The Myth of the Myth of Independence: A Critique of Binder and Spindel's Appraisal of the Fed

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Abstract

The response to Desmond King's review of *The Myth of Independence* by one of the book's authors reveals one of two possible critical flaws in their thesis that the relationship between Congress and the Federal Reserve is best described as one of interdependence. Binder fails to adequately address the most important of King's critiques. This article expands on the points raised by King in a more comprehensive manner than a book review allows for, with a particular emphasis on contributing novel empirical analyses that cast further doubt on the arguments positied by Binder.

Keywords: Inequality, Federal Reserve, Monetary Politics, Financial Crisis

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Introduction

The politics of monetary policy is not the most popular subfield in political science. Therefore, it was curious to see that in 2018, the journal *Perspectives on Politics* published an interesting back-and-forth between two opposing sets of monetary politics scholars. Sarah Binder and Mark Spindel are the authors of *The Myth of Independence*, which argues that the Federal Reserve has an "interdependent relationship" with Congress. Both institutions rely on each other for different things, so neither is wholly dependent on nor independent from the other, hence why Binder and Spindel refer to their relationship as interdependent. On the other hand, Desmond King and Lawrence Jacobs argue in their book, *Fed Power*, that the Federal Reserve is effectively independent of Congress and holds more institutional power than it has at any point in its history. They argue that the Fed's policies, under normal economic conditions, serve to worsen economic inequality by favoring financial capital over working-class Americans. The *Perspectives on Politics* article is unique in that it is structured as follows:

1. King reviews *The Myth of Independence*
2. Binder and Spindel respond to King's review
3. Binder and Spindel reviews *Fed Power*
4. King and Lawrence respond to Binder and Spindel's review

In their initial review, King and Lawrence summarize their main disagreements with *The Myth of Independence*, stating that "Sarah Binder and Mark Spindel view the Fed's actions as part of a dance with Congress that is largely silent about the winners and losers outside of Washington. By contrast, *Fed Power* puts the distributional consequences of the central bank's policy front and center, along with the politics that produces them" (Binder et al. 2018, pg. 783). In other words, King criticizes Binder and Spindel for not paying enough attention to the distributional consequences concerning income and wealth that result from Fed policies, nor do they appear to recognize the actual amount of power held by the Fed. Additionally, King and Jacobs claim that the authors:

1. Overstate the Fed's "deference to Congress and underappreciates the Fed's will and capacity to evade legislative control" (Binder et al. 2018, pg. 783).
2. Underappreciate that the Fed "is independent of the congressional budget appropriations process" (Binder et al. 2018, pg. 783).

3. Omit any discussion of the phenomenon known as "financialization" (Binder et al. 2018, pg. 783).
4. Fail to recognize the clear institutional bias towards the wealthy, which can be seen in how "the Fed's selective benefits for finance and the conduct of monetary policy produce clear winners among the most affluent" (Binder et al. 2018, pg. 783).

Notably, these respective teams of Fed scholars would come to such diametrically opposed positions when it comes to the true nature of the relationship between Congress and the Fed. On its face, the question of whether the Fed depends on Congress would seem rather straightforward. In reality, as all four scholars point out, the quasi-governmental status of the Fed makes it difficult to study, given that its semi-private status prevents much information from being publicly accessible. But with that being said, there is enough public information available to where one might reasonably expect professional academics to be able to agree on a simple question like: What's the relationship between Congress and the Fed? To that end, I argue that Binder and Spindel fail to answer this question in any meaningful way.

What immediately strikes me, as a scholar, is how Binder and Spindel failed to refute King and Lawrence on the actual terms he presented. The approach taken by Binder and Spindel was such that it seemed as if they were intentionally ignoring the crux of King's criticisms because they had no way to counter him directly. Instead, they relied on obfuscation to defend their claims. The authors in question are not addressing each other, thus creating stasis issues in this "critical dialogue." It is frustrating to watch accomplished and no doubt knowledgeable Fed scholars talk past each other, but here we are. What follows is a systematic breakdown of the myriad stasis issues I identified in my reading of the critical back-and-forths presented in Binder et al. (2018).

1 Stasis Issues

Obviously, the authors in question are not addressing each other, thus creating stasis issues in this "critical dialogue." It is frustrating to watch accomplished and no doubt knowledgeable Fed scholars talk past each other, but here we are. What follows is a systematic breakdown of the myriad stasis issues I identified in my reading of the critical back-and-forths presented in Binder et al. (2018).

1.1 Inequality & the Fed

The most egregious example of Binder and Spindel missing the point is how they respond to King's assertion that the Fed's post-2008 policy led to higher levels of income inequality. To highlight the degree to which they miss King's point, here are their respective words:

> **King**: Undeniably, the Fed's interventions after the 2008 Great Recession to prevent a collapse of the financial system in the United States and globally spared many from job loss and misery... it is important to avoid a false equivalency between the gains for finance and those for the general public. The Fed's policies delivered lopsided and often concealed benefits for finance, the top 1%, and the institutional interests of the Federal Reserve Bank that enjoys more power and autonomy than at any time in its 100-year history (Binder et al. 2018, pg. 780).
>
> **Binder & Spindel**: Congress authorizes the Fed to make emergency loans to banks—not to steer aid directly to homeowners. In a crisis, monetary policy can affect the real economy by pumping credit through the clogged plumbing of the financial system. And evidence from progressive economists suggests that the Fed's unconventional bond purchases reduced mortgage rates, making working- and middle-class Americans better-off [Binder et al. (2018), pg. 781][1].

Insofar as the above quotes accurately and fairly represent the authors' respective views concerning the Fed's role in contributing to the 2008 financial crisis and the subsequent worsening of income and wealth inequality, on top of the aforementioned job losses and misery, Binder's response is lacking, to say the least.

Pointing to the fact that Fed's bond buying supposedly "reduced mortgage rates, making working- and middle-class Americans better-off" is tantamount to lauding an engineer for filling a single crack on a fully broken dam. Extending the metaphor, to the extent that the Fed's bond buying reduced mortgage rates, such a benefit to the middle and working classes is multiple factors of power *smaller* than a drop in the bucket of income inequality in the US. It is difficult to accept that Binder and Spindel think that either a) the mortgage rate reductions reduced inequality and/or b) that the Fed's post-2008 did not worsen inequality, but that is exactly what it seems they believe.

To put it bluntly, there is overwhelming evidence that demonstrates, in detail, how QE and other actions taken by the Fed contributed, in meaningful ways, to widening inequality post-2008. Thomas Hoenig, former president of the Kansas City branch of the Fed and former member of the Federal Reserve Board of Governors, stated during and after the financial

[1] I've done my best to fairly and accurately represent each author's views while being concise. If anyone has issues with how I've represented the above exchange, I welcome any criticisms, given the subjective nature of how I chose to shorten the respective quotes.

crisis that the Fed's policies, while largely necessary, always necessarily benefitted those who already owned assets. In other words, while working-class people indirectly benefitted from the Fed's successful efforts to stabilize the national economy, the means employed in said task disproportionately benefitted the wealthy in the short- and long-term.

Further, it seems that Binder and Spindel are implicity arguing that Fed-induced mortgage rate reductions decreased income inequality to some degree. Considered from a different perspective, one could understand the implied meaning to instead be that reducing inequality is less important than relative improvements in standards of living. To make a long story short, there is no reason to take seriously either of the three aforementioned arguments, especially the second one. Let me begin with a quick rundown of short, certain, and insightful facts:

1. Income inequality is worse than it was pre-2008 and in the immediate wake of 2008.
2. The Fed (alongside the federal government) spent hundreds of billions of dollars bailing out banks and financial institutions.
3. Private wealth values decreased sharply during 2007-09 but quickly recovered and improved.
4. The financial crisis destroyed trillions of dollars held by pension funds.

Binder and Spindel's response implicitly under-emphasizes the semi-apocalyptic experience felt by millions of Americans and citizens worldwide, i.e., losing retirement savings. Going back to Binder and Spindel's point about mortgage reductions, it should be clear that said point does not counter the original argument at all. Increased inequality is not mutually exclusive with mortgage rate reductions. Both phenomena can simultaneously be true, for they do not necessarily benefit at the expense of each other. Instead, Binder and Spindel tried to shift the debate onto different terrain, by trying to argue about whether or not the Fed's policies *helped* the middle- and working-class *at all*. In other words, you are not allowed to criticize the Fed if someone can point out a way that a particular Fed policy helped the working class. The Fed is fully capable of increasing inequality while reducing mortgage rates because, as previously outlined, the phenomena are not mutually exclusive. We can therefore conclude that Binder and Spindel either cannot or will not demonstrate any evidence to discredit the otherwise well-supported observation that the Fed's post-2008 policies worsened income inequality in the US. It should also be said that Binder and Spindel fail to demonstrate an understanding of the following two things: income inequality and financialization.

To highlight Binder and Spindel's failure to sufficiently discuss income inequality, it is worth turning to the work of Thomas Piketty—arguably the premier scholar when it comes to income and wealth inequality. In his book, *Capital in the Twenty-First Century*, Piketty argues two main, overarching points. First, the fundamental contradiction of capitalism is that, many times throughout the 18th to 21st centuries, the rate of return on capital assets was greater than the rate of economic growth, which he illustrates with the following simple expression: $r > g$. Albertus & Menaldo (2016) argues that, while Piketty's explanation is mostly accurate, the U-shaped pattern of inequality "only really holds for a handful of industrialized economies and a subset of developing countries" (pg. 49). Instead, the authors argue that the observed pattern of global income and wealth inequality seen in the 20th century resulted from the "political regime types and the social groups they empower, rather than war and globalization" (Albertus & Menaldo 2016, pg. 49).

The most common way scholars measure *income* inequality is by calculating a country's Gini coefficient, an index value ranging from 0 to 1, with 0 representing perfect equality and 1 representing perfect inequality. The World Bank provides the following more comprehensive explanation:

> The Gini index measures the extent to which the distribution of income (or, in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution... The Gini index measures the area between the Lorenz curve and a hypothetical line of absolute equality, expressed as a percentage of the maximum area under the line. Thus a Gini index of 0 represents perfect equality, while an index of 100 implies perfect inequality (World Bank 2022).

Figure 2 shows that, contrary to what Binder and Spindel seem to imply, inequality in the US worsened post-2008. And to bolster King and Jacobs's argument that the Fed should have emulated the Bank of Canada, Figure 2 also shows that the income share of their Top 1% decreased sharply from 2008 to 2013. In contrast, the income share going to the Top 1% in the US sharply *increased* post-2008. But where does the Fed come in? According to Leonard—and in stark contrast to the claims of Binder and Spindel—the Fed's policy of "quantitative easing" (QE) did more than any other single policy "to widen the divide between the rich and the poor (Leonard 2022, pg. 10).

King could have done a better job of demonstrating his claims concerning the Fed and the 2008 financial crisis by providing citations and at least a few more lines of discussion. But it is unclear if such improvements on King's part would have elicited a different response from

Binder, given that the crux of their disagreement has nothing to do with the factual validity of each others' claims. Instead, they are discussing two completely different aspects of the financial crisis that can simultaneously be true. My issue with Binder's response has nothing to do with the factualness of her claim, rather that she 1) underplays the severity of the crisis and 2) makes it seem that the Fed's bond-buying *reduced* inequality rather than increased it.

It is also worth pointing out that the Fed's chosen vehicles for intervening in the economy (capital markets, bond markets, etc.) are not neutral in their distributional consequences. In other words, income inequality is partly fueled by the Fed's usage of various markets as the means to allocate the growing number of different financial assets that it owns and wants to inject into the broader economy. This is why it is said that any effect on the national economy caused by the Fed is indirect since it has to first interact with the banking industry with the reasonable expectation that the banks' behavior will change in some vague proportion to the benefit it received from the Fed.

Having recognized the distributional bias of Fed policy implementation, the next question we should ask ourselves is: Who benefits from the Fed operating this way? The answer: the very wealthy, those who already own assets. The Fed, in its role as a quasi-governmental institution, "operates in areas in which the wealthy possess unique, cumulative advantages" (Jacobs & King 2018, pg. 730).

1.2 Independence vs. Interdependence

The thing that jumps out from Binder's response to King is their remarkable ignorance, whether it is willful or genuine, of the core content of King's critiques, especially on the topics of income inequality and the 2007-08 financial crisis. Let me be clear so scholars like Binder and Spindel have no excuse for misunderstanding or misrepresenting my position: The Federal Reserve is fully independent in all meaningful areas when it comes to its congressionally mandated responsibilities. I disagree with Binder and Spindel's argument. In my view, simply observing that there have been hardly more than a handful of instances since 1913 that Congress has "stepped in" to recalibrate the Fed is not sufficient to confidently assert that the Fed is, to a large degree, *dependent* on Congress due to a myriad of political concerns held by legislators. Rather, concurring with one of King's critiques, Binder and Spindel completely ignore the obvious fact that the Fed lobbies Congress for all sorts of things, not dissimilar to the behavior of private

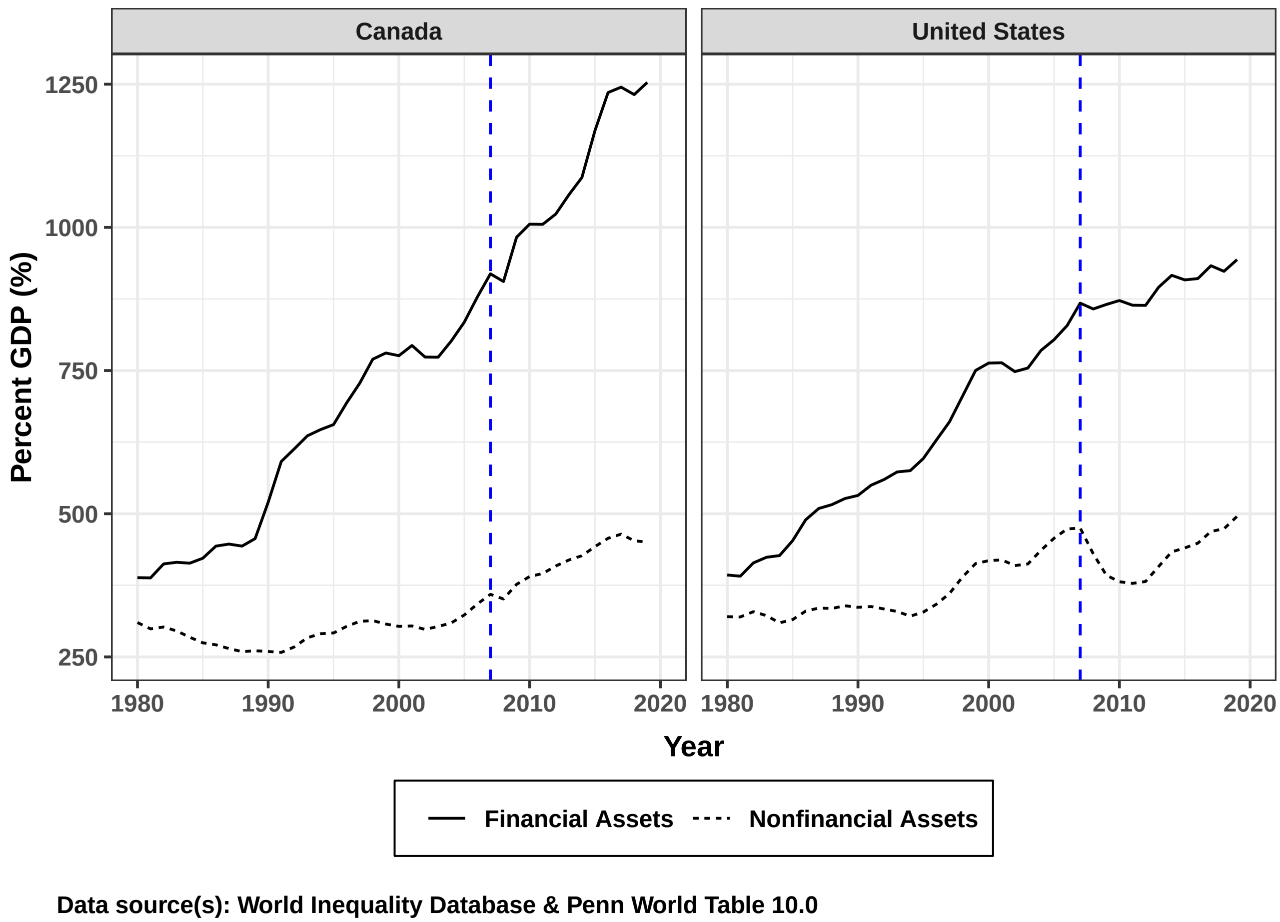

Figure 1: Cross-National Comparison of Capital Investments (% of GDP)

firms and special interest groups. By ignoring the mere capacity for active lobbying by the Fed, Binder and Spindel bias their observations in their favor. They treat every legislative action that concerns the Fed as external to and uninfluenced by the Fed itself, reinforcing Binder and Spindel's idea that the Fed is a mere subject of Congress and not an institution that frequently interacts and coordinates with Congress to achieve its own goals.

In my view, again concurring with King, *the* critical deficiency in Binder and Spindel's analysis is their frequent retreat "to a troubling form of an argument about an 'intuitive' (p. 237) sense that the Fed is dependent on Congress, rather than a cogent demonstration of this proposition" (King 2018, pg. 780). No amount of pontificating about the very real pieces of legislation that have changed the parameters of the Fed's institutional capacity as a central bank is sufficient to demonstrate that the Fed truly, in any meaningful way, is *dependent* on Congress. Instead, they seem to find it sufficiently compelling to draw the reader's attention to the mere fact that Congress has passed laws that, on their face, succeed in holding the Fed *accountable*.

But how, with a straight face, can someone say that the Fed has been effectively reigned in by legislation and successfully held accountable by Congress? As stated earlier, the Fed is the unequivocal most powerful central bank in the world, despite its history of drawing the ire of American voters, their elected representatives, and untold millions of others around the world that have felt, and will nevertheless continue feel, the effects of Fed policy.

King cites Donald Kettl's *Leadership at the Fed* as a complement to Binder and Spindel's book, wherein both works discuss the historical dysfunctionality of Congress as an institution. That said, King asks: How are we to believe that such a dysfunctional institution as Congress can regulate the Fed in any *meaningful* sense? Further, how can it be said that the Fed has been effectively held accountable when it is more powerful now than at any point in its history?

The main point is that Congress is barely capable of handling mundane legislative business, so it's a bit of a stretch to give it the benefit of the doubt concerning its capacity to control the Fed effectively. Could it be any other way? The Fed is more technically advanced in its operations and communications than Congress. Just look at the difference in budgets between the two institutions, and it will become clear which one holds the advantage when intellectually combating the other.

1.3 Transparency vs. Accountability

Binder appears to equate legislation requiring increased transparency at the Fed as verifiable proof that Congress is fully capable of holding the Fed accountable for its actions, especially its failures. To pull from an earlier quote by King, the Fed "enjoys more power and autonomy than at any time in its 100-year history" (Binder et al. 2018). So the question we should be asking ourselves is: How can it be said that the Fed has been held accountable by Congress throughout its 100-year existence despite it currently wielding more power than ever? How does an institution accrue such power while being under the control of Congress?

2 A People's History of the Fed

The scholarly treatment of the history of the Fed is one of the most curious phenomena in the social sciences. As Binder and Spindel did in *The Myth of Independence*, and as countless others have done and will continue to do, the Fed's political history is well documented. That said,

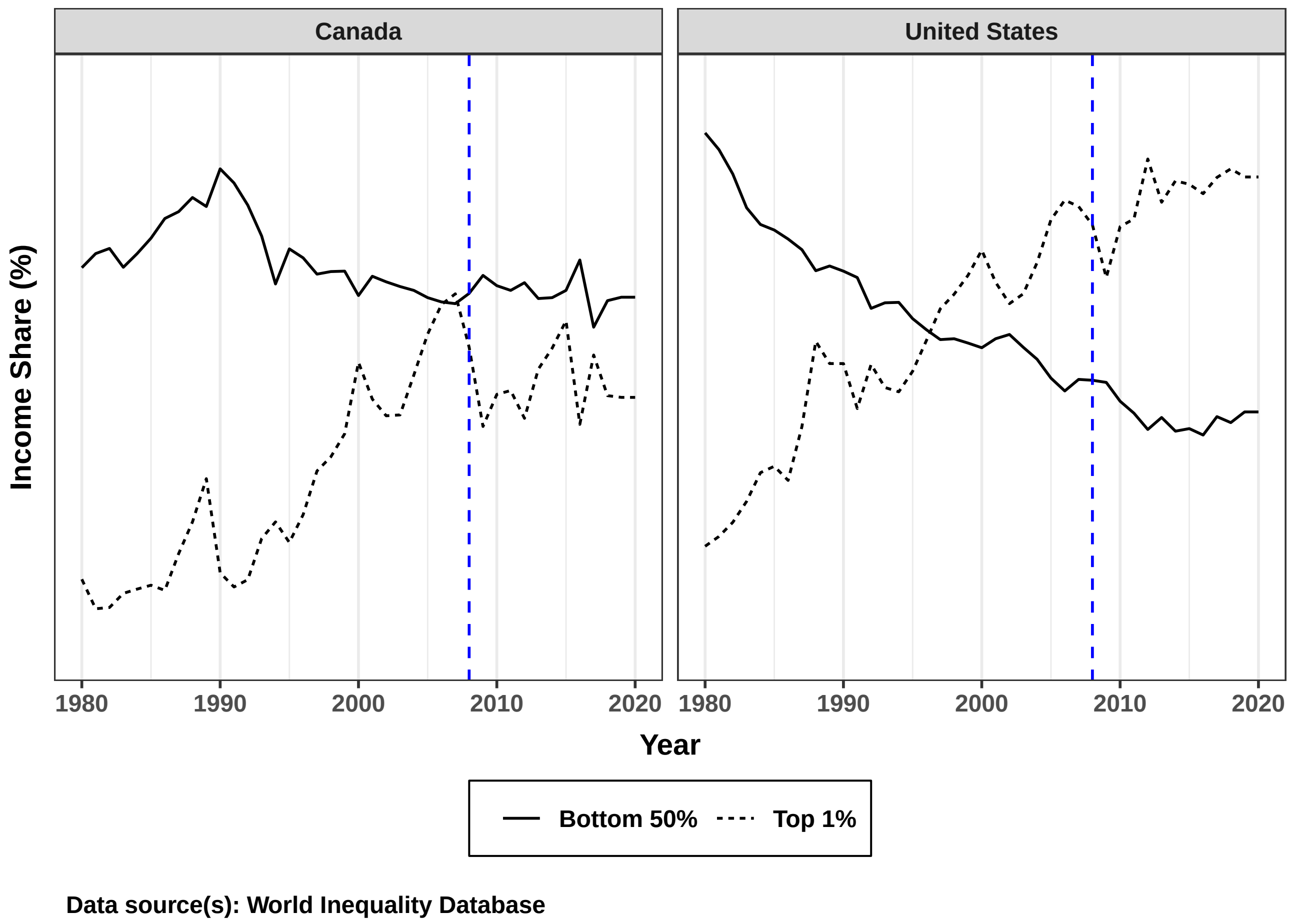

Figure 2: Share of National Income (%)

the *political* history of the Fed is one of the obstacles that prevent most scholars from engaging with the Fed in recognition of what it is, that being the single most powerful and influential central bank in the world, an institution that garners the attention of both the finance ministers of every country as well as every bank and financial asset manager. The next few sections cover a series of pivotal moments in the Fed's history that shaped its role in both the US and global economy, respectively.

2.1 The Volcker Shock

To solve the ill of stagflation circa 1979, then-Fed chairman Paul Volcker raised the Federal Funds Rate to hitherto unheard heights: upwards of 20-percent. For the rest of time, this moment would be referred to as the Volcker Shock, because it hit the world economy like a bolt of lightning that did not let up until approximately 1981.

2.2 The Fed & the Great Financial Crisis of 2007-08

There is ample evidence to suggest that the Fed played a critical role in facilitating the housing bubble, which ultimately led to the Great Financial Crisis of 2007-08 (GFC). The GFC was the worst economic downturn in the US since the Great Depression and the Fed helped make it happen.

2.3 Fed Action During the Eurocrisis

The Fed took on international responsibilities by directly loaning billions of dollars to struggling banks in the European Union during the Eurocrisis, a crisis that was directly caused by the US financial crisis. Tooze (2018) contains jaw-dropping illustrations of the various actions taken by the Fed to help prop up struggling and indebted central banks in Europe. The most important action taken by Fed was the currency swap-lines it created to provide dollars to European banks whose debts were largely denominated in USD. Had the Fed not injected billions of USD into European banks, it is unclear if the EU would still exist today. Successfully intervening in the Eurocrisis further reinforced the fact that the Fed is the most powerful central bank in the world. It is the world's central bank and lender of last resort.

2.4 COVID-19 Fed Action

The downturn caused by the onset of the COVID-19 pandemic was and still is, of ahistorical proportions. On paper, it is verifiably worse than the Great Depression, yet the felt reality of it does not seem to square with its factual components.

2.5 From 2020 Until Today

The Fed played an undue role in setting up the US national economy for disaster heading into 2020, with COVID-19 causing unprecedented amounts of economic and social disruption. Although no firm could have been reasonably expected to have anticipated and thus prepared for the shocks caused by a global economic downturn caused by a pandemic, the Fed's zero-percent interest rate policy strongly encouraged companies to invest in riskier and riskier assets. Further, the virtually free money provided by ZIRP led companies to take on previously unheard-of levels of debt, which exploded in direct response to the Fed's policies.

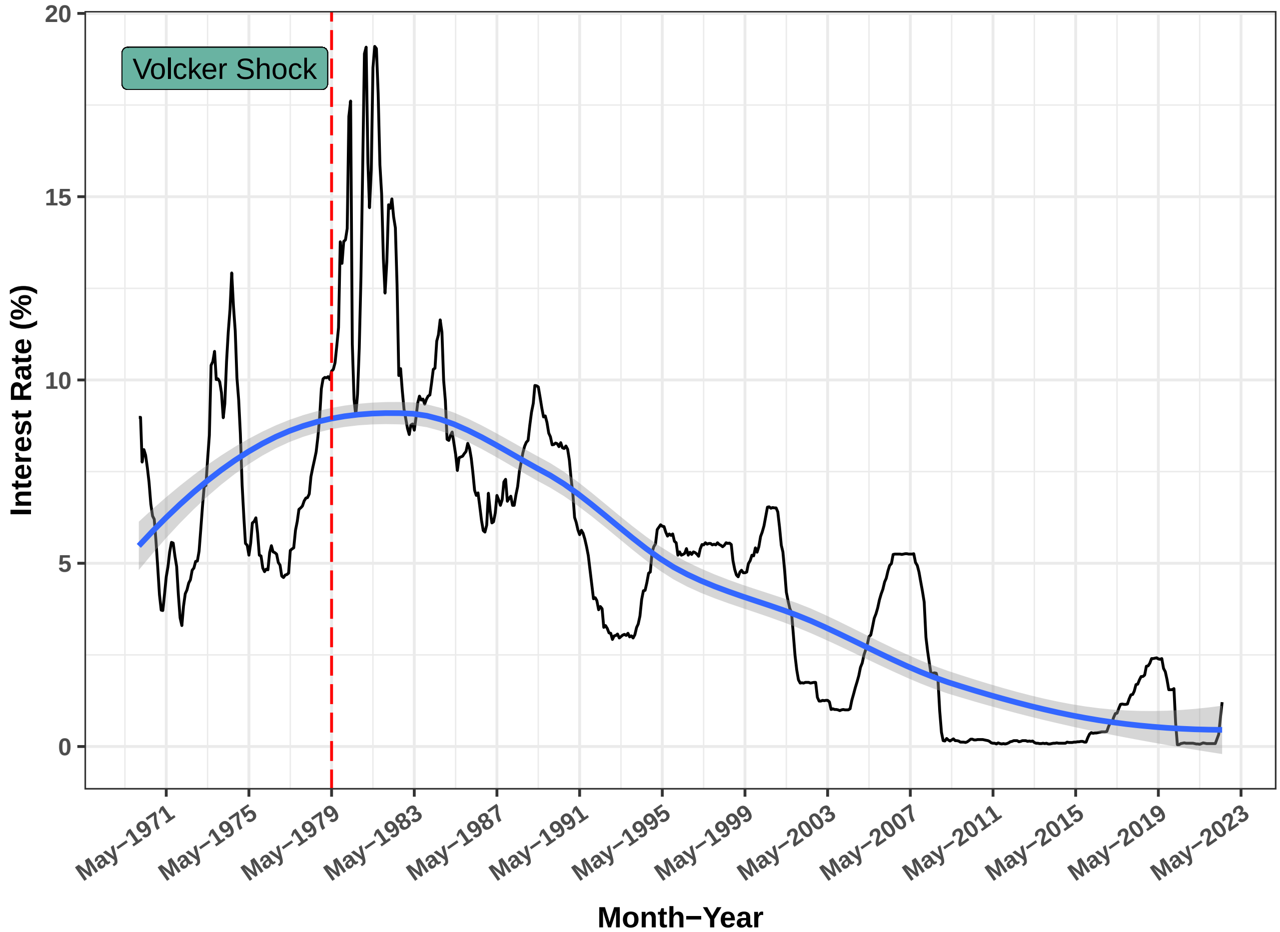

Figure 3: Effective Federal Funds Rate (%)

3 Empircal Analyses

To see which book's thesis holds up better under scrutiny, I have created an empirical model designed to capture all of the major contributors to income inequality. The first question of interest concerns the role of financial capital assets in worsening income inequality.

3.1 Literature Review

There is a large body of literature that examines the various social and political phenomena caused by inequality, but less work has been done to explain what causes inequality in the first place. There has also been a significant amount of research on the role of the Fed in causing the financial crisis. I will dispense with an overview of the literature concerning both topics.

3.2 Theory

My main variable of interest is the "average real internal rate of return on capital" (IRR) taken from the latest version of the Penn World Tables. According to one of the dataset's companion documents, the IRR of any given country is calculated as follows:

$$IRR = \frac{GDP - LABOR - NR}{CAP}$$

The idea behind using IRR as my main variable is rather simple. Because research has well documented the fact that capital ownership is the single largest contributor to income and wealth inequality, the average rate of return on said capital should directly affect inequality levels. In other words, because income from capital is necessarily variable in nature, the rate of return should directly relate to observed changes in inequality.

3.3 Hypotheses

- **H1**: As financial assets *increase* as a share of GDP, income inequality will *increase.*
- **H2**: As union density *increases*, income inequality will *decrease.*
- **H3**: As the real rate of return on capital *increases*, inequality will *increase.*

3.4 Methods

Following the recommendations of Nathaniel Beck and Jonathan Katz, I have employed a time-series panel study of 24 OECD countries that applies panel-corrected standard errors (PCSE) in the final analysis. Each economic variable in each of the models is taken as a percentage of its respective country's GDP. Additionally, the variable represented the real rate of return on capital is calculated as follows:

$$IRR = \frac{GDP - LABOR - NR}{CAP}$$

3.5 Results

Table 1 shows, across multiple model specifications, that a one unit increase in financial assets (as a share of GDP) is associated with, on average and all things being equal, between a 0.204

and 1.346 unit increase in income inequality, depending on how inequality is measured. The main takeaway from this table is that several things appear to affect income inequality, regardless of how it is measured.

Table 1: Determinants of Income Inequality (FE)

	Dependent variable:					
	(1)	(2)	(3)	(4)	(5)	(6)
IRR	0.175***	0.769***	0.148*	1.147***	0.653*	6.170***
	(0.058)	(0.042)	(0.078)	(0.082)	(0.348)	(0.647)
Unemployment	−0.077***	−0.101***	−0.110***	−0.157***	−0.300	−0.890*
	(0.021)	(0.017)	(0.031)	(0.039)	(0.206)	(0.521)
Inflation	−0.067***	0.071***	−0.095***	0.209***	−0.536***	0.928***
	(0.010)	(0.021)	(0.013)	(0.043)	(0.082)	(0.260)
Union Density	−0.077***	−0.057***	−0.136***	−0.129***	−0.775***	−0.713***
	(0.010)	(0.010)	(0.015)	(0.020)	(0.078)	(0.101)
GDP Growth	0.079**	0.077***	0.141**	0.159***	1.166***	0.847**
	(0.041)	(0.019)	(0.065)	(0.036)	(0.399)	(0.360)
Human Capital		4.114***		8.612***		38.456***
		(0.671)		(1.156)		(8.322)
Financial Assets		0.003***		0.004***		0.026***
		(0.0003)		(0.001)		(0.004)
Trade		−0.027***		−0.047***		−0.235***
		(0.005)		(0.010)		(0.058)
Welfare		0.057*		0.177***		0.569*
		(0.030)		(0.056)		(0.342)
Left Cabinet		0.185		0.392**		3.370**
		(0.116)		(0.190)		(1.565)
Constant	11.577***	−7.323***	16.588***	−21.294***	95.050***	−76.856***
	(0.495)	(2.164)	(0.695)	(3.696)	(3.527)	(27.339)
Observations	896	436	896	436	896	436
R^2	0.726	0.863	0.750	0.865	0.654	0.798
Adjusted R^2	0.715	0.855	0.741	0.857	0.641	0.786
Note:						*p<0.1; **p<0.05; ***p<0.01

4 Conclusion

Binder and Spindel fail to effectively refute any of King and Jacobs's criticisms. Instead, they reinforce the validity of the various criticisms by intentionally refusing or failing to provide any comprehensive counter-arguments, only ones that touch on one particular *aspect* of the original criticism. Thus, it is difficult, if not impossible, to find Binder and Spindel's thesis credible

Table 2: Determinants of Income Inequality (Pooled)

	Dependent variable:					
	(1)	(2)	(3)	(4)	(5)	(6)
IRR	0.154***	0.120***	0.229***	0.147**	1.194***	0.848***
	(0.020)	(0.027)	(0.030)	(0.059)	(0.195)	(0.281)
Unemployment	−0.123***	0.143***	−0.204***	0.246***	−0.577***	1.628***
	(0.017)	(0.028)	(0.031)	(0.054)	(0.168)	(0.521)
Inflation	−0.090***	0.031	−0.127***	0.067	−0.544***	−0.090
	(0.014)	(0.025)	(0.022)	(0.046)	(0.143)	(0.310)
Union Density	−0.054***	−0.027***	−0.105***	−0.061***	−0.616***	−0.353***
	(0.003)	(0.006)	(0.003)	(0.011)	(0.018)	(0.070)
GDP Growth	0.086*	0.202***	0.113	0.324***	0.913*	1.535***
	(0.047)	(0.031)	(0.082)	(0.059)	(0.512)	(0.581)
Human Capital		5.427***		9.323***		43.602***
		(0.329)		(0.653)		(4.415)
Financial Assets		0.0004**		0.002***		0.014***
		(0.0002)		(0.0004)		(0.003)
Trade		−0.036***		−0.082***		−0.463***
		(0.002)		(0.005)		(0.029)
Welfare		0.034		−0.022		−0.715
		(0.024)		(0.052)		(0.511)
Left Cabinet		0.193		−0.245		1.721
		(0.158)		(0.304)		(2.306)
Constant	12.290***	−6.767***	17.505***	−13.583***	86.732***	−50.553***
	(0.147)	(1.087)	(0.307)	(1.967)	(1.547)	(15.767)
Observations	896	436	896	436	896	436
R^2	0.267	0.530	0.264	0.584	0.232	0.550
Adjusted R^2	0.263	0.519	0.260	0.575	0.228	0.539
Note:						*p<0.1; **p<0.05; ***p<0.01

when they have shown that they are either unwilling or incapable of defending their claims.

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Appendix