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Why We Have An Independent Fed

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A strange coalition of conservatives and liberals has joined forces in attacking the independence of the Federal Reserve System. From our elected representatives in Congress, to columnists at Forbes, to consumer advocate Elisabeth Warren, people are mad at the Fed. They want the people at the Fed, indeed the Fed itself, to be held accountable.

Why is everyone so wound up about the Fed right now? With the greater transparency that critics are demanding, what do they hope to learn that they can't already know? It is a mystery to me. In my view, endorsed by many economists and business folks, the actions taken by the Federal Reserve and other central banks are the primary reason the credit crisis didn't turn into the Great Depression of the 21st century. So in that that sense, the Fed has gotten a lot of things right. Not that you'd know it from the commentary.

Don't get me wrong. Happy days haven't quite arrived. It is true that the U.S. economy is recovering, but the recovery remains very shaky and financial markets still reflect a lot of uncertainty. We have a long way to go. Further, I would be the first to argue that the Fed made many mistakes on the road to the financial crisis of 2007-2009. They failed at consumer protection, at regulating derivatives, at risk supervision ... we could go on and on. But there are reasons for those failures, systemic reasons, in which a lot of interest groups, individuals and corporate entities had a hand. It seems unfair to load all the criticism onto the one institution that has kept us afloat.

Like U.S. President Andrew Jackson in 1832, many of the supporters of what is now referred to as the Grayson-Paul Amendment to the Financial Stability and Reform Act would like to do away with the central bank, or at least render its decisions irrelevant. Many critics harbor both a general hostility to banking and a belief that commodity money--gold--is the only real money. More than a hundred years ago, Andrew Jackson also believed that bestowing power and responsibility upon a single bank was the cause of inflation and other perceived evils. For that reason he killed the Second Bank of the United States, and it was not until the Panic of 1907 pointed to the need for a lender of last resort that we started on the path that created the Federal Reserve System.

Liberals and consumer advocates complain about the secrecy and special status of the Fed. But it must be that they just don't like banks and bankers these days--no mystery there--and have displaced their anger onto the institution that regulates them. With such different motives it doesn't seem like a marriage made in heaven, so it was a shock when the House Financial Committee passed the Grayson-Paul amendment, which calls for auditing the Fed including auditing monetary policy decisions. The Senate Banking Committee weighed in by proposing to change the way the boards of regional Federal Reserve Banks are chosen, making them political appointees. Under that proposal the President, with the advice and consent of the Senate, would appoint the Chairmen of the regional bank boards. The Board of Governors would appoint the other members. Talk about inviting the foxes into the chicken coop! Political nominees would be more independent than the current regional Fed Reserve Board members? Who came up with that one?

It is true that the dramatic expansion of the Fed's balance sheet, together with its close involvement in the bailout of financial institutions--particularly the massive bailout of AIG and the Fed's alleged involvement in the merger of Bank of America and Merrill Lynch, have put the central bank in a very bad light. The balance sheet itself is a problem precisely because the Fed has targeted particular asset classes, specifically home mortgages, and in doing so has assumed credit risk and made decisions about allocating credit. The Fed now props up a large portion of the mortgage market in the U.S. There is both a question about whether this is socially desirable and whether its actions distort prices for these assets. Buying Treasury securities is completely neutral with respect to the allocation of credit. Buying securities backed by, say, auto loans is not, and most would agree that in normal circumstances they should not be doing this.

But none of this is a mystery. People who want to know what the fed "is doing" need only consult its balance sheet (publicly available here) and the minutes of the FOMC meetings, which are available with a lag. What is the big secret? If people want to know down and dirty about what the Fed was actually doing on the weekend that they decided to let Lehman fail and save AIG, I suspect that most of what is worth knowing can be found accurately portrayed in either Andrew Ross Sorkin's or David Wessel's excellent book about the Fed.

So before we rush to tampering with the Fed's independence, let's review why it is important. The answer is fairly simple. An independent central bank can focus on monetary policies for the long term; that is, policies targeting low and stable inflation and a monetary climate that promotes long-term economic growth. Political cycles, alas, are considerably shorter. Without independence from the political cycle the central bank would be subject to political pressures, which in turn would impart an inflationary bias to monetary policy. In this area politicians in a democratic society are shortsighted because they are driven by the need to win their next election. This is supported by empirical evidence. A politically insulated central bank is more likely to be concerned with long-run objectives.

A variant of the argument for central bank independence is that control of monetary policy is far too important to be put in the hands of politicians. As a group they have repeatedly demonstrated the lack of political will to make difficult economic decisions. But now they want to assert control over the Fed.

The net effect of both of these moves--the House Financial Committee's approval of Grayson-Paul and the Senate Banking Committee's proposal for political appointments--is a major threat to the independence of the Federal Reserve. Worse, it's a major politicization of the Federal Reserve System and the process by which we develop monetary policy.

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