policies. With this consideration in mind, a per se bar on candidates formerly of the private sector is ill-advised. However, the revolving door between the private sector and the Fed should be limited. Like other revolving door policies in the federal government, Congress should implement a limitation on movement between the Fed and substantially related outside positions by means of a time period before which that movement is barred. For instance, if a Fed employee receives and accepts an offer from a private financial institution for a position dealing with the institution’s compliance with Fed policy, that employee must find other employment that is not substantially related to the Fed’s policies for a certain period of time before taking up the work of that position. The reverse scenario (i.e., a private employee seeking to enter the Fed bureaucracy), however, should not warrant application of a time limitation. The United States wants to encourage skilled and experienced candidates to apply for membership in the Fed bureaucracy, and the time bar applicable on exit from the Fed, in

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85 See infra Part III.B.
86 See Meier, supra note 79, at 195 (“[T]he use of merit-oriented procedures, and the ability to exploit economies of scale mean that bureaucracies become storehouses of expertise. They can learn over time . . . and hire or contract for needed expertise.”).
88 Determination of whether one position is “substantially related” to another should be left to courts, and a cause of action should be vested in taxpayers, allowing both watchdog groups and U.S. Attorneys General to bring suit in federal court for perceived violations of the rule.
89 The length of this time might be based on a sliding scale that varies with the relatedness of the two positions. Regardless, it should be at minimum one year in order to ensure at least some buffer between Fed employment and substantially related private employment.
combination with the bar on outside contacts,90 will be sufficient to prevent outside actors from moving back and forth between the Fed and private institutions with the goal of influencing Fed policy.

A merit-based system that encourages diversity among members, coupled with the prohibition on a quickly revolving door between the Fed and related outside positions, will yield the most effective combination of Fed policies. This approach allows input from individuals with different backgrounds, all seeking—with the help of advancement incentives—to maximize national economic stability in each Fed policy decision. In other words, broadening the input in terms of policy suggestions while limiting that input to ideas that seek to forward the Fed’s goals will result in a pool of possible policies that is not only broad and deep, but also motivationally well founded. There are, however, potential problems with this approach.

The central problem and most significant criticism of using meritocratic principles in selecting Fed actors concerns the validity of the mechanisms by which those in power evaluate the variables that determine merit—91— that is, how does one test the intelligence, educational credentials, and ability of an individual seeking to become a member of the Fed bureaucracy? Additionally, there is a problem with access: some applicants, because of lack of resources, prejudice, or other socioeconomic forces, cannot acquire the necessary credentials and abilities to compete with those who can acquire such prerequisites.92

Ideally, this system selects candidates well suited for the Fed and results in an institution that functions more efficiently and with greater effectiveness. Selection based on merit, as critics suggest,93 is somewhat problematic, but if properly implemented, it is neither impossible nor inaccurate. For positions at the Fed, significant educational backgrounds in economics generally and in monetary policy and bank regulation specifically should be requisite, and they are easily verifiable. The risk inherent in attempting to measure the intelligence and ability of a candidate is greater, and that process is perhaps more difficult, but these concerns can be reduced or eliminated with sufficiently narrow tailoring of selection criteria. For instance, academic performance, along with the reputation of the academic insti-

90 See infra Part III.C.
91 See, e.g., Sen, supra note 77, at 5 (“[There is a] tendency, in practice, to characterize ‘merit’ in inflexible forms reflecting values and priorities of the past, often in sharp conflict with conceptions that would be needed for seeing merit in the context of contemporary objectives and concerns.”).
92 See, e.g., John E. Roemer, Equality of Opportunity, in MERITOCRACY AND ECONOMIC INEQUALITY, supra note 77, at 17, 20 (“We must distinguish between the circumstances beyond a child’s control that influence her ability to process educational resources, and her acts of autonomous volition and effort.”).
93 See id.
tution at which the applicant studied, serves as a sufficient proxy for both intelligence and ability. 94 Combining this index with an objective civil service test that preeminent economic scholars design would mitigate, in large part, the dangers of relying wholly on the academic performance and background of a candidate. 95 Finally, reliance on a candidate’s practical, related experience further reduces the danger that comes from relying solely on factors that do not encompass real-world experiences. 96 Moreover, the fact that none of these qualifications are part of a checklist—they are instead part of a composite index for potential in the bureaucracy—removes much of the danger that candidates will represent an unnecessarily narrow cross section of the available talent. Each of these factors taken together indicates that the selection criteria issue is not as problematic as critics suggest.

The criticism concerning access, however, operates in two channels. The first and more general channel is a normative one: as a powerful institution within the federal government, the Fed should do its part to ensure that all those with the inherent talent to effectively decide Fed policy have the chance to do so. 97 But the Fed should not be used as a tool to increase underprivileged participation in policy and should instead focus on its broad goal of maintaining economic growth by setting monetary policy. 98 To divert energy and money toward increasing access would be to necessarily reduce the energy and money spent to ensure that the economy is in the aggregate as stable as possible. 99

The second channel of the access concern argues that the Fed should rely on mechanisms that fill its ranks with the best candidates possible, pointing to those who, if educated, would perhaps surpass

94 Access to education in the first place, however, introduces problems with using education as such a proxy. Those problems will be discussed shortly.
95 There is, of course, the question of who would select those preeminent economic scholars. This is best left to the academy for determination—that is, associations of economists, such as the American Economic Association, should create the exam. Utilizing these groups of professional economists to design these exams both draws from a deep pool of expertise and accounts for the differences of opinion that accompany any organization of experts.
96 This is not to say that academic instruction has no value in real-world practice, but practical knowledge should be considered in selection of the bureaucracy in order to blunt the development of a group of policy makers who possess nondiverse traits.
99 See Roemer, supra note 92, at 25, 29–31 (discussing the “equality-efficiency trade-off” and arguing that opportunities to develop talent ought to be provided to underprivileged students in the educational setting but not to underprivileged adults in the job-seeking setting where efficiency concerns are given additional weight).
their already educated counterparts in terms of effectiveness as Fed policy makers. This suggestion, however, is unrealistic. It is hard to imagine a mechanism that, without significant commitment of resources, could select from among hundreds of millions of lay individuals those with inherent talent. Even if such a mechanism existed, further commitment of resources would be needed to educate the individuals selected as a result of that mechanism. Given the near impossibility of implementing a solution to this channel of the access concern, the Fed should focus on retaining the best of the talent that is already available.

Thus, these proposed selection criteria effectively act as a threshold for entry into the Fed bureaucracy, avoid problems associated with biased qualifying conditions, and broaden access insofar as that goal is practicable.

3. Placement

Once the bureaucracy is available, the Fed must distribute individuals among its positions according to their abilities. To create the most effective Fed possible, the institution should reward those whose policy choices result in economic stability and disincentivize policies that lead to and exacerbate situations like the 2008 financial collapse. Such mechanisms would operate automatically and would depend on outside economic data from non-Fed groups, such as the U.S. Bureau of Economic Analysis and nongovernmental groups of academics. Policies that are successful in both combating inflation and preventing economic instability will reward their creators with advancement in the Fed bureaucracy or continuance in a high-level position. Policies that are unsuccessful in combating inflation and preventing economic instability will result in their creators’ demotion or forced exit from the bureaucracy.

Determining the exact criteria by which these mechanisms of advancement, demotion, and forced exit operate is somewhat problematic but not insurmountable. The results of policies that fail to combat inflation are obvious in the quantitative data and are susceptible to numerical thresholds. For instance, a policy that results in no more than three percent annual inflation might be deemed successful. Exact determination of that number in these types of thresholds should be left to Congress. For policies with less obvious results in economic data—like the Fed’s failure to sufficiently supervise banks

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100 See Poole, supra note 33, at 422–26.
102 I refer here to groups such as the American Economic Association.
that contributed to the 2008 crisis’ severity—courts are well situated to hear evidence and determine whether a link between a particular policy and a negative economic consequence is sufficient to warrant demotion of a Fed bureaucrat. Brought by citizens who disagree with Fed bureaucrats’ policy choices, suits such as these would have two advantages: they would check the aggregation of power in individuals who do not create effective Fed policy and they would give non-Fed actors a forum in which to voice their disapproval of Fed policy choices. Taken together, automatic mechanisms and suits against Fed officials would effectively govern upward and downward movement in the Fed bureaucracy and would narrow Fed policy makers to those who create effective policy.

Of course, at lower levels, the Fed cannot premise advancement or demotion on success or failure of policy choices because lower-level Fed bureaucrats likely will not make such choices. As a substitute, the Fed should base vertical movement on a seniority system for positions in which bureaucrats do not directly make policy. This system would serve a number of functions. First, it would insulate Fed policy making from individuals who have recently transitioned from private or political positions, thus limiting the influence of both spheres on Fed policy. Second, a seniority system would preference experience in the workings of the Fed and its impacts on economic realities over purely theoretical knowledge, creating Fed policy makers who have a grasp of both the theory and the practical impacts of that theory. Finally, this structure would reward bureaucrats who demonstrate long-term loyalty to the Fed and would insulate policy making from those who have other motivations, such as political advancement.

At the outset, the Fed must choose policy makers for the first iteration of this system. To make this choice, the institution should look to available Fed bureaucrats who were not politically appointed and choose the longest-serving bureaucrats to fill policy-making positions.

103 See Poole, supra note 33, at 424–26.
104 These suits would seek injunctive relief—that is, the demotion of those Fed policy makers whose policies do not result in economic stability. In order to deal with these claims and avoid a floodgates problem for federal courts, it might be advantageous to institute an administrative adjudication system, like those in other federal agencies such as the Social Security Administration. See Information About Social Security’s Hearings and Appeals Process, SOC. SECURITY ONLINE, http://ssa.gov/appeals/ (last updated Nov. 13, 2012). Such a solution, however, would require that citizens have standing to bring such suits, which, while somewhat problematic in terms of current Supreme Court jurisprudence, is outside the scope of this Note. See Lujan v. Defenders of Wildlife, 504 U.S. 555, 557–59, 578 (1992) (holding that wildlife conservationists and environmental groups lacked standing to challenge the Endangered Species Act of 1973’s division of power).
These individuals would then be subject to the review described above and held responsible for the consequences, negative or positive, of the policies that they create. Other methods, such as political appointments or maintaining the current occupants of the policy-making positions, fail to avoid political and private influence, as many of those occupants were politically appointed or were private sector employees.  

Having addressed each of the problems with a meritocratic system, the advantages of its use in the Fed are apparent. In that context, the problems with selection and placement of a bureaucracy in a meritocratic system do not pose so high an obstacle as to preclude their use. Moreover, that system results in a Fed that is more effective and more independent of both the private and political sectors.

C. Impermissible Contacts

To ensure that outside actors no longer exert influence over the Fed’s operations, Congress must prevent contact between outside actors and Fed officials. The most straightforward way to implement such a separation is through prohibition on those contacts. The closest analogy to this type of mechanism in existing law is the ban on ex parte communications that prevents a federal agency’s officials from communicating with individuals and groups outside the agency.

Federal agencies under the Administrative Procedure Act (the APA) are subject to a ban on undisclosed ex parte communications with an “interested person” when those agencies adjudicate. “Interested person” refers not only to private sector actors that have a stake in an agency decision, but also “public officials,” such as the Pres-
iden and his staff. An agency decision maker who receives or makes a prohibited ex parte communication must fully disclose the communication “on the public record of the proceeding.” If the decision maker fails to disclose the communication on the public record, federal courts will overturn the relevant agency decision only if the communication “irrevocably tainted” the decision-making process, making the agency’s decision “unfair, either to an innocent party or to the public interest that the agency was obliged to protect.”

The APA’s ban on ex parte communications in the context of adjudication, while perhaps effective where an agency has relatively limited powers and scope of operation, is insufficiently rigorous in the context of the Fed, the powers of which are broad and widely sweeping. The prohibition’s basic attitude toward subject communications is directly applicable—that is, the law should prohibit Fed officials from making or receiving communications from interested persons during the course of decision making. However, the remedy for violation of that ban in the Fed context cannot be merely public disclosure, but should consist of mechanisms that create real and effective incentives for both outside parties and officials inside the Fed.

The remedies should be tailored to each type of outside party and should differ in quality and quantity in order to maximize the incentive to avoid contacts. For actors in the private sector, the ideal remedy for engaging in unauthorized communications with Fed officials is a fine that varies according to the breadth and significance of the communication. This fine should be sufficiently large so as to disincentivize those communications as a general matter. Given the levels of wealth concentrated in most private sector actors with a direct interest in Fed policies, the fines may need to be substantial.

Dealing with communications from congresspersons or the President is more problematic because to penalize members of either

113 PATCO II, 685 F.2d at 564. To make such a determination, the United States Court of Appeals for the D.C. Circuit in PATCO II suggested five possible considerations, including “the gravity of the ex parte communications; whether the contacts may have influenced the agency’s ultimate decision; whether the party making the improper contacts benefited from the agency’s ultimate decision; whether the contents of the communications were unknown to opposing parties, who therefore had no opportunity to respond; and whether vacation of the agency’s decision and remand for new proceedings would serve a useful purpose.” Id. at 564–65 (footnotes omitted).
115 See Meltzer, supra note 1, at 1.
116 See Porter, supra note 55 (describing the large sums with which the largest financial institutions usually transact).
branch raises serious constitutional issues. Subjecting such members to suit for injunctive relief would perhaps be useful, but this too is constitutionally problematic. Removing the incentive for congresspersons or the President to contact Fed officials thus seems to require focusing not on the political branches, but on the Fed officials themselves—that is, once there is contact between outside parties and a Fed official, that official should be screened from participation in the relevant decision-making process. This mechanism would eliminate the incentive for members of the political branches to engage in prohibited contacts by minimizing the influence that the contacted Fed official exerts. In other words, if contacted Fed officials cannot participate in the decision about which they were contacted, political actors will have no reason to contact them in the first place.

All of the above would apply if an outsider contacted a Fed official, but what if a Fed official initiated the contact? Under these circumstances, the incentive structure is more straightforward. Placing the official’s continued Fed employment in the line of fire will surely curb incentives to engage in impermissible contacts. For contacts initiated without ill intent and where the contact is relatively insignificant, a Fed official’s initiation of an impermissible contact should result in screening of the now-conflicted official from relevant decisions. For more significant contacts and contacts initiated with the intent to profit or to otherwise influence Fed decisions for personal or political gain, officials should be subject to termination and, in extreme cases, fines and other criminal penalties. Instituting such a stringent disciplinary scheme would serve both to disincentivize Fed officials from initiating contacts and to eliminate from the Fed’s operations those officials who operate under personal, rather than societal, motivation.

This rule cannot be absolute, but exceptions should be few and far between. Among the rare exceptions should be regular reports to Congress and provision of public information concerning the Fed’s actions and the purpose and effects of those actions, as the current Federal Reserve Act mandates. A completely independent Fed will need transparency, making this exception a necessary one. If the Fed

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117 See 16 C.J.S. Const. Law § 215 (2005 & Supp. 2012). Constitutional problems arise when a federal agency moves to restrict the actions of a branch of the federal government, even where that agency’s organic statute authorizes it to do so. Such restriction may, depending on its degree, encroach on the spheres of influence in which each of the branches is supreme and independent. See id.

118 See id. This type of suit also creates a constitutional problem, as the relief sought is a judicial order to members of the political branches to comply with a statutory rule. Such an order differs from an order to comply with a constitutional rule and potentially impinges on the separation of powers.

engages in opaque practices to the exclusion of outside analysis and criticism, there is a real danger of capture by ideologues and rent-seekers. While the meritocratic structures discussed in Part III.B largely mitigate this worry, control over the Fed at the margins—that is, in situations where the Fed clearly exceeds its statutory authority—requires knowledge of Fed action on the part of those with the power of macrocontrol: Congress by legislation, the President by executive order, and the courts by judicial review. If that knowledge is unavailable and subject to public criticism, each branch will be without reason or motivation to exercise its powers to prevent a runaway Fed.120

Other exceptions to a general rule preventing contacts between outside actors and the Fed should be limited and carefully drafted to avoid swallowing the rule in its entirety.

With these exceptions in mind, a rule limiting contacts between Fed officials and outside actors would act to cement the Fed’s independence in decision making, thus ensuring that the institution takes action divorced from both private profit motivations and swaying political agendas.

D. Transparency

Both the meritocratic system and a bar on impermissible contacts require for their operation that all of the Fed’s processes and constituents be open to public examination. By creating such transparency, the United States can prevent both general aggregation of power in the Fed and concentration of power in particular individuals within the Fed.

To properly implement this transparency, the meritocracy’s operations in terms of both its rules and its results must be open and available for public examination. Absent this transparency, citizens and watchdog groups cannot bring suit, as violations of the system’s constituent structures are hidden. In this sense, the cost of monitoring is simply too high unless transparency predominates. Likewise, Fed bureaucrats must keep detailed records of their communications with non-Fed actors and must make those records available to the public. Otherwise, citizens and those that the Fed affects will not have available to them the mechanisms that facilitate Fed compliance with contact rules.

Thus, transparency is the last piece that, when combined with alteration of the old structures, a meritocratic permanent bureaucracy, and a bar on impermissible outside communications, comprises the Neutral Road.

120 Many, of course, may argue that the proposal presented here describes with precision a runaway Fed. By this term, I refer to a Fed that consolidates power to such a degree that a demonstrable diminution in the branches’ powers results.
CONCLUSION

Given how powerful an institution the Fed is, the problems inherent in its operations significantly affect the economy. These problems prevent the Fed from creating policy that effectively stabilizes the economy and insulate Fed actors from the consequences of any instability that their policies create.121

The solutions that critics propose create costs that outweigh their benefits. Devolving Fed functions to the market implicates the misalignment between profit motivation and the overarching goal of the Fed’s existence: to ease human suffering.122 Allowing politicians to exercise control over Fed policy frustrates the institution’s efficacy by subjecting its policy making to perverse incentives and to processes that simply move too slowly.123

The proposal of this Note, the Neutral Road, would institute a wall of separation between the Fed and outside actors. Free from both political and private influence, the Fed would select policies that maximize economic stability rather than profits or political gains.124

To implement the Neutral Road, Congress should amend the Federal Reserve Act to reflect that wall of separation. The amendment should abrogate both political appointment powers and the Fed structures that include private sector actors in policy-making positions,125 replace the current system of appointments with a meritocracy that selects and encourages bureaucrats who demonstrate effective policy-making skills,126 institute a bar on communications between Fed actors and those outside the Fed,127 and ensure that information concerning the Fed’s operations is open and available for public scrutiny.128

The United States’ central bank must function as effectively as possible. To do so, the Fed must operate independently from the private sector and the political landscape. The Neutral Road offers a blueprint for a Fed independent of both.

121 See supra Part I.
122 See supra Part II.A.
123 See supra Part II.B.
124 See supra Part III.
125 See supra Part III.A.
126 See supra Part III.B.
127 See supra Part III.C.
128 See supra Part III.D.