GANNETT

Fed's independence is an illusion

By: Thomas F. Cargill - Oct 31, 2012

Federal Reserve policy since 2008 has been remarkable. Massive lender of last resort loans to nontraditional borrowers such as AIG, Quantitative Easing Policy 1, QEP2, "operation twist" and now QEP3, in which the Fed recently decided to purchase $40 billion in mortgage-backed bonds each month and keep interest rates at historical lows through 2015.

The Fed's recent move has been criticized both within and outside, and there is concern that it, at least, in part, is politically motivated. Rasmussen reported 44 percent surveyed believe Chairman Ben Bernanke is being influenced by President Barack Obama. This is both remarkable and disturbing.

Many people believe because the Fed is de jure independent of the government, there is no political influence. Textbooks emphasize the Fed's independence, and students are taught the benefits of a politically independent central bank.

My research convinces me otherwise. The Fed more often than not has responded to political pressure. We must not forget central banks were originally created by governments to finance spending, and as creations of government, the concept of true independence seems almost quaint.

The evidence is too expansive to summarize here, but consider the following: The Fed under Arthur Burns (1971-1978) was directly responsible for the "Great Inflation" in the 1970s. His recently published "secret diary" shows he acted as just another member of President Richard Nixon's team. A summary of a meeting with Nixon on Feb. 14, 1972, is revealing: “I was looking after monetary policy and that he need not be concerned about the possibility that the Federal Reserve would starve the economy.”

There is no evidence of such direct exchange between Bernanke and Obama, and I doubt such a direct link; however, the Fed’s actions are troubling, to say the least. Even the perception of political influence is dangerous, and Bernanke of all people knows this. When central banks lose credibility, bad things happen.

Gerald O’Driscoll and I are presenting a paper titled “Central Bank Independence: Reality or Myth?” at the Cato Monetary Policy Conference in Washington, D.C., on Nov. 15 and at the 2013 Meetings of the American Economic Association in January.

Fed independence under its current institutional design is more myth than reality, and recent actions by the Fed suggests real “Trouble in River City.” The economy is in bad shape, more “punch bowls” of liquidity will not be effective and the fact that Fed policy appears to be politically influenced weakens confidence in the Fed to maintain the value of the nation’s money.

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