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In Defense of the FED

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Instead of being one of another million bloggers discussing the Fed's decision to hold interest rates low until 2014, I wanted to write about the Fed's role in the conduct of monetary policy. There has been a lot of criticism of the Federal Reserve from Republican quarters during this presidential primary season. Much of it stems from the likes of Ron Paul.

Marketwatch reports that:

Compounding the criticism of the Fed is the role the central bank has played in the political career of Ron Paul.

“Paul’s position hasn’t changed in decades. He’s opposed to the Fed as an institution, preferring a gold standard and free banking,” said Michael Bardo, an economic professor at Rutgers University.

Other Republican presidential candidates have been just as hostile:

Texas Gov. Rick Perry started the attacks off by threatening bodily harm to Federal Reserve Board Chairman Ben Bernanke and accusing him of treason.

Front-runner Mitt Romney has since said he would fire Bernanke. Former House Speaker Newt Gingrich also said he would fire Bernanke and went further to propose a commission to examine returning the U.S. to the gold standard. And Texas Rep. Ron Paul has reveled in his unwavering stance of simply ending the Fed.

Why the Federal Reserve? Why now? According to Marketwatch:

[Mark] Calabria [director of financial regulation studies at the Cato Institute] thinks the Republicans anger might coalesce behind legislation to end the Fed’s twin goals of low inflation and low unemployment in favor of a single low-inflation mandate.

In praise of the dual mandate

Libertarians such as Ron Paul have long been advocates of abolishing the Federal Reserve in favor of the market discipline of a gold standard. Notwithstanding my opposition to the gold standard (see my previous comments here and here), consider what changing the Fed's dual mandate to a single anti-inflation mandate might mean.

First of all, you get the ECB, which until Draghi era began, stood aside while Europe burned. In addition, good quants know that optimizing a system to a single objective function without considering other factors can lead to perverse results.

For instance, investors generally construct portfolios to maximize their risk-adjusted returns (however that`s measured), which is comparable to the opposing objectives of the dual mandate of the Federal Reserve. What would happen if they were to move to a single mandate by trying to either just maximize expected return or minimize risk?

If they were to maximize expected return, their portfolio would be two holdings, one long and one short. If they were to minimize risk, then the portfolio would be all cash.

Does that kind of portfolio make sense? I have frequently disagreed with many decisions taken by the Federal Reserve, but the idea of either abolishing the Fed or to move it to a single mandate sounds ludicrous to me.