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Cruz's Criticism Underlines Fed's Politics Problem This Election

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It was open season on the Federal Reserve at Tuesday's Republican presidential debate. Candidates blamed Fed officials -- "philosopher kings" in Texas Senator Ted Cruz's words -- for everything from the financial crisis to income inequality.

Their criticism highlights how much the central bank remains a lightning-rod for popular angst toward Washington as the candidates vie for conservative support.

Cruz led the way, calling out the Fed's "loose money" in the early 2000s for causing the real estate bubble, a reference to the period under Chairman Alan Greenspan when its benchmark lending rate was held under 2 percent from December 2001 until November 2004.

While that's a frequent critique of the policy of that time, Cruz also leveled a rarer charge at the Fed, blaming it for triggering the bubble's collapse in 2008.

Cascading Collapse

"In the third quarter of 2008, the Fed tightened the money and crashed those asset prices, which caused a cascading collapse," he said.

In fact, the Fed cut interest rates seven times in 2008, pulling the fed funds rate from 4.25 percent in early January to 2 percent in April, where it held rates until an emergency 50 basis point cut in mid-October. They then kept easing until rates were near zero in December, where they have stayed ever since.

The Fed has been under attack from lawmakers on both the left and right since the 2008-2009 financial crisis and has been forced to defend itself from congressional proposals to curb its powers. These include an Audit the Fed bill from presidential hopeful Senator Rand Paul of Kentucky.

Fed Bashing

"Fed bashing certainly resonates with a certain, significant base of the Republican party," said Mark Calabria, director of financial regulation studies at the Cato Institute in Washington. Debates over the central bank have "certainly become more polarized since the financial crisis," he said.

Cruz would have been on firmer ground if he had argued that borrowing costs, despite the Fed's easing, were too high through most of that year and the Fed was slow to turn to bond purchases to ease credit conditions.

"At the time the Fed was keeping the size of its balance sheet fixed by selling off securities holdings," said Paul Ashworth, chief U.S. economist at Capital Economics NA Ltd. in Toronto, referring to late 2008. The Fed's bond purchases didn't start in earnest, he said, until early 2009.

Still, Ashworth said, the Fed quickly engaged in a range of emergency lending programs, aiming to stabilize the commercial paper market, money market funds and wobbly financial institutions.

"This is quarterbacking seven years later," he said. "When it's unfurling in real time it's very difficult to do."

Taylor Rule

Cruz also argued the U.S. economy would be better off with a rules-based approach to setting interest rates.

The concept of rules-based monetary policy has been a recent favorite of Republican lawmakers critical of the Fed's zero rate policies. Representative Jeb Hensarling of Texas, chairman of the House Financial Services Committee, has urged the Fed to adopt a policy standard such as the Taylor Rule, a mathematical formula developed by Stanford University economics professor John Taylor that proposes an ideal policy rate based on inflation and unemployment.

Current Fed Chair Janet Yellen said in March it would be "very foolish" to set interest rates according to a "simple mathematical rule." Yellen has characterized the proposal as an attempt to limit the Fed's independence in monetary policy.

Ohio Governor John Kasich, while voicing his unhappiness with Fed policies, was the only Republican candidate to defend the central bank during the debate.

Print Money

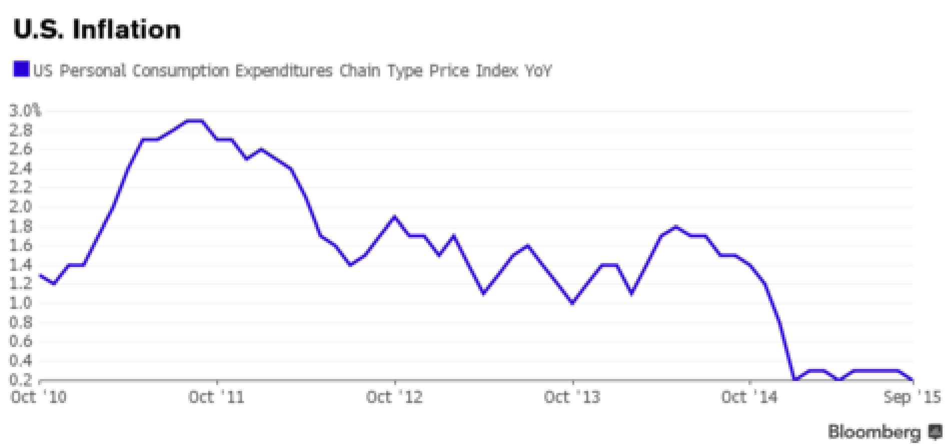
"I don't like what the Fed is doing, but I'll tell you what worries me more than anything else: turning the Fed over to the Congress of the United States so they can print the money," he said.

Kasich's remarks essentially reminded his fellow candidates that the Fed, though created by Congress, was granted independence in setting interest rates in order to protect monetary policy from politicians who might like to cut rates in order to stimulate the economy ahead of elections.

Paul also attacked the Fed, saying it "destroys the value of the currency," and is disadvantaging the poor as prices rise and the value of the dollar shrinks.

"So really we need to reexamine whether we want a Federal Reserve that's involved so much in determining interest rates," Paul said.

Paul was also off on some of his facts. Inflation has stagnated below the Fed's 2 percent goal since 2012 and the dollar has strengthened 8.8 percent this year against a basket of 10 leading global currencies.



Ben Carson, the retired neurosurgeon who is rivaling business mogul and Republican front-runner Donald Trump in some polls, said that Fed policy "makes it very easy for the big corporations, quite frankly, at these very low interest rates to buy back their stock and to drive the price of that up artificially."

Corporate stock buybacks have surged in recent years as companies have been able to access low rates on debt, but haven't been confident enough in the economy to invest in new plants, equipment or hiring.

Gold Standard

Cruz repeated, and expanded on, his idea that the dollar should once again be tied to the value of gold.

"Instead of adjusting monetary policy according to whims and getting it wrong over and over again and causing booms and busts, what the Fed should be doing is, number one, keeping our money tied to a stable level of gold," he said.

Tying money supply to gold reserves prevents central banks from increasing credit during a recession or financial crisis. It's blamed by many economists for exacerbating recessions, including the Great Depression. A 2012 survey of economists at top U.S. universities failed to turn up a single one who endorsed a return to a gold standard.

The U.S. abandoned the strict gold standard in 1933. Under the 1944 Bretton Woods agreement central banks could still convert dollars to gold with the U.S. government, until President Richard Nixon ended the dollar's convertibility in 1971.

Cruz said the U.S. "had a gold standard under Bretton Woods. We had it for about 170 years of our nation's history, and enjoyed booming economic growth and lower inflation than we have had with the Fed now."