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ECONOMICS

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Audit the Fed?

BERKELEY – The party platform adopted at the Republican National Convention includes a number of remarkable planks. To a monetary economist, for example, the party's proposal to restore some kind of metallic monetary standard is so outlandish as to be an almost irresistible target.

More serious is the Republicans' proposal for an annual audit of the United States Federal Reserve. This, like the gold-standard plank, is partly designed to appeal to the libertarian followers of Ron Paul, the Texas congressman and perennial presidential candidate who is hugely popular with the Republicans' "Tea Party" wing. While Paul would go further, and abolish the Fed altogether, several bills in the US Congress have mandated an annual audit; earlier this year, one such bill was passed by the House of Representatives (but not the Senate).

The Republicans' embrace of the audit idea taps into libertarians' general distrust of government. But there is also distrust of the Fed on more specific grounds – distrust that extends well beyond the ranks of the Tea Party. The Fed, its critics complain, has used its expansive powers to engage in a range of unprecedented interventions that have propped up large financial institutions. So the monetary authorities, they argue, must be in the pockets of powerful bankers.

To be sure, central bankers should be democratically accountable for their actions. But accountability by audit would carry significant risks. Undertaken by politicians, an audit might be viewed as an opportunity to score political points or steer policy in self-serving directions, with delicate information leaked in order to pressure policymakers. While monetary policy conducted by independent bureaucrats is imperfect, handing over effective control to congressmen with one eye on the next election would be infinitely worse.

The Republican platform notes that the audit would have to be "carefully implemented" to ensure that the Fed remains insulated from political pressures. Indeed, it would.

An audit would also reveal more details about financial-market interventions like those in 2008, when the Fed purchased mortgage securities from Bear Stearns and AIG. The risk here is that providing too much information in real time about the securities that the Fed is buying and the institutions that it is helping could destabilize markets.

This danger is not hypothetical. We saw an example of it the last time there were massive government interventions in US financial markets – namely, during the Great Depression. In 1932, the Fed was unwilling to help stabilize a collapsing banking system. But someone had to do something. So President Herbert Hoover created the Reconstruction Finance Corporation, an independent government agency, to aid illiquid but fundamentally sound banks.

The RFC's largest loan in the summer of 1932 was to a bank run by former Vice President Charles Dawes. Not only was Dawes, like Hoover, a prominent Republican; he was also an ex-RFC official. Although Dawes refused to make use of his political connections when his bank was pushed to the brink, the RFC nonetheless faced accusations of favoritism. Populist members of Congress, predictably outraged, demanded an audit and insisted on publication of a list of all banks that the RFC had aided.

Publication of that list in January 1933 led to a crisis of confidence in banks that were revealed to have borrowed from the government. Bank runs started almost immediately and quickly engulfed the country, resulting in the Bank Holiday of 1933 – that is, in the forced closure of the entire US banking system.

So it is not just political pressure that an audit must avoid. It must also avoid destabilizing financial markets and institutions. That requires aggregating information and allowing for suitable delay before publishing it. Can we trust politicians to understand and respect this, especially in an election year? It is no coincidence that the demand by Congress for the list of RFC loans occurred in 1932, also a presidential election year.

Fed officials understand that their institution can remain independent only if it is accountable for its actions in the court of public opinion. That is why the Fed has been taking steps to become more transparent: it releases the minutes of Federal Open Market Committee meetings and publishes transcripts with appropriate delay, while FOMC members give speeches detailing their views. Moreover, in a recent innovation, the Fed now publishes the inflation and interest-rate forecasts of FOMC members and Reserve Bank presidents.

The Fed almost certainly will move even further in the direction of transparency. Other central banks are doing likewise. No less is required to reconcile independence with accountability in a democratic society. But an audit overseen by politicians is not the right way.

Read more from our "New Model Central Banking" Focal Point.

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