

DOES THE FEDERAL RESERVE KNOW WHAT IT'S DOING?

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The Federal Reserve is the most financially dangerous institution in the world. It represents tremendous systemic risk—more systemic financial and economic risk than anybody else. Fed actions designed to manipulate the world's dominant fiat currency, based on the debatable theories and guesses of a committee of economists, can create runaway consumer price and asset inflation, force negative real returns on people's savings, reduce real wages, stoke disastrous financial bubbles that lead to financial collapses, distort markets and resource allocation, and in general create financial instability. The Fed has done or is doing all of these things—ironically enough—in the name of pursuing stability. But whatever its intentions, does the Fed actually know what it is doing? Clearly, it hasn't in the past, and it is exceptionally dubious in principle that it ever can. Since that is true, how can anybody think the Fed should be an independent power?

Foolish Hopes

How different are the real results of discretionary central banking from the fond, indeed foolish, hopes that prevailed at the time of the

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Fed's founding. A highly competent man, the then-Secretary of the Treasury, William G. McAdoo (who was, under the original Federal Reserve Act, also the Chairman of the Federal Reserve Board) announced the establishment of the Federal Reserve Banks with remarkable rhetoric, expressing the completely unrealistic expectations of the time (U.S. Treasury 1914).

"The opening of these banks marks a new era in the history of business and finance in this country," he proclaimed. The Federal Reserve Banks "will give such stability to the banking business that the extreme fluctuations in interest rates and available credits which have characterized banking in the past will be destroyed permanently." Nice idea. "The whole country is to be congratulated," said McAdoo, "upon this final step in an achievement which promises such incalculable benefits to the American people."

It was certainly unwise to promise that the United States had taken the final step and had *permanently* destroyed financial instability. This was a prime example of the dream world that Woodrow Wilson and company imported from the theorists of the German Empire: the notion of government based on the superior knowledge of independent experts that bypasses the messy, contentious, and undisciplined world of democratic legislative politics.

It is hardly necessary to say how it turned out. First came the runaway inflation of the First World War and its aftermath, then the depression of 1921. The 1920s saw a gigantic boom, followed by a depression in the early 1930s, which was renewed in 1937. Then the Fed financed the Second World War by buying government debt, thereby setting the stage for the ensuing postwar inflation. After the boom of the 1950s, the United States returned to financial instability: two credit crunches and a decade of dollar crises in the 1960s, the collapse of the dollar in 1971, more runaway inflation in the 1970s, double-digit interest rates and a huge bust in the 1980s, a series of international financial crises in the 1990s, the boom and bust of the 2000s, and now zero nominal and negative real interest rates that pillage savers and reinflate dangerous asset price bubbles.

What a record—giving "such stability to the banking business" indeed! Yet, after 101 years of experience, unrealistic expectations of what the Fed can do are widespread, and unrealistic faith in the Fed's knowledge and competence remains common.

An Independent Price-Fixing Committee

It is easy to explain why the Fed consistently disappoints expectations and fails its believers. Put simply, the Fed is an ongoing attempt at central planning and price fixing by committee. Like all such efforts, it is doomed to recurring failure by the inescapable problem of insufficient knowledge—as has been conclusively demonstrated by F. A. Hayek (1945). The Fed, like all central planners, is faced with virtually infinite complexity and massive uncertainty. The future is inherently uncertain; what is really happening in the present is significantly uncertain. Of course, the Fed doesn't and can't know what the right price (that is, the right interest rate) is.

In fact, the Fed is just as bad at foreseeing the economic and financial future as everybody else. This includes the inability to foresee what the results of its own actions will be. Though it employs hundreds of economists and can have all the computers it wants to run complicated models, its forecasting record shares the poor performance of economic forecasts generally. As Brendan Brown (2015) writes, economists “in the 1960s thought Keynesian economics had eliminated the business cycle only to be ridiculed by the 1969–70 and 1973–75 downturns. A generation later enthusiasts of The Great Moderation believed they had all but killed the business cycle only to be dumbfounded by the 2007–09 great recession.”

Economist Paul Samuelson (U.S. House of Representatives 1964: 51) once told Congress that “the founders of the Federal Reserve really didn't know what they were doing.” It is certain that those founders could not have expected, and indeed could not have imagined in their wildest dreams, what their creation would become over the course of a century. They would have been astonished to behold a central bank that is formally committed to perpetual inflation and intent on producing it; that has no link of any kind to a gold standard; that thinks it is supposed to, and presumes it is capable of, “managing the economy”; that invests vast amounts in real estate mortgages; that has chairmen who achieve media star status; that wields authority as a unitary central bank, not a federal system of regional banks; and that has been taken over by academic economists.

Of course, institutions change over time. Since the Fed cannot operate on knowledge of the future—that being impossible—it has to rely on academic theories. Its theories and accompanying ideology

change over time. Now, for example, it is deeply committed to the “target” of inflation at 2 percent per year forever—a target it made up. At that rate, average prices will quintuple in the course of an expected lifetime. With a straight face, the Fed claims this is “price stability.” Section 2 (a) of the Federal Reserve Act of 1913 instructs the Fed to pursue “stable prices,” not a stable rate of inflation. But if the Fed wants to indulge itself in such newspeak, who is to stop it? The Fed has set out in recent years to create asset price inflation in the hopes of a “wealth effect.” Asset price inflations, as we know, have a way of ending badly. But if the Fed wants to inflate asset prices, who is to stop it? Who is the Fed’s boss?

In spite of the hopelessness of central planning and price fixing by committee, in spite of the massive risk the Fed creates for everyone else, in spite of the Fed’s ineluctable lack of the requisite knowledge, Fed officials and supporters endlessly prate that the Fed has to be “independent.” In other words, it does not have and should not have a boss.

One of the most remarkable developments in modern public opinion is the widely held faith in the Federal Reserve. This odd faith results in a great many otherwise intelligent people, including (and perhaps *especially*) professional economists, ardently maintaining that the Fed has to be an independent, virtually sovereign fiefdom, free to carry out whatever monetary experiments it wants without supervision from Congress or anybody else.

These promoters of Fed independence, including of course the Fed itself, share a common, unspoken, and mistaken central assumption: that the Fed is competent to have the unchecked power of manipulating money and credit—or, in a more grandiose version, of “managing the economy.” Although in fact neither the Fed nor anybody else has the knowledge to do this, it is assumed that the Fed knows what the results will be of, for example, monetizing over \$4 trillion in long-term bonds and mortgages. But the Fed does not know what it is really doing—rather, it is flying by the seat of its pants, a state of affairs only papered over with calculations from models, staff reports, and speeches for the Federal Open Market Committee minutes.

There is no evidence that the Fed has the superior economic knowledge it would need to be competent to exercise its enormous, unchecked power, and a lot of evidence to show that it does not. Believers in the Fed’s special competence are operating purely on a credo: “I believe in a committee of economists manipulating money

according to unreliable forecasts and debatable and changing theories.”

Accountability

The arguments for Fed independence seldom or never consider how the Fed should be *accountable*. Every part of a democratic government should be accountable. No part of a democratic government, let alone one with such immense power and riskiness as the Fed, should be free of checks and balances and free of any serious accountability. To whom should the Fed be accountable? To its creator, the legislature. This is true no matter how much the Fed longs to be free of Congress, no matter how much it thinks that the mere elected representatives of the people can never understand the mysteries of its high calling. Naturally, every bureaucrat's dream is to be free without having to bother with the legislature. But this dream should never be granted. Democratic accountability must qualify whatever “independence” the Fed might have. If accountability takes away independence, so be it.

At various times in its history, especially during major wars, the Fed has been entirely subservient to the Treasury Department—that is, to the executive branch. In these times, the Fed devoted itself to loyally financing the government's deficit as directed. But at all times, the Fed remains the creature of Congress—which may, if the political stars align, rewrite the Federal Reserve Act, and in so doing redirect, restructure, or even abolish the Fed.

Should the Fed be independent? The House Banking Committee reviewed in detail “The Federal Reserve System after Fifty Years” in 1964. This was in a Congress and committee controlled by the Democratic Party. Here is what they thought (U.S. House of Representatives 1964: 20, 31–32):

- “An independent central bank is essentially undemocratic.”
- “Americans have been against ideas and institutions which smack of government by philosopher kings.”
- “Our democratic tradition alone will be enough to make many thoughtful people demand a politically accountable central bank.”
- “To the extent that the Board operates autonomously, it would seem to run contrary to another principle of our constitutional order—that of the accountability of power.”

In my view, all these points are correct. They are consistent with how Marriner Eccles, at that point the Fed chairman, once began testimony to Congress: “I am speaking for the Board of Governors of the Federal Reserve System, an agency of Congress” (Eccles 1947: 1455).

The points above are also consistent with what Alfred Hayes, then-president of the Federal Reserve Bank of New York, told the Banking Committee during the 1964 hearings (U.S. House of Representatives 1964: 17): “Obviously, the Congress which set us up has the authority and should review our actions at any time they want to, and in any way they want to.” That’s right—“obviously.” The Fed is a creature of Congress, and accountable to it.

But exactly *how* should the Fed be reviewed and held accountable to Congress for its ongoing actions, for the theories and political preferences behind those actions, for the tradeoffs it makes (between borrowers and savers, for example), and for the results of its actions, whether intended or otherwise? At present, that is not clear. The Fed’s Humphrey–Hawkins appearances, the product of a 1978 attempt to make the central bank more accountable, certainly do not achieve accountability. They are mere media events that do not serve to hold the Fed accountable for its mistakes. “Central banks have a well-developed resistance to accepting responsibility, because much of their influence depends on the appearance of infallibility,” as Howard Davies (2015: 27) has observed.

However, Senator Richard Shelby’s proposed “Financial Regulatory Improvement Act,” which was approved by the Senate Banking Committee in 2015, is currently pending in the Senate. One of the principal objectives of this bill is “to improve accountability.” Among its most important provisions are those contained in Section 501, which deal with new approaches to the Fed’s “Reports to Congress.”¹ This section would require the Fed’s Open Market Committee to make substantive quarterly reports to the two congressional banking committees addressing its policy decisions, reasoning, monetary policy rules, strategy, economic analysis and forecasts, and, as appropriate, discussion of dissenting opinions. The serious and grown-up discussion it intends seems to me a very good idea. Could it work?

¹See Financial Regulatory Improvement Act, S. 1484, 114th Cong. § 501 (2015).

An interesting parallel from a financially astute country has recently been provided by Jean-Pierre Danthine, the vice chairman of the Governing Board of the Swiss National Bank (SNB)—Switzerland's central bank. While arguing that the SNB is and should be independent, Danthine (2015) also stressed that “the SNB's independence is far from unlimited.” He pointed out that “Independence goes hand in hand with accountability,” and added, “the SNB is accountable to the Federal Council, the Federal Assembly, and the public for the decisions it takes, the means it chooses and the results it achieves.” In this context, Danthine specified “the annual accountability report submitted to parliament,” as well as “regular meetings with the Federal Council and representatives of the relevant committees of the Federal Assembly.” According to Danthine, this increases transparency, but “transparency is not a goal in itself, but rather a means to achieve accountability.” “It is a fact,” Danthine concluded, that “Switzerland has a well-developed system of checks and balances” for the SNB.

This discussion articulates a rational and desirable goal, which is fully consistent with what is required of the Fed in Senator Shelby's bill. However, we should consider one fundamental change to that piece of proposed legislation.

A New Joint Committee of Congress

Congress as a whole is too big and, on average, too poorly informed about the relevant subjects to effectively oversee the Federal Reserve system. The House Financial Services Committee is also very large, with 60 members, and both congressional banking committees have numerous other difficult areas of jurisdiction, not least being the huge, troublesome, and crisis-prone housing finance sector.

Can the existing committees bring the critical focus, steady attention, and specialized knowledge required to oversee the single greatest source of systemic financial risk in the world? Might not the most critical and most dangerous financial institution there is anywhere deserve its own committee?

I propose that Congress should organize a new joint committee on the Federal Reserve. The Fed would be its sole and crucial jurisdiction. All the reports so reasonably required in Senator Shelby's bill should be made to this joint committee. It should have the power to audit whatever about the Fed it deems appropriate.

This committee should have a relatively small membership, made up of senators and representatives who become very knowledgeable about the Fed, central banking, the inherent risks and uncertainties involved, the international relations of central banks, and all related questions. Like the Senate Select Committee on Intelligence, it should include ex officio members from the leadership, but in this case, from both houses.

“The money question,” as fiery historical debates called it, profoundly affects everything else and can put everything else at risk. It is far too critical to be left to a governmental fiefdom of alleged philosopher-kings. Let us hope that the Congress can achieve a truly accountable Fed.

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