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The Federal Reserve in the Shadow of the Bank of Japan

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Abstract
Since the 2000s, the Federal Reserve has been following in the shadow of the Bank of Japan by mimicking its policies. But the Fed has been no more successful with those policies. We briefly present the recent history of monetary policy in the United States and Japan and analyze the consequences. In both countries, it is impossible to consider monetary policy in isolation, so we examine the fiscal and regulatory situations. We also address central bank independence in both countries and explain why its significance is overrated.

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I. Introduction

Since the 2000s, Federal Reserve officials have been following in the shadow of the Bank of Japan, mimicking its policies to no avail. For reasons we examine in the paper, Federal Reserve officials have largely ignored the Japanese experience. Yet the results of Federal Reserve policy have been disappointing. The bursting of the dot-com bubble was followed by a period of then-extraordinarily low interest rates. Those rates inflated a housing bubble, which also burst, resulting in the Great Recession. The Federal Reserve then engaged

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in rounds of large-scale asset purchases, or quantitative easing policy (QEP). That was part of a zero interest rate policy (ZIRP).

Like the Japanese experience, the US recovery has been weak by almost any measure. To name just one, the US economy has gone a decade without one year of at least 3 percent real GDP growth. That is a historical record of economic weakness. There are proposals for institutional redesign of the central bank (e.g., Cochrane and Taylor 2016; Fed Oversight Reform and Modernization Act of 2015, H.R. 3189). 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 fundamental issues of Federal Reserve policy and institutional redesign, as well as the 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 discussion 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, p. 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 rise of the Japanese economy after WWII through the 1980s, and its fall into economic distress starting with the collapse of real estate and equity asset prices in 1990 and 1991, is remarkable and well documented (e.g., Cargill, Hutchison, and Ito 1997, 2000; Cargill and Sakamoto 2008). What is seldom appreciated, however, is the role of the Bank of Japan in this economic performance. Understanding that role casts light on recent Federal Reserve policy and US 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 (1985–1991) and in the United States (2001–2006) 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.

II. 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. In terms of size, it has since moved to third or fourth place, yet 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 was 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. Liberalization was successful, especially compared to the financial distress experienced in Europe and the United States during the 1970s and 1980s. It succeeded in part because the Bank of Japan, despite being de jure dependent of the government, achieved price stability and narrowed the difference between market and regulated interest rates. It avoided the stagflation that characterized European and US 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 asset bubbles in the real estate and equity markets. The country has yet to recover from the collapse of the bubbles in 1990 and 1991. 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 US economic and financial distress that started with the collapse of housing prices in early 2006 and the Lehman Brothers bankruptcy in September 2008 was different than the circumstances in Japan. Further, the US response would prevent the United States from experiencing anything close to a "lost" decade.

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

Central bank policy errors in the context of flawed financial policies and the 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 economic and financial distress. Yet 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 1991, the collapse of which set the stage for the "lost decades" in Japan's economic and financial development that have yet to be resolved. The United States experienced two successive asset bubbles, the first in equities (1995–2000) and the second in housing prices (2001–2006). The bursting of the equity bubble around March 2000 had a relatively minor impact on the US economy, but the bursting of the housing bubble set the stage for the Great Recession.[1] In both countries, easy monetary policy by the central bank played a major role in greatly expanded liquidity. The reasons for each 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'll return to this 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 1990–91, and partly the result of efforts to offset the economic shock of September 11, 2001. In both countries, inflation was low and the central bank assumed it 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 countries.

In 1976, Japan commenced a financial liberalization process by officially recognizing the *gensaki* or repurchase market in government bonds that had existed for over a decade. During the next twenty-five years, Japan achieved a major institutional redesign of its financial system. Interest rates were deregulated, competition between financial institutions was permitted, money and capital markets were established, foreign financial institutions were allowed 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, and intermediation in the form of the Fiscal Investment and Loan Program and the Postal Savings System (Cargill and Yoshino

[1] Asset bubbles financed by debt have far greater consequences than do ones financed by equity.

2003). The latter is unique to Japan and represents a financial budget developed in tandem with the government 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 limit any systemic risk that arose from increased competition in the financial system. These relationships made Japan an accident waiting to happen.

Asset prices began to increase in 1985, at first because of 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 a 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 US financial system was institutionally more liberalized than Japan's when it began an official deregulation process with the 1980 Monetary Control and Deregulation Act.[3] The focus of US liberalization was to improve monetary control, gradually eliminating interest rate ceilings on deposits and loans, and to allow thrifts and credit unions to offer checkable deposits. Like Japan's unwillingness to depart from key elements of the old regime, however, the US liberalization process continued to expand government guarantees in the form of deposit insurance and loan guarantees, primarily in

[2] The narrative on Japan is drawn from Cargill and Royama (1988); Cargill, Hutchison, and Ito (1997, 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.

mortgage lending. The US 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 expanded its commitment to housing to include promotion of home ownership for low- to moderate-income households. The government reduced lending standards, encouraged Freddie and Fannie to expand their operations to support subprime lending, and increased homeownership goals each year (Acharya et al. 2011; 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; 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 economic sectors supported by government guarantees and incentives. In both cases, financial regulators and supervisors failed to appreciate the feedback between increasing asset prices and lending. And, in in both cases, central bank officials failed to appreciate the interaction between the 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 central banks face. 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 economic stability (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.

III. Abe's Three Arrows

In December 2012, the Japanese people returned the Liberal Democratic Party to power and Shinzo Abe was elected prime minister. He announced a "three arrows" approach to ending Japan's two decades of slow growth, deflation, and 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 its 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 had argued publicly that recovery could not be achieved by a new QEP 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 his program with an aggressive QEP based on purchasing long-term government 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 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, Abe's 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 percent to 8 percent in 2014, with a planned increased 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 ratio of 230 percent. There is no serious effort to reform government spending to reduce the role of longstanding 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-to-GDP ratio 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 is long recognized as the problem preventing Japan from returning to sustained economic growth. This outcome is not unexpected. Fiscal stimulus spending is popular, especially when the government has an accommodating central bank willing to purchase government debt. Structural reform is politically difficult. While successful structural reforms can stimulate economic growth, they initially entail revoking privileges from vested interests.

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 has 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 US recovery after the Great Recession has been slow by historical standards. The slow recovery also illustrates the limits of monetary policy if financial services reform and structural economic reforms are not implemented. Despite claims that the Dodd-Frank Act effectively dealt with the flaws in the financial system that contributed to the Great Recession, no serious changes were made. Dodd-Frank did not even address the cause of the financial crisis: subsidies to housing finance. 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 US government runs large deficits 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 buildup of the national debt.

Likewise, the United States 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, as it prevents ordinary people from working in their chosen fields. Many of those adversely affected would have started new businesses, and 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.

The United States 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. And 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 to implement his own vision. But the Japanese leader did at least identify the problems. We can only hope that new leadership in the United States will not only identify the need for structural reforms but also be able to implement them.

IV. 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), and Cargill and O'Driscoll (2013) argue that central bank legal independence from government does not generate better monetary policy outcomes, and, conventional wisdom to the contrary, is and has been largely a myth. In the case of the Bank of Japan (Cargill, Hutchison, and Ito 1997; Cargill and Dwyer 2015) and in the case of the Federal Reserve (Meltzer 2003, 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 in June 1997. Yet the Bank of Japan generated an impressive price stabilization record from 1950 through the late 1980s, which rendered it 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 then contributed to the collapse of the savings and loan 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, it has failed to achieve the same price stability record that characterized its performance in the previous four decades. Then, for all practical purposes, it lost any degree of de facto independence when the Abe administration in early 2013 appointed new management to the Bank of Japan that was willing to double down on the QEP 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 politicization 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 the country's rapid reindustrialization,

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[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.

international isolation, and government administration of the economy in the decades after WWII. That is, relative price stability was due to special circumstances and, as a result, did not undermine 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, even though many of these studies are based on small sample sizes of fewer than twenty observations. It is straightforward to show the serious methodological and statistical problems with this widely accepted literature. The statistical association between independence and inflation is fundamentally flawed (Cargill 2013; Cargill and Dwyer 2015). The reported results 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 stance is clearly illustrated by the Federal Reserve's response to the Fed Oversight Reform and Modernization (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, pp. 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, p. 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 ambiguity in Federal Reserve governance, nontransparency in policymaking, long tenure for Federal Reserve officials, and so on. 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 power 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, are determined 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

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

willingness to change the dynamic and reform Federal Reserve governance. It has done so with the passage of H.R. 3189, the FORM Act, in the last Congress. 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 and actual 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.

V. Conclusion

The Federal Reserve 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 or to 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. Japan is entering its third lost decade; the United States experienced the Great Recession and a 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 nevertheless, 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 a large-scale asset purchase program. It ballooned its balance sheet, in part with purchases of mortgage-backed securities. Once again, it supported the politically connected housing industry (and the banks owning the securities). If this behavior is 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 is 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 to eliminate credit allocation and subsidies to favored institutions, including subsidies to firms deemed "too big to fail" and bailouts of individual banks. We share Conti-Brown's doubts that Dodd-Frank has solved the bank bailout problem (Conti-Brown 2016, pp. 156, 300n14). A strong dose of deregulation in the broader economy to stimulate economic growth should be part of any broad reform effort.

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